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MST Program

TAX EXECUTIVES INSTITUTE, INC.
Silicon Valley Chapter

M&A Deals – What's New?

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Agenda

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Recent Trends in M&A Transactions

Buyer leverage

- More asset deals
- Attempts to bridge valuation gaps
  - Earnouts
  - Founder holdbacks
  - Tax-free reorganizations with adjustments based on buyer stock price
  - CVRs (buy side and sell side)
- Impact of purchase price adjustments (debt-like items, working capital)
- Reverse mergers
- Control over post-closing tax matters that impact tax indemnity
- Stock as consideration

Monetizing tax assets

- R&D Payroll Tax Credits
  - Certain qualified small businesses can apply research tax credit against employer portion of FICA tax (and after 2022, Medicare tax)
  - For taxable years ending on or before 12/31/2022, $250k per year
  - For taxable years beginning after 12/31/2022, $500k per year
  - Eligibility:
    - No more than 5 years past period for which it had no gross receipts
    - Gross receipts in year of election of less than $5mil

Example: Transaction Deductions and NOLS

Buyer	Target
28 % effective tax rate	$ 100 million FMV NOLs $ 40 million Transaction related deductions $10 mil

- Possible tax benefit of NOLS: $ 14 million
- Limitations on use
  - $ 100 million x 3.65% = $3.65mil
  - First 5 years NUBIG (338 method) = $6.67mil
    - Years 1-4: $10.32 mil per year ($2.89 mil cash tax benefit)
    - Year 5: $8.72mil ($2.44 mil cash tax benefit)

Example: Step-Up in Asset Deal

Buyer	Target
28 % effective tax rate	$ 100 million FMV NOLs $ 40 million Transaction related deductions $10 mil 28% effective tax rate

- Tax cost to Target:
  - $ 58 mil of taxable income
  - $ 16.24 mil of tax
  - Amount required for gross-up: $ 22.6 mil
- Benefit to Buyer
  - $ 6.67 mil in amortization per year for 15 years
  - Total: $ 100 mil
  - $ 1.87 mil cash tax savings per year for 15 years
    - Total: $ 28 mil

Section 174 R&E Expenditures

- TCJA disallowed full expensing of research and experimental (R&E) expenditures as of 1/1/2022
- Costs must now be capitalized and amortized
  - Domestic costs = 5 years
  - Foreign costs = 15 years
  - Midyear convention
- Broad definition of R&E under Section 174: generally includes all such costs incident to the development or improvement of a product.
  - salaries, wages
  - G&A
  - travel
  - patent costs
- Latest guidance from IRS released on Sep. 8, 2023

Section 174: Stock Acquisition Examples

- **Assumptions**:
  - R&E expenses $5 mil per year
  - Taxable income in year of close (2024) of $4 mil
- **Tax impact**
  - Total losses as of end of 2023: $2 mil
  - Total losses in 2024: $2.5 mil
  - Taxable income: $300k
  - Total remaining NOLs: $800k
  - Total remaining amortization deductions: $10.5 mil

Tax Consequences of Accounting Method Changes

- Buyer discovers in diligence that target has been using an improper method of accounting, or was properly using the cash method but will be required to switch to the accrual method immediately post-acquisition.
- Income inclusions under §481 resulting from the change in method typically would be spread over four years (i.e., when target is owned by buyer). For example, cash method receivables as of the Closing will be accrued into income upon the switch to accrual method and spread over four years.
- Risk allocated through purchase price adjustment mechanics or indemnity provisions.
- If the accounting method change is not made until after closing, target's pre-acquisition NOLs generally will be limited by §382.
- In contrast, pre-§382 change income recognized after the change by reason of a §481 adjustment is treated as a built-in gain item for purposes of determining the §382 limitation.

Tax Consequence of Accounting Method Changes cont'd

- Rev. Proc. 2015-13 includes elective one-year inclusion rule for positive §481 adjustments for the year of an accounting method change if an eligible acquisition transaction occurs during the year of change or in the subsequent taxable year on or before the due date (including extensions) for filing the taxpayer's federal income tax return for the year of the change.
- Election is irrevocable and applies to all method changes the taxpayer makes pursuant to Rev. Proc. 2015-12 and all §481 adjustments for the year of the change.

Tax Consequence of Accounting Method Changes cont'd

- Eligible acquisition transaction:
  - For a CFC or corporation other than an S corporation, (1) an acquisition of stock ownership interest in the taxpayer by another party that either results in the acquisition of control of the taxpayer or causes the taxpayer's taxable year to end, or (2) an acquisition of assets in a transaction to which §381 applies.
  - For all other taxpayers, an acquisition of an ownership interest in the taxpayer by another party that does not cause the taxpayer to cease to exist for federal income tax purposes (for example, a sale or exchange of a partnership interest.
- Rev. Proc. 2023-24 provides a list of automatic changes to which automatic change procedures in Rev. Proc. 2015-13 apply.
- Change in overall method of accounting from cash method to accrual method is included in automatic change list. Rev. Proc. 2023-24 §15.01.

Tax Consequence of Accounting Method Changes cont'd

EXAMPLE:

- X Corporation enters into an agreement to sell the stock of its wholly owned subsidiary T Corporation to Z Corporation. T is a calendar year taxpayer. Z discovers during due diligence that T improperly defers advance payments for services. Z requires that, prior to its acquisition of T's stock, T changes its method of accounting for advance payments for services to a proper method for 2023. In February 2024, Z acquires the stock of T.
- In March 2024, T files for an extension of the time within which to file its 2023 federal income tax return. In September 2024, T files the return and Form 3115 in accordance with the automatic change procedures of Rev. Proc. 2015-13, which results in a positive §481 adjustment.
- T elects a one-year adjustment period for all changes in method of accounting that it makes pursuant to Rev. Proc. 2015-13 for 2023 (year of change).
- T must take into account the entire §481 adjustment in 2023.

Tax Consequence of Accounting Method Changes cont'd

CONTRACT PROVISION

- Parent shall prepare Parent Prepared Returns for any taxable period that ends on or before the Closing Date in a manner consistent with the past practice of the Company, except as otherwise require by applicable Law; provided that, (x) if permitted by applicable Law, Parent shall be entitled to cause the Company to change its method of accounting for income Tax purposes, effective immediately prior to the Closing, from the cash method of accounting to the accrual method of accounting and, with respect to any positive adjustment under Section 481 of the Code (or any corresponding or similar provision of state, local, or non-U.S. Law) resulting from such change in method of accounting, cause the Company to elect pursuant to the "eligible acquisition transaction" election procedures set forth in Section 7.03(3)(d) of IRS Revenue Procedure 2015-13 (or any comparable election under state, local, or non-U.S. Law) to include such adjustment in its taxable income for the Pre-Closing Tax Period (collectively, the "Elective Accounting Method Change"), and (y) if the Elective Accounting Method Change is not permitted by applicable Law, Parent shall be entitled to take all actions permitted by applicable Law to result in the same consequences, and in any event all Pre-Closing Taxes will be computed for purposes of this Agreement, as if the Elective Accounting Method Change had been made.

Recent Developments in Success-Based Fees

- Amounts paid to facilitate certain business acquisitions or reorganizations, including amounts paid in the process of investigating or otherwise pursuing the transaction, generally must be capitalized. Treas. Reg. §1.263(a)-5(a).
- Amounts that are contingent on the successful closing of the transaction are presumed to facilitate the transaction. A taxpayer my rebut the presumption by maintaining sufficient documentation that a portion of the fee is allocable to activities that do not facilitate the transaction. Treas. Reg. §1.263(a)-5(f).
- Numerous disagreements have arisen between taxpayers and the IRS about the type and extent of the documentation required to establish the portion of a success-based fee allocable to activities that do not facilitate a business acquisition or reorganization.
- Rev. Proc. 2011-29, 2011-18 IRB 746, provides for an election to treat 70% of a success-based fee as an amount that does not facilitate the transaction in lieu of maintaining documentation.

