Hoops, LP v. Commissioner: Section 404(a)(5) and the Assumption of Deferred Compensation Liabilities in the Sale of a Business

In *Hoops, LP v. Commissioner*,[1] the Seventh Circuit was asked to decide what is the proper treatment to the seller of a business where nonqualified deferred compensation liabilities are assumed by the purchaser. Section 404(a)(5) states that an employer must defer its deduction for compensation paid until that amount is included in the employee's gross income. While this rule is straightforward in its application where the seller retains the liability, the situation is complicated where the liability is transferred by the employer on the sale of its business. At the Tax Court and on appeal, the Commissioner argued that the deferred compensation liability assumption must be included in amount realized with the related deduction lying in wait until the purchaser satisfies the obligation. The taxpayer countered that it should be allowed a present deduction under the deemed payment theory—that it had effectively paid the liability through its acceptance of a lower purchase price in exchange for the buyer's assumption of the liability. After hearing oral argument, the Seventh Circuit held for the Commissioner, affirming the Tax Court's decision that Section 404(a)(5) controlled the outcome.

Though the Seventh Circuit correctly found that Section 404(a)(5) generally requires that the employer's deduction be deferred, neither the statute nor the regulations contemplate the present scenario. A mechanical application of Section 404(a)(5) in this context results in harsh tax consequences, namely the mismatching of income and expense and the potential loss of any deduction due to the application of Sections 461(l) and 172. In light of the economics of the transaction, a more sensible approach is necessary. Hoops should have been allowed a present deduction under the deemed payment theory applied by the Tax Court in *Commercial Security*

[1] Hoops, LP v. Commissioner, 77 F.4th 557 (7th Cir. 2023).

Bank[2] in recognition of the fact that it bore the liability through its acceptance of a lower purchase price on the sale of its business. This approach has the added benefit of administrative feasibility in that it closes the loop on the seller's side of the transaction, rather than impose on the seller a continuing obligation of ascertaining when the purchaser satisfies the obligation.

I. Summary of Case

The case involved the sale of the Memphis Grizzlies NBA Basketball Team by Hoops LP (Hoops) to Memphis Basketball, LLC (Memphis Basketball) in 2012.[3] As part of the purchase agreement, Memphis Basketball agreed to pay Hoops $201 million of cash and to assume $219 million of liabilities. Included in the liabilities assumed were $12.6 million of deferred compensation contracts to two former Grizzlies franchise players. The present value of this obligation was $10.7 million. These contracts represented future payments from Hoops to the players in remuneration for past services and basketball jersey sales.

In its 2012 tax return, Hoops included in its amount realized the liabilities assumed by Memphis Basketball, including the $10.7 million present value of the deferred compensation contracts. Hoops later filed an amended return, claiming a deduction for a "deemed payment" of $10.7 million from Hoops to Memphis Basketball in exchange for its assumption of the deferred compensation contracts. The Commissioner disallowed this deduction, which Hoops challenged in the Tax Court.

At the center of this case lie two Code sections and one Treasury Regulation. Section 461(h) states that expenses are generally deductible when the all events test is met and economic

[2] Commercial Security Bank v. Comm'r of Internal Revenue, 77 T.C. 145 (1981).
[3] *Hoops*, 77 F.4th at 559.

performance has occurred.[4] Section 404(a)(5) suspends the deduction for deferred compensation payments under a nonqualified plan (as in this case) until the compensation is actually paid and the employees are required to include the compensation in income. Finally, Treas. Reg. § 1.461-4(d)(5)(i) accelerates the deduction for liabilities for which economic performance has not occurred when such liabilities are included in amount realized in the sale of a business.

At the Tax Court, Hoops argued that though Section 404(a)(5) generally requires deferral of the employer's deduction, the deemed payment doctrine embodied in Treas. Reg. § 1.461-4(d)(5)(i) operated to provide it with a current deduction. Alternatively, Hoops argued that it need not include the liability assumption in amount realized if no current deduction is allowed.[5] The Tax Court ruled for the Commissioner, dismissing as meritless both of Hoops's arguments. As to Treas. Reg. § 1.461-4(d)(5)(i), the court held that these general deduction rules were inapposite where Section 404(a)(5)'s more specific timing requirement applied. Regarding the inclusion in amount realized, the court stated that Section 1001 required inclusion because Hoops was discharged of its obligation to pay deferred compensation as a result of the sale. Hoops appealed to the Seventh Circuit.

