INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

FROM: Deborah A. Butler
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SUBJECT:

This Field Service Advice is in response to your memorandum dated August 6, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be relied upon or otherwise cited as precedent.

LEGEND:

A =
B =
C =

D =

E =

$F =
$G =
$H =

$I =
$J =
$K =
$L =
$M =
$N =

O% =
P =
Q =
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PREAMBLE:

A, the taxpayer, has argued that I.R.C. § 1274, but not section 1235, applies to this transaction. We are not opining on section 1235, but rather on whether the transaction falls under section 1274.

ISSUES:

1. Assuming that the original issue discount ("OID") rules apply, was A's interpretation of section 1274 reasonable?

2. Whether A may rely on Prop. Treas. Reg. §§ 1.1012-1(g) and 1.1274-2 in determining its basis in the debt instruments issued for the patent or patent rights that it purchased from the partners of B, in DATE 3?

3. If A could have relied on the Prop. Treas. Reg. §§ 1.1012-1(g) or 1.1274-2,

which statute would control in order to determine the basis of the instruments?

CONCLUSIONS:

1. A's deductions are not allowable under section 1274 in DATE 9 when the debt instruments were issued.

2. The taxpayer may rely on Prop. Treas. Reg. §§ 1.1012-1(g) and 1.1274-2 as substantial authority under section 6662. The proposed regulations, however, have no more legal authority than a litigating position and do not preclude the Service from contending that the transaction was not in harmony with the statutes to which the proposed regulations relate.

3. If A's determination of basis was reasonable, or if A could have relied on the regulations, then A would possibly have been able to determine its basis under Prop. Treas. Reg. §§ 1.1012-1(g) and 1.1274-2. A could not rely on the proposed regulations, and, therefore, existing statutory authority, legislative history, regulations and case law are controlling to determine basis.

FACTS:

A, the taxpayer, is a large company that organized and formed B on DATE 1. B consisted of Q limited partners owning R partnership units, divided into Class A limited partners and Class B limited partners. Each full partnership unit represented an investment of $H. C, a subsidiary of A, was the general partner of B and owned O% of B. The purpose of the B partnership was to develop, produce and derive income from the sale of certain products for human pharmaceutical use.

On DATE 2, A and B entered into several agreements. Under one of these agreements, the Cross License Agreement, A granted to B an exclusive license to use "Background Technology," defined as all patent rights, technical information and biological materials owned or controlled by A. B funded the research on the products, but A actually conducted the research. A product known as D was eventually developed, and which has been financially successful.

In DATE 8, A had an option to purchase all of the R Class A and Class B limited partnership interests in B under the Partnership Purchase Option Agreement. A had the choice of paying for the partnership interests in either A stock or in cash. The purchase price would be contingent upon the success and sales of D. A exercised its Class A options on DATE 4. A notified the Class B limited partners of its intent to exercise its option to purchase the Class B partnership interests in DATE 5.

A paid the Class A limited partners an initial payment of $F cash per full partnership unit, and paid the Class B limited partners $G cash per full partnership unit. A issued debt instruments to both classes of limited partners, pursuant to which A was obligated to make future payments to be paid quarterly beginning with the quarter ending DATE 6, and continuing through the fourth quarter of DATE 12. These instruments, the payments to the B partners, are the instruments at issue. All of the payments have been without stated interest. None of the debt instruments issued to B, the patents themselves or the partnership interests are publicly traded.

In DATE 9, A deducted $J and deducted $ I interest for a total amount deducted of $M. In DATE 10, A deducted $L, and deducted $K in interest, for a total amount deducted of $N.

A calculated these amounts that it amortized and deducted by determining the fair market value of the annual contingent payments to the partners by projecting a P% growth in the sales of the underlying product, the D. The B partners were to receive contingent payments based on the success of the D. After calculating the payments over the E year period, from DATE 9 to DATE 12, A discounted the amount by the applicable Federal rate to determine the issue price of the contingent liability under section 1274. A then amortized the issue price over E years. A has stated that the basis for the instruments is determined under Treas. Reg. § 1.1012-1(g) and Prop. Treas. Reg. § 1.1274-2.

