This Month in M&A / Issue 2 / February 2013

M&A tax developments

This month features:

- New GLAM (AM2012-010) helps clarify IRS position on consolidated group 'end-of the-day,' 'next-day' rules
- New proposed GRA regulations address filing failures, other GRA administrative deficiencies

Did you know...?

When a consolidated group acquires a target corporation (Target), it is often necessary to allocate Target's taxable income for the year between the pre and post acquisition periods. Relatively little guidance exists to help taxpayers determine how to apply the so-called 'end-of-day' and 'next-day' rules with respect to certain Target deductions. The rules have been a frequent source of debate and controversy.

To address these issues, the IRS recently released AM 2012-010, a generic legal advice memorandum (GLAM) addressing application of the end-of-the-day rule and the next-day rule of Treas. Reg. Sec. 1.1502-76(b) in determining when Target should report certain deduction items with respect to liabilities incurred by it on the day it joins or leaves a consolidated group.

Facts in the GLAM

An acquiring corporation (Acquiring), a calendar-year taxpayer and the common parent of a consolidated group, acquires Target, a stand-alone corporation, during Acquiring's tax year. On the date of acquisition, Target incurs the following three separate liabilities, which are all assumed to become deductible on that date:

- Item 1 relates to nonqualified stock options and stock appreciation rights held by certain Target employees. Target is obligated to pay the holders certain amounts upon a change-in-control event, such as Target's acquisition.
- Item 2 relates to success-based fees, i.e., fees for services provided by financial advisers and investment banks in connection with the acquisition, the payment of which is contingent on successful closing of the acquisition.
- Item 3 arises from Acquiring's request that Target retire some of its outstanding debt. Before the acquisition, Acquiring and Target agree that Target will give its bondholders the opportunity to tender their bonds at a premium. The bondholders must tender their bonds before the acquisition date, but Target is not obligated to purchase them. After the acquisition, Target accepts the tendered bonds and uses its own funds or funds from Acquiring to pay the bondholders.

IRS analysis

Target joins Acquiring's consolidated group as a result of the acquisition. Under Treas. Reg. Sec. 1.1502-76(b), Target will have two short tax years during the calendar year: a short stand-alone tax year ending on the date of acquisition, and a short tax year that begins the following day as a member of Acquiring's consolidated group.

In certain situations, a taxpayer could ratably allocate its items across these short tax years; however, certain extraordinary items are ineligible for proration and must be allocated to the day they are taken into account. The IRS indicated in the GLAM that Items 1, 2, and 3 were extraordinary items, citing the portion of the definition of 'extraordinary item' under Treas. Reg. Secs. 1.1502-76(b)(2)(ii)(C)(7) and (9), relating to the discharge or retirement of indebtedness and compensation-related deductions, respectively.

The IRS seems to treat the success-based fees as compensation related fees. Alternatively, the IRS might have viewed success-based fees as an item that, if ratably allocated, would result in a substantial distortion of income under Treas. Reg. Sec. 1.1502-76(b)(2)(ii)(C)(14).

If extraordinary items are taken into account on the day of the acquisition, the allocation of those items depends on application of the end-of-the-day rule and the next-day rule of Treas. Reg. Sec. 1.1502-76(b):

- In general, the <u>end-of-the-day rule</u> in Treas. Reg. Sec. 1.1502-76(b)(1)(ii)(A) provides that a corporation becomes or ceases to be a member of a consolidated group at the end of the day on which its status as a member changes. Thus, items taken into account on the acquisition date generally are reported on Target's stand-alone return for its short tax year ending on the acquisition date.
- The <u>next-day rule</u> in Treas. Reg. Sec. 1.1502-76(b)(1)(ii)(B) is an exception to the end-of-the-day rule. The next-day rule provides that if a transaction occurs on the acquisition date and is properly allocable to the post-closing portion of Target's day, then the transaction is treated for US federal income tax purposes as occurring at the beginning of the day after the acquisition date. A determination as to whether a transaction is properly allocable to the portion of Target's day after the event resulting in Target's change in status will be respected if it is reasonable and consistently applied by all affected persons.