On appeal, Hoops echoed its argument at the Tax Court that Treas. Reg. § 1.461-4(d)(5)(i) allows it to accelerate its deduction because Section 404(a)(5)'s economic performance requirement was satisfied when Memphis Basketball assumed the obligation to pay the compensation. In the alternative, Hoops argued that Section 404(a)(5) is inapplicable to this case since its constructive payment for Memphis Basketball's assumption of the liability is not a payment of deferred compensation subject to Section 404(a)(5); instead, the constructive payment is currently deductible under general principles of business expenditures.

[4] Treas. Reg. § 1.461-1(a)(2).
[5] Hoops abandoned this argument on appeal.

As to Hoops's reliance on Treas. Reg. § 1.461-4(d)(5)(i), the Commissioner maintained that this general provision does not apply because Section 404(a)(5) is not an economic performance requirement and because Section 404(a)(5) provides a more specific rule. Regarding the Seller's more general deemed payment theory, the Commissioner responded that the Seller cannot so easily dodge deduction-limiting provisions by characterizing expenditures as something other than what they are–deferred compensation payments subject to Section 404(a)(5).

II. Section 404(a)(5)

A closer inspection of how Hoops's deduction for the deferred compensation liabilities operates without the sale is helpful in understanding the controversy. As aforementioned, Section 461 states that an accrual-method taxpayer is generally entitled to a deduction in the year in which the all events test is met. That test requires that deductions be suspended until all events have occurred that establish the fact of the liability and that the amount of the liability can be determined with reasonable accuracy.[6] In 1984, Congress enacted Section 461(h), which added an additional requirement–economic performance. Specifically, 461(h) provides that "the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs." For liabilities that arise from a taxpayer's receipt of services or property, economic performance occurs when such property or services are provided to the taxpayer.[7] Based solely on these requirements, Hoops was entitled to a deduction when the players played in basketball games for the Grizzlies, as Hoops was then indebted to pay compensation for the services rendered by the players.

[6] Section 461; Treas. Reg. § 1.461-1(a)(2)(i); United States v. Gen. Dynamics Corp., 481 U.S. 239, 242 (1987).
[7] Section 461(h)(2)(A).

Had Hoops retained the deferred compensation obligation, its deduction would lay in wait because of Section 404(a)(5)'s alternative timing rule for deferred compensation deductions. Section 404(a)(5) prohibits an employer from taking a deduction until the compensation is paid and included in the taxpayer's income. This requirement effectively shifts Hoops from accrual basis accounting to the cash basis method. Put differently, Hoops is over-taxed to compensate for the employee's deferral. In effect, the deferral of the deduction to Hoops operates to subject Hoops to taxation on the investment yield inherent in the deferred compensation arrangement.

III. Liability Assumption in the Sale of a Business

Section 404(a)(5)'s deduction deferral works as expected where the employer is present from the accrual of the deferred compensation liability to its subsequent payment. However, this timing rule presents complications when the employer transfers the deferred compensation liability on the sale of its business. In this scenario, the employer-seller has to include the liability assumption in its amount realized on the sale of its business, but apparently has to wait for a deduction until the compensation is paid to the employees under Section 404(a)(5) and Treas. Reg. § 1.404(a)-12(b)(1). However, this result is contrary to the general treatment of liabilities assumed in the sale of a business.

Upon a purchaser's assumption of a seller's liability, the seller must include the liability assumption in its amount realized under Treas. Reg. § 1.1001-2(a)(1).[8] That provision states that "the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition." Where the liability assumed is a liability for tax purposes[9]–meaning that it has accrued economically

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[8] *See also* IRC 752(d).
[9] Focht v. Comm'r of Internal Revenue, 68 T.C. 223, 228 (1977).

and the seller has recognized an associated tax benefit–the inclusion yields anticipated results. Indeed, proper tax timing requires that where Target received a prior tax benefit from the liability, additional amount realized is required to zero out that benefit.[10] The purchaser is then allowed an increase in its basis equal to the amount of the liability assumed under Section 1012.

