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Memorandum

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subject: Allocation of Certain Items Under Treas. Reg. Section 1.1502-76(b)(1)(ii)

This memorandum discusses the effect of Treas. Reg. section 1.1502-76(b)(1)(ii) on determining the taxable year in which a corporation ("Target") should report certain items of deduction with respect to liabilities that Target incurs on the day Target leaves or joins a consolidated group (a "change in status"). This memorandum should not be used or cited as precedent.

ISSUE

Under Treas. Reg. section 1.1502-76(b)(1)(ii), should items of deduction with respect to certain liabilities that Target incurs on the date of its Acquisition by Acquiring be reported on Target's tax return for the short taxable year ending on the Acquisition date, or should such items instead be reported on Target's tax return for the short taxable year beginning the following day?

CONCLUSIONS

Deductions arising from the liabilities described in Items 1 and 2 below are governed by the "end-of-the-day rule" in Treas. Reg. section 1.1502-76(b)(1)(ii)(A)(1) and are properly reported on Target's tax return for the short taxable year ending on the Acquisition date. In contrast, deductions arising from the liabilities described in Item 3 below may be properly reported on Target's tax return for the short taxable year beginning the following day under the “next-day rule” in Treas. Reg. section 1.1502-76(b)(1)(ii)(B).

FACTS

Acquiring is a calendar-year taxpayer and the common parent of a consolidated group (the “Acquiring Group”). On November 30, 20XX, a subsidiary in the Acquiring Group merges with and into Target (a calendar-year, accrual-basis C corporation) and Target’s shareholders exchange their Target stock for cash (the “Acquisition”). Target thus becomes a member of the Acquiring Group on November 30, 20XX. No election under section 338 is made with respect to the Acquisition.[1]

Assume that each item discussed below is deductible by Target and that the item becomes deductible on November 30, 20XX (the “Acquisition date”).

Item 1

At the time of the Acquisition, Target has outstanding nonqualified stock options and stock appreciation rights (“SARs”) issued to certain of its employees. The options did not have a readily ascertainable fair market value when they were granted. Furthermore, the options and the SARs do not provide for a deferral of compensation as defined in Treas. Reg. section 1.409A-1(b). Under the terms of its agreements with its employees, Target is obligated to pay its employees certain amounts for and in cancellation of their stock options and SARs in the event of a change in control.

The Acquisition causes a change in control of Target and, as a result, Target’s obligation to pay its employees with respect to their stock options and SARs becomes fixed and determinable at the time of the Acquisition. Within several days after the Acquisition, Target pays its employees (using its own funds or funds received from Acquiring) the amounts required under the terms of the option and SAR agreements.

Item 2

Target engages financial advisory and investment banking firms to provide certain consulting services for Target in connection with the Acquisition. Pursuant to the terms of the engagement letters, Target’s obligation to pay for these services is contingent upon the successful closing of the Acquisition. Target’s obligation to pay the consultants becomes fixed and determinable upon closing.

Item 3

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[1] This GLAM applies generally to situations where a C corporation becomes or ceases to be a member of a consolidated group. These facts illustrate just one of many situations to which this GLAM potentially applies. For example, the results would be the same if Target were acquired in a tax-free transaction or if Target were acquired out of another consolidated group.

In contemplation of the Acquisition, Acquiring requests that some of Target's outstanding debt be retired. Before the Acquisition, Target and Acquiring agree that Target will give its bondholders the opportunity to tender their bonds at a price that reflects a premium over the adjusted issue price. Under the terms of the tender offer, bondholders may tender their bonds to Target (or, having done so, may withdraw their tender) by November 28, 20XX, but Target is not obligated to purchase any of the tendered bonds. On November 30, 20XX, after the Acquisition has closed, Target accepts the tendered bonds for reacquisition. Later that day, using its own funds or funds received from Acquiring, Target retires the bonds at a premium.