It is District Counsel's position that A should not have included the fair market value of these instruments in basis. It is District Counsel's position that Associated Patentees v. Commissioner, 4 T.C. 979 (1945), acq. 1946-1 C.B. 1, and acq. 1959-2 C.B. 3, is controlling for the determination of the amortization deduction of contingent payments, and consequently A is limited to deducting the amounts that it had paid out in each year as the amount becomes fixed.

A has stated that these instruments are OID instruments, and that section 1235 does not apply to this transaction. This analysis assumes that the instruments are debt instruments, issued in exchange for property. This analysis also assumes that section 1235 does not apply to this transaction.

LAW AND ANALYSIS:

Section 1274

Sections 1271 through 1275 provide the rules for the inclusion of OID in income. The income from the OID to the holder of the instrument is determined under section 1272(a). Section 1274 determines the issue price of the instrument in the case of a debt instrument issued for property. The daily portion of the amount includible in

income to the holder is determined by allocating to each day in any accrual period its ratable portion of the increase during such accrual period in the adjusted issue price of the debt instrument. § 1274(a)(3). The adjusted issue price is the issue price of the debt instrument at the beginning of the period and the adjustments before the first day of such accrual period. § 1274(a)(4). Thus, the holder accrues interest income and the issuer can deduct the amount equal to the sum of the daily portions of the original issue discount for each day during the taxable year on which such holder held such debt instrument, under section 163(e).

Section 1274 provides that, where adequate stated interest has not been provided for, the issue price shall be the imputed principal amount. § 1274(a)(2). The imputed principal amount is equal to the sum of the present values of all payments due under the debt instrument (except in potentially abusive situations), as of the date of the sale or exchange, and using a discount rate. § 1274(b). The present value of the instrument is determined as of the date of the sale or exchange, and by using a discount equal to the applicable Federal rate, compounded semiannually. § 1274(b)(2).

Section 1275(d) reads, in relevant part, as follows:

> The Secretary may prescribe regulations providing that where, by reason of . . . contingent payments. . . the tax treatment under this subpart (or section 163(e)) does not carry out the purposes of this subpart (or section 163(e)), such treatment shall be modified to the extent appropriate to carry out the purposes of this subpart (or section 163(e)).

This language authorizing the Secretary to prescribe regulations on contingent payments is the only reference to contingent payments in the OID statutes.

Congress granted the Secretary “regulatory authority to make appropriate modifications to the treatment under these provisions if, because of . . . contingent payments, . . . or other circumstances, the tax treatment otherwise accorded to the borrower and lender or the purchaser and seller is inconsistent with the purposes of these provisions.” S. Rep. No. 169, 98th Cong., 2d Sess., Vol. 1, 249, 256 (1984). Thus, Congress acknowledged that the treatment of instruments with contingent payments may be different from the treatment generally of instruments with fixed payments. Legislative history to section 1274 states that, “Where the OID rules do not apply, the parties will report the transaction according to the terms of the instrument and their normal methods of accounting. In general, however, the committee expects that where a transaction involving deferred payments is not subject to the OID rules, any changes imposed for the borrower’s right to the use of funds will be computed according to an economically sound method.” Id. at 256.

The application of section 1274 to the contingent payments at hand does not produce the deduction that A has proposed. Sections 1272 and 1274 determine interest based on a principal amount that is already fixed and creates no exception in the treatment of contingent payments. Therefore, under section 1274, the OID is calculated by using the issue price as determined by imputed principal amount.

In section 1275(d), Congress specifically directs the Secretary to provide regulations for contingent payments, which are otherwise not provided for in the OID statutes generally or in regulations other than those that were proposed during this transaction, as discussed below. The proposed regulations that could be applicable are discussed below.

