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Speakers' Corner

- **Todd Reinstein** and **Howard Goldberg** will speak on “Consolidated Return Issues Affecting Use of Tax Attributes” at the Twenty-Second Annual Tax Executives Institute Houston Chapter Tax School on February 11 in Houston, TX.
- **Joan Arnold** will chair the Annual U.S.A. Branch Meeting of IFA in Philadelphia on February 25-26. See page 3 for details.
- On March 18, **Todd Reinstein** and **Steve Bortnick** will be panelists on a webcast, “Taxation and Accounting Issues with Debt Restructuring, Modifications and Bankruptcies.” See http://www.lorman.com/teleconference/teleconference.php?product_id=208050 for details.

Quotable

- **Joan C. Arnold** was quoted in a January 5, 2010 article in *Treasury & Risk Magazine*. See page 5 for details.

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New IRS Ruling Endorses Standard For Determining Treatment of Transaction Costs

ELLEN McELROY | MCELROYE@PEPPERLAW.COM

MARC D. NICKEL | NICKELM@PEPPERLAW.COM

On January 1, 2010, the IRS released a ruling (PLR 2009-53-014)¹ that provides deeper insight into the provisions of Treas. Reg. § 1.263(a)-5 (the “transaction costs regulations”). In the ruling, the IRS held that a company could take into account merger transaction costs that were arranged for and incurred by one or more companies in an acquisition transaction when (i) the company can demonstrate that the services were directly rendered to the company, and/or on behalf of the company, and (ii) the fees associated with such services were paid for by the company, and/or reimbursed by the company, among other rulings.

In the transaction at issue, the target company (the Taxpayer) was the surviving company in an acquisitive merger, which was accomplished by the use of an acquisition subsidiary (Merger Sub), which merged into Taxpayer and out of existence. The Taxpayer was a public corporation that was to be taken private in an acquisition funded by an Acquiring Group consisting of private equity financial buyers and related-industry strategic buyers.

SERVICE FEES AT ISSUE

Prior to and during the course of the transaction costs were incurred by both the Acquiring Group and the Taxpayer. At issue in the ruling was whether the Taxpayer could deduct certain costs incurred during the transaction, and the standards it should use in determining the character of those costs.

The Acquiring Group arranged for (and in certain instances incurred) a number of transaction-related costs prior to completion of the transaction. The Acquiring Group arranged for various service providers to plan, model, investigate, pursue, and finally

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complete the Transaction. In many cases, the services arranged for by the Acquiring Group were meant to benefit the Taxpayer, as it was to survive the merger. Specifically, these advisors provided advice regarding corporate governance and other advice directly to the Taxpayer's Board of Directors.

Additionally, the Taxpayer engaged other financial advisors to provide advice directly to the Taxpayer and its Board of Directors regarding different strategic transaction alternatives, prior to deciding to move forward with the Acquiring Group on a transaction. After deciding to proceed with the Transaction, Taxpayer engaged financial advisors, legal advisors, accounting service providers, and other service providers to advise on securing debt financing arrangements related to the Transaction and to evaluate the Transaction. In addition, members of the Acquiring Group itself were engaged by the Taxpayer to provide Transaction-related services.

Regardless of whether the Taxpayer or the Acquiring Group engaged the service providers, the Taxpayer paid for any fees for these services if they were directly aimed at benefitting the Taxpayer's business going forward. The Taxpayer requested two principal rulings that were intended to bless both the Taxpayer's ability to deduct the fees it paid for providers it did not engage, and the Taxpayer's method of determining the tax treatment of the fees.

DEDUCTIBILITY BY THE TAXPAYER

In most circumstances, one corporation's payment of another corporation's expenses does not give rise to a trade or business tax deduction for the payor corporation. However, there is a line of Tax Court cases that endorse the deduction of such costs when they are paid by the party that "directly and proximately benefits" from the services, even if the payor was not the party that engaged the service provider.²

The IRS ruled that on the authority of that line of cases, a deduction may "be taken into account by a taxpayer where the taxpayer properly incurs the liability associated with the costs" and that in order to make that determination, the particular facts of the transaction must be evaluated—including the parties object in incurring the cost, the nature of the transaction, the relationship of the parties, and the anticipated benefit to be derived from incurring the cost.

The IRS ruled that the Taxpayer could properly deduct transaction-related service fees arranged for by another party to the transaction, if based on the facts and the factors listed, the

THIS IS A SINGLE RULING THAT CANNOT BE CITED FOR PRECEDENT. HOWEVER, IT IS AN EXCELLENT INDICATOR OF THE THINKING OF THE IRS AND HOW IT PLANS TO INTERPRET LAW AND REGULATIONS IN THE FUTURE.