Where the purchaser assumes a liability of the seller that is not a liability for tax purposes–one that has accrued economically but not resulted in a deduction or an addition to basis–inclusion in amount realized results in unsatisfying consequences. Rather than zeroing out a tax benefit, the inclusion in this context punishes the taxpayer by increasing recognized gain without a corresponding deduction. This situation arises where the liability assumed relates to an obligation with a special timing rule, such as Section 461(h)'s economic performance requirement or, as here, Section 404(a)(5)'s timing requirement.

To cope with this harsh consequence, the courts and the Treasury Department have developed the deemed payment rule. This rule recognizes that by accepting a reduced price in the sale of its business, the seller has borne the non-tax liabilities as an economic matter and should be allowed a deduction. Whether the seller accepts less cash on the sale or chooses to retain the liabilities and pay them off as they come due, the net effect is the same.[11] For example, where a buyer assumes the seller's liabilities in an asset acquisition, the buyer reduces the amount of cash paid. Instead of assuming the liabilities, the buyer could simply purchase only assets and pay more cash, which the seller would in turn use to pay off the liabilities.[12] If so desired, the buyer could then raise the extra cash by borrowing to replace the liabilities paid by the seller.[13] The

[10] Ethan Yale, *Anti-Basis*, 94 N.C. L. REV. 485 (2016); Richard W. Harris & Brian J. Verhoeven, *Vacation Pay In Asset And Deemed Asset Sales: A Half-Baked Trap For The Unwary*, 2001 WL 1650941, 10.
[11] C. Ellen Macneil et al., *Dealing With Contingent Liabilities In Taxable Asset Acquisitions*, 83 J. TAX'N 208, 210 (1995).
[12] Daniel Halperin, *Assumption of Contingent Liabilities on Sale of A Business*, 2 FLA. TAX REV. 673, 676 (1996).
[13] *Id*.

deemed payment rule also recognizes that it would be unfair to require a taxpayer to recognize income from certain aspects of a transaction while requiring that the taxpayer suspend its deduction for a directly related part of the same transaction.[14] The Treasury Department has codified the deemed payment rule in its promulgation of various regulations, including Treas. Reg. § 1.461-4(d)(5)(i),[15] which states that:

> If, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a liability arising out of the trade or business that the taxpayer but for the economic performance requirement would have been entitled to incur as of the date of the sale, economic performance with respect to that liability occurs as the amount of the liability is properly included in the amount realized on the transaction by the taxpayer.

In operation, this provision accelerates the deduction of a non-tax liability suspended by Section 461(h).

Regarding the timing of the deduction, that the seller takes a deduction for the present value of the obligation now rather than the full amount in the future should not change the outcome.[16] So long as the purchaser does not claim a deduction when it satisfies the liability, the special timing rule is not impugned.[17]

Applying the foregoing to the present case, it is clear that sound tax policy requires that where Hoops includes the liability assumption in amount realized, it must be allowed a deduction

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[14] MARTIN D. GINSBURG, JACK S. LEVIN & DONALD E. ROCAP, MERGERS, ACQUISITIONS, AND BUYOUTS ¶ 304.3 (Apr. 2018 ed.); *see also* Johnson v. Commissioner, 184 F.3d 786, 790 (8th Cir. 1999).

[15] IRS TAM 8741001 (June 16, 1987) (stating that the assumption of a deductible fixed liability in a section 338(h)(10) transaction triggers income and an offsetting deduction to the seller).

[16] Brant J. Hellwig, *Exploring Hoops*, 181 Tax Notes Federal 89, 91, 97-100 (October 2, 2023); Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N. C. L. REV. 571, 598 (2007); *see also* Halperin, *supra* note 12 at 684 ("While [the present deduction treatment] accelerates the deduction as compared to the situation where the business is not transferred or [the seller] retains the obligation, the present value of the deduction is unchanged.").

[17] The purchaser should be prohibited from deducting the implicit interest in the deferred payment obligation to preclude this arrangement from generating a better result than if the seller had simply retained the liabilities. *See* Albertson's Inc. v. Commissioner, 42 F.3d 537, 537 (9th Cir. 1994).

at that point for the present value of the assumed payment obligation. Through its acceptance of a lower purchase price in consideration for Memphis Basketball's assumption of the deferred compensation liability, Hoops bore the liability to the extent of $10.7 million. Hoops's immediate deduction for the $10.7 million present value does not provide a workaround for Section 404(a)(5) because it is economically equivalent to taking a $12.9 million future deduction.

