Planning and Pitfalls in Consolidated Returns

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Allocation of Income When a Member Joins or Leaves the Group
THE “END OF DAY RULE”

- Treas. Reg. § 1.1502-76(b)(1)(ii)(A) provides that if a corporation becomes or ceases to be a member of a consolidated group during the year, “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.”

- Consequently, where a subsidiary is sold, items of income and deduction that arise on the Closing Date are generally taken into account by the selling consolidated group.

- This normally requires a closing of the books as of the end of the Closing Date.
  - There is a provision which permits the parties to elect to ratably allocate items between the pre-closing and post-closing portions of the taxable year. The ratable allocation election cannot be made for certain “extraordinary items.” Treas. Reg. § 1.1502-76(b)(2)(ii).
  - A separate provision allows items for only the month in which the closing occurs to be ratably allocated. Treas. Reg. § 1.1502-76(b)(2)(iii).
THE “END OF DAY RULE”

- Ratable allocation cannot be used for certain “extraordinary items”:
  - Any item from the disposition or abandonment of a capital asset as defined in section 1221;
  - Any item from the disposition or abandonment of property used in a trade or business as defined in section 1231(b);
  - Any item from the disposition or abandonment of an asset described in section 1221(1), (3), (4), or (5), if substantially all the assets in the same category from the same trade or business are disposed of or abandoned in one transaction (or series of related transactions);
  - Any item from assets disposed of in an applicable asset acquisition under section 1060(c);
  - Any item carried to or from any portion of the original year (e.g., a net operating loss carried under section 172), and any section 481(a) adjustment;
  - The effects of any change in accounting method initiated after S's change in status;
  - Any item from the discharge or retirement of indebtedness (e.g., cancellation of indebtedness income or a deduction for retirement at a premium);
THE “END OF DAY RULE”

- Any item from the settlement of a tort or similar third-party liability;
- Any compensation-related deduction in connection with S's change in status (including, for example, deductions from bonus, severance, and option cancellation payments made in connection with S's change in status);
- Any dividend income from a nonmember that S controls within the meaning of section 304 at the time the dividend is taken into account;
- Any deemed income inclusion from a foreign corporation, or any deferred tax amount on an excess distribution from a passive foreign investment company under section 1291;
- Any interest expense allocable under section 172(h) to a corporate equity reduction transaction;
- Any credit, to the extent it arises from activities or items that are not ratably allocated; and
- Any item which, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any consolidated return or separate return in which the item is included.
THE “NEXT DAY RULE”

- The “next day rule” is an exception to the normal requirement that Closing Date items be reported by the seller. This rule provides that if a transaction occurs on the Closing Date that is “properly allocable” to the portion of the day which is after the time of the closing, the parties “must treat the transaction for all Federal income tax purposes as occurring at the beginning of the following day.” Treas. Reg. § 1.1502-76(b)(1)(ii)(B).

- The current regulations provide that, “A determination as to whether a transaction is properly allocable to the portion of S’s day after the event will be respected if it is reasonable and consistently applied by all affected persons.”

- Traditionally, many tax advisors have believed that the “next day rule” permitted the parties to an acquisition to allocate items occurring on the Closing Date between the buyer and seller in a “reasonable” manner that reflected the economic arrangement between the parties.
THE “NEXT DAY RULE”

- However, a memorandum issued by the IRS Associate Chief Counsel (Corporate) in November 2012 applied a very restrictive interpretation to the “next day rule.” GLAM 2012-010.

- The memorandum addressed whether the following three items incurred by a Target on the date of its acquisition could be allocated under the “next day rule” to the taxable year beginning on the following day:

  - Payments made to cancel stock options and stock appreciation rights, which were payable upon a change in control.

  - Financial advisory and investment banking fees that were contingent upon the closing of the acquisition.

  - The retirement of Target bonds at a premium after the closing, using funds furnished by the acquiring corporation.
THE “NEXT DAY RULE”

- The memorandum held that the “next day rule” could not be applied to the first two items (the payments in cancellation of stock options and SARs and the advisory and banking fees), since such items did not arise from any “transaction” occurring on the acquisition date.

- Although such payments were triggered by the acquisition of Target, it was held that these items were attributable to transactions (the performance of services) that took place prior to the acquisition.

- The IRS also reasoned that the purpose of the “next day rule” required that it be limited to items that are within the control of the acquiring corporation.