PLR 202308010

- Parent sought 9100 relief for an extension of time on behalf of its wholly owned subsidiary ("Taxpayer") to file a safe harbor election under Rev. Proc. 2011-29 for a success-based fee paid to an investment bank ("IB") in connection with the acquisition of Parent.
- Parent's majority shareholder ("Seller") was a PE fund and the stockholder representative in connection with the sale of Parent. Seller "was in the business of investing in and selling interests in companies" and generated substantial gain from the sale.
- Taxpayer had entered into an agreement with IB for services relating to the sale of Parent under which Taxpayer was obligated to pay a fee of a percentage of the base purchase price upon the completion of a successful transaction.
- Taxpayer's executives took the lead and primarily engaged in communication with IB regarding prospective buyers and in gathering information for prospective buyers.
- Seller discussed, consulted, reviewed, and approved the transaction terms sent to Buyer.
- Seller and Taxpayer negotiated with Buyer. Selling stockholders of Parent (including Seller) entered into an SPA. Parent and Taxpayer were not parties.

PLR 202308010, cont'd

- Acquisition agreement provided that certain sales-related expenses, including the IB fee, were required to be paid out of the sales proceeds payable to selling stockholders.
- IB invoiced Taxpayer for its services.
- Prior to the disbursement of sales proceeds to selling shareholders, Buyer transferred a portion of the gross sales price to Seller to satisfy certain liabilities, including IB fee and other transaction costs. That day (the date of the IB invoice), either immediately before or after receiving the funds from Buyer, Seller wired funds to pay IB and other advisors their fees, thereby reducing the total sales proceeds payable by Buyer to the selling stockholders.
- Pursuant to a management consulting agreement between Taxpayer and Seller, Taxpayer was required to pay directly or reimburse Seller for any amounts Seller paid in connection with the consulting services, including services rendered by IBs or financial advisors. However, Taxpayer did not record a payable or reimburse Seller for the IB fee that was paid out of the sales proceeds and Seller did not record a receivable on its books for the unreimbursed amounts.
- Double tax benefit? Taxpayer intended to claim an additional tax benefit by making the safe harbor election for success-based fees (and also sought a PLR).

PLR 202308010, cont'd

<u>TAXPAYER'S POSITION</u>

- Taxpayer "incurred" the IB fee because it, not Seller, entered into the contract with IB that obligated Taxpayer to pay the fee. Seller or Buyer paid the fee on its behalf. Treas. Reg. §1.263(a)-5(k).
- IB fee is properly regarded to be paid on Taxpayer's behalf because it primarily benefited from IB's engagement in that it was actively involved with the negotiation of its sale, which enabled it to obtain funding for its expansion efforts, and engagement of IB provided only incidental benefits to Seller.
- A press release issued by Seller and IB states that IB provided strategic and financial advisory services to both Taxpayer and Seller with respect to the sale of Parent to Buyer.
- Double tax benefit is justified because (a) Seller should be deemed to have made a capital contribution to Taxpayer equal to the IB fee (thereby increasing Seller's basis in Parent and reducing Seller's gain on the sale), and (b) Taxpayer should be deemed to have paid the IB fee eligible for the success-based fee safe harbor election under Rev. Proc. 2011-29.

PLR 202308010, cont'd

RULING

- Denied late election relief because, in the interest of sound tax administration, IRS has discretion to deny relief to make a late election for which the taxpayer fails to qualify.

RATIONALE

- Safe harbor election is not available because an amount required to be capitalized by Treas. Reg. §1.263(a)-1 does not facilitate a transaction described in Treas. Reg. §1.263(a)-5(a). Treas. Reg. §1.263(a)-5(b)(2).
- Section 1.263(a)-1(e)(1) states that commissions and other transaction costs paid to facilitate the sale of property are not currently deductible under Section 162 or 212, but instead are capitalized costs that reduce the amount realized in the taxable year in which the sale occurs. *Spreckels v. Helvering,* 315 U.S. 626 (1942).
- The deductibility of third-party costs is not controlled by which related party contracted to pay or paid the cost. *Deputy v. du Pont,* 308 U.S. 488, 496 (1940).
- The IB fee was directly and proximately connected to and arose from seller's activity of investing in and selling portfolio companies, but was only indirectly or incidentally related to Taxpayer's business activity.

PLR 202324001

- After its deduction for an IB success-based fee was disallowed on audit, Taxpayer sought 9100 relief for an extension of time to file a safe harbor election under Rev. Proc. 2011-29.
- Taxpayer had entered into an agreement with IB for services in connection with the sale of Taxpayer (whether in the form of a merger, asset sale, or equity sale) under which IB would receive a percentage of the sale consideration, plus expenses.
- Taxpayer was acquired in a reverse triangular merger. Prior to the merger, IB invoiced Taxpayer $x for the fee, which Taxpayer paid (along with an additional amount for IB's expenses) the day after Closing.
- Taxpayer's shareholders were interrelated PE funds whose proceeds in the merger were reduced by the fee and other expenses.
- Taxpayer was advised by its return preparer that it could elect under Rev. Proc. 2011-29 or forego the election, in which case it might be able to deduct more than 70% of the fee. Preparer helped IB draft a letter to classify IB's fees and expenses as the portion for investigatory/due diligence services rendered pre-BoD approval of the sale (which was more than 70% of the total) and the portion thereafter for services facilitating the sale.

PLR 202324001, cont’d

RULING

- Denied late election relief because Taxpayer was informed of the election and its consequences in all material respects and chose not to make it.
- In addition, taxpayer had the benefit of hindsight, and the policies behind Rev. Proc. 2011-29 (to eliminate controversy) exacerbate the hindsight issue.
- Finally, in the interest of sound tax administration, IRS has discretion to deny relief to make a late election for which the taxpayer fails to qualify.
- Fee “likely was not Taxpayer's expense, and Taxpayer likely was not ‘otherwise eligible to make’ the safe-harbor election. The costs “originated from and directly and proximately related” to the former shareholders' generation of sales proceeds from the disposition of Taxpayer, a portfolio company invested in by the interrelated private equity funds. Therefore, the fee would likely have been taken into account by Former Shareholders, not Taxpayer, as an offset to amount realized.

PLR 202335013

- Taxpayer sought an extension of time to make a safe harbor election under Rev. Proc. 2011-29 relating to a contingent fee paid on Taxpayer’s behalf pursuant to Treas. Reg. §1.263(a)-5(k).
- Taxpayer is a private corporation with no majority controlling shareholder.
- Taxpayer was acquired in a reverse triangular merger, with Target surviving. The facts of the PLR stated that there was no pre-existing agreement among the selling shareholders that enabled one or more of them to effectively control the sale of Taxpayer.
- Prior to entering into the merger agreement with Buyer, Taxpayer and IB had entered into an engagement letter in connection with the potential sale pursuant to which Taxpayer would be obligated to pay a contingent fee to IB of a specified percentage of the deal value.
- Under the merger agreement, Buyer was obligated to (and did) pay IB and other transaction costs, which reduced the sales proceeds to Taxpayer’s shareholders.
- The merger agreement provided that pre-closing income would be calculated on the assumption that a safe harbor election would be made, but Taxpayer overlooked it. Taxpayer’s historic advisors were not aware of the contingent fee and did not advise Taxpayer of the possibility of making the safe harbor election.

