Report No. 1328

# NEW YORK STATE BAR ASSOCIATION

## TAX SECTION

## PROPOSED AMENDMENTS TO

## TREASURY REGULATIONS SECTION 1.1502-76

**August 20, 2015**

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**REPORT PROPOSED AMENDMENTS TO**
**TREASURY REGULATIONS § 1.1502-76**

# I. INTRODUCTION

This report[1] of the Tax Section of the New York State Bar Association sets forth comments on the recently proposed amendments to Treasury Regulations § 1.1502-76[2] (the "Proposed Regulations"). The Proposed Regulations would revise the "Next Day Rule" and related rules that determine how certain items of income, deduction, gain, loss or credit arising on the day that a corporation ("Target") joins or leaves a consolidated group (such day, the "Change Date," and such joining or leaving, the "Status Change") are allocated between Target's taxable year that terminates as a result of the Status Change and the immediately following taxable year (such years, the "Pre-Change Year" and the "Post-Change Year," respectively). In the notice of proposed rulemaking, the Internal Revenue Service (the "Service") and Treasury Department (the "Treasury") also request comments on certain other issues affecting allocations of items between the Pre-Change Year and the Post-Change Year.

The report is divided into four parts. Part I is this Introduction. Part II describes the background of the Proposed Regulations and summarizes the provisions

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1 The principal author of this report is Andrew H. Braiterman. Helpful comments were received from Kimberly Blanchard, Lawrence Garrett, Edward Gonzalez, Andrew Herman, Stephen Land, Andrew Needham, Adam Perry, Yaron Reich, Michael Schler and David Sicular. The assistance of Justin Cohen is gratefully acknowledged. This report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

2 REG-100400-14, 80 Fed. Reg. 12097 (Mar. 6, 2015).

thereof. Part III is a summary of our recommendations. Part IV is a discussion of the issues and our recommendations.

## II. BACKGROUND

### A. Current Regulations

Section 1502[3] gives the Treasury authority to prescribe regulations regarding consolidated returns. In 1966, the Treasury promulgated the original version of Treas. Reg. § 1.1502-76, which provided rules for determining the taxable years of corporations leaving or joining consolidated groups.[4] The 1966 regulations did not include specific rules regarding allocation of tax items arising on the Change Date.[5] In 1994, the Treasury issued the current regulations which introduced the End of the Day Rule, the Next Day Rule, and other related rules which determine how such tax items are allocated between Target's Pre-Change Year and Post-Change Year.[6]

Under the current regulations, for all federal income tax purposes, Target's Pre-Change Year generally terminates at the end of the Change Date (the current "End of the Day Rule").[7] All tax items arising on the Change Date are allocated to the Pre-

3 Unless otherwise specified, all "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury Regulations promulgated thereunder.

4 T.D. 6894, 31 Fed. Reg. 11794 (Sept. 7, 1966).

5 *Id.*

6 T.D. 8560, 59 Fed. Reg. 41666 (Aug. 15, 1994).

7 Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(1).

Change Year, other than items allocated to the day after the Change Date (and thus to the Post-Change Year) under the "Next Day Rule."[8]

The current regulations provide that a transaction that occurs on the Change Date is treated as occurring on the next day for all federal income tax purposes if the transaction is "properly allocable" to the portion of the Change Date after the event that causes Target's Status Change (such event, the "Triggering Event").[9] This Next Day Rule was included in the current regulations in response to comments on the proposed form of those regulations that added the End of the Day Rule but did not include a Next Day Rule; the notice of proposed rulemaking accompanying the current Proposed Regulations indicates that there were concerns that the End of the Day Rule could result in a seller of Target's stock being unfairly surprised by non-ordinary course transactions (*e.g.*, a sale by Target of a division) effected on the Change Date after the Triggering Event at the direction of Target's buyer, resulting in gain being inappropriately reflected in the Pre-Change Year.[10] A determination as to whether a transaction is properly allocable to the portion of the Change Date following the Triggering Event is respected if the allocation is "reasonable" and consistently applied by all persons affected by it.[11] The regulations enumerate a non-exclusive list of four factors to be considered in determining whether an allocation is reasonable.[12]

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[8] *Id*.

[9] Treas. Reg. § 1.1502-76(b)(1)(ii)(B). The current Next Day Rule can apply to nonextraordinary items if no ratable allocation election is made pursuant to Treas. Reg. § 1.1502-76(b)(2)(ii)(B).

[10] REG-100400-14, 80 Fed. Reg. 12097, 12098 (Mar. 6, 2015).

[11] Treas. Reg. § 1.1502-76(b)(1)(ii)(B).

[12] The factors include: (i) whether there are inconsistent allocations of items of income, gain, deductions, loss and credit; (ii) whether tax items with respect to Target's stock reflect the ownership of Target's

If, however, Target was an S corporation and joins a consolidated group, other than in connection with a qualifying stock purchase for which a Section 338(g) election is made, Target's S election is terminated at the end of the day preceding the Change Date[13] and Target becomes a member of the acquiring consolidated group on the beginning of the Change Date (the current "Beginning of the Day Rule").[14] The current regulations do not include a rule analogous to the Next Day Rule pursuant to which Change Date items that are "properly allocable" to the portion of such day prior to the Triggering Event are allocated to the Pre-Change Year.

Items of income, deduction, loss and credit generally are allocated between the Pre-Change Year and the Post-Change Year based upon a closing of the books. However, unless Target was an S corporation prior to the Change Date, an election can be made to ratably allocate all tax items other than "extraordinary items" for the year or the month in which the Change Date occurs, based upon the relative number of days in the year or month that fall within the Pre-Change Year and the Post-Change Year.[15] If Target is a partner in a partnership, Target is treated as selling its interest in the

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stock before and after the Status Change; (iii) whether the allocation is inconsistent with requirements of other Sections or regulations (such as Section 338(g) election timing rules or Section 108(a) discharge of indebtedness rules); and (iv) whether other facts (such as prearranged transactions) exist indicating that the transaction is not properly allocable to the portion of the Change Date following the Triggering Event. Treas. Reg. § 1.1502-76(b)(1)(ii)(B)(1)-(4).

[13] *See generally* Treas. Reg. §§ 1.1362-2(b)(2), 1.1362-3(a).

[14] Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(2).

