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Speakers’ Corner

- Philip Cook will present a state and local tax update to the Pennsylvania Society of Public Accountants on January 20.
- Philip Cook will present a state and local tax update to the Community College of Allegheny County on January 23.
- Todd Reinstein and Howard Goldberg will speak on “Consolidated Return Issues Affecting Use of Tax Attributes” at the Twenty-Second Annual Tax Executives Institute Houston Chapter Tax School on February 11 in Houston, TX.

Quotable

- Todd Reinstein was quoted on December 15 in Tax Notes Today regarding the new five year NOL carryback provision.
- Todd Reinstein was quoted on December 17 in Tax Notes Today in an article on Notice 2010-2 and on how Section 382 may apply to TARP recipients.

Bonus Accrual and the 2½ Month Rule: New CCA Shines Light on IRS Position

It is common industry practice for corporate taxpayers to accrue employee bonuses earned throughout the year with the anticipation that they will be paid within 2 ½ months from the end of the year. Under Section 404, although deferred compensation payments may be otherwise deductible, (i.e., a company has accrued the amount and satisfied the all events test), these payments are not deductible until the employee has reported the compensation in income. Thus, Section 404 generally requires a matching of deferred compensation income and expense. As a result, deferred compensation payment deductions are generally deferred to a year subsequent to the year of payment. However, immediate deduction is available in certain circumstances — that is, if the deferred compensation payment satisfies the requirements of Sections 404 and 451. If the payment is made within 2 ½ months of the end of the employer’s tax year in which the services creating the right to the compensation are performed, then the compensation payments are deducted in the tax year in which the services were performed (known as the “2 ½ month rule.”). Under the 2 ½ month rule, companies must meet the following conditions: (i) the accrual meets the “all events test” and (ii) it pays the bonus within 2 ½ months after year-end.

To meet the all events test, the liability must be determined with reasonable accuracy and economic performance must have occurred with respect to the liability. Most companies feel they meet the all events test for employees that have met the bonus plan’s goals during the year and by virtue of declaring the amount of the bonus before the year-end. Caution is advised, however, because this may not be as simple as it looks. A recent Chief Counsel Advice memo-
randum (CCA) points out that other variables may preclude the liability from meeting the all events test.

CCA 200949040

On December 4, 2009, the IRS issued CCA 200949040 denying the taxpayer’s accounting method change to deduct a bonus in the year accrued as opposed to the following year when the bonus was paid. As described in the CCA, the taxpayer’s incentive plan required that employees could only receive the bonuses if they were employed by the taxpayer on the date the bonuses were paid in the following tax year. Unpaid bonuses were supposed to revert back to the corporation and be paid to a charity. In this CCA, the IRS concluded that the taxpayer’s requirements regarding bonus reversions created a contingency, and as such, the liability to pay the bonuses could not be considered fixed until the contingency was satisfied. Consequently, the IRS concludes that no deduction would be available until the contingency was removed (i.e., if the individual was employed on the date the bonus was paid).

By way of background, the taxpayer sought to treat the bonuses paid within 2 ½ months of the following year as properly accrued and deductible in the previous tax year under an accounting method change. The IRS concluded that the taxpayer’s liability arising from the incentive plan must be taken into account in the year paid and not the year accrued since the payment was contingent on the taxpayer’s employees still being employed in order to receive the bonuses. The taxpayer in the CCA argued that it had a fixed and determinable liability at the end of the first year for 90 percent of the amount accrued for financial statement purposes for its incentive plans for the first year, and thus, was entitled to take it as a deduction in the first year.

The IRS disagreed and explained that the taxpayer’s failure to contribute funds to charity did not mean that the taxpayer necessarily satisfied the requirements of the all events test. The IRS focused on the fact that the liability was not fixed in the first year because the employees had to perform services in the second year and be employed by the taxpayer when the bonuses were paid. According to the IRS, this meant that the taxpayer did not know at the end of the first year whether it owed bonuses to any employee. Also, there was no indication that the corporation’s employees (or ex-employees) could require the corporation to make a charitable contribution absent the bonus payments.

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Taxpayers looking at preparing their year-end provision should carefully review their incentive compensation plan requirements before taking the benefit of their bonus accrual. If they do not meet the criteria set forth in the CCA, they may want to consider avenues to mitigate any potential exposure. Publication of the CCA would indicate that IRS Exam teams will closely scrutinize the treatment of these items. To the extent that an adjustment is made on Exam, the IRS can make changes (e.g., defer the year in which the deductions are taken) in the earliest open year. Any Exam adjustments will be taken into account immediately. One way to mitigate any exposure is to file a change in accounting method. This method change is available automatically and it may be filed with the annual tax return. Such a change provides audit protection and any unfavorable Section 481(a) adjustment would be recognized over four years rather than immediately, as would occur in an Exam adjustment. Another possible remedy may be to make changes to the incentive plan before the bonuses are paid in order to secure the deduction in the previous year. To ensure that other changes are not made in an earlier year by IRS Exam, it also may be prudent to consider changes to earlier-filed returns through an amended return.
Final regulations on “cash D reorganizations” were issued on December 17, 2009. The regulations address the qualification of certain transactions as tax-free reorganizations where, by virtue of the fact that the same owners hold all the stock of the transferor and transferee corporations, no stock or securities of the transferee corporation are required to be issued and distributed.

