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Tax Treatment of Deferred Revenue in a Taxable Stock Acquisition

MERGERS AND ACQUISITIONS, TAX
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The general rule under Internal Revenue Code §451 is that an item of income shall be included in gross income for the taxable year or receipt unless a method of accounting is used to include the income in a different period. Revenue Procedure 2004-34 allows taxpayers on the accrual method of accounting a limited deferral beyond the year of receipt for payments that qualify as advance payments. To qualify as an advance payment under the Revenue Procedure, the payment must: 1) be included in gross income under a permissible method of accounting for federal tax purposes, 2) be recognized by the taxpayer in revenues (in whole or part) in its applicable financial statement ("AFS") in a subsequent year, and 3) be a payment for goods or services or other defined items in Section 4 of the Revenue Procedure. A taxpayer meeting these requirements may elect to use the Deferral Method under Revenue Procedure 2004-34. The Deferral Method requires the recognition of the advance payment into gross income for the year of receipt to the extent revenue is recognized in its AFS, and the remaining amount in the next succeeding taxable year.

When a business combination (stock acquisition) occurs, financial accounting standards ("FASB") require the measurement of assets and liabilities at their fair value on the acquisition date. The difference in the carrying value on the books and the fair value on the closing date is recorded as an adjustment to retained earnings on the opening balance sheet of the acquirer and not included in post-acquisition book income. For tax purposes, the timing of when deferred revenue should be recognized has been treated inconsistently by taxpayers as stated in an AICPA letter to the IRS on February 13, 2015. The IRS recently provided guidance in an Office of Chief Counsel Memorandum (Number 201619009), stating that the purchase accounting rules do not eliminate the requirement to follow the Deferral Method. A FASB adjustment reducing the carrying value to fair value was determined to properly be treated as income in the year succeeding the year of receipt for tax purposes, in this case, the post-acquisition year. Buyers and sellers should carefully evaluate the impact of an acquisition and GAAP treatment to tax accounting methods.

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