[15] Treas. Reg. § 1.1502-76(b)(2)(ii) & (iii). Treas. Reg. § 1.1502-76(b)(2)(ii)(C) sets forth various categories of extraordinary items, including gains and losses from capital assets and Section 1231 assets and bulk sales of inventory.

partnership for purposes of allocating Target's share of partnership items in the year in which the Change Date occurs.[16]

The current regulations also include an anti-avoidance rule. Under the anti-avoidance rule, if any person acts with a principal purpose contrary to the purposes of Treas. Reg. § 1.1502-76(b) to substantially reduce the federal income tax liability of any person, adjustments are to be made to carry out the purposes of the regulation.[17]

B. Proposed Regulations

In the notice of proposed rulemaking, the Service and the Treasury express the view that the flexibility in the current Next Day Rule's factor-based reasonableness approach has led to uncertainty.[18] The notice expresses concern that taxpayers have interpreted the rules in a manner that results in inappropriate electivity and may not result in a clear reflection of income.[19] The Proposed Regulations combat this perceived abuse by making the proposed Next Day Rule less flexible than the current version of the rule. In particular, the proposed Next Day Rule would require that an extraordinary item that results from a transaction that occurs and would be taken into account on the Change Date be allocated to the next day if the transaction occurs after the Triggering Event.[20] If the extraordinary item becomes includible or deductible simultaneously with the Triggering Event, the Next Day Rule would not apply. The proposed Next Day Rule

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[16] Treas. Reg. § 1.1502-76(b)(2)(vi)(A).

[17] Treas. Reg. § 1.1502-76(b)(3).

[18] REG-100400-14, 80 Fed. Reg. 12097, 12098-99 (Mar. 6, 2015).

[19] *Id.*

[20] Prop. Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(2).

would not apply to items that are not extraordinary items, regardless of whether those items arise from transactions that occur after the Triggering Event.

The Proposed Regulations also add a new "Previous Day Rule" applicable to Targets that are S corporations prior to the Change Date. Under the Previous Day Rule, an extraordinary item that occurs on the Change Date but before or simultaneously with the event that causes the termination of Target's S corporation status would be treated as occurring on the day prior to the Change Date and therefore would be included in Target's last S corporation year.[21]

The Proposed Regulations would also expand the category of compensation-related deductions treated as extraordinary items to include deductions for fees for services rendered in connection with the Status Change, in addition to bonus, severance or option cancellation payments made in connection with the Status Change.[22] The notice of proposed rulemaking indicates that extraordinary items would include deductions of financial advisory fees that are contingent upon a successful sale of Target.[23]

The Proposed Regulations also attempt to make application of Treas. Reg. § 1.1502-76 more consistent with the principles and approaches of other consolidated return rules and Code provisions.[24] Under the current regulations, the End of the Day

[21] Prop. Treas. Reg. § 1.1502-76(b)(1)(ii)(B)(2).

[22] Prop. Treas. Reg. § 1.1502-76(b)(2)(ii)(C)(9).

[23] REG-100400-14, 80 Fed. Reg. 12097, 12099 (Mar. 6, 2015).

[24] *Id*.

Rule and the Next Day Rule apply for all federal income tax purposes.[25] However, the notice of proposed rulemaking indicates that this could yield inconsistent results with the objectives of other consolidated return rules the application of which depends upon whether a corporation is a member of a consolidated group immediately after a transaction. Under the Proposed Regulations, the End of the Day Rule, the Beginning of the Day Rule, the Next Day Rule and the Previous Day Rule would apply only for purposes of determining the period in which Target must report its tax items and for purposes of Sections 382(h) and 1374.[26] The Proposed Regulations also add coordination rules applicable to situations where both Treas. Reg. § 1.1502-76(b) and Section 382[27] or 1374[28] apply.

The Proposed Regulations would also expand the anti-avoidance rule to expressly apply to modifications of existing contracts or other agreements in anticipation of a Status Change in order to alter the taxable year to which tax items are allocated if this results in a substantial reduction in any person's federal income tax liability.[29]

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[25] Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(1)-(2), (B).

[26] Prop. Treas. Reg. § 1.1502-76(b)(1)(ii)(A)-(B), (D).

[27] Under the Proposed Regulations, if the Triggering Event also triggers an ownership change under Section 382, tax items included in the Post-Change Year will be included in the recognition period, defined in Section 382(h)(7)(A), and tax items included in the Pre-Change Year will not be included in the recognition period. Prop. Treas. Reg. § 1.1502-76(b)(2)(ii)(D).

[28] The Proposed Regulations specify that where Target ceases to be an S corporation as a result of joining a consolidated group or becomes an S corporation after leaving a consolidated group, Target's calculation of built-in gain or loss for purposes of Section 1374 will only include tax items reported on Target's separate return. *Id.*

[29] Prop. Treas. Reg. § 1.1502-76(b)(3).

C. Practical Consequences of Allocation Rules

Properly evaluating the appropriateness of rules for allocating items between the Pre-Change Year and the Post-Change Year requires taking into account the practical consequences of such rules. In many cases, the period to which an item is allocated does not merely affect the timing of an income inclusion or deduction,[30] but also affects the aggregate tax liability of the parties and revenue to the government.

For example, where Target belongs to a consolidated group prior to the Change Date, in many, if not most, cases any item of income or deduction allocated to the Pre-Change Year is offset by a corresponding change in gain or loss on the sale of Target's stock as a result of adjustments to the basis of Target's stock under the investment adjustment rules,[31] so that any such income inclusion is effectively free of tax and any deduction is effectively wasted. By contrast, accounting for the item of income or deduction in the Post-Change Year generally will have a real effect on Target's tax liability. This difference in tax effect between allocations to the Pre-Change Year or the Post-Change Year does not always apply, however. Where the item to be allocated to the Pre-Change Year is ordinary income or loss, the corresponding effect on capital gain or loss from sale of Target's stock may not be a full offset if the selling group has potentially unusable capital losses (either pre-existing or created as a result of the investment adjustment and stock sale) or the adjustment to the basis of the Target's stock increases or decreases a disallowed capital loss under the unified loss rule of the

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[30] Where mere timing is at stake, as long as all parties are aware of the relevant facts and rules, any consequences of contractual allocation of pre-closing Target taxes between the buyer and the seller in a stock purchase agreement can be taken into account in the purchase price.

[31] *See* Treas. Reg. § 1.1502-32.

consolidated return regulations.[32] Conversely, the tax effect of an item of income allocated to the Post-Change Year may be offset by other tax attributes of an acquiring group.

Where Target is an S corporation prior to the Change Date, items of income or loss allocated to the Pre-Change Year also result in an adjustment to stock basis, so that an item of ordinary income or deduction that is allocated to the Pre-Change Year results in a substitution of an ordinary item for capital gain or loss.[33] In this case, the change in character generally will be significant, as the affected S corporation shareholders generally will face different rates on ordinary income and capital gain. In the case of a deduction that cannot be used as a result of basis limitations, however, an item allocated to the Pre-Change Year may have no effect at all. Other situations where the period to which an item is allocated has a real impact on the parties' aggregate tax liability include situations where allocation of the item to the Pre-Change Year increases or decreases a net operating loss or net capital loss that is subject to limitation under Sections 382 or 383.