Proposed regulations for OID instruments were published in 1986, 1992, and 1994. Final regulations were published in 1994 and in 1996. Under the proposed regulations that were published in the Federal Register in April 1986, and reprinted as LR-189-84, 1986-1 C.B. 820, contingent payments were not generally taken into account in determining OID; rather, the contingent payments were accounted for separately. Under Prop. Treas. Reg. § 1.1274-2(a), the cost basis of the property was the issue price of the instrument. 1986-1 C.B. 820, 864. Under Prop. Treas. Reg. § 1.1275-4(c), a contingent payment was not taken into account until the payment became fixed. 1986-1 C.B. 820, 885-886. These proposed regulations were proposed to be effective for debt instruments issued after July 1, 1982.

On December 22, 1992, the Service published Prop. Treas. Reg. § 1.1012-1(g), as follows:

> *Debt instruments issued in exchange for property.* In the case of any debt instrument issued in exchange for property, the amount of the basis of the property attributable to the debt instrument is the issue price of the debt instrument as determined under paragraphs (c) or (e) of § 1.1273-2, or § 1.1274-2(b).

1993-1 C.B. 734, 744.

Prop. Treas. Reg. § 1.1274-2(b)(2) read as follows:

> *Debt instruments that do not provide for adequate stated interest; imputed principal amount.* The issue price of a debt instrument that does not provide for adequate stated interest is the imputed principal amount of the debt instrument (as determined under paragraphs (c), (d) and (e) of this section).

1993-1 C.B. 734, 754.

Prop. Treas. Reg. § 1.1274-2(e), proposed in 1992, provided as follows:

> *Contingent payments*-(1) *General rule.* For purposes of paragraph (c)(1) of this section, the stated principal amount of a debt instrument that provides for contingent payments is the maximum amount of the contingent and noncontingent payments, excluding any amount of stated interest (whether or not contingent). The imputed principal amount of such a debt instrument is the sum of the present values of the noncontingent payments as determined under paragraph (c) of this section, and the fair market value of the contingent payments as of the issue date. If the fair market value of the contingent payments cannot be determined when separated from the noncontingent payments, the imputed principal amount of the debt instrument is its fair market value. Only in rare and extraordinary cases will the fair market value of the debt instrument be treated as not reasonably ascertainable. For additional rules relating to contingent payments, see Treas. Reg. § 1.1275-4.
>
> (2) *Special rule for earn-outs.* Notwithstanding paragraph (e)(1) of this section, the imputed principal amount of a debt instrument that provides for contingent interest payments is its stated principal amount if –
>
> > (i) All or a portion of the contingent interest payments are conditioned on a return from the exploitation of the property acquired for the debt instrument (including payments conditioned on profits, sales, rents, production, or royalties);
> > (ii) The debt instrument would provide for adequate stated interest under paragraph (c) of this section at a test rate of interest equal to 80 percent of the test rate applicable to the debt instrument; and
> > (iii) It is reasonable to expect that contingent payments of interest described in paragraph (e)(2)(i) of this section will raise the total yield on the debt instrument to at least the test rate of interest applicable to the debt instrument.

1993-1 C.B. 734, 756.

With regard to the effective dates, Prop. Treas. Reg. §§ 1.1012-1(g) and 1.1274 were proposed to be:

> effective for debt instruments issued on or after the date that is 60 days after the date the regulations are finalized. The proposed regulations are also proposed to be effective for lending transactions, sales and exchanges that occur on or after the date that is 60 days after the date the regulations are finalized.

1993-1 C.B. 734, 739.

These proposed regulations altered the treatment of contingent payments in OID instruments that was proposed in 1986. The regulations proposed in 1992 allowed for the determination of basis of the contingent payments using fair market value.