- The deductions with respect to the first two items were not considered to relate to events within the control of the acquiring corporation. However, the IRS found that it was proper to apply the “next day rule” to the deduction for the bond repurchase premium, since this item resulted from a payment that was “based on a decision made by Target after the closing.”
PROPOSED REGULATIONS

- In March 2015, regulations which would revise the scope of the “next day rule” were proposed.
- Under the proposed regulations, the application of the “next day rule” would be mandatory, but the rule would apply only to “extraordinary items.”
- The rule would apply when there is:
  - an “extraordinary item” that
  - results from a transaction that occurs on the closing date, but after the event resulting in the change in S’s status,
  - and the item would be taken into account by S for tax purposes on such date.
- Significantly, the proposed regulations would provide that the next day rule would not apply, however, to “any extraordinary item that becomes includible or deductible simultaneously with the event that causes the change in S’s status.”
And, in a related change, the proposed regulations would broaden the provision in the current regulations which treats certain compensatory expenses as extraordinary items, so that it also covered a “deduction for fees for services rendered in connection with S’s change in status.”

Thus, for example, investment banker fees and other success-based fees for which a fixed obligation arises at closing would be “extraordinary items,” and since they become deductible simultaneously with the closing, they could not be treated as allocable to the purchaser under the next day rule.

Similarly, option cancellation payments that become due upon a change in control of S would not be subject to the next day rule.
The proposed regulations would include an anti-avoidance rule that could apply to a modification of an existing agreement in anticipation of a change in S’s status which had the effect of shifting an item between S’s pre-and post-closing taxable years.

The “next day rule” would apply only where an extraordinary item would, but for application of the rule, “be taken into account by S” on the day of its change in status.

- Thus, an extraordinary item that is subject to special timing rules is outside of the scope of the rule.

- For example, deferred compensation subject to the rules of Code Section 404(a)(5) would not be governed by the next day rule.
The proposed regulations would also make it clear that the timing rules of Treas. Reg. § 1.1502-76(b) generally apply only for purposes of determining the taxable period in which S is required to report its items.

- For example, assume that a member of a consolidated group contributes property to a nonmember in a Section 351 exchange which results in the transferee becoming a member of the group, and that the property is subject to a liability which exceeds the basis of the property.

- Under Treas. Reg. § 1.1502-80(d)(1), Section 357(c) does not apply to an “intercompany transaction,” which is defined in Treas. Reg. § 1.1502-13 as a “transaction between corporations that are members of the same consolidated group immediately after the transaction.” However, under Treas. Reg. § 1.1502-76(b), S is generally not treated as becoming a member of the group until the end of the day.

- The proposed regulations would clarify that the rules of Treas. Reg. § 1.1502-76(b) are not to be used to determine whether corporations are members of the same consolidated group, and that the above exchange is an intercompany transaction.
The proposed regulations would also coordinate the rules of Treas. Reg. § 1.1502-76(b) with certain provisions of Section 382 relating to “recognized built-in loss” or “recognized built-in gain.”

Under Section 382, if a corporation has a net unrealized built-in loss (NUNIL) or net recognized built-in gain (NUBIG) on the date of an ownership change, special rules apply to the built-in losses or built-in gains that are recognized during the “recognition period.”

The “recognition period” is the five-year period that begins on the date of the ownership change.
If S recognizes a built-in gain or built-in loss item on the closing date (but before the closing), the “end of the day” rule of Treas. Reg. § 1.1502-76(b) would require that this item be taken into account in the taxable period of S that ends on the closing date.

However, since the “recognition period” under Section 382(h) begins on the “change date,” the item would be treated as a “recognized’ built-in gain or loss for purposes of Section 382. (Even though the built-in gain or loss is not recognized on the purchasing corporation’s tax return.)

This can have unintended results.
The proposed regulations would provide that items that are taken into account in the taxable year of S that ends on the closing date are not treated as occurring during the “recognition period” for purposes of Section 382(h).

The provisions of the proposed regulations discussed above would be used to determine whether an item of S is taken into account on the closing date.
Continuation/Termination of a Consolidated Group
GROUP CONTINUATION RULES

- A consolidated group remains in existence so long as (i) the common parent remains the common parent, and (ii) at least one subsidiary that was a member of the group at the end of the prior taxable year remains affiliated with the common parent as of the beginning of the current taxable year. Treas. Reg. § 1.1501-75(d)(1).

- Thus, if P files a consolidated return with a single subsidiary, S, for Year 1, and sells the stock of S to an unrelated party on June 30 of Year 2, the consolidated group is considered to remain in existence until the end of Year 2. P is required to file a consolidated return for Year 2, which would include items of S for the January 1 through June 30 period.