## III. SUMMARY OF COMMENTS AND RECOMMENDATIONS

As discussed in more detail below, our principal comments and recommendations are as follows:

1. We agree with the general approach of the proposed changes to the Next Day Rule. We believe that these changes reduce inappropriate opportunities for

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[32] *See* Treas. Reg. § 1.1502-36(c) & (d).

[33] *See generally* Section 1367(a) and Treas. Reg. § 1.1367-1(a)-(c).

electivity and largely succeed in allocating items between the Pre-Change Year and the Post-Change Year in a manner that is consistent with the period to which items are economically attributable. To the extent that the Proposed Regulations do not entirely succeed in that objective, we believe that this is an unavoidable consequence of the application of general tax accounting principles which are not within the scope of Treas. Reg. § 1.1502-76.

2. We agree with the Proposed Regulations' allocation to the Pre-Change Year of compensation deductions and success-based fees that are taken into account on the Change Date.

3. We agree with the Proposed Regulations' allocation to the Pre-Change Year of deductions associated with debt refinancings that occur simultaneously with the Triggering Event.

4. With respect to extraordinary items that arise from asset sales on the Change Date, we recommend that examples be added to illustrate that where the sale occurs prior to or simultaneously with the Triggering Event, gain or loss is properly reflected in the Pre-Change Year. In addition, the definition of extraordinary transaction should be broadened to include all dispositions of assets outside the ordinary course of business.

5. We generally agree with the provision in the Proposed Regulations limiting the scope of the End of the Day, Next Day, Beginning of the Day, and Previous Day Rules to the determination of the tax year in which to report items, rather than having such rules apply for all federal income tax purposes as provided in the current

regulations. Our view is based on the fact that the relevant policies are different, but we acknowledge that this approach will require consideration of the interplay of various other provisions of the consolidated return regulations with the Proposed Regulations, and in the discussion below we note several instances where the rules should be clarified. We would change two of the results reached in the examples in the Proposed Regulations involving redemptions of stock that result in a company ceasing to be a member of a group.

6. We agree with the addition of the Previous Day Rule applicable to Status Changes involving former S corporations to which the Beginning of the Day Rule generally applies. We suggest clarifying changes to ensure that the Previous Day Rule operates consistently with the Next Day Rule.

7. We recommend that even if Target is not an S corporation prior to its Status Change, parties should be permitted to elect application of the Beginning of the Day and Previous Day Rules where that is consistent with the non-tax economics of a sale transaction —*e.g.*, where purchase price adjustments are based on Target's working capital as of the close of the day prior to the Change Date.

8. We recommend amending the regulations so as not to permit election of ratable allocation of non-extraordinary items for an entire year. However, we believe that ratable allocation for the month in which the Status Change occurs should be permitted as a matter of administrative convenience as long as there is no closing of the books for non-tax purposes (*e.g.*, purchase price adjustments or financial accounting).

9. We do not recommend changing the current regulations' treatment of items relating to controlled foreign corporations ("CFCs") and passive foreign investment companies ("PFICs") as extraordinary items in cases where no qualified electing fund ("QEF") election has been made. In the case of a PFIC with respect to which Target has made a QEF election, we recommend adding rules similar to those applicable to partnership interests owned by Target for purposes of allocating QEF inclusions.

10. We recommend adding examples to illustrate the intended application of the anti-avoidance rule.

## IV. DISCUSSION

### A. General Approach to Modification of Next Day Rule

We agree with the general approach of the Proposed Regulations in clarifying the scope of the Next Day Rule and attempting to minimize the extent to which its application is elective. The basic objective of the Proposed Regulations' approach to the Next Day Rule appears to be to apply clear reflection of income principles to determine the period for reporting extraordinary items based upon whether the items are economically attributable to the seller (and thus allocable to the Pre-Change Year) or the buyer (and allocable to the Post-Change Year).[34] We agree that this objective is a salutary one. The standard set forth in the Proposed Regulations is clearer than that of the current regulations, which apply the Next Day Rule to transactions that are "properly

[34] Reference in this report to the "seller" and the "buyer" are intended to refer to Target's owners before and after the Status Change, except where the context otherwise requires.

allocable" to the portion of the Change Date following the Triggering Event and respect determinations that are "reasonable and consistently applied by all affected persons."[35] Requiring the application of the Next Day Rule to extraordinary items that result from transactions that occur on the Change Date but after the Triggering Event is appropriate. Such transactions generally are beyond the control of the seller and are therefore not properly reportable on the return for the Pre-Change Year. More significantly, where Target is a member of a consolidated group prior to the Status Change, such transactions are properly attributable to the buyer's activity and their tax effects should not be effectively eliminated as a result of being allocated to the Pre-Change Year and potentially offset by reason of the investment adjustment rules.[36]

Likewise, we believe that the standard set forth in the Proposed Regulations that "[t]he Next Day Rule does not apply to any extraordinary item that becomes includible or deductible simultaneously with the event that causes the change in S's status"[37] is appropriate. This rule generally has the effect of allocating income and deductions of Target that are tied to the Triggering Event to the Pre-Change Year. These items are appropriately viewed as "seller" items and should not give rise to a tax cost or tax benefit to the buyer. We acknowledge that if Target is a stand-alone C corporation prior to the Status Change, there generally would be a real tax savings from deductions that accrue upon the occurrence of a Triggering Event (*e.g.*, compensation deductions triggered by a change in control), and therefore one can argue that the parties should be permitted to avoid wasting the deduction by allocating the deduction to the Post-Change

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35 Treas. Reg. § 1.1502-76(b)(1)(ii)(B).

36 *See supra* note 31 and accompanying text.

37 Prop. Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(2).

Year if Target is included in a consolidated group prior to the Status Change. We believe, however, that the elimination of the effect of the deduction (or of an income item) is a natural and appropriate consequence of the single-entity concepts inherent in the consolidated return regulations generally and the investment adjustment rules in particular.

The Proposed Regulations fall short of fully achieving the objective of allocating extraordinary items based upon whether items are economically attributable to the seller or the buyer. This is, however, an unavoidable consequence of the fact that potential application of the principles of the Next Day Rule is by definition limited to items that are taken into account on the Change Date under applicable tax accounting rules, subject to possible application of the anti-avoidance rule.[38] Tax accounting rules do not always result in items being taken into account in the taxable year in which they economically accrue. Under Section 404(a)(5), for example, an employer is not entitled to a deduction for nonqualified deferred compensation until its taxable year within which the employee's taxable year of inclusion ends. Thus, if the Change Date occurs in the middle of a calendar year, deductions for deferred compensation that become fixed on or prior to the Change Date — even if the payment obligation is an extraordinary item triggered by the Status Change — will be allocated to the Post-Change Year (or conceivably a later year). Similar results occur for deductions subject to the economic performance rule of Section 461(h). On the income side, gain reported on the installment method can be deferred for many years after the year in which the sale takes place. We believe that these results are inevitable, given that, absent a Section 338 election, Target

[38] *See* discussion at IV.J, below.

is still the same taxpayer before and after the Change Date and is subject to general principles of annual tax accounting. A stock sale is by its nature different from an asset sale (or a deemed asset sale under Section 338) in which the purchaser generally is not entitled to deduct, and instead must capitalize, assumed liabilities that could have been deducted by the seller absent the sale.