The proposed regulation under Prop. Treas. Reg. § 1.1012-1(g) was made final in 1994. T.D. 8517, 1994-1 C.B. 38. The final regulation under Treas. Reg. § 1.1012-1(g) reads:

> *(g) Debt instruments issued in exchange for property*–(1) *In general*. For purposes of paragraph (a) of this section, if a debt instrument is issued in exchange for property, the cost of the property that is attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1273-2 or § 1.1274-2, whichever is applicable. If, however, the issue price of the debt instrument is determined under section 1273(b)(4), the cost of the property attributable to the debt instrument is its stated principal amount reduced by any unstated interest (as determined under section 483). This paragraph (g) applies to sales or exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this paragraph (g) for sales and exchanges that occur after December 21, 1992, and before April 4, 1994.

1994-1 C.B. 38, 47.

The preamble to the final regulations under Treas. Reg. § 1.1012-1(g) states that "§ 1.1274-2(e) of the proposed regulations no longer remains as a proposed regulation." 1994-1 C.B. 38, 41.

On June 11, 1996, the final regulations regarding the tax treatment of debt instruments that provide for one or more contingent payments were filed with the Federal Register and were published as T.D. 8674, 1996-2 C.B. 84. The final regulations concerning contingent payments apply to transactions occurring after August 13, 1996.

The final regulation under Treas. Reg. § 1.1012-1(g) published in 1994 reads as above. In 1996, it was republished and reads as follows:

> *Debt instruments issued in exchange for property-*
> (1) In general. For purposes of paragraph (a) of this section, if a debt instrument is issued in exchange for property, the cost of the property that is attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1273-2 or § 1.1274-2, whichever is applicable. If, however,

> the issue price of the debt instrument is determined under section 1273(b)(4), the cost of the property attributable to the debt instrument is its stated principal amount reduced by any unstated interest (as determined under section 483).
> * * *
> (3) Effective date. This paragraph (g) applies to sales or exchanges that occur on or after August 13, 1996.

1996-2 C.B. 84, 91.

The final regulation under Treas. Reg. § 1.1274-2(g) does not adopt the treatment of contingent payments that was proposed in 1992. The final regulation, Treas. Reg. § 1.1274-2(g), provides in pertinent part:

> *(g) Treatment of contingent payment debt instruments.* Notwithstanding paragraph (b) of this section, if a debt instrument subject to section 1274 provides for one or more contingent payments, the issue price of the debt instrument is the lesser of the instrument's noncontingent principal payments and the sum of the present values of the noncontingent payments (as determined under paragraph (c) of this section). However, if the debt instrument is issued in a potentially abusive situation, the issue price of the debt instrument is the fair market value of the noncontingent payments. For additional rules relating to a debt instrument that provides for one or more contingent payments, see § 1.1275-4. This paragraph (g) applies to debt instruments issued on or after August 13, 1996.

1996-2 C.B. 84, 93-94.

Treas. Reg. § 1.1275-4(c) provides that contingent payments and noncontingent payments are to be treated separately. Treas. Reg. § 1.1275-4(c)(4)(iii) reads, in relevant part, as follows:

> [T]he issuer and the holder are treated as if the issuer had issued a separate debt instrument on the date the payment becomes fixed, maturing on the date the payment is due. . . . The stated principal amount of this separate debt instrument is the amount of the payment that becomes fixed.

1996-2 C.B. 84, 103.

A's use of other than the issue price for determining the principal amount of the instrument upon which the OID was calculated was not reasonable under section 1274 or under the legislative history. See Carpenters Dist. Council v. Dillard Dept. Stores,

15 F.3d 1275, 1282-85 (5th Cir. 1994) (analyzing statute through language of statute, legislative history, and by avoiding absurd or unreasonable outcomes). A determined issue price using contingent payments instead of payments that were fixed.

Reliance on Prop. Treas. Reg. § 1.1012-1(g) and Prop. Treas. Reg. § 1.1274-2

A filed its DATE 9 federal income tax return on DATE 7, and its DATE 10 federal income tax return on DATE 11. The instruments at hand were issued to the B partners in either DATE 3 or DATE 5.