PLR 202335013, cont'd

RULING

- Late election relief granted. Taxpayer acted reasonably and in good faith and granting relief will not prejudice the interests of the government.
- To be deductible as an ordinary and necessary expense, the cost must be "directly connected with" or have "proximately resulted from" a taxpayer's business activity. *Kornhauser v. United States*, 276 U.S. 145, 153 (1928).
- The Service generally has not asserted that costs directly paid by a non-majority controlled public target company must be treated as the costs of selling shareholders so as to preclude a Section 162 deduction by the target. *INDOPCO.*
- No opinion is expressed in the PLR as to whether Taxpayer is otherwise eligible or otherwise qualifies to make the safe harbor election, the fee was paid on the taxpayer's behalf, properly treated as a cost of Taxpayer, was a success-based fee or subject to any other Code section that would preclude deduction or capitalization.

Abandoned Deal Developments

Deal Termination Fees

- What are deal termination fees?
  - Cash payment for deal termination
- Why would a buyer want this?
  - Deal certainty
  - Evidence of commitment
  - Compensation for opportunity costs
  - Reimbursement of acquirer's expenses
- What about the target?
  - Reverse termination fee
- How is this documented?
- How is this characterized for tax purposes?

Why Does It Matter For Tax Purposes?

- Character
- Withholding
- Treaty Characterization
- Special issues for certain recipients

Does Section 1234A Apply?

- Section 1234A provides:
  - Gain or loss attributable to the cancellation, lapse, expiration, or other termination of:
    - a right or obligation
    - with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer
  - Shall be treated as gain or loss from the sale of a capital asset.
- Legislative history as of certain 1997 amendments implies a broad interpretation

TAM 200438038

- Facts
  - Taxpayer entered contract with target corporation to acquire all its stock
  - Target reneged and paid taxpayer a fee
- Taxpayer
  - Reported the fee as return of basis because it was compensation for damages that the target's breach had inflicted on its assets, including its goodwill
- IRS Analysis
  - IRS disagreed with return of basis conclusion. Advised the fee had been paid as compensation for lost profits and thus reportable as ordinary income
  - No mention of Section 1234A (transaction pre-dates 1997)

PLR 200823012

- A would-be buyer requested a ruling regarding the fee it was paid when a target backed out of a planned acquisition
- IRS concluded that the fee was ordinary income.
  - Same lost profits analysis as in TAM
  - This time, IRS mentioned Section 1234A but only to say it did not apply (no explanation)

FAA 20163701F

- Advice describes a would-be inversion
  - Inversion would be structured so that buyer and target would both become subsidiaries of a new foreign parent
- Deal was terminated after Treasury issued a notice adversely affecting the tax aspects of the deal
- Buyer terminated the deal and had to pay the foreign target a termination fee
- IRS conclusion:
  - Shares of new foreign parent would have been capital assets in buyer's hands Section 1234A applied to buyer's payment to terminate its obligations regarding the shares
  - Thus, termination fee gave rise to a buyer capital loss

CCA 201642035

- Addressed how Section 1234A would apply if a buyer received a termination fee in a busted stock deal
- The deal document at issue permitted target to terminate to accept a better offer from a third party. But, if target did so, it had to pay the buyer a $1M breakup fee

IRS:

- Considered first what if buyer received the fee after incurring $200K in capitalizable costs
  - Concluded buyer had a right with respect to stock, which makes it a capital asset. Thus, buyer had $800K gain under Section 1234A
  - What if had incurred $1.1M in costs? Buyer would recognize $100K capital loss
- Specifically notes that conclusion is contrary to PLR 200823012. Overrules 2008 guidance?

CCA 202224010

- Taxpayer paid a reverse termination fee to target upon termination of a merger agreement
- That termination triggered termination of a related agreement with another buyer (possibly with respect to a portion of the assets of target), under which taxpayer was required to pay another termination fee
- Taxpayer took the position that termination fees were ordinary business expenses deductible under Section 162 and Section 1234A does not apply
- IRS:
  - Taxpayer's terminations of the transactions resulted in dispositions under Section 1001 that gave rise to losses under Section 165 rather than business expenses under Section 162
  - Section 263(a) regulations do not require that the termination fees be treated as Section 162 expenses
  - Case law (pre-1997 amendment to Section 1234A) pertaining to merger terminations and the origin of the claim doctrine does not require that IRS accept taxpayer's treatment of the termination fees

CCA 202224010, continued

- Section 1234A applies to characterize the Section 165 losses as capital losses to the extent those losses were attributable to the termination of rights or obligations with respect to capital assets
- Taxpayer's loss resulting from the termination of the merger agreement is characterized as capital to the extent that loss was attributable to property that would have been capital assets in taxpayer's hands, if taxpayer had acquired the property pursuant to the two-step merger. Presumably mostly ordinary business assets, which would not have been the case if the deal had been structured as a stock acquisition
- Taxpayer's loss resulting from the termination of the second agreement is characterized as capital to the extent the property that taxpayer would have sold pursuant to that agreement constituted capital assets of taxpayer

AbbVie Litigation

- AbbVie Inc. filed a petition in Tax Court re: IRS disallowance of a deduction claimed for a $1.6 million termination fee it made to Shire plc after a failed merger
  - FAA 20163701F appears to about this deal
- The deficiency notice, dated 12/6/22, relates to tax year 2014 and asserts that AbbVie owes $572.4 million in additional taxes
  - The $1.64 billion ordinary tax deduction AbbVie claimed on its Form 1120 for the year "is not deductible as an expense under [S]ection 162 or as an ordinary loss under [S]ection 165 because the payment of that amount and termination of an agreement resulted in loss that is treated under [S]ection 1234A as a loss from the sale of a capital asset"
- AbbVie argues that IRS erred in determining the payment was a capital loss under Section 1234A

AbbVie Litigation, continued

- AbbVie cites TAM 200438038 and LTR 200823012 as examples of IRS treatment of termination fees as ordinary income
- Since the AbbVie merger was terminated, IRS released CCA 201642035 and CCA 202224010 (which guidance suggests a change to treat breakup fees as capital in nature)
- AbbVie also filed three FOIA lawsuits against IRS in the U.S. District Court for the District of Columbia March 3, challenging IRS failure to hand over records concerning its handling of AbbVie's breakup fee and post-2014 guidance on the tax consequences of termination fees
- AbbVie filed a lawsuit in September 2023 stating IRS is impermissibly withholding records

Open Questions

- Is there property which is or would be a capital asset at issue?
- Does character of the fee need to match between payor and payee?
- What if the fee is paid before a contract is executed?
- Many others...

Consolidated Group M&A Developments and Reminders

Consolidated Group M&A Developments and Reminders

- Consolidated Group – Allocation of Income on Joining or Leaving a Group
- Unified Loss Rule
- Member Liability for Group Taxes

Consolidated Group
Allocation of Income on Joining or Leaving a Group

Taxable Year of Group Members (§1.1502-76)

- All members of a group must use the common parent's taxable year (§1.1502-76(a)(1))
  - A corporation using a different taxable year **must change to the common parent's taxable year** immediately after joining the group

- Consolidated return must include the income/loss of a subsidiary **only for portion of year it is a member of the group** and any portion of the year that is not included in the consolidated return is treated as a separate year for all Federal income tax purposes (§1.1502-76(b)(1)(i))
  - As a result, a corporation that joins or leaves a consolidated group during the year **has TWO short taxable years** for all Federal income tax purposes

NOL Rules for Departing Members (1.1502-21)

- If a departing member has NOLs (e.g., a portion of the CNOL is allocable to the member), **only that portion NOT absorbed by the old group through the end of the group's year of the departure** is carried forward by the departing member (§1.1502-21(b)(2)(ii)(A))
  - As a result, post-sale income of the group can be offset by the departing member's NOLs. In that event, **use of those NOLs will affect the group's gain/loss on the sale of the stock**.
  - Allocation of CNOLs to a departing member requires apportionment of the CNOLs, applying a separate formula to the CNOL from each year.
  - The allocation of any prior Section 382 limitation is **OPTIONAL** and, if no allocation is elected, the departing member **takes a ZERO Section 382 limitation**.