B. <u>Compensation-Related Deductions and Success-Based Fees</u>

The Proposed Regulations include an example in which Target becomes obligated to cash out nonqualified options upon a change in control and the payment is made several days after the Change Date.[39] The example states that the associated deduction is an extraordinary item and that the Next Day Rule is inapplicable because the liability becomes deductible on the Change Date simultaneously with the Triggering Event. The Next Day Rule therefore cannot apply and the deduction must be reported in the Pre-Change Year. This result is consistent with what appears to be the Service's view of the operation of the current regulations.[40]

The Proposed Regulations expand the category of compensation-related deductions treated as extraordinary items to include deductions "for fees for services

[39] Prop. Treas. Reg. § 1.1502-76(b)(5) *Example 8(a) & (b)*.

[40] *See* AM 2012-010 (November 15, 2012) (deduction for cashing out nonqualified options and stock appreciation rights ("SARs") allocable to the Pre-Change Year); *but see* PLR 200009013 (November 26, 1999) (deduction for cash-out of certain SARs allocated to the Post-Change Year by reason of application of Section 404(a)(5), which was not analyzed in detail in AM 2012-010).

rendered in connection with" the Triggering Event.[41] An example applies this rule to a success-based fee owed to a consultant in connection with a change in control.[42]

These results are a straight-forward and appropriate application of the general principles of the Proposed Regulations. As is the case with the Proposed Regulations more generally, however, actual results may vary based upon relevant tax accounting rules. For example, as noted above, a deduction for vested deferred compensation that becomes payable upon a change in control may nonetheless be allocated to the Post-Change Year pursuant to Section 404(a)(5). The applicability and appropriateness of these tax accounting rules in different situations (*e.g.*, in the case of cash-outs of SARs) is beyond the scope of this report. As noted above,[43] we do not believe that this is the type of issue that can be resolved under the consolidated return regulations. To the extent that taxpayers attempt to manipulate the timing of deductions by means of imposing artificial conditions on payment obligations, we believe that the anti-avoidance rule of the Proposed Regulations can appropriately be applied, as discussed below.[44]

We recognize that there are arguments that certain compensation-related expenses that occur in connection with the Status Change may be associated more closely with enhancing the future profitability of the business than with compensation for past services and thus are appropriately allocable to the Post-Change Year. This argument has perhaps greatest weight in the cases of severance payments, which presumably benefit

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41 Prop. Treas. Reg. § 1.1502-76(b)(2)(ii)(C)(9).

42 Prop. Treas. Reg. § 1.1502-76(b)(5) *Example 8(c)*.

43 *See* discussion at IV.A, above.

44 *See* discussion at IV.J, below.

the buyer by reducing future compensation expenses (but could also be viewed as compensation for past services), and payments for post-Change Date services. We do not believe, however, that this justifies a departure from the bright-line rule of the Proposed Regulations, which generally produce appropriate results in the case of option expense, transaction bonuses, and success-based fees. We further note that, subject to possible application of the anti-avoidance rule, the Proposed Regulations do not impede taxpayers from structuring severance payments so that the deduction does not accrue until after the Change Date. In the case of payments made to incentivize continued work after the Change Date, we are not sure why the tax rules should play much of a role here, as we are hard-pressed to see how such payments are effective in achieving their objectives unless they are conditioned upon continued work after the Change Date and therefore do not accrue on or before the Change Date.

### C. Deductions Associated with Debt Repayment

Target’s preexisting indebtedness is often repaid in connection with the event giving rise to the Status Change, and the repayment of indebtedness generally results in deductions for any redemption premium as well as previously unamortized financing costs associated with the debt. In some cases, repayment may be required upon a change of control under the terms of the indebtedness. In other situations, existing debt may be refinanced at the behest of a buyer that is able to arrange financing on more favorable terms or that requires increased indebtedness in order to finance the acquisition of Target.

The current regulations treat items resulting from the retirement of indebtedness as extraordinary items,[45] and the Proposed Regulations do not change such classification. Under the current regulations, taxpayers could argue that it would be reasonable to apply the Next Day Rule where indebtedness is required to be paid simultaneously with a change in control. The Proposed Regulations would eliminate this argument — to the extent that such deductions accrue simultaneously with the Triggering Event, the Next Day Rule is not applicable under the Proposed Regulations, and the deductions are allocated to the Pre-Change Year.

One can argue that, at least in cases where refinancing occurs in order to further the buyer's objectives and is not required under the terms of the original indebtedness upon a change in control, deductions associated with debt repayment should be allocated to the Post-Change Year because the refinancing produces benefits in post-Change Date periods. We believe, however, that, wholly apart from the complexity inherent in factual determinations regarding the motivation for refinancing, this argument proves too much. The rules that generally permit immediate deductibility of debt retirement premium when debt is refinanced, rather than requiring amortization over the term of the new debt,[46] strongly imply that the deduction is properly associated with the refinanced debt and therefore appropriately allocated to the Pre-Change Year.

We recognize that where the parties are able to arrange for the repayment of indebtedness to occur after the Change Date (or, at least in theory, on the Change Date

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[45] Treas. Reg. § 1.1502-76(b)(2)(C)(7).

[46] Treas. Reg. § 1.163-7(c). There is an exception requiring amortization over the term of the new debt in the case of debt-to-debt exchanges involving non-publicly traded debt.

but after the Triggering Event with no requirement of repayment at the time of the Triggering Event), the deduction can be postponed until the Post-Change Year, absent applicability of the anti-avoidance rule. We note that the circumstances that permit the parties to do this likely tend to support the argument that allocating the deduction to the Post-Change Year is in fact appropriate as a matter of principle. In addition, this possibility is an inevitable consequence of the inherent limitations of Treas. Reg. § 1.1502-76, and should not change what we consider to be the sound result of the Proposed Regulations in cases where the refinancing occurs simultaneously with the Triggering Event.