Regulations are authorized under section 7805. The regulations explain the Service's position and prescribe the operating rules for compliance with the tax laws. As a general matter, proposed regulations constitute "a body of informed judgment which courts may draw on for guidance and are accorded no more weight than a litigation position. KTA-Tator, Inc. v. Commissioner, 108 T.C. 100, 102-03 (1997). The court in Garvey, Inc. v. United States, 1 Cl. Ct. 108, 118 (1983), aff'd, 726 F.2d 1569 (Fed. Cir. 1984), explained:

> As the term itself makes clear, proposed amendments [to regulations] are merely preliminary proposals. They are published in the Federal Register pursuant to the Administrative Procedure Act, 5 U.S.C. § 553, in order to give notice to the public of a proposed regulation that is under consideration. But there is nothing that requires the government to adopt in final form a regulation published as a proposed amendment.

Proposed regulations are treated as substantial authority for the purposes of the accuracy-related penalties under section 6662. See T.D. 8517, 1994-1 C.B. 38, 42-43 ("Although the final regulations dispose of the underlying proposed regulations. . ., the IRS will allow taxpayers to treat the proposed regulations as authority under section 6662 of the Code for debt instruments issued after December 21, 1992, and prior to April 4, 1994."). This is in contrast to those cases in which the Service has expressly stated that taxpayers may rely on proposed regulations for guidance pending the issuance of final regulations and that the Service will apply the proposed regulations in issuing rulings and in examining returns with respect to taxpayers.

The Service did not make the final regulations retroactive. It provided that the final regulations under both sections 1012 and 1274 had prospective application for purposes of determining basis. See T.D. 8175, 1994-1 C.B. 42. Because the final regulations became effective after the transaction at issue, the question becomes whether the proposed regulations, which were revoked prior to the time A filed its income tax returns, could be relied upon. Neither the final regulations nor the proposed regulations apply with the force of law to the debt instruments that A has issued. The question is whether the taxpayer's treatment of the transaction is in harmony with the

statutes. Therefore, in order for A to properly take the deductions for the contingent payments based on projections, A's reliance on the proposed regulations must fit within the statute.

Basis determination

As a general matter, a taxpayer's basis in purchased property is equal to the cost of the property. § 1012. Cost under section 1012 includes any valid liabilities incurred in financing the purchase. Crane v. Commissioner, 331 U.S. 1 (1947). Recourse liabilities generally pose no problem because the borrower is unconditionally obligated to pay a fixed amount with interest. In this case, however, there apparently is no set price for each partnership interest. Instead, the amount depends on the profits generated by the sale of D over a E-year period. Thus, the total amount the taxpayer is obligated to pay is not fixed. Under these circumstances, we conclude that the taxpayer's obligation is too contingent for purposes of determining cost basis, and therefore, no OID can be determined on the contingent payments. Waddell v. Commissioner, 86 T.C. 848 (1986), aff'd 841 F.2d 264 (9th Cir. 1988); Lemery v. Commissioner, 52 T.C. 367, 377-378 (1969), aff'd on another issue, 451 F.2d 173 (9th Cir. 1971).

Among the issues in dispute in Waddell was the taxpayers' entitlement to depreciation deductions and investment tax credits related to their investment in four medical equipment franchises. The amount of the disputed deductions and credits depended on the taxpayers' basis in the property. The taxpayers' investment totaled $124,000, $24,000 of which was paid in cash. The remaining $100,000 was in the form of a promissory note. The note, labeled "recourse," was for an initial term of 7 years and called for interest at 6% per year on the unpaid balance. If payments were current at the end of the initial term, the taxpayers could extend the note for an additional 7-year period. During the extended period, the taxpayers had the option of converting the note to a nonrecourse note by paying $1,000 for each franchise interest. Waddell, 86 T.C. at 854. The note called for minimum payments to be applied against accrued interest. Any other payments on the note were to come only from net receipts from the exploitation of the purchased equipment.