IV. The Seventh Circuit's Decision

Though tax and economic theory were certainly in Hoops's corner, the Seventh Circuit held that the law was not. The Court ruled that despite having to include the liability assumption in its amount realized on the sale, Hoops's deduction must nevertheless lie in wait until the players recognize income upon satisfaction of the deferred compensation obligation by Memphis Basketball.[18] The Court's conclusion was centered on its findings that Section 404(a)(5) was a more specific rule that took precedence over the more general deduction theories on which Hoops relied and that Treas. Reg. § 1.461-4(d)(5)(i) was inapplicable because Section 404(a)(5) was not an economic performance requirement.[19] Though not explicitly considered in the Seventh Circuit's opinion, the history surrounding the promulgation of the Section 461(h) regulations supports its conclusion.

A. Section 404(a)(5)'s Takes Priority as a Specific Rule

Beginning with the priority of specific versus general provisions, the Seventh Circuit highlighted that Section 404(a)(5) uses mandatory language and itself provides a controlling rule.[20] Section 404(a) states that "if compensation is paid or accrued on account of any employee

[18] *Hoops*, 77 F.4th at 563-64.
[19] *Id.*
[20] *Id.*

under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under this chapter." The statute goes on to list the exceptions and limitations to this directive, including for employees compensated through a nonqualified plan. Section 404(a)(5) instructs that for those employees, the employer's deduction is suspended until the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan.

The Seventh Circuit also noted that the Section 461 regulations themselves recognize their subservience to Section 404(a)(5)'s directive.[21] Indeed, Treas. Reg. § 1.461-4(d)(2)(iii) instructs that "the economic performance requirement is satisfied to the extent that any amount is otherwise deductible under Section 404 (employer contributions to a plan of deferred compensation)." In this way, the Seventh Circuit explained, the regulation directs taxpayers to Section 404 to confirm their entitlement to a deduction, showing the emphasis placed on taxpayer's meeting Section 404(a)(5)'s specific requirements for amounts owed under deferred compensation plans.[22]

B. Section 404(a)(5) is not an Economic Performance Requirement

As to the applicability of Treas. Reg. § 1.461-4(d)(5)(i), the Seventh Circuit stated that the regulation is inapposite because Section 404(a)(5) is not an economic performance requirement. The Court highlighted that economic performance had already occurred when the players played in past seasons and earned their deferred compensation; what disallowed the deduction was the limitation Congress imposed in Section 404(a)(5) on Hoops's decision to adopt a nonqualified plan and not pay the players before the sale of its business.[23]

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[21] *Id.*
[22] *Id.*
[23] *Id.*

It is worth spending time to consider and address Hoops's argument closely. Remember, Treas. Reg. § 1.461-4(d)(5)(i) accelerates the deduction of assumed liabilities when *economic performance* is the only thing standing in the way of realizing a tax benefit. In relying on this provision, Hoops asserted that Section 404(a)(5) itself is an economic performance requirement. Hoops cited Treas. Reg. § 1.461-1(a)(2)(iii)(A) in favor of its proposition, providing, in relevant part, that "the economic performance requirement of section 461(h) and the regulations thereunder is satisfied to the extent that any amount is otherwise deductible under section 404." Hoops also highlighted the Tax Court's decision in *Weaver v. Commissioner*, holding that "[Treas. Reg.] § 1.461–1(a)(2)(iii)(D) . . . mandates that [the taxpayer] also meet the timing rule of section 404(d) in order to satisfy the requirement of economic performance."[24] Based on these authorities, Hoops concluded that it was entitled to a deduction under Treas. Reg. § 1.461-4(d)(5)(i) because Section 404(a)(5)'s economic performance requirement was met when Memphis Basketball assumed the deferred compensation liabilities. However, Hoops is mistaken in its assertion.