D. Dispositions of Unwanted Assets

Gain or loss from the disposition or abandonment by Target of a capital asset or Section 1231 asset, disposition of substantially all the assets described in Section 1221(1), (3), (4) or (5) used in a trade or business, or disposition of assets in an applicable asset acquisition under Section 1060(c) is treated as an extraordinary item.[47] The Proposed Regulations include an example in which a purchaser of Target causes Target to sell trade or business assets that are not wanted by the purchasing group on the Change Date after the Triggering Event.[48] Under the Next Day Rule, gain or loss from the sale of unwanted assets is allocated to the Post-Change Year.[49]

We think that although the result in the example is likely correct, the proper period for reporting gain or loss from sale of "unwanted assets" is highly

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[47] Treas. Reg. § 1.1502-76(b)(2)(ii)(C)(1)-(4). This provision is unchanged by the Proposed Regulations.

[48] Prop. Treas. Reg. § 1.1502-76(b)(5) *Example 8(d)*.

[49] *Id.*

dependent on the relevant facts. In the clearest case, where the sale takes place during the portion of the Change Date following the Triggering Event and the pre-change owners of Target are not involved in negotiating the sale, and the asset sale is not a condition to closing the Target stock sale and does not affect the stock sale price, allocation to the Post-Change Year is obviously the right result.

Different considerations arise where Target has more than one business, the pre-Status Change owners want to dispose of Target in its entirety, the purchasing group is interested in only one of Target's businesses, and the sale of Target cannot happen unless a buyer is found for the assets of the remaining businesses. Assuming that both sales occur on the Change Date, we believe that it can be appropriate to allocate gain or loss to the Pre-Change Year; the purchasing group should not be required or entitled to take into account gain or loss from the disposition of assets that the seller intended to sell and the purchasing group never intended to acquire.

A more complicated situation is posed where Target engages in a sale-leaseback transaction[50] involving some of its assets in order to provide financing for the buyer's acquisition of Target. Such a financing transaction is typically for the buyer's benefit and negotiated by the buyer, which suggests that allocation of gain or loss from the sale-leaseback to the Post-Change Year is appropriate. As a practical matter, however, the pre-Status Change owners generally are required to help facilitate the sale-leaseback (*e.g.*, by providing information to the financing party). Especially where the availability of the sale-leaseback financing is a condition to the buyer's obligation to

[50] This discussion assumes that the sale-leaseback is treated as a true sale and lease for tax purposes, rather than as a loan.

purchase Target, it is arguably appropriate to allocate gain or loss from the sale-leaseback to the Pre-Change Year. Although the buyer of Target benefits from obtaining financing, it has not realized any economic gain or loss. Moreover, although allocating gain or loss to the Pre-Change Year may result in the total tax liability being unaffected by such gain or loss, the ability to offset gain or loss taken into account in the Pre-Change Year as a result of the investment adjustment rules is consistent with the general manner in which those rules operate.

Although we believe that the considerations discussed above provide an appropriate framework for thinking about the proper period for allocating gain or loss from dispositions, we do not believe it is practical to prescribe rules based upon subjective factors such as the parties' intent and which party really benefits from the disposition. Applying the general rule of the Proposed Regulations and allocating gain or loss from Change Date dispositions based upon whether the disposition occurs before or after the Triggering Event should generally produce appropriate results. This would not materially expand the potential for inappropriate electivity beyond what can be achieved by effecting a disposition on the day before or the day after the Change Date. It would be helpful to include an example in which gain or loss from a disposition of unwanted assets prior to the Triggering Event is allocated to the Pre-Change Year. We also believe that where the disposition and the Triggering Event are essentially simultaneous, allocation to the Pre-Change Year is the correct result; this is consistent with the general rule of the Proposed Regulations that the Next Day Rule does not apply to items that arise simultaneously with the Triggering Event.

We also recommend that the category of asset dispositions that are treated as giving rise to extraordinary items be broadened to include all dispositions outside the ordinary course of business. For example, gain or loss from a non-ordinary course sale of half of Target's inventory should be treated as an extraordinary item. Although such a sale is not treated as giving rise to an extraordinary item under the current regulations, the gain or loss from such a sale that occurs after the Triggering Event could still be allocated to the Post-Change Year under the current Next Day Rule; the current Next Day Rule, unlike that in the Proposed Regulations, is not limited to extraordinary transactions.[51] We note, however, that in what is arguably the most flagrantly abusive case, where a non-ordinary course sale of inventory to an affiliate of the purchasing group is treated as occurring during the Pre-Change Year, the Section 338 consistency rules generally would prevent the purchasing group from getting a stepped-up asset basis without the economic cost of gain recognition.[52]

E. Limitation of Scope of End of the Day Rule

The End of the Day Rule in the current regulations states that it applies "for all Federal income tax purposes."[53] As indicated in the preamble to the Proposed Regulations, this causes confusion as to whether a Target is considered to be a member of the group "immediately after" a transaction for purposes of application of other consolidated return regulations such as the intercompany transaction rules of Treas. Reg.

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[51] *See supra* note 9.

[52] Section 338(e)(1) and Treas. Reg. § 1.338-8(b)(1).

[53] Treas. Reg. § 1.1502-76(b)(1)(ii)(A).

§ 1.1502-13.[54] The Proposed Regulations clarify that the End of the Day Rule, as well as the Next Day Rule, the Beginning of the Day Rule and the Previous Day Rule, apply only for purposes of determining the period in which a tax item is reported.[55]

This limitation on the scope of the End of the Day Rule generally produces appropriate results. The notice of proposed rulemaking discusses an example in which a group member transfers assets along with liabilities to a nonmember in a Section 351 transaction that results in the nonmember becoming a member.[56] If the liabilities exceed the basis of the transferred assets, and the End of the Day Rule were to apply for all federal income tax purposes, it appears that Treas. Reg. § 1.1502-80(d)(1) would not apply to override gain recognition under Section 357(c) because the nonmember would not become a member until the day after the asset transfer. We believe that the Proposed Regulations produce the correct result by providing that the nonmember becomes a member immediately after the asset transfer, notwithstanding the fact that its tax items on the day of the transfer are included in the Pre-Change Year (except as provided under the Next Day Rule).

Having different rules for determining when a member joins or leaves a group for purposes of determining whether its items of income and deduction are included in the Pre-Change Year or the Post-Change Year and for other purposes does require careful consideration of the operation of the rules. Although this entails some complexity, we do not believe that it would be any simpler to have "consistent" rules for

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[54] REG-100400-14, 80 Fed. Reg. 12097, 12099 (Mar. 6, 2015).

[55] *See supra* note 26 and accompanying text.

[56] REG-100400-14, 80 Fed. Reg. 12097, 12099 (Mar. 6, 2015).

all purposes. As illustrated by the Section 357(c) example, adjustments to other rules would still be necessary.

