

New GLAM helps clarify IRS position on consolidated group 'end-of-the-day' and 'next-day' rules

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In brief

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-the-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 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.

In detail

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 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 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 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 Reg. sec. 1.1502-76(b):

In general, the end-of-the-day rule in 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 next-day rule in 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 determination to apply the next-day rule is heavily fact-dependent. It is possible to imagine scenarios involving Items 1, 2, and 3 in which 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 more than 2.5 months after closing. In that scenario, the payments may 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 affect their analysis of this issue.

The takeaway

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.

Let's talk

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

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