



Extra Severance Pay Deductible Following Merger

by Robert W. Wood • San Francisco

The IRS has issued a technical advice memorandum stating that an acquiring company may deduct severance payments made under a merger agreement, even though the payments were clearly more than would have been required under the pre-merger plan. The extra compensation did not have to be capitalized. In TAM 9731002, the acquiring company had acquired all of the stock of the target, and the target was merged into the acquirer pursuant to a plan.

Before the merger, the target paid one week of severance pay for every year that an employee had worked for it. In the merger agreement, the acquirer agreed to pay two weeks severance pay instead of one week to the employees of the target after the merger. The company believed that this additional severance would be an incentive for employees to remain after the merger. The severance pay agreement did not affect the purchase price for the target's stock. Likewise, severance payments were not a purchase price adjustment to the cost of the target's stock, and were not made to the target's shareholders.

To Deduct or Capitalize?

In considering whether these extra severance payments were deductible, the IRS reasoned that the increase in severance payments was coincidental to the acquisition and merger, and was motivated by the acquiring company's desire to successfully integrate the merged business operations. Nonetheless, the IRS found that the additional severance payments had their origin in the company's post-acquisition employment relationship with its employees. The additional severance payments, said the IRS, were

therefore deductible under Section 162, and did not have to be treated as capital expenditures under Section 263.

In a recent issue of *The M&A Tax Report*, we noted that deductible severance pay after an acquisition may be becoming increasingly common—or at least it seems now the subject of authority cropping up. See Wood, "Severance Payments Deductible After Acquisition," Vol. 5, No. 12 *M&A Tax Report* (July 1997), p. 1. There, we considered TAM 9721002, in which severance payments awarded was based on the employment status and length of service which each person had with the target. The Service seemed to have little difficulty in that ruling in allowing the buyer to deduct the cost of these severance payments as ordinary and necessary business expenses. Interestingly, the IRS there concluded that the events that were most crucial to the creation of these severance obligations occurred after the acquisition. Technically, said the Service, because employees were not terminated until after the consummation of the acquisition, the IRS argued that there was simply no liability for severance payments before the acquisition.

The IRS so argued even though the amount of the target's liability could be based on the employment status and length of service of the employees. According to the IRS, though, severance payments did not result from liabilities of the target that could be treated as assumed in the stock purchase (a stock purchase that was treated as an asset purchase under Section 338 in the transaction in question).

In TAM 9721002, the IRS concluded that the severance pay liabilities were not the target's liabilities before the acquisition. Such severance payments therefore had their origin in the termination of target employees by the buyer. Because the severance payments were not made in connection with the acquisition of the target, the target was not required to capitalize them. The target could deduct the payments as ordinary and necessary business expenses.

In TAM 9731001, the ruling characterizes the increasing severance payments as coincidental to the acquisition and merger, being motivated by the

Continued on Page 7

SEVERANCE DEDUCTIBLE Continued from Page 6

acquiring company's desire to successfully integrate merged operations. The additional severance payments therefore had their origin in the company's post-acquisition employment relationship with its employees.

Conclusion

Virtually any business will want to deduct severance payments regardless of the context. However, these two recent technical advice memoranda give hope that the category of deductible severance payments in this context is being treated as reasonably broad. ■