The court analyzed the likelihood of payment of the note according to its terms and concluded it was too speculative for the note to be recognized for Federal tax purposes. Id. at 910. Instead the court allowed the taxpayers to compute basis based on their cash down payment, the minimum required payments, and conversion and renewal fees, all of which the court concluded constituted bona fide debt.

In Wofford v. Commissioner, T.C. Memo. 1997-62, the issue was whether the taxpayer was entitled to amortization deductions related to her interest in a customer list. In connection with becoming a distributor of Safeguard products, the taxpayer was

required to buy the right to receive commissions on sales to a base of customers within a defined geographical territory from a current or former distributor. The distributor agreement the taxpayer entered into had an initial term of 5 years. It called for the taxpayer to pay a total of $588,020 for the protected right to sell Safeguard products to certain listed customers. It provided that Safeguard would withhold from the taxpayer's pay fixed monthly amounts in accordance with a "Territory Payback Schedule" until the purchase price was paid. However, no Territory Payback Schedule was ever executed by the taxpayer or attached to the agreement. Further, no interest rate was ever stated in connection with the taxpayer's payment obligation and there was no set time for final payment of the obligation.

The agreement provided that if it was terminated before the taxpayer paid the full amount for the customer list, the taxpayer would have no further liability for additional payments. In addition, if commissions were insufficient to cover the territory paybacks due in that month, as a matter of practice, Safeguard would pay the former distributor the amount due. Amounts were withheld from the taxpayer in 1988, 1989, 1990 and 1991 as follows, respectively: $18,238, $16,425, $16,800, and $19,000.

The taxpayer claimed amortization deductions related to the customer list based on a cost basis of $588,020 and a useful life of 7 years. This resulted in amortization deductions on the taxpayer's Schedule C in the amounts of $77,003, $84,003, $84,003 and $84,003 for 1988, 1989, 1990 and 1991, respectively. The Commissioner adjusted the amortization deductions based on a determination that the taxpayer's liability for making the territory paybacks was contingent and, therefore, could not be included in computing the taxpayer's basis in her distributorship.

The Tax Court agreed. Because the taxpayer's obligation was payable only out of commissions and the monthly withholding amount was not set at the inception of the transaction, the court was convinced that the taxpayer's liability was conditioned on her success in earning commissions. In addition, in Wofford neither the taxpayer nor Safeguard required or was subject to a final payment date, a written repayment schedule, a minimum repayment amount or a specified interest factor. These facts persuaded the court that the taxpayer's liability under the agreement was contingent and could not be included in computing her cost basis in the distributorship.

The facts of this case are similar to the Wofford case in that, other than the cash payments made at the outset, the taxpayer's obligation to pay the limited partners is conditioned entirely on future profits from sales of D. There is no written payment schedule, minimum repayment amount or specified interest factor. Moreover, unlike the situation in Waddell or in Wofford, the overall obligation in this case is not even fixed. Under these circumstances, we conclude that the taxpayer's obligation does not constitute a genuine obligation for purposes of determining the basis in the partnership or the partnership assets. Instead the taxpayer's basis should be limited to actual cash

payments.

The current regulation under Treas. Reg. § 1.1012-1(g), which went into effect in 1994, provides that "the cost of the property that is attributable to the debt instrument is the issue price of the debt instrument." Thus, for the periods before and after the first date of the transaction, in DATE 9, the basis of the instrument was determined by the issue price of the instrument.

A has stated that,

> Although the regulation [Treas. Reg. § 1.1274-2] by its own terms states that it does not apply to sales or exchanges that occur before August 13, 1996 (the general effective date of the new original issue discount regulations), a taxpayer's basis in property has long been held to include the amount of money paid and the fair market value of any debt instrument given for the property. See Crane v. Commissioner. . .