For starters, the timing of when these provisions were codified counsels toward treating them as part of separate regimes. It would be strange to say that Section 404(a)(5) is an economic performance requirement when that provision was enacted well before Section 461(h)'s addition to the Code in 1984. Moreover, the preamble to the 461(h) regulations indicates that the Treasury Department viewed the "specific timing rules contained in Section 404" as separate from the "general economic performance rules."[25]

Furthermore, Treas. Reg. § 1.461-1(a)(2)(iii)(A)'s statement that economic performance is satisfied *to the extent that* the amount is deductible under Section 404 does not go as far as to

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[24] 121 T.C. 273, 276 (2003).
[25] *Economic Performance Requirement*, 57 Fed. Reg. 12,414 (Apr. 10, 1982).

convert Section 404 into an economic performance rule. Instead, this language simply indicates that economic performance generally will be met by the time Section 404(a)(5) is satisfied. This proposition is best explained through an example of how Sections 461(h) and 404(a)(5) apply outside the sale of a business. When an employee renders services to an employer, economic performance has been satisfied under Section 461(h)(2)(A) because the employer has received the services on which the liability is based. At this point, the employer is entitled to a deduction under Section 461. That deduction, however, is suspended by Section 404(a)(5)'s inclusion in income requirement. When the amount is paid to the employee, then Section 404(a)(5) allows the deduction. By the time that payment is rendered, economic performance has long since occurred, given that the payment is in recognition of services that previously satisfied Section 461(h). Thus, it is appropriate to say that economic performance is met to the extent Section 404(a)(5) allows a deduction, even though the payment itself is not economic performance.

Hoops continued in its argument that it makes sense that Congress intended for Section 404(a)(5) to function as a rule of economic performance given that the deductibility of deferred compensation under the provision works the same way as the deductibility of all other liabilities for which payment is economic performance under Section 461(h).[26] However, Hoops made a faulty comparison by looking to the wrong portion of Section 461(h). Section 461(h) provides two different treatments for various kinds of liabilities. The first treatment is in Section 461(h)(2)(A), referring to services and property provided *to* the taxpayer. That provision states that "[i]f the liability of the taxpayer arises out of . . . the providing of services to the taxpayer by another person, economic performance occurs as such person provides such services." The second is apparent in Section 461(h)(2)(B) and (C), referring to services and property provided

[26] Hoops, LP, v. Commissioner, Respondent-Appellee, 2023 WL 158282 (C.A.7), 9.

by the taxpayer. Under these provisions, economic performance occurs as the taxpayer provides such property or services or makes a payment to the person to whom the obligation is owed. The major distinction between these two treatments is how the liability arises. For (h)(2)(A), liability arises due to the taxpayer's receipt of services or property. For (h)(2)(B) and (C), however, liability arises irrespective of the taxpayer's receipt. In its comparison, Hoops refers to this latter category of the economic performance provisions. Hoops is right to note that economic performance (and usually a related deduction) occurs for these at the time of payment, just as it does under Section 404(a)(5). But this case presents a Section 461(h)(2)(A) liability governed by a different rule.

C. The History of the Section 461(h) Regulations Counsel's Against a Deduction

Though not explored in the Seventh Circuit's decision,[27] the regulatory history surrounding the passage of the Section 461(h) regulations indicates that the Treasury Department likely did not intend for Treas. Reg. § 1.461-4(d)(5)(i) to apply to deferred compensation liabilities. The parties' disagreement on this point centered on their differing interpretations of a New York State Bar Association (NYSBA) Report's commentary addressing how the economic performance requirement of Section 461(h) interacts with Section 404.[28] This report was submitted to the Treasury Department in response to its notice of proposed rulemaking seeking commentary on this exact question, along with more general inquiries of how the economic performance requirement operates in the sale of a business.[29] The NYSBA recommended that because the assumption of the liability results in amount realized, the seller should be allowed to

[27] The parties discussed this issue extensively in their briefings.
[28] New York State Bar Association, *Report on Proposed Regulations Relating to Economic Performance Requirement* (Nov. 7, 1990), https://perma.cc/M8B7-V7E5.
[29] *Economic Performance Requirement*, 55 Fed. Reg. 23,235 (June 7, 1990).

deduct the "assumed compensation liabilities" even where the service provider has not yet recognized income.[30]