  The reasonableness of an allocation under the next-day rule depends on several factors, including (i) whether income, gain, deduction, loss, and credit are allocated inconsistently; (ii) whether the allocation reflects ownership of the stock before or after the event (if the item is from a transaction in the subsidiary's stock); (iii) whether the allocation is inconsistent with other

requirements under the Internal Revenue Code; and (iv) whether other facts exist that indicate that the transaction is not properly allocable to the portion of the day after the change event. The next-day rule was intended to prevent sellers from bearing tax liability for post-closing events that are under the buyer's control (and of which the seller may be unaware).

Items 1 and 2

The GLAM concluded that the end-of-the-day rule should apply to Items 1 and 2, and that application of the next-day rule would be inappropriate. The IRS reasoned that although Items 1 and 2 are triggered by the acquisition, they are attributable to transactions that precede the acquisition date (i.e., services performed by Target's employees and consultants) and result from events that were not within Acquiring's control. Thus, the next-day rule does not apply because Items 1 and 2 are not attributable to a transaction occurring on the acquisition date that is properly allocable to the post-closing portion of Target's day.

Item 3

The IRS concluded that it may be appropriate to apply the next-day rule to Item 3 because (i) the deduction for Item 3 arises as a result of a transaction on the acquisition date (i.e., Target's repurchase of the tendered bonds); (ii) the transaction occurs in the post-closing portion of the acquisition date; and (iii) the transaction occurs based on a post-closing decision made by Target while under Acquiring's control. Notably, Target was under no obligation to repurchase the bonds before the acquisition. Therefore, the IRS concluded that it is reasonable for Target to report the premium deduction on its tax return for the short tax year beginning the following day under the next-day rule.

Observations

The GLAM provides insight into current IRS thinking on application of the end-of-the-day and next-day rules. At the same time, as with other recent guidance on the matter (e.g., TAM 200548022, holding that investment banking fees paid by Target on the acquisition date were not next-day expenses), the GLAM is not precedential.

The determination to apply the next-day rule is heavily fact-dependent. It is possible to imagine scenarios involving Items 1, 2, and 3 where the conclusion might be different based on relatively minor modifications to the terms of the various agreements. For instance, query whether the IRS would have determined that Item 1 was properly allocable to the pre-closing portion of the day if the employees were paid 2.5 months after closing. In that scenario, the payments should be treated as deferred compensation and taxed on a cash basis.

Furthermore, the IRS did not address all of the factors for determining whether an allocation of the post-closing portion of the day is reasonable, focusing instead on whether it may be appropriate to apply the next-day rule to Item 3. It would be helpful if in future guidance the IRS were to provide an analysis with respect to all the factors included in the determination. That said, taxpayers and advisors should look to the GLAM as a starting point when considering what types of terms or provisions might impact their analysis of this issue.

For more information, please contact Bart Stratton, Arthur Sewall, or Matthew Lamorena.

Treasury regulations

Proposed Section 367 GRA regulations

In general

US persons who either fail to timely file a gain recognition agreement (GRA) or related documents under the Section 367(a) regulations, or file such documents with material deficiencies, would be subject to modified rules for obtaining relief under proposed regulations released on January 30, 2013. The proposed regulations also address failures to file (and deficient filings of) certain documents required in the

Section 6038B regulations concerning outbound transfers, as well as Form 926 (Return of U.S. transferor of property to a Foreign Corporation), and the Section 367(e)(2) regulations for liquidations into foreign corporations.

The current GRA regulations require taxpayers seeking GRA filing relief to meet a 'reasonable cause' standard. By contrast, the proposed regulations would only require the US person to demonstrate that the failure was not 'willful.' On the other hand, the proposed regulations would continue to apply the current 'reasonable cause and not willful neglect' standard to US persons seeking relief from failure to report penalties under Section 6038B.

