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Proposed Regulations Create Rules for Closing Date Deductions

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A frequent point of negotiation in corporate acquisitions is which side—buyer or seller—will get the benefit of any tax deductions resulting from closing bonuses, option cashouts, banker fees, and other transaction expenses. The buyer often bears the cost of these expenses, but the seller may feel that it is entitled to deductions where the costs relate to pre-closing services and agreements.

Last week, the IRS proposed amendments to the consolidated return regulations that will impact the ability to negotiate over these deductions in certain transactions. Specifically, the proposed regulations would limit the parties' ability to shift these deductions to the buyer's consolidated return. These proposed regulations will not be effective until the date they are published as final in the Federal Register, but they reflect the IRS's position (even under the current regulations) on these deductions.

The proposed regulations will impact transactions in which a consolidated group acquires a target company that is a C corporation for tax purposes. Often the target has an obligation to cash out outstanding options held by employees. Although the payment accrues as of the closing date, it is usually made a few days later in the first payroll run after closing. The target also is frequently liable for financial advisory and investment banking services, for which payment is contingent on closing.

Under the current regulations, the target will usually have two short taxable periods in the acquisition year—a short "pre-closing" period ending at the end of the closing date (end-of-the-day rule), and a short "post-closing" period as a member of the buyer's consolidated group. There is an exception to the end-of-the-day rule for transactions that occur on the closing date but are properly allocable to the portion of the day after closing. These transactions are subject to the "next-day rule" and are deemed to occur on the day after closing, in the buyer's post-closing consolidated group. Many taxpayers have taken the position that closing-related transaction expenses can be allocated to the buyer's consolidated return under the next-day rule. The current regulations provide that the parties' determination that a transaction is properly allocable to the "next day" will be respected by the IRS if it is "reasonably and consistently applied by all affected persons." Four factors are to be considered in determining whether an allocation is reasonable and consistent. None of these factors would, by their terms, prohibit the allocation of a transaction expense to the post-closing period.

In other words, depending on the facts, the current regulations appear to provide at least some ability to elect the tax return on which deductions will appear. That is, the parties could negotiate which party would receive the tax benefit from these expenses.

The IRS indicated its disapproval of this practice in a nonprecedential legal memorandum, A.M. 2012-010 (Nov. 15, 2012) (2012 GLAM), which involved both option cashouts and banker fees. In short, the 2012 GLAM takes the position that the target must claim the deductions for such compensation and transaction expenses on its final pre-closing return rather than allocating these amounts to the buyer's consolidated return. The 2012 GLAM reasons that compensation for pre-closing services that is payable as a result of the change of control and transaction expenses contingent on the change of control both become "fixed and determinable" at closing. Both items result from transactions preceding the closing, and neither is attributable to any "transaction" occurring after the closing on the closing date. Accordingly, the 2012 GLAM takes the position that the "next-day rule" is inapplicable on its terms, and it is neither proper nor reasonable to allocate deductions from these liabilities to the buyer's post-closing return. The 2012 GLAM is consistent with an earlier technical advice memorandum (TAM 200548002), which held that success-based investment banking fees paid by the target on the acquisition date were not subject to the next-day rule.

The proposed regulations released last week reach the same result by narrowing the next-day rule. The next-day rule as amended would not apply to any "extraordinary item" that becomes includible or deductible simultaneously with the change of control transaction. For this purpose, an extraordinary item includes any compensation-related deduction in connection with the transaction, including deductions for fees for services rendered in connection with the transaction (*e.g.*, bankers' fees), and bonus, severance, and option cancellation payments made in connection with the transaction. In other words, these transaction-related expenses would automatically fall in the pre-closing period.

There are two key differences from the current regulations. One, the current regulations provide merely that extraordinary items cannot be ratably allocated between the two short periods, but do not require that they be allocated to the pre-closing period. In contrast, the proposed regulations require that certain extraordinary items be allocated to the pre-closing period. The preamble explains that the purpose of this change is to eliminate the perceived electivity existing under the current regulations. Two, the proposed regulations broaden the extraordinary item definition. Specifically, the definition in the proposed regulations has been expanded to "clarify" that deductions for fees paid to bankers and other independent service providers in connection with the transaction are extraordinary items.

Thus, in effect the proposed regulations create a regime in which the time when rights accrue completely determines the period in which the deduction falls. This may create new tax planning opportunities.

The result discussed above should be compared with the consequences if the neither the buyer nor the seller is a consolidated group (for example, if individual owners sell the target C corporation to a fund treated as a partnership). In that case, the target corporation's tax year does not end in connection with the closing, but rather the target has a "straddle period." Frequently the seller is responsible for the taxes allocable to the pre-closing portion of the straddle period and the parties negotiate which side will benefit from transaction expense deductions. The consolidated return regulations do not limit this allocation, which is for indemnification purposes only and does not affect target's tax returns.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

Charles C. Hwang
Partner – Washington, D.C.
Phone: +1.202.624.2626
Email: chwang@crowell.com