Separately from that suggestion, the NYSBA Report next addressed Prop. Reg. § 1.461-4(g)(1)(ii)(C), which applied the deemed payment rule to liabilities where economic performance occurs only upon payment to the person to whom the liability is owed.[31] This Proposed Regulation likely refers to Section 461(h)(2)(C), which states that for certain liabilities arising out of workers compensation and tort claims, "economic performance occurs as the payments to such persons are made." The NYSBA recommended that taxpayer sellers be allowed to accelerate the deduction of liabilities not only for these liabilities, but also for those liabilities arising out of an obligation to *provide* property or services, referred to as "provider liabilities."[32] This recommendation coincides with Section 461(h)(2)(B), stating that "[i]f the liability of the taxpayer requires the taxpayer to provide property or services, economic performance occurs as the taxpayer provides such property or services."

In the preamble to the final regulations, the Treasury Department appears to have adopted the NYSBA's suggestion as to "provider liabilities" under Section 461(h)(2)(B), but not for assumed compensation liabilities. As to the latter, the Treasury Department stated that it "believes that the specific timing rules contained in Section 404 . . . generally should take precedence over the more general economic performance rules.[33]" Later, the preamble cited an unnamed commentator's recommendation that the deemed payment rule of Prop. Reg. § 1.461-4(g)(1)(ii)(C) be extended to "service and property liabilities.[34]" The preamble states that "the

[30] NYSBA Report at 12.
[31] *Id.* at 15-16.
[32] *Id*.
[33] *Economic Performance Requirement*, 57 Fed. Reg. at 12,411, 12,413-14 (Apr. 10, 1992).
[34] *Id.* at 12,415.

regulations adopt this suggestion.[35]" Hoops insists that this language was referring to the NYSBA's recommendation for assumed compensation liabilities, since these could be viewed as a type of service liability. However, this is unlikely to be the case, as the structure of the language in the preamble exactly mirrors that in the NSYBA Report, beginning with Prop. Reg. § 1.461-4(g)(1)(ii)(C) treatment of payment liabilities and arguing for this approach to be extended to service and property liabilities.[36] Thus, it seems more likely that the preamble was referring only to provider liabilities under Section 461(h)(2)(B) and not to assumed compensation liabilities.

V. Consequences of Seventh Circuit's Decision

In light of the above discussion of Sections 404(a)(5) and 461 and the regulations thereunder, the Seventh Circuit properly concluded that neither Section 404(a)(5) nor Treas. Reg. § 1.461-4(d)(5)(i) provides a deduction. Still, this result remains unsettling from the standpoint of general tax principles. As discussed earlier, this outcome is at odds with the fundamental tax and economic theories undergirding M&A transactions, such as the matching of income and expenses and parity between all-cash transactions and transactions where liabilities are assumed. Moreover, as Hoops argued, this ruling puts Hoops (and other sellers) in an impractical situation where it must keep track of the buyer's activities surrounding the deferred compensation liabilities in order to confirm the seller's entitlement to a deduction for potentially years down the line. The Seventh Circuit was dismissive of these unattractive consequences, stating only that Hoops should have been aware of Section 404(a)(5)'s "clear" mandate and protected itself

[35] *Id.* at 12,413-14.
[36] *Id.* at 12,415; NYSBA Report at 15.

contractually from the tax risks.[37] However, these consequences were not fully developed before the Court and merit closer attention here.

Beginning with the practical consequences flowing from the Seventh Circuit's decision, it would be difficult for Hoops to ascertain when it is entitled to the deduction. Indeed, it makes no sense to keep the seller in the picture after the sale and have its deductible expenses be determined by future events over which it has no information.[38] The Seventh Circuit is right to suggest that sellers can contract for buyers to notify sellers of when the obligations are satisfied, but this would not be a viable solution because of the many complications that could arise down the line. For example, were the buyer to ignore its obligation to notify the seller of payment on the deferred compensation liabilities, the seller would either not get its deduction at all or would not find out about its entitlement for years down the line. The same would occur if the buyer and the players agreed to cancel the players' rights under the deferred compensation agreement in exchange for a different payment.[39] But this only reflects where the seller communicates with a single buyer in tracking its deduction; dealing with future deductions would become even more complex for all parties if the buyer subsequently sells the basketball franchise to another buyer, adding an additional level of separation between the seller and the deductions to which it is entitled. These situations would also pose difficulties for the seller and the Commissioner in litigating refund claims and dealing with statutes of limitations.