Also under the proposed regulations:

- The determination of whether the failure to file a GRA or to comply in all material respects with the GRA regulations was willful would be determined based on all the relevant facts and circumstances.
- The proposed regulations illustrate application of the 'willful' standard through a series of examples.
- The proposed regulations would eliminate the requirement that the IRS respond to requests for relief for missed and deficient GRA filings within 120 days of receipt of the request.
- The proposed regulations would extend the requirement to file Form 926 to outbound stock transfers if the US transferor files a GRA.
- The proposed regulations would provide relief rules similar to the proposed GRA relief rules for failures to file statements required by Treas. Reg. Secs. 1.367(a)-3(c)(6), (c)(7), (d)(2)(vi)(B)(1)(ii), and 1.367(e)-2.
- In general, the new rules are proposed to apply with respect to documents or statements required to be filed with a timely filed return on or after the date final regulations are published, as well as to requests for relief submitted on or after that date.
- The IRS directive put in place in 2010 (the GRA Directive), which applies to timely filed but deficient GRAs and related documents, was not withdrawn in conjunction with release of the proposed regulations. The GRA Directive likely will be revoked when the regulations are finalized, if not sooner.

Proposed GRA relief provisions

With respect to failures to file GRAs, the proposed regulations would modify the current relief provisions under Treas. Reg. Sec. 1.367(a)-8(p) requiring the taxpayer to prove reasonable cause, instead providing that a taxpayer instead demonstrate that any failure to comply is not a 'willful' failure as defined in the context of other civil penalties. Whether a failure is 'willful' would be determined based on all the facts and circumstances.

In civil contexts involving a requirement to report or disclose certain information to the IRS, 'willfulness' has been defined as conduct that is voluntary, rather than accidental or unconscious. The Supreme Court has stated that acting with 'willful blindness' to obvious or known consequences of one's action also satisfies a willfulness requirement in the civil context.

As compared to the reasonable cause standard currently applicable to taxpayers that have failed to timely file an initial GRA (and for whom relief under the GRA Directive therefore currently is not available), the proposed regulations' wilful failure standard would provide taxpayers a more favorable standard for obtaining relief.

As noted above, the current 'wilful failure' standard is intent-based; however, in some circumstances (based on all the relevant facts and circumstances) conduct that is not willful itself, but that demonstrates a taxpayer's disregard of the rules and/or lack of diligence, may be considered willful. When finalized, the regulations may expand on what constitutes this type of conduct or may provide more illustrative examples. Generally, under the reasonable cause standard, reasonable reliance upon

competent tax advisors can provide taxpayers with reasonable cause for failures to comply. Such reasonable reliance might be deemed acceptable under the new 'willful' standard.

In a change from the current regulations, the IRS will would not be required to respond to relief requests within 120 days of receipt of the request.

Examples of willful failure to file

The proposed regulations provide additional insight as to what would constitute a valid GRA – i.e., a GRA that is 'timely filed' and 'completed in all material respects' – through the use of four examples.

Of particular importance, in Example 1 a taxpayer with a history of timely filing valid GRAs is determined not to have a willful failure to file because the failure to timely file the GRA was an 'isolated oversight.' When juxtaposed with Example 2, in which a taxpayer was determined to have a wilful failure in part because of its "history of failing to file required tax and information returns in general and GRAs in particular," it appears that the IRS would give particular importance to a taxpayer's prior GRA filing experience, diligence, and protocols in determining whether the failure to file was a willful failure.

Example of a willful failure to comply

Example 3 confirms the government's position that a failure to provide either the fair market value or the basis of the transferred stock invalidates a GRA. Under the example, a taxpayer responding 'available upon request' for either the fair market value or the basis on a GRA is treated as willfully failing to comply with the GRA regulations and thus would not be entitled to relief under the proposed regulations.

Proposed GRA and Form 926 coordinating rule

As noted above, under the current regulations a US transferor is relieved from its obligation to report the stock transfer on Form 926 and from the associated penalties under Section 6038B if it has timely filed a proper GRA. The proposed regulations require that a Form 926 be filed in all cases in which a GRA is filed. Specifically, the US transferor must include on Form 926 the basis and fair market value of the property transferred. However, if the only asset being transferred is stock, the taxpayer only would need to fill out Part I (US Transferor Corporation Information) and Part II (Transferee Foreign Corporation Information) of Form 926.