The Proposed Regulations include examples involving redemptions that result in Status Changes.[57] Where the redemption reduces the group's interest in a member's stock from 80% to 75% and is treated under Section 302(d) as a distribution to which Section 301 applies, the example concludes that the distribution does not qualify as an intercompany distribution eliminated under Treas. Reg. § 1.1502-13(f)(2)(i) because the distributing corporation is not a group member immediately following the distribution, and the distributee's stock basis is not reduced by the amount of the distribution pursuant to Treas. Reg. § 1.1502-32(b)(2)(iv);[58] however, the distributee may be entitled to a dividends-received deduction under Section 243 and stock basis generally would be reduced under Section 1059(e).[59] We do not believe that this result is appropriate and recommend that it be changed in the final regulations. The redemption should be treated similarly to a dividend, which under the entitlement rule of Treas. Reg. § 1.1502-13(f)(2)(iv) would be deemed to occur before the distributing company leaves the group, with the result that the dividend would be eliminated in consolidation and stock basis would be reduced under the investment adjustment rules.

A variant of the above example concludes that if a redemption of all the group's stock in an 80%-owned member involves a distribution of loss property and results in capital gain or loss to the distributee member under Section 302(a), the

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[57] Prop. Treas. Reg. § 1.1502-76(b)(5) *Example 9*.

[58] *Id.*, *Example 9(c)*.

[59] *Id.*

distributing corporation's loss is disallowed under Section 311(a); because consolidation is broken, the rule of Treas. Reg. § 1.1502-13(b)(6), which would allow the loss in the case of an intercompany distribution, does not apply.[60] Because the loss is taken into account by the group under the End of the Day Rule, the example provides that the loss is a noncapital, nondeductible loss that reduces the basis in the distributing corporation's stock under Treas. Reg. § 1.1502-32(b)(1)(i).[61] We believe that this results in a double disallowance of loss that is not consistent with the general principles of the consolidated return regulations. The distributing corporation's loss should be allowed and stock basis should be reduced, or the loss should be disallowed but not reduce stock basis. We recommend that Treas. Reg. § 1.1502-13(b)(6) be amended to provide that the Section 311 loss is allowed in this situation; under the general principle of the End of the Day Rule, the loss would be taken into account in the Pre-Change Year and reduce stock basis.

If Target sells an asset or makes a distribution to a member of the buyer group after the Triggering Event on the Change Date, the transaction is properly treated as an intercompany transaction. As such, it would not be consistent to reflect such transaction in the Pre-Change Year. The Next Day Rule should be expanded to apply to all items resulting from post-Triggering Event intercompany transactions involving Target and the buyer group, regardless of whether they are extraordinary items.

The principles of the Next Day Rule should also apply to the elimination of earnings and profits upon the deconsolidation of Target from a seller group. Treas.

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60 *Id.*, *Example 9(d)*.

61 *Id*.

Reg. § 1.1502-33(e)(1) provides that if Target leaves a group, its earnings and profits that have tiered up to higher-tier group members under the consolidated return rules are eliminated as of the first day of its first separate return year. If Target makes a distribution to the buyer after the Triggering Event on the Change Date, it is unclear under the current regulations whether the elimination of earnings and profits is effective with respect to the distribution since the first separate return year begins on the day following the Change Date. The proper result would be to treat the elimination of earnings and profits as occurring prior to the distribution.

F. Previous Day Rule

We agree with the addition in the Proposed Regulations of the Previous Day Rule that applies where Target is an S corporation prior to the Status Change. The Previous Day Rule applies to extraordinary items that arise on the Change Date prior to or simultaneously with the Triggering Event.[62] This rule is necessary in order to provide consistency with the treatment of extraordinary items to which the Next Day Rule does not apply in situations where the End of the Day Rule applies. As illustrated in one of the examples,[63] the Previous Day Rule ensures that where the Change Date is included in the Post-Change Year, expenses such as success-based fees are taken into account in the Pre-Change Year.

We note a potential inconsistency, which we assume is inadvertent, between the wording of the proposed version of the Next Day Rule and the new Previous

[62] *See supra* note 21 and accompanying text.

[63] Prop. Treas. Reg. § 1.1502-76(b)(5) *Example 10*.

Day Rule. The Next Day Rule does not apply to an extraordinary item that "becomes includible or deductible simultaneously with the event that causes the change in S's status."[64] The Previous Day Rule applies to an extraordinary item that "results from a transaction that occurs on the termination date, but before or simultaneously with the event resulting in the termination of S's election under Section 1362(a)."[65] Consistent with the limitation on the application of the Next Day Rule, the Previous Day Rule should apply to items that become includible or deductible simultaneously with the Triggering Event rather than the less precise standard based upon when the transaction giving rise to the item "occurs."[66]

We also note that the Previous Day Rule is based upon the timing of the item in relation to the event giving rise to the termination of Target's loss of S corporation status, rather than the event that gives rise to Target becoming a member of the buyer group. If the event giving rise to Target's loss of S corporation status occurs prior to the Triggering Event (*e.g.*, if stock in Target is issued to an impermissible shareholder at 11:00 A.M. on the Change Date and the sale of Target to the buyer occurs at 2:00 P.M. on the Change Date), our reading of the Proposed Regulations is that the Beginning of the Day Rule does not apply because Target's S corporation election is not in effect immediately prior to it becoming a member of the buyer group;[67] Target would

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[64] Prop. Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(2).

[65] Prop. Treas. Reg. § 1.1502-76(b)(1)(ii)(B)(2).

[66] For example, where a compensation deduction accrues at the time of the Triggering Event but payment is made after the Triggering Event, it is unclear when the relevant transaction "occurs."

[67] Prop. Treas. Reg. § 1.1502-76(b)(1)(ii)(B) provides that the Beginning of the Day Rule applies if the S corporation election is in effect "immediately before S becomes a member. . .," and thus appears not to apply if termination of S corporation status occurs on the same day as, but prior to, Target becoming a member of the buyer group.

instead have a one day C corporation year on the Change Date. If this is not correct, and the Beginning of the Day Rule does apply, then, under a literal reading of the Proposed Regulations, deductions such as success-based fees that are triggered by the buyer's acquisition of Target (rather than by the event earlier on the Change Date that causes Target to lose its S corporation status) would not be subject to the Previous Day Rule and would instead be taken into account in the Post-Change Year, which we do not believe is the correct result. If the Beginning of the Day Rule is intended to generally apply in this circumstance, the Previous Day Rule should be revised so that its applicability is determined by reference to the Triggering Event.

G. Extension of Beginning of the Day and Previous Day Rules

Stock sale agreements commonly include purchase price adjustments based on closing working capital, as well as provisions that make the seller contractually liable for Target's Pre-Change Year taxes. For business reasons having nothing to do with taxes, working capital adjustments are often based upon working capital as of the end of the day immediately prior to the closing date. In such cases, including the closing date in the Pre-Change Year has the anomalous result of having the buyer receive the economic benefit of Target's Change Date income while the seller bears the associated tax liability.