Allocation of Income between Departing Member's Two Tax Years

- Suppose P, S and S1 file consolidated returns. Assume P, S, and S1 are calendar year taxpayers.
- During the first half of 2018, S1 has income of $300. During the last half of 2018, S1 has a loss of $100.
- How is this income/loss reported by the parties?

Allocation of Income between Tax Years (Cont'd)

- There are **two methods for the allocation of income** between separate return and consolidated return periods
  - Close the books (§1.1502-76(b)(2)(i))
  - Pro rata allocation (§1.1502-76(b)(2)(ii))
  - Consolidated group is permitted to "**ratably allocate**" (as opposed to "closing the books") the income of a departing/joining subsidiary, provided the subsidiary is not required to change its year end **AND makes an election to ratably allocate** its income for the year
  - Special rules apply to the allocation of the departing member's income from its interest in a partnership

Allocation of Income between Departing Member's Two Tax Years

- Suppose P, S and S1 file consolidated returns. Assume P, S, and S1 are calendar year taxpayers.
- During the first half of 2018, S1 has income of $300. During the last half of 2018, S1 has a loss of $100.
- How is this income/loss reported by the parties?
  - *Closing of the books: +300 for first period, (100) for second period*
  - *Ratable Allocation: +100 for first period, +100 for second period*

Allocation of Income between Tax Years (Cont'd)

- Certain **extraordinary items may not be ratably allocated** and are allocated to the day on which they occur (§1.1502-76(b)(2)(ii)(C)):
  - Section 1231 gains & losses
  - Capital gains & losses
  - Income from discharge of indebtedness
  - Subpart F income
  - PFIC income
  - NOL carryovers
  - Section 481(a) adjustments
  - Credits from activity or items that are not ratably allocated (e.g., the purchase of property)
  - Tort settlements
  - **Compensation related deductions**
  - Dividends from section 304 controlled but unaffiliated corporations

Taxable Year of Members of Group - §1.1502-76(b)(1)

- Timing
  - Departing/Joining Member is **deemed to leave or enter group at close of the day** of the event (§1.1502-76(b)(1)(ii)(A)(1))
  - Next day rule: Certain items incurred on day of change in status **deemed to occur on next day** (§1.1502-76(b)(1)(ii)(B))

- Special rules for S Corporations (§1.1502-76(b)(1)(ii)(A)(2))
  - Joining S corporation becomes a member **at the beginning of the day** of the acquisition

Next Day Rule -- Reg. § 1.1502-76(b)(1)(ii)(B)

"If on the day of S's change in status as a member, a transaction occurs that is properly allocable to the portion of S's day after the event resulting in the change, 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 will be respected if it is reasonable and consistently applied by all affected persons." (emphasis added.)

Consider non-qualified stock options and when the right to payment vests (i.e., before closing, after closing, or at closing).

GLAM 2012-010: The IRS concluded that Next Day Rule does not permit certain expenses associated with stock options, SARs, and success-based fees to be allocated to the period after the acquisition.

See also proposed regulations (REG-100400-14) that would amend §1.1502-76(b) and modify how certain items are reported when a corporation joins or leaves a consolidated group.

Overview of Unified Loss Rules

Treas. Reg. § 1.1502-36: Unified Rule to Address Three Types of Subsidiary Stock Loss

- **One integrated set of rules** apply to all transactions in which noneconomic or duplicated loss in the stock of a group member is either recognized or preserved for later use
- Noneconomic stock and duplicated losses attributable to the allocations under Treas. Reg. § 1.1502-32
  - Addressed in Treas. Reg. § 1.1502-36(b)
  - Previously addressed, to a limited extent, in Treas. Reg. § 1.1502-35(b)
- "Son of mirror" stock loss **without any economic loss**
  - Addressed in Treas. Reg. § 1.1502-36(c)
  - Previously addressed by Treas. Reg. § 1.337(d)-2
- "Duplicated" loss for single economic loss
  - Addressed in Treas. Reg. § 1.1502-36(d)
  - Previously addressed in part by Treas. Reg. § 1.1502-35(c)

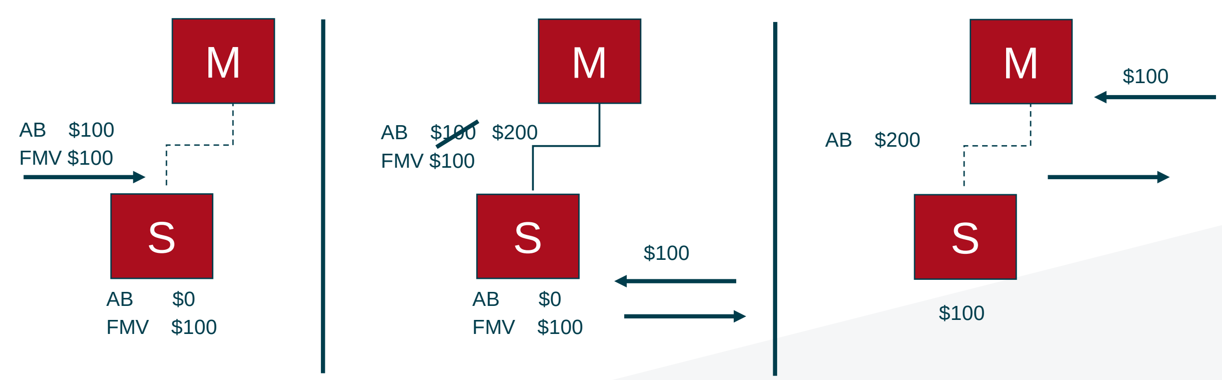
Overview of § 1.1502-36 Unified Rules

- Immediately before the "**transfer**" of a loss share of S stock, there is the sequential application of three rules:
  - All members' bases in S shares are **subject to redetermination** under Treas. Reg. § 1.1502-36(b)
  - If any member's basis in a transferred S share exceeds the share's value after application of Treas. Reg. § 1.1502-36(b), that **basis is subject to reduction** under Treas. Reg. § 1.1502-36(c)
  - If any member's basis in a transferred S share exceeds the share's value after application of Treas. Reg. § 1.1502-36(c), S's **attributes are subject to reduction** under Treas. Reg. § 1.1502-36(d)
- Misc. operating rules – Treas. Reg. § 1.1502-36(e)
- Definitions – Treas. Reg. § 1.1502-36(f)
- Anti-Abuse Rule – Treas. Reg. § 1.1502-36(g)

Key Definitions: "Transfer"

- For this purpose, M and S are members of a consolidated group
- A "transfer" by M of an S share is ***any event in which***:
  - M ceases to own the S share in a taxable transaction
  - M and S cease to belong to the same group
  - The S share is **acquired from M by a nonmember**
  - The S share is **worthless** (taking into account Treas. Reg. § 1.1502-80(c))
- Excludes
- Intra-group section 381 transactions
  - Multiple-member section 332 liquidations subject to redetermination rule
  - Certain section 355 distributions

The Problem – Stock Loss without Economic Loss



- S's $100 gain from the sale of its asset generates a $100 positive Treas. Reg. § 1.1502-32 adjustment to M's basis in the S stock.
- Because M's $100 "cost" basis in the S stock ***already reflects*** **the $100 gain** before it is recognized, the positive Treas. Reg. § 1.1502-32 adjustment "duplicates" M's existing S stock basis and results in M recognizing a $100 noneconomic S stock loss.
- M's $100 loss offsets S's $100 gain (disregarding character differences) on the M group's consolidated return, "stepping up" the basis of S's asset with no corporate level tax, **a result that is inconsistent with *GU* repeal**.