The proposed GRA regulations continue to apply the current 'reasonable cause and not willful neglect' standard to US persons seeking relief from the Section 6038B penalty.

The proposed regulations also explicitly fold the GRA into the Section 6038B reporting requirements. Thus, a failure to file a GRA, or filing of a GRA with a material deficiency, could (without the appropriate relief) trigger both gain on the outbound stock transfer and a Section 6038B reporting penalty.

Proposed relief provisions for certain reporting obligations

Whereas the current regulations are silent on the issue, the proposed regulations would apply the wilful failure standard (as it applies to GRAs) to failures to file the required documents and statements under Treas. Reg. Secs. 1.367(a)-3 and 1.367(e)-2 discussed above.

The proposed regulations would apply the willful failure standard only to those filings outlined under the applicable statutory or regulatory provisions of Section 367. The proposed regulations would maintain the reasonable cause standard for failures and deficiencies in reporting under Section 6038B, such as Form 926.

Observations

The proposed regulations appear taxpayer-friendly in that they would replace the existing 'reasonable cause' standard in the current GRA relief regulations with a less strict 'willful failure' standard. Furthermore, the proposed regulations do not revoke

and replace the temporary GRA Directive that applies to timely filed but deficient GRAs and related documents.

In light of the temporary nature of the GRA Directive, US persons that have entered into GRAs should review all GRAs and related statements, and perfect such filings as appropriate. In particular, taxpayers should determine if any of their GRAs used 'available upon request' or similar language for either the fair market value or basis of the transferred stock. The proposed regulations make clear that the IRS considers such GRAs materially deficient and will only provide relief to correct them under the temporary GRA Directive.

In addition, taxpayers should consider their current and future protocols for ensuring GRA compliance, as it appears the IRS will assess the taxpayer's protocols in making future relief determinations. Taxpayers may benefit from demonstrating effective protocols for ensuring GRA compliance and that any future errors would be an 'isolated oversight.'

For more information, please contact Marty Collins, Carl Dubert, or Sean Mullaney.

PwC M&A publications

In an article titled, *Better Late than Never: The Proposed CERT Regulations,* published in the Journal of Corporate Taxation (January/February 2013), Washington National Tax Services' authors William Sutton and Rob Melnick discuss the proposed corporate equity reduction transaction (CERT) regulations.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

Tim Lohnes, *Washington, DC*
+1 (202) 414-1686
timothy.lohnes@us.pwc.com

Rich McManus, *Washington, DC*
+1 (202) 414-1447
rich.mcmanus@us.pwc.com

Art Sewall, Washington, *DC*
+1 (202) 414-1366
arthur.w.sewall@us.pwc.com

Matthew Lamorena, *Washington, DC*
+1 (202) 312-7626
matthew.lamorena@us.pwc.com

Matthew Manning, *Washington, DC*
+1 (202) 346-5014
matthew.e.manning@us.pwc.com

Jon Lewbel, *Washington, DC*
+1 (202) 312-7980
jonathan.lewbel@us.pwc.com

This issue's contributors

Marty Collins, *Washington, DC*
+1 (202) 414-1571
marty.collins@us.pwc.com

Sean Mullaney, *Washington, DC*
+1 (202) 495-9545
sean.w.mullaney@us.pwc.com

Carl Dubert, *Washington, DC*
+1 (202) 414-1873
carl.dubert@us.pwc.com

Horacio Sobol, *Washington, DC*
+1 (202) 312-7656
horacio.sobol@us.pwc.com

Bart Stratton, *Washington, DC*
+1 (202) 312-7531
bart.stratton@us.pwc.com

Wade Sutton, *Washington, DC*
+1 (202) 346-5188
wade.sutton@us.pwc.com

Rob Melnick, *Washington, DC*
+1 (202) 312-7906
robert.s.melnick@us.pwc.com