Taxpayer (i) could demonstrate that the services were directly rendered to the Taxpayer, and/or on behalf of the Taxpayer, and (ii) the fees associated with such services were paid for by the Taxpayer, and/or reimbursed by the Taxpayer.

TAX TREATMENT OF THE FEES

Under the transaction costs regulations, costs that facilitate the acquisition of a business generally must be capitalized, and other costs are typically deductible. The regulations specifically describe some activities as inherently facilitative, and thus require that their associated costs be capitalized.³ However, outside of those delineated activities, the regulations provide that an amount is paid to facilitate a transaction if the amount is paid in the process of investigating or otherwise pursuing the transaction, if it relates to activities performed on or after the earlier of the date a letter of intent or similar communication is executed or the date on which the material terms of the transaction are authorized or approved by the taxpayer's board of directors.⁴ Whether an amount is paid in the process of investigation or otherwise pursuing the transaction is determined based on all of the facts and circumstances.

This factual determination is difficult to make when a taxpayer makes payments of success-based fees to a service provider, whose activities are partially facilitative and partially not. The Treasury Department provided some guidance about what factual documentation may be used by a taxpayer to support its position that certain fees are not facilitative in Treas. Reg. § 1.263(a)-5(f). In general, the documentation must consist of supporting records that identify the activities performed by the service provider, the fee allocable to those activities, and the date of performance. Additionally, this documentation must be com-

Annual U.S.A. Branch Meeting of IFA in Philadelphia, February 25-26



The U.S.A. Branch of the International Fiscal Association, the world's largest organization of international tax advisors, will present a two-day conference on all things international that are important to corporate tax advisors, both in-house and in private practice. Come hear Eric Solomon chair a panel that will address how to plan for the Obama changes; hear what Steve Shay has to say about the ideas at Treasury for changes to the system; listen to the panel headed by Peter Barnes on state tax issues for international companies, and many other top-notch panelists and topics.

Visit <http://www.ifausa.org/Resource.phx/public/annualmeeting/ifa2010/agenda10.htm> for further information and registration. You do not need to be a member of IFA to register, but it's less expensive if you are, and your membership would be welcomed. The meeting is being chaired by Joan Arnold of Pepper Hamilton.

pleted on or before the due date for the taxpayer's timely filed return. In this case, the Taxpayer requested a ruling on whether the types of evidence it was using to allocate success-based fees were sufficient, and specifically if Treas. Reg. § 1.263(a)-5(f) could be satisfied to successfully support a deduction of a portion of a success-based fee, even if a taxpayer could not provide detailed time records.

The IRS ruled that the regulation "does not require time records" in order to factually demonstrate the elements necessary to determine which service provider fees the Taxpayer could take into account. Rather, the IRS ruled that a Taxpayer "should evaluate all available evidence." In the ruling, the IRS endorsed the Taxpayer's documentation used to make its determinations, such as service provider attestation regarding the scope and timing of services (*e.g.*, interview memoranda and fee allocation letters), service provider engagement letters, board of director meeting minutes, documents developed by the providers and presented to the board of directors, management agreements, flow of funds memos, wire transfer and other bank records, transaction documents, and the Taxpayer's internal accounting information. The IRS cited authority that such documentation is appropriate to apportion costs, "even if the apportionment derived ... is 'less scientific'."⁵

OTHER RULINGS

In addition to the two principal rulings, the IRS also issued two other rulings to the Taxpayer. First, the IRS specifically approved that the Taxpayer could take trade or business expense deductions for costs incurred in a business expansion context that relate to (i) expanding an active trade or business, and (ii) for investigating a transaction prior to making a decision to proceed with the transaction. In doing so, the IRS endorsed several cases that support the deductibility of these costs.⁶ Second, the IRS ruled that costs paid by the Taxpayer in connection with financing the Transaction are eligible for amortization over the term of the debt per Treas. Reg. § 1.446-5, even though this was a going private transaction.

PEPPER PERSPECTIVE

At the end of the day, this is a single ruling that cannot be cited for precedent, and it is based largely on the particular Taxpayer's facts. However, it is an excellent indicator of the thinking of the IRS and how it plans to interpret law and regulations in the future, and of opportunities to serve our clients in the future.