However, A's conclusion is incorrect, and the basis for these contingent payments, when determining the OID on the instrument, is not the fair market value of the instrument including the contingent payments. Rather, the basis is limited to the payments on the instrument that are fixed.

Although Treas. Reg. § 1.1012-1(g), in both the proposed and final forms, clearly contemplates including in cost basis any amount attributable to debt instruments issued in exchange for property, the regulation does not eliminate the need to test the purported debt. Accordingly, we do not view the regulation as supporting the taxpayer's contention that it is entitled to estimate its basis in the B partnership interests based on its purported obligation to make future payments to limited partners because those amounts are so contingent as not to be valued.

In Associated Patentees, Inc. v. Commissioner, 4 T.C. 979 (1945), the Tax Court determined that the petitioner was "entitled to a deduction for exhaustion of the patents equal to the total payments of $42,209.76 made in that year," and no more than the amount paid. Associated Patentees, 4 T.C. at 987.

The petitioner in Associated Patentees acquired certain patents and paid as consideration 80 percent of the yearly income it received from licenses granted for use of the patents. The payments were therefore contingent upon actual income. In determining the depreciation of the patents, the court said that, "It is impossible to determine in this year what the total cost will be, since it will include a percentage of earnings of petitioner in each year of that term. These earnings can not now be determined." Associated Patentees, 4 T.C. at 985-986. The court determined that petitioner could not deduct the value of the patent, but rather was limited to deducting

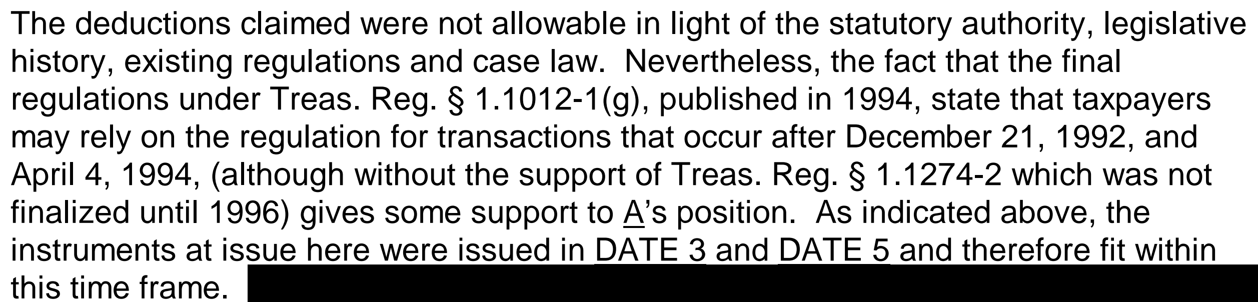
the cost. The court determined that the petitioner's method for computing the depreciation deduction was reasonable, that is, depreciating the full amount in the year paid because it is the cost pertaining to that year alone. Therefore, petitioner could only deduct what it paid in that tax year.

The tax treatment of contingent payments would then necessarily have to be determined using the "normal" methods of accounting, as Congress required when the OID rules do not apply. S. Rep. No. 169, 98th Cong., 2d Sess., Vol. 1, at 255 (1984).

Section 1012 and its regulations, and case law in effect would then be used to determine basis. Under section 1012, the contingent payments are too contingent to be included in basis. Under Associated Patentees, A is limited to deducting the amount that it actually paid out each year.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The deductions claimed were not allowable in light of the statutory authority, legislative history, existing regulations and case law. Nevertheless, the fact that the final regulations under Treas. Reg. § 1.1012-1(g), published in 1994, state that taxpayers may rely on the regulation for transactions that occur after December 21, 1992, and April 4, 1994, (although without the support of Treas. Reg. § 1.1274-2 which was not finalized until 1996) gives some support to A's position. As indicated above, the instruments at issue here were issued in DATE 3 and DATE 5 and therefore fit within this time frame.



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DEBORAH A. BUTLER

By: __________________________
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