THE M&A TAX REPORT

The Monthly Review of Taxes, Trends & Techniques

Volume 5, Number 12 July 1997

Severance Payments Deductible After Acquisition

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Although in some cases it cannot be avoided, it is certainly not ideal tax planning to pay out compensation (on which the company has to pay employment taxes, etc.), and yet have the compensation be nondeductible. On the surface, it seems almost a contradiction in terms for compensation not to be deductible. Yet, there are times when the cost of compensation must be capitalized. In the same way, many other traditionally deductible items—say attorneys' fees—are

Continued on Page 6

ALSO IN THIS ISSUE:

SEVERANCE PAYMENTS Continued from Page 1

also in some situations subject to the dreaded "C" word.

In the merger and acquisition context, one question can be the triggering event in the nature of the payments themselves. A recent technical advice memorandum sheds light on this question, and gives at least one favorable rule in this context. In Technical Advice Memorandum 9721002, the IRS considered a target company that was acquired in a stock purchase that was treated as an asset purchase under Section 338. The target company made severance payments to employees following the acquisition, and the question was the appropriate treatment of those severance payments.

Underlying Facts

The buyer in TAM 9721002 purchased the target stock from the seller for cash, and a Section 338 election was made on the purchase. Two days after the purchase, the buyer issued termination notices to 40 executives of the target, and also began eliminating the jobs of another 850 salaried employees of the target. The executives were entitled to severance payments under their individual termination protection agreements.

Salaried and other employees who did not have these individual employment contracts were entitled to severance payments under the personnel policies of the target, or the Worker Adjustment and Retraining Notification Act ("WARN"). The severance pay that was awarded to these individuals was based on the employment status and length of service which each person had with the target.

To Deduct or Not to Deduct?

As virtually any taxpayer would, the buyer deducted the cost of these severance payments as ordinary and necessary business expenses on its consolidated return. The IRS, however, concluded that the events that were most crucial to the creation of these severance obligations occurred *after* the acquisition. How did the Service reach this conclusion?

Because employees were not terminated until after the acquisition, the IRS argument was that there was simply no liability before the acquisition. In fact, 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. Thus, according to the IRS, the severance payments did not result

Continued on Page 8

SEVERANCE PAYMENTS Continued from Page 6

from liabilities of the target that could be treated as assumed in the stock purchase (that was treated as an asset purchase under Section 338).

And, because the severance pay liabilities were in the IRS' view not the target's liabilities before the acquisition, it followed that such amounts did not have to be included in the adjusted grossed-up basis of the target's assets following the 338 acquisition. Moreover, the IRS concluded that the acquisition was not the basis for the severance payment. According to the IRS, severance payments 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. ■