Moreover, this is the second time that the IRS has ruled in the regarding the deductibility of transaction costs in two years,⁷ which indicates that the IRS is becoming more comfortable in ruling on the transaction cost allocation regulations. The Internal

Revenue Code and attendant regulations regarding the deductibility of transaction costs contain a number of ambiguities, which in recent years have resulted in a substantial increase in examinations of taxpayers' returns. Therefore, this ruling represents a very positive development for all taxpayers, because it means a taxpayer can obtain protection from such examinations with respect to the costs evaluated.

ENDNOTES

- 1 <http://www.irs.gov/pub/irs-wd/0953014.pdf>.
- 2 See *Square D v. Comm'r*, 121 T.C. 168 (2003); see also *Dinardo v. Comm'r*, 22 T.C. 430 (1954); *Fishing Tackle Products Co. v. Comm'r*, 27 T.C. 638 (1957).
- 3 Treas. Reg. § 1.263(a)-5(e)(2).
- 4 Treas. Reg. §§ 1.263(a)-5(b) & (e).
- 5 See *Putnam-Greene Financial Corp. v. United States*, 308 F.Supp. 2d 1374 (Mid. D. Ga. 2004).
- 6 *Briarcliff Candy Corp v. Comm'r*, 475 F.2d 775, 787 (2d Cir. 1973); *NCNB Corp v. United States*, 684 F.2d 285 (4th Cir. 1982); *Wells Fargo & Co. v. Comm'r*, 224 F.3d 874 (8th Cir. 2000).
- 7 See Priv. Ltr. Rul. 2008-30-009 (July 25, 2008).

Reporting of Uncertain Tax Positions on the Tax Return

JOAN C. ARNOLD | ARNOLDJ@PEPPERLAW.COM

At the New York State Bar Association Tax Section meeting on January 25, IRS Commissioner Douglas Shulman announced the good news – the IRS has no current intention to change its policy of restraint in asking for disclosure of a taxpayer's tax accrual work papers. But that news was balanced by news that, quite frankly, may be more onerous. While the IRS will leave the Fin 48 work papers alone (absent unusual circumstances), that is because taxpayers will now be required to disclose with their tax returns any uncertain tax position. The outline of the proposal is found in Announcement 2010-9.

One attendee at the meeting described the reaction of the audience to the announcement by Commissioner Shulman as follows: One half of the attendees turned absolutely white, and the other half were busy lifting their jaws off of the floor. Such reactions seem completely understandable given the scope of the Announcement.

Under the proposal, business taxpayers with total assets of \$10 million or more and one or more uncertain tax positions will be required to complete a new schedule to be attached to the 1120 or other business return. The schedule will require:

- a concise description of the uncertain tax position, and
- the maximum amount of the potential federal tax liability attributable to each uncertain position.

As currently contemplated, there's not a lot of wiggle room on what comprises a concise description. It would need to contain:

- the Code sections implicated
- the tax years to which the position relates
- information on whether it is a permanent or timing difference for any tax item
- a statement as to whether the position involves a determination of value of any property or right, and
- a statement as to whether the position involves a basis computation.

There is little guidance in the Announcement on when there is an uncertain tax position. Clearly, if the taxpayer has put up a FIN 48 reserve, or other reserve for taxes under its accounting standards, such as the International Financial Reporting Standards, the Announcement assumes there is an uncertain tax position. It also provides that if no FIN 48 reserve has been provided because the taxpayer expects to litigate the issue, or the taxpayer has determined that the IRS has a general administrative practice to not exam the issue, the issue is still an uncertain tax position that must be disclosed. There are other exceptions to FIN 48 disclosure – for example if there is sufficient third-party indemnification for the tax risk, a FIN 48 reserve may

not be needed. That is because FIN 48 is looking to provide an accurate financial picture of the taxpayer. The Announcement has a different goal – to make it easier for the IRS to quickly and efficiently identify significant issues and prioritize the focus of audits. Presumably any exceptions to FIN 48 that do not support the goal of the Announcement will not be respected for purposes of the schedule.

Once a taxpayer has a disclosable uncertain tax position, it needs to list on the schedule the *maximum* amount of potential federal tax liability if the position were disallowed in its entirety on audit. There is no offset for evaluation of ability to settle, or the possible outcome of litigation. Thus, the amount recorded for FIN 48 purposes may be considerably less than what will need to be on the schedule. Based on the request for comments we expect to see considerable attention paid to the parameters of the definition of “maximum.”