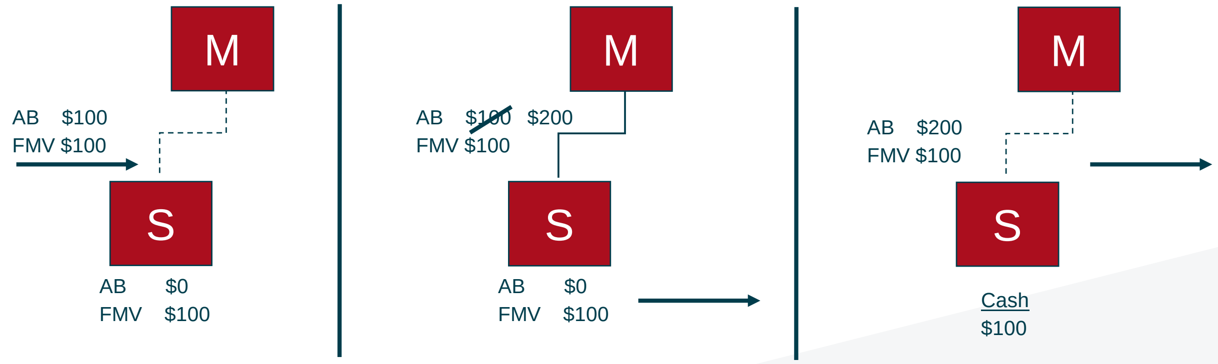
Basis Reduction - §1.1502-36(c)

- **Rule (§ 1.1502-36(c)(2)):** If a transferred S share is a loss share after the application of the basis redetermination rule, **M's basis in the share is reduced**, but not below value, by the lesser of:
  - The share's net positive adjustment
  - The share's disconformity amount
- **Net positive adjustment (NPA) (§ 1.1502-36(c)(3)):** The **sum of all investment adjustments** (excluding distributions), from all tax periods, reflected in the basis of the share. This amount cannot be less than zero
- **Disconformity amount (§ 1.1502-36(c)(4)):** The **excess**, if any, of M's basis in the share over the share's "allocable portion" of S's "*net inside attribute amount*"
- **Special rules for lower-tier subsidiaries**

Basis Reduction (cont'd)

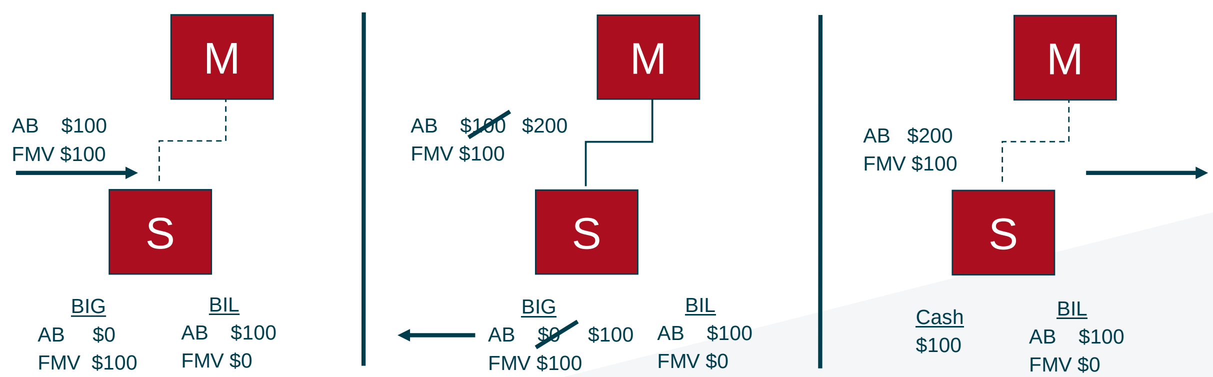
- Under § 1.1502-36(c)(5), **the "net inside attribute amount" equals**:
  - The sum of S's
    - Money
    - Basis in assets other than money
    - Net operating and capital loss carryovers
    - Deferred deductions
  - Minus S's liabilities
- The "net inside attribute amount"
  - Is determined immediately before the transfer, taking into account all other rules of law (e.g., Treas. Reg. § 1.1502-32)
  - Does not include S's credits, if any

Basis Reduction Rule Disallows "Noneconomic" Loss Classic of "Son of Mirror" Case



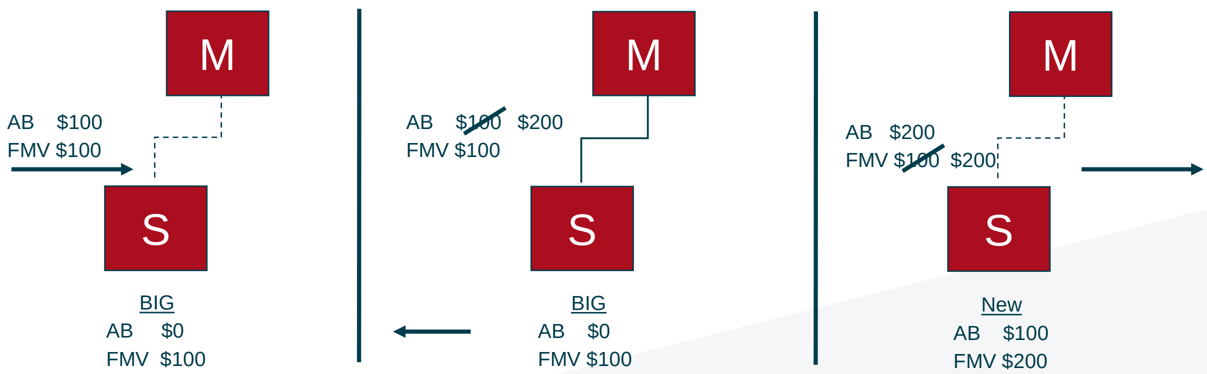
- Facts: M buys the S stock for $100, when S's asset has a $0 basis and $100 FMV. S sells its asset for $100. M sells the S stock for $100.
- Basis Reduction: **M's $100 loss is *disallowed*** because basis in stock of S must be reduced by $100, which is the lesser of:
  - Net Positive Adjustment (NPA) of $100: $100 positive Treas. Reg. § 1.1502-32 adjustments.
  - Disconformity amount of $100: The excess of M's $200 basis in the S stock over S's $100 "net asset basis" (i.e., money of $100) (zero NOLs).
- Result: M's $100 loss is disallowed.

Basis Reduction Rule Allows "Noneconomic" Loss BIG and BIL Assets in Son of Mirror" Case



- Facts: M buys the S stock for $100, when S's BIG asset has a $0 basis and $100 FMV, and BIL asset has a $100 basis and $0 FMV. S sells the BIG asset for $100. M sells the S stock for $100.
- Basis Reduction: M's $100 loss is ***allowed*** because adjustment to stock in S of $0, which is the lesser of:
  - **NPA of $100**. M has positive investment adjustments of $100 in the stock of S
  - **Disconformity amount of $0**: The excess of M's $200 S stock basis over S's $200 net inside attributes (money and asset basis)
- **Attribute Reduction Rule Backstops Basis Reduction Rule**: Here, the attribute reduction rule backstops the basis reduction rule. The attribute reduction rule will *require a reduction in S's asset basis* if no elective reduction in M's basis in the S stock.

