New IRS Tax Accounting Rule to Benefit M&A

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The IRS recently adopted a taxpayer-favorable new tax rule that alleviates one of the more significant tax risks that often complicates M&A. Historically, if a target company had been reporting something incorrectly on its tax returns, the buyer often had to foot the bill for correcting the mistake going forward (termed a "change in method of accounting" by the IRS). Under the IRS' pragmatic new rule, the additional income that results from correcting that mistake now can be taken into account all in the preacquisition final target taxable year, rather than over the next four years (when the target is owned by the buyer), as had been the case historically. The four-year spread was always intended to be favorable to taxpayers — an incentive for them to correct an improper method. In M&A deals, however, the four-year spread often had the opposite effect, potentially triggering tax indemnity provisions and/or adjustments to the purchase price for the target. The new rule is a welcome change and a sensible solution for which the IRS should be applauded.

Here's how it works. Under new IRS guidance (Rev. Proc. 2015-13), the target in an "eligible acquisition transaction" can elect to take the full amount of the income resulting from the method change into account in the tax year the change is effective (which can be the target's final year before being acquired). For most target corporations, an eligible acquisition transaction means either (1) an acquisition of a stock ownership interest in the target by another party that either results in the acquisition of control of the target or causes the target's taxable year to end, or (2) an acquisition of the target's assets in the case of certain tax-free corporate reorganizations or liquidations. For all other targets (including a partnership or S corporation), an eligible acquisition transaction is an acquisition of an ownership interest in the target by another party that does not cause the target to cease to exist for federal income tax purposes. For example, the sale or exchange of a partnership interest that does not cause a "technical termination" of the partnership would be considered an eligible acquisition transaction.

Some special rules and limitations apply to the new election. Among them, the eligible acquisition transaction has to occur either in the tax year of the requested method change or in the subsequent tax year before the due date (including any extension) for filing the target's federal income tax return for the year of change. Once the election is made, it is irrevocable.

In addition to this election, the new IRS guidance introduces a number of other new rules in the accounting method area concerning, among other things, taxpayers that want to change their method of accounting while they are under audit by the IRS, method changes by controlled foreign corporations and the consequences of a taxpayer computing its additional income from a method change incorrectly. The new guidance generally is effective for method change applications filed after January 16, 2015, but some transition rules are provided.