LAW AND ANALYSIS

The Acquisition causes Target to become a member of the Acquiring Group on the Acquisition date. Under Treas. Reg. section 1.1502-76(b)(1)(ii)(A)(1), Target's taxable year as a stand-alone C corporation ends on November 30, 20XX. Target thus will have two short taxable years for calendar year 20XX: one (as a stand-alone C corporation) that ends on the Acquisition date; and another (as a member of the Acquiring Group) that begins on December 1 and ends on December 31, 20XX.

Treasury Reg. section 1.1502-76(b)(2)(ii) provides a rule under which, in certain cases, a corporation entering or leaving a consolidated group may elect to prorate its items between the two short taxable years resulting from its change in status. However, certain extraordinary items cannot be prorated and must be allocated to the day they are taken into account. Treas. Reg. section 1.1502-76(b)(2)(ii)(B)(1). Deductions arising from the liabilities described above in Items 1 - 3 are extraordinary items ineligible for proration and must be allocated to November 30, 20XX. Treas. Reg. section 1.1502-76(b)(2)(ii)(C)(7) and (9).

Under the "end-of-the-day rule" in Treas. Reg. section 1.1502-76(b)(1)(ii)(A), if a corporation (S) becomes or ceases to be a member of a consolidated group, it becomes or ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends for all Federal income tax purposes at the end of that day. Accordingly, under this general rule, the deductions described above would be reported on Target's stand-alone tax return for the short taxable year ending November 30, 20XX.

The "next-day rule" in Treas. Reg. section 1.1502-76(b)(1)(ii)(B), however, provides an exception to the end-of-the-day-rule. If, on the day of S's change in status, a transaction occurs that is properly allocable to the portion of S's day after the event resulting in the change, then S (and all persons related to S under section 267(b) immediately after the event) must treat the transaction for all Federal income tax purposes as occurring at the beginning of the following day. A determination as to whether a transaction is properly allocable to the portion of S's day after the event resulting in S's change in status will be respected if it is reasonable and consistently applied by all affected persons. In determining whether an allocation is "reasonable,"

certain factors enumerated in section 1.1502-76(b)(1)(ii)(B) are among those to be considered. For example, if an item of deduction or loss is from a transaction with respect to S stock, one factor to be considered is whether it reflects ownership of the stock before or after the transaction. Section 1.1502-76(b)(1)(ii)(B)(2).
In the present case, the event resulting in Target's change in status is the Acquisition. For the next-day rule to apply, a transaction must occur on the Acquisition date (November 30, 20XX) and must be properly allocable to the portion of that date after the Acquisition closes.

With respect to Items 1 and 2, Target's obligation to pay and the amount of its liability become fixed and determinable upon closing. These items are not "from a transaction with respect to S stock"; rather, they are items from transactions that precede the Acquisition and that involve the performance of services for Target by employees and consultants, respectively. Moreover, although consummation of the Acquisition is the condition that fixes S's liability to make these payments, the corresponding deductions are not attributable to any "transaction" on the Acquisition date other than the Acquisition itself. Accordingly, the next-day rule is inapplicable by its terms, and it is neither proper nor reasonable to allocate deductions from the liabilities in Items 1 and 2 to the post-closing portion of the Acquisition date. Instead, these deductions are governed by the end-of-the-day rule and are properly reported on Target's short-year return for the taxable year ending November 30, 20XX.

Reporting these deductions on Target's last stand-alone tax return is consistent with the purpose underlying the next-day rule. The next-day rule was added to the final Treasury regulations in 1994 in response to comments that a seller should not bear tax liability for post-closing events that are under the buyer's control (and of which the seller may be unaware). In the case of Items 1 and 2, Target entered into agreements with its employees and consultants, respectively, prior to the Acquisition. Deductions with respect to these items thus result from events that are not within the control of Acquiring, and application of the next-day rule would be inappropriate.

With respect to Item 3, in contrast, application of the next-day rule may be appropriate. As noted above, Target retired the tendered bonds at a premium for cash after the closing. Since a deduction for this item arises as a result of a payment in the post-closing portion of the Acquisition date based on a decision made by Target after the closing, it is reasonable for Target to report the deduction on its tax return for the short taxable year beginning December 1 and ending December 31, 20XX.

If you have any additional questions on this matter, please contact Russell Jones at (202) 622-7770.

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