Basis Reduction Rule Allows Sheltering of Economic Gain: "Son of Mirror: Gain + Unrealized Other Gain



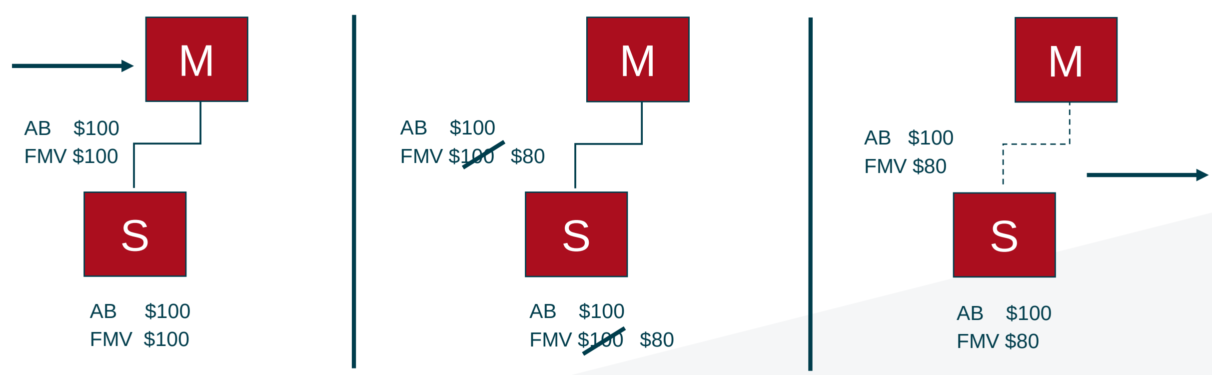
- Facts: M buys the S stock for $100, when S's BIG asset has a $0 basis and $100 FMV. S sells the BIG asset for $100. **S reinvests the $100 in a new asset, which appreciates in value to $200**. M sells the S stock for $200.
- Result: M has an economic gain of $100 on the stock due to the appreciation in the new asset. M has no taxable gain because its basis increased from $100 to $200 on S's sale of the BIG asset.
- **Nothing in Treas. Reg. § 1.1502-36 changes this result**. Even though Treas. Reg. § 1.1502-36 does not allow noneconomic basis increases to create or increase a loss, it does allow noneconomic basis increases to shelter post-acquisition gain.

Treas. Reg. §1.1502-36(c): Buyer Beware

- Suppose Buyer buys a member (T) of a consolidated group. T might or might not be the common parent. T has a subsidiary S.
- Suppose Buyer sells the T stock at a loss. The loss will be disallowed to the extent of the lesser of (1) Buyer's NPA in the T stock, or (2) Buyer's disconformity amount in T, which depends in part on T's prior NPA in the S stock.
- Alternatively, suppose T sells the S stock at a loss. The loss will be disallowed to the extent of the lesser of (1) T's NPA in the S stock, **including adjustments attributable to periods before the Buyer's acquisition**, and (2) T's disconformity amount in S.
- Thus, in either case, for Buyer to apply the rules, Buyer must know not only the stock and asset basis that exists at each level on the purchase date, **but also the history of all NPAs in the stock of all direct and indirect subsidiaries of T**.
  - If Buyer acquired the T stock in a reorganization such as a "B" reorganization, and T was a subsidiary in another group, the history of NPA's in the T stock itself in the prior group would also be relevant to Buyer.

Treas. Reg. 1.1502-36(d)
Attribute Reduction to Address "Duplicated" Economic Loss

The Duplicated Loss Problem



- Facts: M buys the stock of S for $100 when S's asset has a $100 basis and $100 FMV. **S's asset declines in FMV to $80**. M sells the S stock for $80.
- Result: Absent an anti-loss duplication rule, M's $20 stock loss is allowed and S can later sell its asset and recognize a $20 loss.

Attribute Reduction – §1.1502-36(d)

- Under § 1.1502-36(d)(2), if a transferred share is a loss share after the application of § 1.1502-36(b) and (c), **S's attributes are reduced by S's attribute reduction amount**, which is the lesser of:
  - ***Net stock loss*** – the excess, if any, of members' aggregate bases in transferred S shares over the aggregate value of those shares (§1.1502-36(d)(3)(ii))
  - ***S's aggregate inside loss*** – the excess, if any, of S's net inside attributes (inside asset basis plus losses minus liabilities) over the value of all outstanding shares of S stock (§1.1502-36(d)(3)(iii))
- Exception for attribute reduction amount below 5% of value of transferred shares:
- No attribute reduction required
  - Group may elect to apply rule, e.g., in order to reattribute S's losses

Application of Attribute Reduction Amount: The Basics (§1.1502-36(d)(4))

- Recognized losses must be reduced in full before reducing asset basis. S's attribute reduction amount is applied:
  - **First to reduce recognized losses**:
    - Capital loss carryovers
    - Net operating loss carryovers
    - Deferred deductions, including Section 163(j) carryovers
  - **Then, to reduce asset basis**
- The selling group may specify the losses to which the attribute reduction amount (ARA) is applied. To the extent the group doesn't specify, they are **reduced in the following order**:
  - Capital loss carryovers (oldest to newest)
  - Net operating loss carryovers (oldest to newest)
  - Deferred deductions (proportionately)

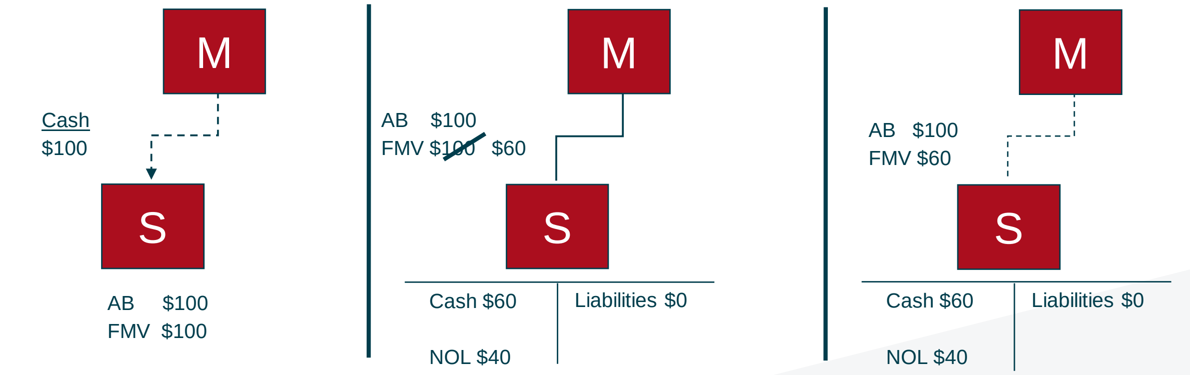
Application of Attribute Reduction Amount (Cont'd)

- Any ARA not applied to reduce recognized losses is applied to S's assets – assets other than Class I assets in Treas. Reg. § 1.338-6(b)(1) (e.g., cash and cash equivalents). ARA is allocated to S's assets under the "**reverse residual method**," using categories in Treas. Reg. § 1.338-6(b):
  - ARA allocated first to Class VII (reducing basis in that class to zero); then remaining ARA allocated to each next lower class successively (other than Class I)
  - If ARA is less than basis in a class, basis is reduced proportionately within class
- Special rules for lower-tier subsidiaries
- If ARA exceeds attributes, no further effect unless S has contingent liabilities (in which case excess ARA suspended and applied as liabilities are taken into account)
- Reductions **effective immediately before transfer of S shares**
- Attribute reduction is not treated as noncapital, nondeductible expense (so no duplicative stock basis reduction under Treas. Reg. § 1.1502-32)
- Special rules in the case of worthlessness or a taxable liquidation