The final regulations retain the “nominal share” approach of the predecessor temporary regulations. They also modify and clarify the prior regulations, addressing in particular the treatment of transactions where no consideration is received by the transferor corporation or the value of such consideration is less than the value of the transferor corporation’s assets transferred.

D Reorganizations — Generally

A D reorganization requires the transfer by one corporation of substantially all of its assets to another corporation and that, immediately after the transfer, the transferor corporation or one or more of its shareholders (or a combination thereof) is in control of the transferee corporation. One requirement of a D reorganization is that stock of the transferee corporation be received by the transferor corporation and distributed to its shareholders in the reorganization.

Example 1: Corporation A owns all of the stock of each of Corporation B and Corporation C. Corporation B transfers its assets with a fair market value of $100 to Corporation C in exchange for Corporation C stock and cash together worth $100. Corporation B then liquidates, distributing the stock and cash to Corporation A. The transaction qualifies as a D reorganization.

The Meaningless Gesture Doctrine

Over time, the courts and IRS have held that in cases in which there is an exact identity and proportionality of ownership by the shareholders of both the transferor and transferee corporations, a sale by the transferor corporation of its assets to the transferee corporation for cash will be treated instead as a D reorganization. The rationale is that an issuance of stock by the transferee corporation would be a “meaningless gesture” and therefore is not required for D reorganization qualification.
Example 2: Same as Example 1, except that Corporation C pays for Corporation B’s assets solely with $100 cash. Since Corporation A owns all of both Corporation B and Corporation C, the transaction is recast as a D reorganization instead of an asset sale. No shares of Corporation C stock need be issued.

The Temporary Regulations

Temporary Regulations issued on December 18, 2006 set forth the IRS' position on cash D reorganizations and the meaningless gesture doctrine. These regulations provided:

1. in cases where the same person or persons own, directly or indirectly, all of the stock of the transferor and the transferee corporations in identical proportions, the stock distribution requirement under the D reorganization rules will be treated as satisfied even though no stock is actually issued in the transaction

2. for purposes of number 1, above, an individual and all members of his family, as defined in Section 318(a)(1) of the Internal Revenue Code, will be treated as one individual

3. a de minimis exception, which permitted a one percent ownership deviation in determining the existence of shareholder identity and proportionality

4. that non-voting, non-convertible preferred stock, which is limited and preferred as to dividends and liquidation and redemption rights, is disregarded for purposes of determining shareholder identity and proportionality, and

5. in each case where it is determined that the same person or persons own all the stock of the transferor and transferee corporations in identical proportions, a nominal share of stock of the transferee corporation will be deemed issued in addition to the actual consideration exchanged in the transaction.

The Final Regulations

The final regulations retain the above five items of the temporary regulations. In addition, they provide that if the transferor corporation receives no consideration from the transferee corporation, or the value of the consideration received from the transferee corporation in the transaction is less than the value of the transferor corporation’s assets that are transferred, the transferee corporation will be treated as issuing stock with a value equal to the excess of the fair market value of the transferor corporation’s assets over the value of the consideration actually received by the transferor corporation in the transaction.

Further, with respect to the deemed issuance of the nominal share, the regulations provide that such nominal share is deemed to be transferred upward through the chain of ownership to the extent necessary to reflect the ultimate, actual ownership of the transferor and transferee corporation. By deeming the transfer of the share up the chain, the preservation of the potential future gain or loss in the share is held by the appropriate shareholder. This may facilitate future planning as to when the nominal share is sold.

Consolidated Return Issues

One major change between the temporary and final regulations is the consolidated return effect the nominal share creates. Under the temporary regulations, practitioners were concerned as to the effect the nominal share would have in the case of an excess loss account. The final regulations provide that in the event an intercompany cash D reorganization results in an excess loss account in the nominal share (by virtue of the cash being treated as a distribution by the transferor corporation to its direct owner that reduces stock basis), the amount of this excess loss account will result in intercompany gain (to be taken into account under the matching and acceleration rules) to the extent the nominal share is deemed distributed by the direct owner of the transferor corporation up the chain of corporations.1
**PEPPER PERSPECTIVE**

The final regulations cement the meaningless gesture doctrine and cash D reorganization in the tax law. Where the regulations apply, a taxpayer cannot choose between a sale and D reorganization merely by deciding whether to have the transferee corporation issue stock. A consolidated group must be wary of the intercompany gain a cash D reorganization may create by virtue of triggering an excess loss account attributable to a nominal share. Importantly, however, a group may be able to avoid triggering such an excess loss account by keeping the transaction out of the cash D reorganization rules (and thus avoiding the deemed distribution of the nominal share that triggers the excess loss account, as discussed above) through actually issuing a small amount of stock in the transaction.

The final regulations are not the end of the cash D reorganization saga. The IRS and Treasury are seeking comments on the application of the final regulations to reorganizations involving foreign corporations. More guidance in this area is on the horizon.

**ENDNOTE**

1 The Treasury confirmed this treatment by adding an example in Treas. Reg. 1.1502-13(f)(7)(i)Ex. 4.
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