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April 2013

What Day Is It? - IRS Speaks Out on Acquisition Deduction Issues

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Corporate tax concerns dictate the structure of many merger and acquisition transactions. A recurring issue in the consolidated tax return context is whether the buyer group (Buyer) will be able to claim a deduction for certain transaction-related expenses or whether a deduction must be claimed by the target (Target), which often turns on application of the "which day?" rule.

When a Target becomes part of the Buyer's consolidated tax group, the Target normally has two short tax years (the tax year ending on the date of the transaction and the tax year starting the next day).

- End-of-the-Day Rule (Treasury Regulation section 1.1502-76(b)(1)(ii)(A)) -- Under the general "end-of-the-day" rule, in such a case, the Target's tax year ends as of the end-of-the-day of the transaction (normally creating a short tax year for the Target) and matters occurring with respect to the Target that occur through the end-of-that-day generally are reported entirely on the Target's tax return (unless special pro-ration rules apply) and matters that occur the next day (after the transaction) are reported on the buyer's consolidated return (which then includes the Target and normally gives rise to a second short Target tax year).
- Next-Day Rule (Treasury Regulation section 1.1502-76(b)(1)(ii)(B)) -- Under the "next-day" rule, in such a case, although the Target's tax year ends as of the end-of-the day of the transaction, certain items that properly are allocable to the stub portion of the day after the transaction actually occurs can be treated as though they happened the next day and reported on the Buyer's consolidated return as long as this treatment is "reasonable and consistently applied by all affected persons." The intent of the "next-day rule" is to prevent sellers from bearing tax liability for post-closing events that are not under the seller's control.

Thus, under the general end-of-the-day rule, certain extraordinary Target transaction-related expenses, such as the cash-out of stock options and stock appreciation rights and payment of advisor fees normally will be allocated to the Target's short taxable year that includes the transaction date. If Target has no tax liability (e.g., because of net operating losses), the deduction may not be as valuable as it would be if it could be claimed by the Buyer under the special next-day rule. It is for this reason that many Buyers would like to apply the next-day rule so that they can utilize the deductions in their consolidated tax return).

In the past, the IRS informally warned taxpayers not to seek technical advice on this issue, because they might not be happy with the IRS' position. These IRS statements were prescient, as it recently released a generic legal advice memorandum (GLAM) providing guidance on the applicability of the "which day" rule in the acquisition context.[1]

In the hypothetical scenario posed in the GLAM, a Target is acquired by a Buyer (which is part of a consolidated tax group) by way of a reverse triangular merger in which a subsidiary of Buyer merges with and into Target in a taxable cash-for-stock exchange.[2] The GLAM addresses three extraordinary items of deduction:

- Nonqualified Stock Options and Stock Appreciation Rights (SARs) – Target is obligated to cash out non-qualified, 409A-exempt stock options and SARs (that did not have a readily ascertainable value at grant) held by Target's employees on a change in control.
- Success-based Advisory Fees – Target is obligated to pay financial advisory and investment banking firms for their consulting services on the closing of the acquisition.
- Bonds – Parent and Target agree that Target will offer its bondholders the opportunity to tender their bonds at a premium prior to the closing of the acquisition and be paid following the acquisition.

As explained above, determination of when the extraordinary items are accounted for depends on application of the "end-of-the-day" and the "next-day" rules and many taxpayers historically have applied the next-day rule to the types of payments described in Items 1 and 2.

According to the GLAM, items 1 (the equity awards) and 2 (the advisor fees) should be deducted under the "end-of-the-day rule" because they involve the performance of services by the employees and consultants of Target which precede the acquisition date, and the obligation to pay the stock options, SARs and advisory fees becomes fixed and determinable at and upon the closing of the acquisition. Because of this pre-existing obligation, the payment and deduction of these items are not within the control of Parent and renders the "next-day rule" inapplicable, regardless of whether the payments are funded by Parent or if they are made days after the transaction.

With respect to item 3, the GLAM concludes that application of the "next-day rule" is appropriate because the decision to pay the bonds and the actual payment of the bonds occurs following the close of the acquisition. Since Parent has taken control of Target when the determination and payments are made, application of the "next-day rule" is appropriate.

Because equity-related cash-outs and advisory fees often are significant, buyers and sellers alike will want to be armed with the IRS' position, as articulated in the GLAM, during negotiation and may wish to consider whether it is appropriate to stake out a different tax position.

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[1] GLAMs are not to be used or cited as precedent, but they are nonetheless often a useful window into the IRS' current position on the covered matters.

[2] The GLAM notes that the analysis would be the same if the Target had been acquired in a tax-free transaction or if the Target were acquired out of another consolidated tax group.

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