Treas. Reg. § 1.1502-36(d)(6) Election

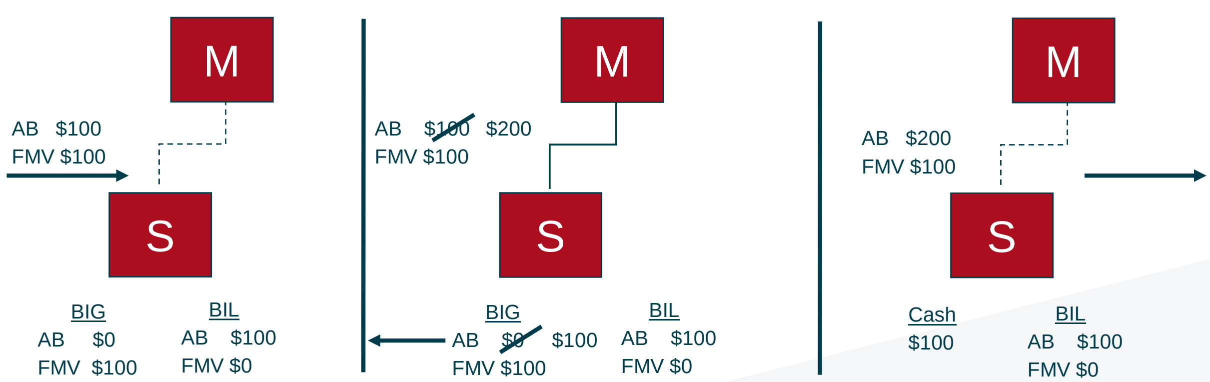
- Group can **avoid or reduce attribute reduction by electing to reduce members' bases in transferred loss shares**, reattribute S's attributes to P (if S leaves the group), or a combination
  - Can specify amount elected (or not elected)
  - Can only reattribute up to ARA: No effect given to election for any amount in excess of ARA (i.e., P can make protective election)
  - Can reattribute section 382 limit to which reattributed losses are subject
- S's attributes can be reattributed in the same manner as they are reduced (i.e., P can specify the losses to be reattributed or use the default order)
- The election is made by a **statement on or with the group's return for the taxable year of the transfer**. Statement by S is not required.
- In effect, the parties can convert what would otherwise be a capital loss for the seller, and an NOL subject to section 382 for the buyer, to an NOL, not limited by section 382, for the seller
- Generally, heavily negotiated between parties to transaction

Loss Duplication with NOLs



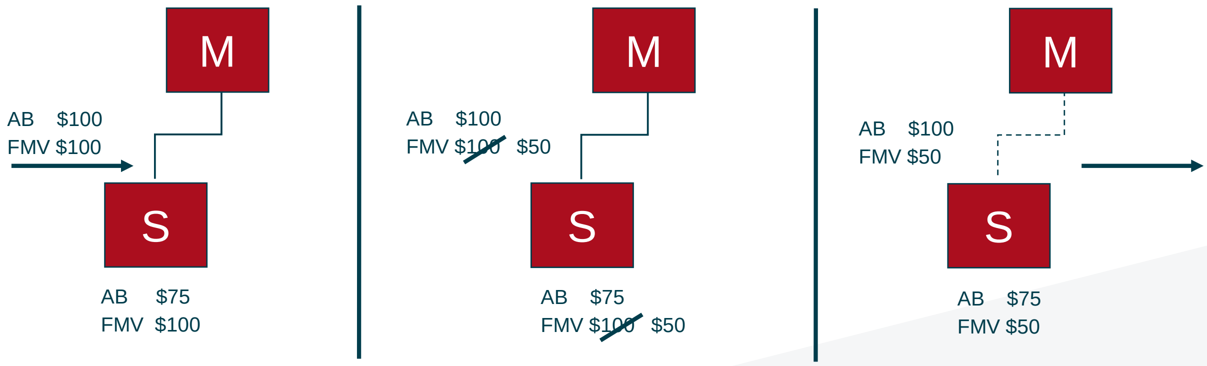
- Facts: M contributes $100 to S. S spends $40 on deductible R&D that generates a $40 consolidated NOL carryover. M sells the S stock for $60.
- Basis Reduction: M's $40 **loss is *allowed*** because $0 is the lesser of:
  - NPA of $0. No positive or negative investment adjustments.
  - Disconformity amount of $0. The excess of M 's $100 basis in the S stock, over S's $100 net inside attributes (money and NOLs).
- Loss Duplication Result: M's $40 loss is allowed, **but S must reduce its NOL from $40 to $0 to prevent duplication**. The group **may elect** to reduce M's stock basis and retain the NOL in S or it can elect to reattribute the NOL to M.

Loss Duplication Back Stops Basis Reduction



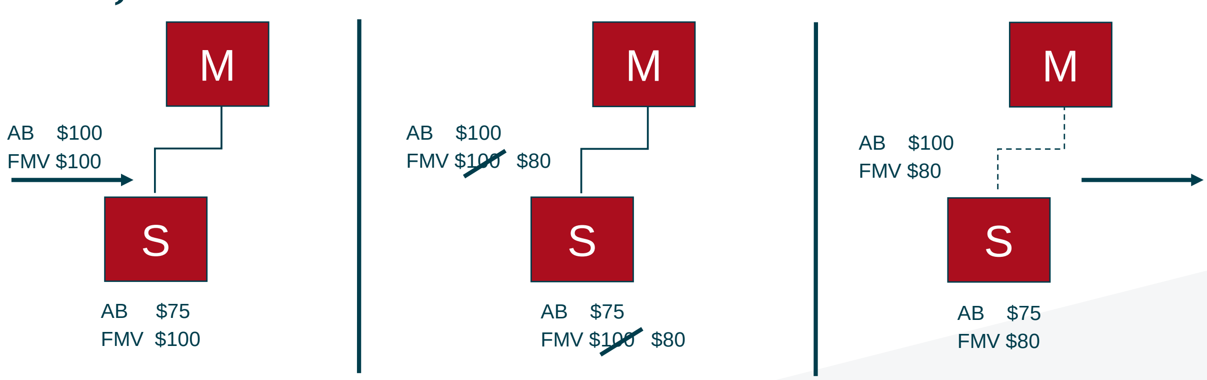
- Facts: M buys the S stock for $100, when S's BIG asset has a $0 basis and $100 FMV, and BIL asset has a $100 basis and $0 FMV. S sells the BIG asset for $100. M sells the S stock for $100.
- Basis Reduction: M's $100 **loss is *allowed*** because $0 is the lesser of:
  - NPA of $100. $100 positive Treas. Reg. § 1.1502-32 adjustments
  - Disconformity amount of $0. The excess of M's $200 S stock basis, over S's $200 net inside attributes
- Loss Duplication Result: M's $100 loss is allowed, **but S's asset basis is reduced from $100 to $0**. Alternatively, **M may elect to forego its stock loss and preserve S's unrealized loss**.

