

TAX LAWFLASH

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IRS PROPOSES CURTAILING “NEXT-DAY RULE” IN CORPORATE ACQUISITIONS

Are you a day late?

On March 5, the Internal Revenue Service (the IRS) published proposed regulations (REG-100400-14, RIN 1545-BM14) (the Proposed Regulations) that would place strict new guidelines on the “next-day rule” and other rules used to determine how to treat corporations’ income and deductions on the day that they leave or join a consolidated group. These rules, if finalized as proposed, would restrict the flexibility that buyers and sellers in many corporate transactions currently enjoy to allocate closing-date income and expense items between the seller’s and the buyer’s tax period.

Under existing regulations, when a corporation enters or leaves a consolidated group, its taxable year closes at the end of the day on which its status as a member of the group changes, and a new taxable year begins the following day. Accordingly, upon entering a consolidated group (i.e., upon purchase by the group), a corporation’s items of income and loss for the day on which it enters the group are generally included in its separate tax return for the tax year that ends at the close of the day of the sale. Conversely, when a corporation leaves a consolidated group (i.e., upon a sale to a third party), its items of income and loss for the day of the sale are generally included in the group’s tax return for the year in which the sale occurs.

Existing regulations provide two exceptions to the above rule. The first exception harmonizes the S corporation rules with the consolidated return rules to avoid the necessity of an S corporation that is acquired by a consolidated group having to file a “one-day” C corporation return for the date of the sale.

The second, more significant, exception is the “next-day” rule, which provides that transactions that occur on the day that a corporation enters or leaves a consolidated group and that are “properly allocable” to the portion of the day after the transaction’s consummation are treated as occurring at the beginning of the following day for all federal income tax purposes. Under current regulations, a determination as to whether a transaction is “properly allocable” to the portion of the day after the sale is respected if it is reasonable and consistently applied by all affected persons, and certain criteria are used in deciding whether the determination is “reasonable.”

The next-day rule’s effect, particularly when viewed in light of the IRS’s willingness to respect reasonable determinations that parties arrive at in that regard, has been to afford buyers and sellers in many corporate transactions a fair amount of flexibility in allocating items of income or expense that are accrued or paid on the date of the sale (including many closing-date transaction expenses, such as third-party fees, certain types of compensation, etc.) between the seller’s and buyer’s tax period.

However, the IRS has had a difference in opinion with some corporations about how these companies have interpreted the next-day rule. In the preamble to the Proposed Regulations, the IRS expressed concern that some taxpayers have interpreted the existing next-day rule as providing essentially an election as to which party would bear the burden, or enjoy the benefit, of closing-date tax items. This has led to numerous controversies between the IRS and taxpayers over the proper allocation of such items.

Accordingly, the Proposed Regulations would revise the existing next-day rule so that the rule is mandatory, rather than elective, with respect to “extraordinary items”—generally, items that result from a transaction on the date that a corporation enters or leaves a consolidated group (but after the event that results in that change in status) and that would otherwise be taken into account by the corporation on that day. If these criteria are met, the transaction that results in the extraordinary item will be treated as occurring at the beginning of the day following entry into, or exit from, the group for purposes of determining the period in which the item must be reported. At the same time, the proposed next-day rule would *not* apply to any “extraordinary item” that becomes includible or deductible simultaneously with the event that causes the corporation to enter or leave the group.

The only specific category of “extraordinary items” included in the Proposed Regulations is a category for “compensation-related deductions” in connection with a corporation’s change in status. This category would include a deduction for fees for services rendered in connection with that change or payments made in cancellation of employee stock options in connection with an acquisition. The deduction for the accrual of that expense is now an “extraordinary item.” However, if the accrual of the deduction is simultaneous with the transaction’s closing, i.e., if an adviser’s fee, or the right to receive payments in respect of options, is contingent on, and accrues as of, the transaction’s closing, the deduction for that expense will *not* be subject to the next-day rule but will be allowable only in the corporation’s preclosing tax year.

The effect of the above rules on the types of expenses incurred in routine corporate acquisitions will depend to some extent on what is included in the list of “extraordinary items” when the Proposed Regulations are finalized. It appears, however, that most transaction-contingent compensation deductions will be required to be reflected on the return of the acquired corporation for the year ending with its entry into, or exit from, the consolidated group. The value of such deductions on the acquired corporation’s preclosing return can be significantly less than the value on the acquiring group’s return if the acquired corporation has net operating losses but the acquiring group does not.

Moreover, as a general matter, if the Proposed Regulations are finalized in their current form, they could significantly restrict the flexibility that buyers and sellers have heretofore enjoyed to allocate items of closing-date income and expense between them for tax purposes. The IRS apparently disagrees with the view of many tax advisers that the current regulations do, in fact, provide for a degree of electivity when it comes to allocating closing-date items.

The IRS is seeking taxpayer comment on the Proposed Regulations, including on whether any extraordinary items on the list should be modified and whether items should be added or deleted. Comments and requests for a public hearing are due by June 4.

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