Stepping to the tax side of the equation, further complications arise for Hoops and other sellers, depending on whether the entity dissolves before or after the buyer's payment of the liabilities. Regarding the consequences of the sale to pass-through sellers like Hoops, where the

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[37] *Hoops*, 77 F.4th at 565.

[38] Halperin, *supra* note 12 at 710.

[39] The payment of an amount as a substitute for a payment of deferred compensation will generally be treated as a payment of the deferred compensation itself. Treas. Reg. § 1.409A-3(f).

deferred compensation liabilities are paid before Hoops dissolves, the partners would historically be allowed to use those deductions against ordinary income without limitation. Under current law, however, these flow-through deductions would be subject to Section 461(l)'s disallowance of excess business losses.[40] Added by the Tax Cuts and Jobs Act of 2017, that provision disallows a taxpayer's aggregate deductions attributable to trades or business to the extent they exceed the sum of income attributable to such trades or business plus $250,000.[41] That Hoops may no longer be actively engaged in its NBA Franchise business would not bar the application of this limitation, since the deduction was nonetheless incurred in an active trade or business.[42] A taxpayer's excess business losses are then rolled over to future years as net operating losses (NOLs) subject to Section 172.[43] Interestingly, Section 461(l) functions as a "one and done" rule, meaning that it applies to a deduction only in the year in which it is incurred, after which it is only subject to the Section 172 limitations. This functionality is helpful for Hoops's individual partners in that once the flow-through deduction has made it through Section 461(l) and into Section 172, the deduction can now be taken against both active and passive income.[44] Nevertheless, Hoops's partners' ability to utilize these NOLs is predicated on having sufficient taxable income in future years. If these partners had since retired or were no longer in business, the NOLs would be worthless. Moreover, even if they had taxable income to offset, the NOLs could only be used to the extent of 80 percent of such taxable income, the rest rolling over to

[40] Section 461(l)'s limitation is set to phase out on January 1, 2026.
[41] This amount is doubled to $500,000 for joint returns and is adjusted for inflation. Section 461(l)(3).
[42] Flood v. United States, 133 F.2d 173, 178 (1st Cir. 1943) (stating that business expenses need not be paid while the business is being carried on so long as the expense was in fact incurred in connection with the operation of a trade or business).
[43] Section 461(l)(2).
[44] See generally Section 172.

future years.[45] As these NOLs are carried forward, their value would quickly plummet, since the amount carried forward is not adjusted for time value purposes.

If Hoops is dissolved before the buyer pays the deferred compensation liabilities, Hoops's partners would no longer be able to offset the payment against ordinary income. Instead, they would have to settle for a capital loss on the dissolution of the partnership.[46] This capital loss would occur because of the increase in their outside partnership basis from their allocable gain on the sale of the business without a corresponding deduction.[47]

Shifting to the effect on corporate sellers, when the buyer pays the liability before the seller dissolves, the seller's deduction is simple.[48] However, the buyer's post-liquidation payment yields much harsher results than for pass-through entities. If the purchaser does not pay the deferred compensation liabilities in time for the corporate seller to deduct the payments on its final return, the deduction may be lost entirely.[49] The same result occurs in deemed asset sales under Section 338 since the asset sale and liquidation occur simultaneously with the election– certainly before the compensation has been paid. Unlike for a liquidating pass-through, the corporate seller's consequences would not be tempered by an indirect deduction through additional basis.

VI. Extension of the Deemed Payment Rule

In light of the questionable consequences that will follow the Seventh Circuit's decision, that neither Section 404(a)(5) nor Treas. Reg. § 1.461-4(d)(5)(i) provide Hoops a deduction

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[45] Section 172(a)(2)(B)(ii), (b)(1)(A)(ii)(II).
[46] Section 741.
[47] Section 705(a); *see also* Harris & Verhoeven, *supra* note 10 at 13.
[48] Unlike for pass-throughs, there is no corollary excess business limitation for corporate entities.
[49] It is unclear whether the liquidated corporation's shareholders could take a deduction when the liability is actually paid. *See* Jacobs v. Commissioner, 45 T.C. 133 (1965). The shareholders might be able to argue for an offsetting capital loss in the future based on the reasoning in *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

should not end the discussion. As noted above, Section 404(a)(5) and the surrounding regulations contemplate the typical situation where the employer is present from the accrual of the deferred compensation obligation to its future payment. But the statute and the regulations simply did not contemplate the present circumstance where the liability is assumed in connection with the sale of a business. Because of this, it is appropriate for courts to step in and reach a result that is sensible from a tax perspective even if contrary to a literal application of the statute.

