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Proposed Treasury Regulations Aim to Curb Elective Treatment of M&A Transaction Costs

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Some taxpayers have taken the position that an acquiring corporation and a target corporation, when the target corporation is joining the acquiring corporation's consolidated corporate group, can choose between taking certain acquisition-related expenses into account in the target's pre-acquisition taxable year or the post-acquisition consolidated taxable year. If included in the post-acquisition consolidated taxable year, this has the effect of permitting the use of these deductions to offset the income of other group members without limitation under section 382 of the Code. On March 5, 2015, Treasury issued proposed regulations that would reverse this result.

The Next Day Rule under Current Law

The parent of a consolidated group generally must include each subsidiary's items of income, gain, deduction, loss and credit on the parent's consolidated return. When a corporation is acquired by a consolidated group, its items of income, gain, deduction, loss and credit must be allocated either to the period before or to the period after it became a member of the group. The current regulations provide that a corporation is generally considered to join or leave a consolidated group at the end of the day on which its status as a member changes (the "end of the day" rule), and its taxable year is treated as ending at that time.

Application of the end of the day rule means that tax items related to the acquisition of a target corporation (*e.g.*, bankers' fees or compensation paid to employees on a change in control) are allocated to the target's pre-acquisition taxable year. However, the current Treasury regulations also include a "next day" rule as an exception to the end of the day rule. Under the next day rule, transactions that occur on the day of the member's change in status and are "properly allocable" to the portion of the day after the event that resulted in the change in status are treated as occurring at the beginning of the following day. In effect, the next day rule allocates a target corporation's tax items to its post-acquisition taxable year, and so to the acquiror's consolidated return.

For purposes of the next day rule, the current regulations add that a determination that a transaction is properly allocable to the post-change portion of a day will be respected if it is "reasonable and consistently applied," and further provide examples of what will be considered reasonable. From the IRS perspective, taxpayers have taken advantage of this to allocate acquisition-related expenses to the year that is most advantageous to the parties, resulting in controversy between taxpayers and the IRS as to how the next day rule should be applied.[1]

As an example of when the next day rule ought to apply, a Treasury official recently cited the sale of a target corporation's assets immediately after the acquisition of the target corporation.[2] In that case, if the end of the day rule applied, the seller of the target corporation would bear the tax consequences of a transaction undertaken by the buyer. Similarly, in a general legal advice memorandum written in 2012 (the "2012 Memo"), the IRS concluded that the next day rule should apply to a deduction for a prepayment premium paid by a target corporation on retirement of its bonds because the decision to retire the bonds was not finally made until after the closing of the acquisition.[3]

But the IRS concluded that the next day rule should not apply to a target corporation's compensation deduction for payments made when an acquisition triggered change in control payments to employees holding nonqualified stock options and stock appreciation rights[4] or to deductions for financial services and investment banker fees paid by recently-acquired corporations in connection with their respective acquisitions by a consolidated group.[5]

The Next Day Rule under the Proposed Regulations

The preamble to the proposed regulations explains that some taxpayers have interpreted the next day rule as elective, giving them flexibility in reporting tax items that result from transactions occurring on the day of a change in status. According to the preamble, this electivity is inappropriate because taxpayers may use it to allocate tax items in a manner that does not clearly reflect taxable income, which would be inconsistent with the purpose of the consolidated return regulations.

The proposed regulations would revise the next day rule to mandatorily apply to "extraordinary items," (described below) that result from a transaction occurring after the target corporation has been acquired but on the same day as the acquisition. Importantly, the revised next day rule explicitly does not apply to any extraordinary item that becomes includible or deductible simultaneously with the acquisition.

An "extraordinary item" is defined in relation to an election in the current regulation that permits a target corporation, when allocating tax items to the periods when it was or was not a member of a consolidated group, to allocate tax items ratably to the days in its taxable year. This allocation by days does not apply to extraordinary items, which must be allocated entirely to the day on which they are properly taken into account.

The current list of extraordinary items includes gains and losses from the sale of various types of property, compensation deductions from bonus, severance and option cancellation payments made in connection with a change in control, and any item that, in the opinion of the IRS, would substantially distort income if ratably allocated. The proposed regulations would add to this list any deduction for fees for services rendered in connection with a change in status (*i.e.,* leaving or joining a consolidated group).

Thus it appears that, under the proposed regulations, the next day rule should continue to apply (as described above) to a post-acquisition sale of assets by the buyer, or to a deduction related to a post-acquisition decision to retire a target corporation's debt. To limit application of the next day rule in the future, however, the proposed regulations add an example stating that payments in cancellation of stock options and contingent fees paid to financial consultants only upon closing are both extraordinary items that are not subject to the next day rule.

Enhanced Anti-Avoidance Rule

The current regulations provide that if any person acts with a principal purpose contrary to the purposes of the regulations to substantially reduce the federal income tax liability of any person, then adjustments must be made as necessary to carry out the purposes of the regulations.

The proposed regulations clarify that the anti-avoidance rule may apply to situations involving a modification of an existing contract or agreement in anticipation of a change in status so as to shift an item between the periods before or after a target corporation joined or left a consolidated group.

Other Changes in the Proposed Regulations

If an S corporation is acquired by a consolidated group, the S election is terminated. The current regulations provide that the S corporation's taxable year is treated as ending at the end of the day preceding (rather than the day of) the acquisition.[6] To mirror the revised next day rule, the proposed regulations include a "previous day" rule for S corporations. Under the previous day rule, if an extraordinary item results from a transaction that occurs before or simultaneous to (but on the same day as) the acquisition of a target S corporation, then that transaction will be treated as occurring at the end of the previous day. The effect of this change is to ensure that extraordinary items are allocated to buyers or to sellers in the same way, regardless of whether the target corporation had made an S election.

The proposed regulations also include a provision that would apply the end of the day and next day rules when calculating any section 382 limitation applicable to a newly-acquired target corporation. (Section 382 of the Code may limit a target corporation's ability to use pre-acquisition operating losses to offset post-acquisition income.) Specifically, the target corporation's net unrealized built-in gain or loss would be calculated taking into account items subject to the end of the day rule (which items would not be treated as occurring during the recognition period), but not items subject to the next day rule (which would be treated as occurring during the recognition period). Where this rule applies, it would further restrict an acquiring group's ability to access a target corporation's net operating losses.

The Road Ahead

Taxpayers are now on notice that Treasury and the IRS oppose application of the next day rule to acquisition-related expenses. Although the proposed regulations remain open for comment and are not effective until finalized, one Treasury official has suggested in an early (and unofficial) response to criticism that the changes to the next day rule will be finalized in their proposed form.[7]

[1] REG-100400-14, 80 FR 12097, at 12099 (Mar. 6, 2015).

[2] Amy S. Smith, *Axelrod Responds to Criticism of Proposed Next-Day Regs*, Tax Notes Today, March 6, 2015 (2015 TNT 45-8).

[3] GLAM 2012-010.

[4] *Id.*

[5] TAM 200548022.

[6] This is done to avoid a one-day C corporation return that could strand deductions.

[7] See note 2, above.

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