Loss Duplication: Appreciated Asset Declines in Value, FMV Below Basis



- Facts: M buys the stock of S for $100, when S's asset has a $75 basis and $100 FMV. S's asset declines in FMV to $50 (i.e., below S's basis in its asset). M sells the S stock for $50.
- Basis Reduction: M's $50 **loss is *allowed*** because $0 is the lesser of:
  - NPA of $0. No positive or negative Treas. Reg. § 1.1502-32 adjustments
  - Disconformity amount of $25. The excess of P's $100 basis in the S stock, over S's $75 "net asset basis"
- Loss Duplication Result: **S must reduce the basis of its asset by $25**, the lesser of:
  - The net stock loss of $50, and
  - S's aggregate inside loss of $25 (i.e., $75 net inside attributes (asset basis) over the $50 value of the S stock).
  - **Alternatively, M can reduce its stock basis by $25, eliminating $25 of its $50 stock loss.**

Loss Duplication: Appreciated Asset Declines in Value, FMV Above Basis



- Facts: M buys the stock of S for $100 when S's asset has a $75 basis and $100 FMV. S's asset declines in FMV to $80 (i.e., below M's basis in its S stock but above S's basis in its asset). M sells the S stock for $80.
- Basis Reduction: M's $20 **loss is *allowed*** because $0 is the lesser of:
  - NPA of $0. No positive or negative Treas. Reg. § 1.1502-32 adjustments
  - Disconformity amount of $25. The excess of P's $100 basis in the S stock, over S's $75 "net asset basis"
- Loss Duplication Result: **M's $20 loss is allowed. S need not reduce the basis of its asset because M's stock loss does not duplicate a loss inside S.**

Buyer Concerns Arising from Attribute Reduction

- Attribute reduction might arise any time (1) the *purchase price of S stock is less than the total net attributes* of S, and (2) the selling group has a *loss on the S stock*
- A potential *buyer of S will generally want P to elect to reduce stock basis* instead of acquiring S with reduced attributes
- The attribute reduction amount may not be known at closing
  - S's attributes may be subject to audit adjustment
  - Purchase price may be subject to adjustment
  - Buyer normally would not know or care about the selling group's stock basis, or whether the selling group has a tax loss on the sale, and *would want to be protected regardless of that basis*
- P can make a "***protective election***" to reduce stock basis at the time of sale in order to *prevent any future attribute reduction to the buyer*, even though the amount of the potential attribute reduction may not be known at that time

Member Liability for a Group's Taxes: Treas. Reg. 1.1502-6

Member Liability for Taxes: Treas. Reg. 1.1502-6

- §1.1502-6(a) – General Rule
  - General rule provides that the common parent corporation and each subsidiary which was a member of the group during any part of the consolidated return year is **severally liable** for the tax for such year.
    - The several liability of the member or subsidiary with respect to the consolidated return **is not what the federal income tax would have been for the subsidiary had it filed and been liable on a separate return**, but is for the tax computed in accordance with the consolidated return. It is severally liable for the tax liability of the group. *MidAmerica Television Co. v. State Tax Commission of Missouri*, 652 S.W.2d 674 (1983) (Sup. Ct. of MO.).
    - When a tax is severally owed by two or more taxpayers, the Service has the authority to **collect the full amount of unpaid tax from any of the taxpayers who are members of the group**. McCray v. United States, 910 F.2d 1289 (5th Cir. 1990).

- §1.1502-6(c) – Intercompany agreements
  - Provides that agreements entered into by one or more members of a group **do not have the effect of reducing the liability** prescribed in §1.1502-6.

Member Liability for Taxes: Treas. Reg. 1.1502-6

- §1.1502-6(b) – Departure of member from group
  - If a subsidiary has ceased to be a member of the group and if such cessation resulted from a bona fide sale or exchange of its stock for fair value and occurred prior to the date upon which any deficiency is assessed, **the Commissioner may, make assessment and collection of such deficiency from such former subsidiary** in an amount not exceeding the portion of such deficiency which the Commissioner may determine to be allocable to it. See §1.1502-6(b).
    - Can IRS assess for the entire amount of tax due against the departed member?
      - "This provision has been interpreted to mean that the District Director may assess a member of the group for only the portion of the consolidated group's tax liability that is attributable to it, **but still has authority to assess the entire consolidated tax from this former member**." 1995 FSA Lexis 522 (Mar. 30, 1995);
      - "This section appears to be within the district director's discretion, **but does not appear to limit** the district director to assessing and collecting solely a former subsidiary's allocable share of the consolidated tax liability." 1994 FSA Lexis 358 (July 27, 1994).
    - What if a member departs group as "new Target" in a Section 338(h)(10) transaction?
      - §1.338(h)(10)-1(d)(2) provides that new T remains liable for the tax liabilities of old T (including the tax liability for the deemed sale tax consequences). For example, **new T remains liable** for the tax liabilities of the members of any consolidated group that are attributable to taxable years in which those corporations and old T joined in the same consolidated return. See §1.1502-6(b).

Partnership M&A Developments and Reminders

Tax Treatment of Buying a Partnership

- Depends on whether purchase all or a portion.
- Rev. Rul. 99 -6 provides the federal tax consequences of the sale of partnership interests to a single owner, thereby converting the partnership into a disregarded entity.
  - When a third party buys all the interests of an existing multi-member partnership, the partnership status of the partnership is terminated under Section 708(b)(1).
  - The partnership is treated as making liquidating distributions of its assets to the former partners.
  - The buyer is then treated as purchasing the assets for a price equal to the amount paid for the interests.
  - The buyer can continue the business as a single-member entity/LLC.

Some Complexities of Buying a Partnership

- Allocation among purchased assets/assumed liabilities.
- Section 1445/1446 withholding.
- BBA audit regime.
  - Under the default rule of the BBA audit regime, IRS has authority to determine, assess, and collect tax on partnership underpayments at the partnership level.
  - A single person — the partnership representative (or a designated individual) — has the exclusive authority to represent, negotiate, and bind the partnership at all stages of a partnership proceeding subject to the BBA audit regime.
  - Partners do not have a statutory right to notice or to participate in the partnership proceeding.
  - Buyers may want to examine whether or when the partnership representative is obligated to make a push-out election and consider requesting that a push-out election be made absent an express obligation to do so in the operative documents.

Lack of Technical Terminations

- Repeal of Section 708(b)(1)(B).
  - Technical terminations no longer exist at the federal level.
  - Retained in some states in certain situations (e.g., certain counties transfer tax rules in CA follow the Code of 1986 or 1954).

Continuing Partnership Considerations

- Section 708(a) states that "[a]n existing partnership shall be considered as continuing if it is not terminated…A partnership shall be considered as terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership."
- Partnerships therefore can continue through different transaction types, entity changes and unexpected circumstances; for a couple of simple examples, see, e.g., Rev. Rul. 66-264, and Rev. Rul. 95-37.
- Rollovers are of particular concern.

Continuing Partnership Considerations, continued

- A continuing partnership may, and in some instances must, use the former partnership's EIN instead of obtaining its own.
- Under Section 703(b), a partnership is generally entitled to make partnership-level tax elections; a continuing partnership would generally be bound by the elections previously made.
- BBA considerations.
- Others?

Other Ongoing M&A Considerations

Preserving QSBS in M&A Deals

- **QSBS**: Qualified Small Business Stock
- **Rule**
  - Tax-free reorganization or exchange (368 or 351)
  - Stock of Acquiror does not qualify as QSBS
  - Stock of Acquiror is QSBS in hands of exchanging stockholder, but only up to gain that would have been recognized as of the date of the exchange
- **What does eligible mean?**
  - Eligible corporation
    - Domestic C corporation
    - Not a DISC or former DISC, RIC, REIT, REMIC or co-op
  - $ 50 million gross assets
  - No redemptions
  - Active conduct of a qualified trade or business