

FALL 2004

## THE TAX TREATMENT OF PREPAID SUBSCRIPTION INCOME –

### A POTENTIALLY SIGNIFICANT PART OF MEDIA ACQUISITIONS AND RESTRUCTURINGS

#### OVERVIEW

The tax treatment of prepaid subscription income is an aspect of acquisitions and restructurings of publishing operations that presents potentially significant and often overlooked tax planning opportunities and pitfalls. Without proper planning, sellers seeking capital gain treatment may trigger ordinary income, purchasers may be forced to deduct future operating costs over an extended period of time, and internal and joint venture restructurings that are intended to be tax-free may be subject to current tax.

#### ELECTING DEFERRAL OF PREPAID SUBSCRIPTION INCOME

Publishers of periodicals can elect to defer recognition of income from prepaid subscriptions until the year in which the periodicals are produced and delivered. The deferral of prepaid subscription income is available not only for traditional media, such as newspapers and magazines, but also for periodicals that are delivered through new media, including via the Internet. Without this deferral election, a publisher is generally required to recognize taxable income from prepaid subscriptions in the year in which the payment is received, even though the publisher cannot deduct the cost of producing and delivering the periodical until it incurs these costs in a later year.

#### CONSEQUENCES OF A SALE OR RESTRUCTURING

Two important examples of transactions that can trigger recognition of deferred subscription income are (i) the sale by a pub-

lisher of assets associated with the periodical (including a stock sale that is treated for tax purposes as an asset sale pursuant to a "338(h)(10) election" and (ii) a transfer by the publisher of assets associated with the periodical to a related entity, such as a subsidiary or a joint venture.

The IRS and the courts have provided limited guidance regarding the treatment of prepaid subscription income in the context of acquisitions. What this guidance suggests is that the way in which the parties document (or fail to document) their intended tax treatment of deferred subscription income can be significant. Where parties to an acquisition have not specifically addressed the way in which the liability to fulfill prepaid subscriptions is to be handled, the IRS and the courts have come to a variety of treatments, some of which may not reflect the intention of the parties.

#### CONSEQUENCES TO A SELLER

From a seller's point of view, the approach taken to deferred subscription income can result in a portion of the gain on a sale being characterized as ordinary income, rather than capital gain. When a periodical is sold, the seller may recognize a deduction reflecting the amount that the seller pays, or is deemed to pay, to the purchaser to take on the cost of fulfilling the future obligation to produce and deliver the periodical. If the cost of fulfillment is less than the amount of previously deferred subscription income, the result for the seller will be ordinary income reflecting this difference. In general, the overall effect to a seller of allocating less to the assumed cost of fulfilling future subscriptions will be

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that a portion of what would have been capital gain on the sale of assets, if the fulfillment cost were equal to the deferred subscription income, instead becomes ordinary income. This typically would be a concern when the seller is a flow-through entity owned by individuals, because ordinary income is subject to a higher tax rate than capital gains, and also may be of concern when the seller is a corporation and has capital losses it wishes to utilize on the sale.

### CONSEQUENCES TO A PURCHASER

In general, a purchaser of a periodical is deemed to have received a payment from the seller in exchange for taking on the obligation to produce and deliver periodicals in the future. The purchaser can elect to delay recognizing income on this deemed payment, as deferred subscription income. However, the

purchaser's expenses in producing and delivering the periodicals are likely to be viewed in the same manner as assumed liabilities generally—these expenses, rather than being deductible as incurred, would be added to the purchaser's tax basis in the purchased assets and be subject to deduction only over time (generally over a 15 year period from the date of the purchase). The purchaser may well be interested in allocating a smaller amount to the cost of fulfilling prepaid subscriptions, to reduce the amount of taxable income that the purchaser is required to recognize in earlier years than when the purchaser can recognize offsetting deductions. As noted above, a seller interested in minimizing ordinary income may have a contrary interest in allocating more to these costs.

### CONSEQUENCES WHEN FORMING SUBSIDIARIES OR JOINT VENTURES

Corporate restructuring transactions present special concerns. For example, if a parent cor-

poration contributes the assets of a periodical to a subsidiary, it should consider explicitly retaining the liability to fund the subsequent production and delivery of periodicals for which the parent corporation has deferred subscription income. Otherwise, the parent corporation may be treated as having triggered the deferred subscription income (although recognition of this income may be deferred for federal tax purposes if the parent and subsidiary are members of a consolidated tax group). Similar concerns arise when a periodical's assets are transferred to a joint venture, including one organized as a partnership or limited liability company. ■

This bulletin provides only a brief overview of the important tax implications of prepaid subscription income in the context of acquisitions and restructurings of publishing businesses, and should not be construed as, or substitute for, tax planning.

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### EDITOR'S NOTE

#### WHAT "FULL SERVICE" MEANS FOR OUR MEDIA CLIENTS

While it is natural for our clients to think of us as a media firm for media-related legal projects such as M&A and Intellectual Property, we are a full-service firm that can handle all of your needs. For example, in recent months we have handled numerous matters for our media industry clients that would not be typically thought of as "media" issues, such as insurance recovery, asbestos, CERCLA, criminal investigations, employment discrimination, general commercial contract and breach of duty litigation, and real estate negotiations and litigation. While many firms can handle different types of litigation, we can do it more efficiently because we know your business. ■