We recommend that the Proposed Regulations be revised to permit the parties to agree to apply the Beginning of the Day and Previous Day Rules in cases where Target is not an S corporation prior to the Status Change to the extent that applying the End of the Day Rule would be inconsistent with the non-tax economics of the

transactions. Our recommendation would promote consistency between the tax and non-tax economics of a sale transaction. We do not believe that this recommendation is tantamount to permitting a transaction to have effect for tax purposes as of a date prior to the transaction (a result that the tax law generally abhors), because the choice between allocating items that accrue on the Change Date to the Pre-Change Year or the Post-Change Year is inherently arbitrary. The only "precise" method of allocation would be to close the year at the instant of the Triggering Event, which is obviously impracticable in the case of non-extraordinary items.

### H. Ratable Allocation

The current regulations permit taxpayers to elect to ratably allocate items other than extraordinary items for the entirety of the Pre-Change Year and the Post-Change Year between the Pre-Change Year and the Post-Change Year rather than allocating such items based upon a closing of the books.[68] Alternatively, the election can be made to apply only to items arising in the month in which the Triggering Event occurs.[69] The Proposed Regulations do not change the availability of the ratable allocation election, but the notice of proposed rulemaking solicits comments as to whether the ratable allocation election should be preserved.[70]

Even allowing for the fact that ratable allocation does not apply to extraordinary items, ratably allocating items for an entire year has enormous potential for distortion because of the likelihood that it will not properly reflect taxable income for the

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[68] Treas. Reg. § 1.1502-76(b)(2)(ii).

[69] Treas. Reg. § 1.1502-76(b)(2)(iii).

[70] REG-100400-14, 80 Fed. Reg. 12097, 12100 (Mar. 6, 2015).

Pre-Change Year and the Post-Change Year. For example, there can be major changes in the way Target's business is conducted before and after the Status Change, including as a result of expansions or contractions of Target's business or moving assets between Target and other group members or as a result of changes in leverage and interest expense. For this reason, and the desire of sellers to avoid potentially unwelcome surprises based upon post-closing actions of the buyer, we believe that taxpayers only rarely elect ratable allocation for an entire year. More importantly, we believe that the most likely reason to make a ratable allocation election would be a conscious effort to achieve distortion. Therefore, we recommend that the regulations be amended to eliminate the ability to elect ratable allocation for an entire year.

We recognize that our position is arguably inconsistent with the operation of Section 382 in the case of ownership changes that do not result in a closing of the tax year. Absent a closing-of-the-books election, Section 382(d)(1) and Treas. Reg. § 1.382-6(a) provide for ratable allocation of taxable income or loss for the year of the ownership change. We note, however, that Treas. Reg. § 1.382-6(a) does not apply to situations to which Treas. Reg. § 1.1502-76 applies, and we do not see why the Treas. Reg. § 1.382-6(a) ratable allocation rule should apply in the context of a Status Change that actually results in two separate tax years. Whether the Treas. Reg. § 1.382-6(a) ratable allocation rule should be changed is beyond the scope of this report.

Whether to permit ratable allocation limited to items arising in the month of the Triggering Event is in our view a closer question than ratable allocation for the entire year. Although the potential for distortion exists, it is more limited. An election to apply ratable allocation for the month of the Triggering Event may be motivated by the

relative administrative simplicity of closing Target's books at month-end rather than on a mid-month Change Date. This rationale does not apply, however, if the books are actually closed on the Change Date (or the day prior thereto) for non-tax purposes (*e.g.*, if they are closed for purposes of a working capital adjustment pursuant to a stock sale agreement). Accordingly, we recommend retaining the ability to elect ratable allocation for the month, as long as there is no closing of the books on the Change Date for non-tax reasons (including financial accounting requirements), subject to possible application of the anti-avoidance rule.

## I. Application of Rules to Income from Foreign Entities

The current regulations provide that deemed inclusions from foreign corporations (*e.g.*, subpart F inclusions and qualified electing fund inclusions) and deferred tax amounts on excess distributions from PFICs are extraordinary items.[71] The notice of proposed rulemaking asks for comments as to whether these items should continue to be treated as extraordinary items and whether rules similar to those applicable to partnerships should be adopted for CFCs and PFICs.[72] Where Target owns an interest in a partnership, the current regulations allocate partnership items between the Pre-Change Year and the Post-Change Year as if Target sold its interest on the Change Date.[73]

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[71] Treas. Reg. § 1.1502-76(b)(2)(ii)(C)(11).

[72] REG-100400-14, 80 Fed. Reg. 12097, 12100 (Mar. 6, 2015).

[73] Treas. Reg. § 1.1502-76(b)(2)(vi)(A). This rule currently does not apply to deemed inclusions of income of foreign corporations. Treas. Reg. § 1.1502-76(b)(2)(vi)(C).

Where a CFC's taxable year (as determined for U.S. federal income tax purposes) does not close on the Change Date, the effect of extraordinary item treatment is that subpart F income and Section 956 inclusions for the CFC's entire year are taken into account by Target in its Post-Change Year.[74] This result is arguably anomalous where the CFC earns subpart F income or makes investments in U.S. property throughout the course of its taxable year. It is consistent, however, with the result that would apply if Target sold its stock in the CFC to an unrelated U.S. shareholder in the middle of the CFC's taxable year; in such a case, the U.S. shareholder who owns the CFC stock at the end of the CFC's taxable year is required to include the entire year's subpart F inclusion.[75] Although the merits of this result may well be questionable, we do not think that a different result is appropriate in the consolidated return context.

Where Target owns shares in a PFIC and has made a QEF election with respect to the PFIC, Target is required to include its pro rata share of the PFIC's ordinary earnings and net capital gain in Target's taxable year within which the PFIC's taxable year ends.[76] Treatment of the QEF inclusion as an extraordinary item appears to result in the entire QEF inclusion with respect to the PFIC's taxable year that includes the Change Date being taken into account in the Post-Change Year. This is consistent with the treatment of subpart F inclusions from CFCs, as discussed above. However, it is inconsistent with the results that would apply if shares in the PFIC were sold by a U.S. person during the course of the year. In the case of a sale of PFIC shares, unlike the case

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[74] *See* Prop. Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(2).

[75] Section 951(a)(1). In the case of a sale of CFC stock, however, the buyer's subpart F inclusion would be reduced by any Section 1248 inclusion recognized by the seller. Section 951(a)(2).

[76] Section 1293(a)(2) and (b).

of a sale of CFC shares, the seller of the PFIC stock that made a QEF election would include its ratable share of the PFIC's ordinary earnings and net capital gain for the taxable year of the PFIC.[77] We recommend adding a rule, similar to that applicable to partnerships, that would allocate QEF inclusions between the Pre-Change Year and the Post-Change Year in the same manner as if Target had sold its PFIC shares. This is generally more consistent with the timing of economic accrual of income (as well as the general rules for QEF inclusions) than a rule under which the entire QEF inclusion is allocated to the Post-Change Year.