- The consolidated group will terminate at the end of Year 2 unless P acquires another subsidiary before the end of that year.
GROUP CONTINUATION RULES

- If P acquires another subsidiary, T, on January 1 of Year 3, the prior group will still terminate at the end of Year 2, since T was not a member of the group at the end of Year 2.

- Potential consequences of termination of group include:
  - Taxable years of members may terminate.
  - Deferred intercompany items may be triggered.
  - Excess loss accounts may be triggered.
  - Taxable years of the terminated group become separate return limitation years (SRLYs).
  - Certain elections made by the group will terminate.
The regulations provide two important exceptions to the above rules, under which a consolidated return group is treated as remaining in existence despite the fact that the common parent is no longer in existence.

**Transfer of Assets to Subsidiary**

- The consolidated group remains in existence if substantially all of the assets of the former parent are transferred to another member of the group, and there remains a chain of includible corporations connected through stock ownership with a common parent. In other words, there must still be a parent corporation and at least one subsidiary. Treas. Reg. § 1.1502-75(d)(2)(ii).
GROUP CONTINUATION RULES

- Where this exception applies, the former common parent does not close its taxable year, the transferee acquiring the assets closes its taxable year.

- Example:

```
Merger

P
S
X

<---}
Shs.

Shs.

S
X
```
GROUP CONTINUATION RULES

- Contrast the above example to the following transaction:

  ![Diagram](Diagram1.png)

- Would the result be different if instead S merged into P?
Reverse Acquisitions

A reverse acquisition occurs where a corporation (the “first corporation”) acquires the stock or substantially all of the assets of another corporation (the “second corporation) in exchange for stock of the first corporation, and as a result of such exchange the shareholders of the second corporation own more than 50% of the value of the stock of the first corporation. Treas. Reg. 1.1502-75(d)(3)(i).

Where a reverse acquisition occurs, any consolidated group of which the first corporation was the common parent ceases to exist, and any consolidated group of which the second corporation was the common parent is treated as remaining in existence (with the second corporation being substituted as the common parent of the continuing group).
GROUP CONTINUATION RULES

- Example:

```
T            P            >50%
X                 Y

T Stock
P Stock
```

>50%
GROUP CONTINUATION RULES

- The reverse acquisition rules can apply if either or both of the acquiring or acquired corporations did not file a consolidated return prior to the transaction. See, e.g., Rev. Rul. 72-322, 1972-1 C.B. 28.

- Consequences of reverse acquisition treatment include:
  - In a reverse acquisition, the first corporation (the acquiring corporation) is required to close its taxable year as of the date of the acquisition.
  - Any pre-acquisition losses of the first corporation (the acquiring corporation) are considered to arise in separate return limitation years (SRLYs).
  - A reverse acquisition is treated as a “group structure” change under Treas. Reg. § 1.1502-33(f)(1).
    - Thus, P’s basis in the stock of S is determined by reference to S’s net asset basis. Treas. Reg. § 1.1502-31(c).
    - P’s earnings and profits are adjusted to include the E&P of S. Treas. Reg. § 1.1502-33(f)(1).
GROUP CONTINUATION RULES

- In Rev. Rul. 82-152, 1982-2 CB. 205, the Service held that an internal restructuring which resulted in the common parent becoming a first-tier subsidiary of a new holding company did not terminate the parent’s consolidated group, even though the transaction did not literally qualify under the two exceptions discussed above.
GROUP CONTINUATION RULES

- The transaction did not qualify as the transfer of substantially all of the parent’s assets to a subsidiary within the meaning of Treas. Reg. § 1.1502-75(d)(2), since P survived the merger and continued to exist.

- The transaction would have qualified as the transfer of the parent’s assets to a subsidiary, and not resulted in the termination of P’s group, if P had merged into T, with T being the surviving corporation.

- The transaction was not a reverse acquisition within the meaning of Treas. Reg. § 1.1502-75(d)(3), since the reverse acquisition rules assume that the acquiring and acquired corporations were not members of the same affiliated group prior to the transaction.

- The Service stated that “there is no significant difference, other than in form, between a transaction in which T would be the survivor and one in which P survives.” Since the merger in Rev. Rul. 82-152 was viewed as “indistinguishable in substance” from a transfer of all of P’s assets to T, it was concluded that the P group should be treated as continuing in existence after the merger, with S becoming the common parent of the group.