INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

August 31, 1999

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Index (UIL) No.: 1502.76-00
CASE MIS No.: TAM-105383-99

District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Parent	=
Target	=
Date A	=
Date B	=
Date C	=
Date D	=
Date E	=

ISSUE:

Whether fourth quarter retail sales of inventory, under the facts and circumstances described herein, should be treated as an extraordinary item under § 1.1502-76(b)(2)(ii)(C), and thereby precluded from being ratably allocated under § 1.1502-76(b)(2)(ii).

FACTS:

Parent is the common parent of a consolidated group that files a consolidated federal income tax return based on a 52/53 week fiscal year ending on the Friday nearest Date A. Target is a corporation that files a federal income tax return based on a 52/53 week fiscal year ending on the Friday nearest Date A. Target is engaged in retail sales, and the nature of its business results in a greater portion of its sales occurring in the fourth quarter of its tax year than in any other quarter.

On Date B, Parent purchased all of the stock of Target. As a result, Target's tax year (which began on Date C) ended on Date B, and Target became a member of Parent's consolidated group on Date D. Parent's tax year ended on Date E.

Target filed a separate return for the tax year that ended on Date B, and joined in Parent's consolidated return for the tax year that ended on Date E. Both returns reflected an election under § 1.1502-76(b)(2) to ratably allocate Target's items. Target did not ratably allocate some of its items (i.e, severance pay, cost associated with retirement of debt, and gain from disposition of property), treating them instead as extraordinary items under § 1.1502-76(b)(2)(ii)(C). Target, however, did not treat its fourth quarter retail sales, which arose in the ordinary course of its business, as an extraordinary item. As a result, the retail sales were ratably allocated between Target's two short tax years that resulted from Target joining the Parent group.

EXAMINATION'S POSITION:

Examination contends that because a larger portion of Target's retail sales occurred in the fourth quarter, after Date B, the ratable allocation of such sales under § 1.1502-76(b)(2)(ii) results in a substantial distortion of Target's income. Examination concludes that Target's retail sales should be treated as an extraordinary item, and thus not available for ratable allocation.

TAXPAYER'S POSITION:

Taxpayer argues that its retail sales are not an extraordinary item because the ratable allocation of the items does not result in a substantial distortion of Target's income. Target further argues that § 1.1502-76(b)(2)(ii)(C)(14) was not intended to treat retail sales in Target's normal course of business as an extraordinary item.

LAW AND ANALYSIS:

The issue in this case is the proper allocation of retail sales between the two tax years that result from Parent's acquisition of Target. The relevant consolidated return regulations governing the manner in which items are reported when a corporation joins a consolidated group are under § 1.1502-76(b).

During the years relevant to this case, § 1.1502-76(b)(1) required that a consolidated return include the common parent's items of income, gain, deduction, loss, and credit for the entire consolidated return year, and each subsidiary's items for the portion of the year for which it was a member. If the consolidated return only included the subsidiary's items from a portion of its tax year determined without taking § 1.1502-76 into account, the items from the portion of the year not included in the consolidated return must be included on a separate return.

Treas. Reg. § 1.1502-76(b)(2)(ii) provides an election permitting taxpayers to ratably allocate items between the tax years that end and begin as a result of the subsidiary joining the consolidated group. Extraordinary items, however, may not be ratably allocated and must be allocated to the period for which they are taken into account. To the extent that such election is not made, the acquired corporation is treated as having closed its books immediately before it joins the consolidated group.

Treas. Reg. § 1.1502-76(b)(2)(ii)(C) identifies those items that are treated as extraordinary items. Among the items listed as extraordinary items are "any items which, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any consolidated return or separate return in which the item is included." § 1.1502-76(b)(2)(ii)(C)(14).

Parent's acquisition of Target on Date B resulted in Target becoming a member of Parent's consolidated group. Pursuant to § 1.1502-76(b), Parent's federal income tax return for the tax year ending Date E includes Target's items from Date D through Date E. Target is required to file a separate return for the period from Date C through Date B.

Pursuant to § 1.1502-76(b)(2)(ii), the taxpayer elected to ratably allocate its items between the two periods that ended and began as a result of Parent's acquisition of Target. The election generally permits items from the two periods to be ratably allocated between the periods. Extraordinary items, however, may not be ratably allocated and must be included in the period in which the item is taken into account. The regulation also provides that an extraordinary item will be any item which, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any consolidated return or separate return in which the item is included. The underlying question is whether permitting the ratable allocation of the fourth quarter retail sales results in a substantial distortion of income.

Prior to 1994, the consolidated return regulations provided little guidance for the allocation of items between the separate tax years that result from a corporation joining a consolidated group. In 1994, the consolidated return regulations were amended to provide greater certainty and prevent inconsistent allocations with respect to the reporting of items when a corporation joins a consolidated group. T.D. 8560, 1994-2 C.B. 200. Under these newer regulations corporations joining a consolidated group generally close their books at the end of the day of the acquisition. Recognizing that it may be administratively burdensome for some taxpayers to close their books mid-year, the regulations allow taxpayers, under specified circumstances, to elect to keep their books open and ratably allocate their items between the two tax years that result from the acquisition.

The regulations do not permit the ratable allocation of extraordinary items because it is relatively easy to identify the specific period in which such items arose and should be taken into account. The regulation identifies specific items that are treated as extraordinary items. Extraordinary items also include "any items which, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any consolidated return or separate return in which the item is included." The regulations do not define substantial distortion.

The information submitted indicates that Target has been in the same retail business for an extended period of time. Although Target conducts its business throughout the entire year, a larger portion of its sales regularly occur during the fourth quarter. The facts demonstrate that Target's inventory does not vary during the year (except for seasonal changes) and that items offered for sale are consistent throughout the year. An increase in expenses (e.g., salaries, cost of goods sold, and utilities) also occurs during the fourth quarter. Target, as a result of ratably allocating its items, reported its retail sales from the fourth quarter over both short tax years. As a result, the tax year ending Date B reflected more income than would have been reported had the election to allocate not been made. Whether this allocation produces a substantial distortion in Target's income is determined on all of the facts and circumstances. Target's retail sales occurred as part of its overall business pattern and practice. Target's operations for the tax year(s) are also consistent with prior years. In previous years, the percentage of sales for each quarter was approximately the same as in the tax year(s) under examination. Absent any other circumstances, the ratable allocation of the fourth quarter retail sales did not result in substantial distortion.

CONCLUSION:

Target elected to ratably allocate its items between the periods ending and beginning with its joining Parent's group. Under the facts and circumstances, the ratable allocation of Target's fourth quarter retail sales did not result in the substantial distortion of income in either the consolidated or separate return. Accordingly, the fourth quarter retail sales were not extraordinary items within the meaning of § 1.1502-76(b)(2)(ii)(C).

CAVEAT(S):

This technical advice memorandum expresses no opinion about the tax treatment of the above transactions under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transactions above that are not specifically covered by the above technical advice memorandum.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. Pursuant to section 6110(c) of the Code, names, addresses, and taxpayer identification numbers are required to be deleted from the copy of this technical advice memorandum that will be made open to public inspection.