Does a Target or Acquiring Corporation Claim Significant Transaction-Related Deductions? IRS Wades into Murky Waters

TODD B. REINSTEIN | reinstein@pepperlaw.com
ELLEN McELROY | mcelroy@pepperlaw.com

According to the consolidated return Regulations, when a corporation is acquired and joins a consolidated group, the acquired corporation's tax year ends at the end of the day it is acquired.1 An exception, however, allows certain transactions that occur on the acquisition date to be allocated to the day following the acquisition.2 Application of these distinctive provisions affect whether certain extraordinary deductions are reflected on the target corporation's separate tax return or the acquiring corporation's consolidated tax return. Limited guidance addresses how and when to apply these rules and how the consolidated return Regulations interact with other Code and regulatory provisions when extraordinary deductions are at issue.

The Internal Revenue Service (IRS) recently published a general legal advice memorandum, the “GLAM,”3 which broadly suggests that the target corporation in an acquisition must claim transaction and option cost deductions on its final separate tax return rather than allocating these amounts to the consolidated return. Although the GLAM acknowledges that other Code and regulatory provisions should be considered in this context, the memo's analysis is limited to the consolidated return provisions. As a result, the GLAM leaves the impression that this analysis is fairly straightforward; it also fails to address the government’s views about how the consolidated return Regulations interact with other Code and regulatory provisions. Because taxpayers and practitioners must evalu-

Follow Us on Twitter
http://twitter.com/PepperTax

Speakers’ Corner

• On January 14, Todd Reinstein presented a Lorman webinar on the “Fundamentals of Section 382.”

• Joan Arnold presented “Update and Planning for Inbound Mergers and Acquisitions” at the American Bar Association Tax Section Meeting on January 25.

• Todd Reinstein presented at the Bloomberg BNA Advisory Board meeting on January 31.

• On February 21, Joan Arnold presented “International Partnership Tax Issues – Does Checking the Box Cure All Ills?” at the Tax Executives Institute Partnership Program.

• Todd Reinstein presented “The Nuts and Bolts of Section 382” at the Tax Executives Institute New Jersey Chapter’s All-Day Tax Seminar on February 22.

• Joan Arnold will participate in Practising Law Institute’s Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2013, scheduled for April 30-May 2, 2013 in Chicago. Ms. Arnold will serve on the panel discussing “Check-the-Box” Planning.
News
• Joan Arnold was elected to the office of vice chair of the American College of Tax Counsel; her term begins on April 1.

Quotable
• Ellen McElroy spoke for the American Bar Association Tax Accounting Committee’s January 25 program on “Hot Topics in Healthcare,” in Orlando, FL. A January 28 Tax Analysts article reported on the discussion.
• Steven Bortnick was quoted in the article “A ‘BIG’ Tax Relief: Changes to U.S. ‘Built-in Gains’ Tax Made in the Recent Fiscal Cliff Deal Have Boosted the Attractiveness of Mid-Market Deal Opportunities,” published in PE Manager.
• Lisa Petkun was quoted in The Wall Street Journal on March 13 in the article, “Payroll Audits Put Small Employers on Edge.”

ate a range of tax issues when considering how extraordinary deductions should be parsed between parties to a transaction the IRS guidance provides limited insight into what can be a vexing challenge. Moreover, taxpayers may find that the GLAM is wielded by either IRS Exam during the course of an examination or by audit firms during provision review. Because the GLAM suggests a simplistic analysis without fully considering the range of technical issues, a taxpayer may find issues being needlessly challenged. A more thorough consideration of all of the relevant issues, however, may produce different results.

BACKGROUND ON THE END OF THE DAY AND NEXT DAY RULES
To appreciate the significance of the GLAM, it is important to understand the consolidated return provisions at issue in the memorandum. Whenever a subsidiary corporation either enters or exits a consolidated group, that corporation’s tax year ends on the day its status changes. A consolidated return must be filed on the basis of the common parent’s taxable year and it must include the common parent’s items of income, gain, deduction, loss, and credit for the entire year, and each member’s items for the portion of the year during which it is a member of the consolidated group. Thus, a new or departing subsidiary will have a separate federal income tax return for the portion of the year it was not a member of the consolidated group. As a result, any entering or exiting member must allocate its items of income, gain, deduction, loss and credit for the entire year, and each member’s items for the portion of the year during which it is a member of the consolidated group. Although an election is available to make a pro-rata allocation of general items between the two tax periods, as described below, a separate set of rules governs the recognition of extraordinary items between the two periods.

