

Mergers: The Timing Rules for Compensation Deductions in C-Corporation Acquisitions

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When a C corporation is acquired and joins the acquirer's consolidated group, the target's taxable income for the year between the pre- and post-acquisition periods must be computed under the "end-of-day" and "next-day" rules of U.S. Treasury Regulation Section 1.1502-76(b). Historically, though, guidance was lacking on the application of the end-of-day and next-day rules to the timing of the target's compensation deductions.

On Nov. 30, 2012, the IRS Office of Chief Counsel responded to this gap by issuing General Legal Advice Memorandum 2012-010 (the GLAM). The GLAM addresses the application of the rules to nonqualified stock options and stock appreciation rights held by certain target employees; compensatory deductions (such as investment bankers' success-based fees that are contingent on the closing of the acquisition); and deductions related to the retirement of the target's debt in certain circumstances. Deductions for deferred compensation, however, fall under different rules.



General Rule for the Target's Expenditures

In general, the end-of-day rule provides that a corporation becomes or ceases to be a member of a consolidated group at the end of the day on which its status as a member changes. Thus, items taken into account on the acquisition date generally are reported on the target's stand-alone return for its short tax year ending on the acquisition date.

The next-day rule is an exception to the end-of-day rule. It provides that if a transaction occurs on the acquisition date and is properly allocable to the post-closing portion of the target's day, the transaction is treated for U.S. federal income tax purposes as occurring at the beginning of the day after the acquisition date. A determination as to whether a transaction is properly allocable to the portion of the target's day after the event resulting in the target's change in status will be respected if it is reasonable and consistently applied by all affected persons.

The reasonableness of an allocation under the next-day rule depends on several factors, including:

- Whether income, gain, deduction, loss, and credit are allocated inconsistently
- Whether the allocation reflects ownership of the stock before or after the event (if the item is from a transaction in the subsidiary's stock)
- Whether the allocation is inconsistent with other requirements under the IRC
- Whether other facts exist that indicate that the transaction is not properly allocable to the portion of the day after the change event

The next-day rule was intended to prevent sellers from bearing tax liability for post-closing events that are under the buyer's control (and of which the seller may be unaware).

The GLAM Guidance

In the GLAM, the IRS concluded that, under the end-of-day rule, stock options, stock appreciation rights, and success-based fee deductions should be taken in the target's pre-acquisition taxable year. The agency reasoned that the compensation expenses become fixed and determinable on the day of the acquisition, and, under the end-of-day rule, these deductions ordinarily would be taken in the target's pre-acquisition taxable year.

The next-day rule, which arguably might shift these deductions into the target's post-acquisition taxable year, applies only to transactions involving the target or its subsidiaries that survive the transaction and join the buyer's consolidated return group. The IRS held that deductions for stock options, stock appreciation rights, and success-based fees are deductions from services provided to the target before the acquisition. Therefore, the next-day rule is inapplicable, and the deduction must be taken in the target's pre-acquisition taxable year.

The GLAM provides some valuable insight into current IRS thinking on application of the end-of-day and next-day rules, but guidance still is lacking on many other types of compensatory payments that are triggered as a result of a change in control. Transactions such as payouts of previously deferred compensation and vesting of restricted stock are outside the scope of the GLAM, leaving taxpayers to seek guidance under the general rules for the timing of tax deductions for compensation.

Compensatory Transfers of Property and Deferred Compensation

The fact that the GLAM addressed the timing of deductions for nonqualified stock options and stock appreciation rights might lead taxpayers to believe that all compensation triggered in the event of a change in control of a target is subject to the same rules. However, the language in the next-day rule in the consolidated return regulations interplays with the wording of IRC Section 83(h) and Section 404(a)(5).

Section 83 governs compensatory transfers of property, such as compensation in the form of stock. Under Section 83(a), in the case of a transfer of property in connection with the performance of services, the employee must include in income the fair market value of the property at the first time that the property is no longer subject to substantial risk of forfeiture. If the property is not subject to substantial risk of forfeiture at the time it is transferred to the employee, the employer takes a deduction under its normal method of accounting. If the property is subject to a substantial risk of forfeiture, as is the case with restricted stock, the employer then obtains a corresponding deduction under Section 83(h) in the employer's year that includes the employee's year-end in which the amount is includable in the employee's income.

As a result of the interplay between Section 83(h) and the consolidated return rules, an employer corporation that becomes a member of the acquiring group can claim the deduction for restricted stock in the post-acquisition period, provided the employee's tax year ends on the same date as the employer corporation's tax year or ends sometime during the employer corporation's post-closing tax year.

Section 404(a) presents a rule similar to Section 83(h), but for payments of deferred compensation. This regulation establishes the same timing rule for deferred compensation deductions as for compensatory transfers of property deductions under Section 83(h) – namely, that the deduction is allowable for the target's post-acquisition tax year ending on Dec. 31.

In the acquisition of a C-corporation target, items that constitute deferred compensation (for example, pure deferred compensation and restricted stock) fall under the rules of Section 83(h) and Section 404(a), rather than Treasury Regulation Section 1.1502-76(b). The timing of such deductions is deferred until the tax year in which the recipient records the income on his or her personal tax return. Thus, in a carryover basis reorganization transaction, the tax attributes related to the employer's timing of the tax deduction carries over to the successor entity and be recognized in the year that the recipient recognizes them (generally in the return that ends on Dec. 31).

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This treatment is true not only for deductions governed by Section 83(h) that are triggered as a result of a change in control but also for all payments of deferred compensation under Section 404(a) and all vesting of restricted stock, regardless of whether the payments and vesting are directly related to the reorganization transaction. As a result of the application of the “in which or with which ends” rules of Section 83(h) and Section 404(a) in an acquisition context, compensation deductions subject to the timing rule generally will be pushed into the acquiring company’s return.

Different Timing Rules for Different Types of Compensation

It’s important to realize that no single set of timing rules applies to all types of compensation deductions that can arise in a C-corporation acquisition. Proper tax planning requires an accurate understanding of which rules apply to which compensation.