This tax return reporting requirement may drive changes in taxpayer reporting under FIN 48. Assume a taxpayer takes a tax position for which it has an opinion that the position “should” be sustained. In certain circumstances, even with a “should” opinion taxpayers may decide to put up a reserve to be conservative. Once that reserve is put on, the Announcement would require that it be disclosed on the schedule, with the maximum federal tax liability at risk reported. If it is not included in the FIN 48 reserve, as currently worded in the Announcement, no reporting would be required with the tax return. Given the competing interests, it will not be as attractive to be conservative.

The reporting may also have an effect on allocation of tax risks in transactions. If in fact a position is covered by insurance, and does not need to be included in a FIN 48 reserve because of the lack of risk, it is unclear whether the position would have to be disclosed under the Announcement. It is not specified as an uncertain position, but it would be consistent with the intent of the Announcement, which is to enable the IRS to streamline audits and make more informed decisions on the areas that should be given priority.

The reporting is expected to be required for tax returns filed after the release of the schedule. Corporate returns for calendar year 2009 may well be subject to the reporting requirement if the schedule is released before the filing date.

Joan Arnold Quoted in *Treasury & Risk Magazine*

Pepper Hamilton Tax Practice Group chair Joan C. Arnold was quoted in a January 5, 2010 article in *Treasury & Risk Magazine*, which noted that companies are wary of changes to international tax rules proposed by the Obama administration. In the article, “The Obama administration’s proposed changes in international tax regulations could send some corporate headquarters packing,” Arnold said that the proposal “is extraordinarily stressful for U.S. multinationals” and that “it will significantly complicate the ability to operate in a tax-efficient manner.”

The article asserts that companies’ biggest concerns involve the so-called deferral rules. The administration wants companies to hold off taking deductions related to offshore earnings until those earnings have been repatriated and taxed.

“So if a U.S. corporation funds itself by borrowing in the U.S. and it has significant operations offshore, and earnings offshore aren’t subject to tax until brought back, the Obama proposal would defer a proportion of the deduction from the interest expense,” Arnold said. She added that concerns among corporations are so intense that advisers are seeing a pick-up in inquiries about moving corporate headquarters out of the U.S., and that companies are looking not at tax havens like Bermuda, but at Canada and the U.K, because “their tax plans with regard to earnings earned outside their regime are to many companies more rational.”

Meanwhile, the article says, companies are facing much more aggressive enforcement from the Internal Revenue Service. Arnold noted that the IRS is responding to Congress’ demand that it narrow the gap between the amount it’s owed and what it actually collects.

The entire article may be viewed at <http://www.treasury-andrisk.com/Issues/2010/DecemberJanuary-2010/Pages/Overseas-Tax-Watch.aspx?k=pepper+hamilton>.

Pepper Hamilton's Tax Practice Group

Federal and International Tax Issues

Annette M. Ahlers	202.220.1218	ahlersa@pepperlaw.com
Joan C. Arnold	215.981.4362	arnoldj@pepperlaw.com
James W. Barson	412.454.5077	barsonj@pepperlaw.com
Steven D. Bortnick	212.808.2715	bortnicks@pepperlaw.com
	609.951.4117	
Gordon R. Downing	215.981.4434	downingg@pepperlaw.com
W. Roderick Gagné	215.981.4695	gagner@pepperlaw.com
Howard S. Goldberg	215.981.4955	goldbergh@pepperlaw.com
Benjamin M. Hussa	215.981.4728	hussab@pepperlaw.com
Bryan D. Keith	202.220.1220	keithb@pepperlaw.com
Timothy J. Leska	215.981.4008	leskat@pepperlaw.com
Ellen McElroy	202.220.1589	mcelroye@pepperlaw.com
Marc D. Nickel	202.220.1618	nickelm@pepperlaw.com
Michelle Parten	215.981.4894	partenm@pepperlaw.com
Lisa B. Petkun	215.981.4385	petkunl@pepperlaw.com
Todd B. Reinstein	202.220.1520	reinsteint@pepperlaw.com
Joan M. Roll	215.981.4515	rollj@pepperlaw.com
Leonard Schneidman	617.204.5104	schneidmanl@pepperlaw.com
Laura D. Warren	215.981.4593	warrenl@pepperlaw.com

State and Local Tax Issues

Philip E. Cook, Jr.	412.454.5075	cookp@pepperlaw.com
Lance S. Jacobs	202.220.1202	jacobsls@pepperlaw.com

Employee Benefits Issues

Jonathan A. Clark	215.981.4436	clarkja@pepperlaw.com
David M. Kaplan	215.981.4620	kapland@pepperlaw.com
Andrew J. Rudolph	215.981.4749	rudolpha@pepperlaw.com