Where Target makes a mark-to-market election under Section 1296, the analysis is simple. Income and deductions are based upon changes in value of the PFIC stock between the beginning and end of the shareholder's taxable year. It is therefore clearly appropriate to take changes in value into account in both the Pre-Change and Post-Change Years, and this is consistent with extraordinary item treatment.

Where no QEF or mark-to-market election is made, the effect of extraordinary transaction treatment for deferred tax amounts with respect to excess distributions received during the year in which the Status Change occurs is consistent with the general application of the PFIC rules. Section 1291 generally applies based upon distributions received in each taxable year of the PFIC shareholder. If Target is not

[77] Section 1293(b); Temp. Treas. Reg. § 1.1294-1T(b)(3)(ii) *Example 1*. The buyer would also have a current inclusion for such taxable year if it makes a QEF election. These rules provide for ratable allocation rather than a closing of the PFIC's books; whether this is appropriate is a more general PFIC issue and is beyond the scope of this report.

an S corporation before or after the Status Change, this is consistent with the Pre-Change Year and the Post-Change Year being separate taxable years.[78]

We note that additional complications arise where Section 1291 applies to PFIC shares owned by Target and Target is an S corporation before or after the Status Change. These complications, which go beyond situations involving joining or leaving a consolidated group, result from the fact that if Target is an S corporation, Target's shareholders, rather than Target, are treated as the PFIC shareholders for purposes of Sections 1291 and 1298.[79] If Target is an S corporation prior to the Status Change and has not made a QEF election (or the election was not in effect during its entire holding period), the selling shareholders' gain on sale attributable to the PFIC shares generally will be treated as an excess distribution.[80] Following the Status Change, Target will be treated as the PFIC shareholder, and its holding period for purposes of applying the excess distribution rules in subsequent periods presumably would begin on the day following the Change Date. This is an appropriate result. If, however, Target is a consolidated group member prior to the Status Change and is sold to one or more individuals and then makes an S corporation election, Target does not recognize gain when its stock is sold by the consolidated group. It appears that if the buying shareholders subsequently sell their Target stock, they will be required to recognize gain with respect to their indirect disposition of the PFIC shares in an amount that potentially

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78 We note that under Section 1291(a)(1)(B) only the portion of an excess distribution that is allocated to the current year or pre-PFIC years in the shareholder's holding period is included in gross income. The remaining portion of the excess distribution is subject to the imposition of the deferred tax amount under Section 1291(c), but is not included in gross income; this has the anomalous result that it may not be taken into account under the investment adjustment rules, thus resulting in the potential for double taxation.

79 Temp. Treas. Reg. § 1.1291-1T(b)(7) & (8).

80 Section 1291(a)(2) and Prop. Treas. Reg. § 1.1291-3(e).

exceeds their gain with respect to their Target stock and to include an excess distribution over a period that includes the pre-Change Date portion of Target's holding period.[81] This is arguably an anomaly, since the pre-Change Date gain on the PFIC shares is economically attributable to the selling group which was not subject to the tax on excess distributions, but it exists whenever a corporation owning PFIC shares is sold and converts from a C corporation to an S corporation, and it is not limited to situations involving consolidated returns.

## J. Anti-Avoidance Rule

The current regulations provide that "[i]f any person acts with a principal purpose contrary to the purposes of this paragraph (b) to substantially reduce the Federal income tax liability of any person, adjustments must be made as necessary to carry out the purposes of this section."[82] The Proposed Regulations would amend this rule to specifically provide that such acts include "modifying an existing contract or other agreement in anticipation of a change in [Target's] status to shift an item between the taxable years that end and begin as a result of [Target's] change in status."[83]

Neither the current regulations nor the Proposed Regulations include any examples or other explanation that might clarify the intended scope of the anti-avoidance

[81] Although Prop. Treas. Reg. § 1.1291-1(h)(4)(i) provides that an indirect shareholder's holding period in a PFIC generally begins on the date that it becomes an indirect shareholder, Prop. Treas. Reg. § 1.1291-1(h)(4)(iii) provides that where a C corporation becomes an S corporation, the S corporation shareholders' holding period includes the C corporation's holding period. If the shareholder sells his or her S corporation shares, Prop. Treas. Reg. § 1.1291-3(e)(4)(i) appears to require recognition of an excess distribution based upon the gain that the S corporation would have recognized if it sold the PFIC shares.

[82] Treas. Reg. § 1.1502-76(b)(3).

[83] Prop. Treas. Reg. § 1.1502-76(b)(3).

rule. We recommend that examples be added to illustrate the application of the anti-avoidance rule. One example would be a success-based fee that is conditioned upon a transaction not being rescinded by the government (or, for that matter, upon the sun rising in the east) on the day following the Change Date. A taxpayer might argue that the deduction does not accrue until the day after the Change Date and is therefore properly allocable to the Post-Change Year. One can question whether a seemingly artificial condition should be taken into account under the all-events test applicable to deductions by accrual basis taxpayers. It is more straightforward, however, to address such situations under the anti-avoidance rule of the Proposed Regulations. Changes in the operation of Target's business in order to take advantage of the ratable allocation rule, to the extent that such rule remains in effect, would be another example.[84]

Although we are unsure that the proposed addition to the anti-avoidance rule actually expands the rule's scope, we believe that an example illustrating its application would be helpful. An appropriate example would be a change in a stock option plan to provide for cancellation payments to be made more than two and a half months after the Change Date, which would likely result in the deduction being deferred to the Post-Change Year under Section 404(a)(5). Another example would be modification of a compensation arrangement that conditions payment on a change of control by adding a further condition that the employee works for a day following the change of control.

[84] *See* IV.H, above.

Finally, we recommend that the anti-avoidance rule, which refers to a principal purpose of substantially reducing the tax liability of any person, be clarified to provide that it applies only where there is a potential for substantial reduction of the aggregate tax liability of all affected persons. For example, if Target is a C corporation that is not included in a consolidated group (or is the common parent of a consolidated group) prior to the Status Change, shifting items between the Pre-Change Year and the Post-Change Year generally does not affect the parties' aggregate tax liability. To the extent that the relative contractual responsibility of the buyer and the seller is the only relevant consequence, it is preferable to protect the parties' expectations rather than applying the anti-avoidance rule to achieve a theoretically more correct result if an item is "inappropriately" shifted to reduce Pre-Change Year tax liability while correspondingly increasing the Post-Change Year tax liability by the same amount. This result is arguably consistent with the current regulations, on the theory that the only "person" involved is Target, but clarification would be helpful.