Courts can achieve this sensible result by applying the deemed payment reasoning adopted in *Commercial Security Bank*,[50] where the Tax Court allowed a present deduction to the seller of a business on the assumption of cash-basis liabilities that had not yet ripened into a deduction. As Hoops did here, the seller included its liability relief in its amount realized and deducted the same amount on the net economic effect theory previously discussed.[51] The Tax Court agreed that a deduction was in order, holding that "by accepting less cash than it otherwise would have received, it made *an actual payment to [acquiror]* which was sufficient to justify the deductions."[52] The Tax Court was careful to clarify that "[it was] not holding that [the seller] was making a constructive payment of the liabilities in question.[53]" Applying the *Commercial Security Bank* holding, Hoops's payment to Memphis Basketball is not a payment of the underlying deferred compensation liabilities, but is instead a general payment to Memphis Basketball in exchange for its assumption of the liability.[54] Under this reasoning, Section

[50] *Commercial Security Bank*, 77 T.C. at 145.
[51] *Id*.
[52] *Id*. at 149 (emphasis added).
[53] *Id*.
[54] This deemed payment analysis raises questions as to the buyer's treatment. For instance, should the purchaser have to treat the deemed payment as an actual receipt and include it in income? Relatedly, how should that deemed payment "asset" then be classified under the Section 1060 regulations? Recognizing these concerns, one commenter has suggested that the deemed payment analysis be utilized only for the seller and have the purchaser treated as usual. *See* Robert H. Wellen, *Contingent Consideration and Contingent Liabilities in Acquisitions*, SS034 ALI-ABA 113, 178 (2011).

404(a)(5)'s timing rule is inapplicable, as that rule only applies to the payment of deferred compensation.

During oral argument,[55] the Seventh Circuit expressed concern that allowing a general business deduction without regard to the nature of the underlying liability would be imprudent because it would allow a deduction for otherwise nondeductible amounts.[56] To prevent such abuses, the deemed payment analysis could be limited to liabilities that would be deductible in ordinary course.

VII. Exclusion of the Liability Assumption From Amount Realized

As a final point, I address Hoops's argument at the Tax Court that relief could be afforded by allowing it to exclude the liability assumption from amount realized instead of allowing a deduction. Other commenters have suggested this treatment, questioning the appropriateness of having amount realized from a liability that has produced no tax benefit. However, this is an imperfect solution because of the character mismatch of the gain and deduction in question. Hoops's inclusion of the $10.7 million in its amount realized would likely result in at least a portion of that purchase price being allocated to capital assets, the gain on which is taxed at lower rates. The related $10.7 million deduction, on the other hand, would be ordinary in nature because it pertains to compensation payments to employees. So, Hoops would be worse off because it would be missing out on more valuable ordinary deductions in exchange for the avoidance of tax at the lower capital gains rates.

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55 Oral Argument at https://media.ca7.uscourts.gov/sound/2023/lp.22-2012.22-2012_01_19_2023.mp3.
56 Such as penalties under Section 162(f).

Conclusion

Though the Seventh Circuit is correct that neither Section 404(a)(5) nor Treas. Reg. § 1.461-4(d)(5)(i) provides a deduction for Hoops's assumed deferred compensation liabilities, the deemed payment principle indicates that this is the wrong economic result. Given the equivalent net effect of Hoops accepting less cash on the sale of its business versus paying off the liability itself, it makes sense to provide Hoops with a current deduction for the present value of the liability. This approach is also advantageous in that it mitigates the tax and administrative complications that may arise depending on whether the seller's business dissolves before or after the buyer's payment of the deferred compensation. In recognition of the fact that neither Section 404(a)(5) nor the regulations thereunder contemplate the present scenario, courts could provide Hoops with a present deduction by treating it and similar sellers as having made a deductible deemed payment to the buyer for its assumption of the liabilities.