The consolidated return Regulations provide that the change in a subsidiary company’s status (entering or exiting a consolidated group) occurs at the end of the day of the status change and its tax year ends for federal income tax purposes at the end of that day (known as the “end of the day rule.”) The end of the day rule acknowledges that “appropriate adjustments must be made” if another Code or regulatory provision contemplates the event occurring before or after the change in status. The consolidated regulations note one significant exception to the end of the day rule, the “next day rule,” under which allocations are attributable to a “transaction” deemed to occur “at the beginning of the following day.” The Regulation is unfortunately silent on how the term “transaction” is defined.
GLAM fails to address the government's views about how the consolidated return Regulations interact with other Code and regulatory provisions.

As discussed below, the consolidated return Regulations provide that a corporation, entering or exiting a consolidated group may ratably allocate items of income, gain, deduction, loss and credit between the short periods based either on days or months. Under the Regulations, however, “extraordinary items” are not eligible for the pro rata allocation, as they must be reported on the day they are recognized for federal income tax purposes. Consequently, extraordinary items are subject to the application of the next day and end of the day rules, which may affect both the tax return and the tax period when extraordinary items will be recognized. This rule has caused taxpayers and practitioners a great deal of concern as numerous extraordinary items arise when a member enters or exits a consolidated group.

Treas. Reg. Section 1.1502-76(b)(1)(ii)(B) provides that a determination as to whether a transaction is properly allocable to the portion of the subsidiary’s day after the event resulting in the change will be respected if it is reasonable and consistently applied by all affected parties. In determining whether an allocation is reasonable and consistent, Treas. Reg. Section 1.1502-76(b)(1)(ii)(B) list four separate factors:

1) whether income, gain, deduction, loss, and credit are allocated inconsistently
2) if the item is from a transaction with respect to the corporation leaving or joining the consolidated group, whether it reflects ownership of the stock before or after the event
3) whether the allocation is inconsistent with other requirements under the Code and Regulations, and
4) whether “other factors” exist, such as prearranged transaction of multiple changes in the corporation’s status, indicating that the transaction is not properly allocable to the portion of its day after the event resulting in the change.

These factors are subjective and the IRS’s view regarding the application of each factor is not set forth. The Treasury Regulation lists the factors includes an example from the second factor listed above regarding whether the item is from a transaction with respect to a member leaving or joining the group. The example states that, “if a member transfers encumbered land to nonmember S in exchange for additional S stock in a transaction to which Section 351 applies and the exchange results in S becoming a member of the consolidated group, the applicability of Section 357(c) to the exchange must be determined under 1.1502-80(d) by treating the exchange as occurring after the event; on the other hand, if S is a member but has a minority shareholder and becomes a nonmember as the result of a redemption of stock with appreciated property, S’s gain under Section 311 is treated as from a transaction occurring before the event.” This example is significant in that if the corporations were filing separate returns and liabilities transferred are greater than the adjusted basis of the assets transferred in a Section 351 transaction, the transferor would recognize gain under Section 357(c). Treas. Regulation Section 1.1502-80(d), however, generally turns off the application of Section 357(c) in a consolidated return context. This example tries to resolve the conflict when a new member joins by applying Treas. Regulation Section 1.1502-80(d) immediately after the transaction, even if the corporations were unrelated prior to the transfer. The example would indicate the tax treatment of the transaction is separate from the transaction related to the tax issue.

Depending on the specific facts, there can be significant economic consequences if either the end of the day or the next day rule is applied. For example, if a target company is compelled to include a series of extraordinary deductions that arise as part of the transaction on its final and separate federal income tax return (for the period prior to consolidation with the buyer), the result may not clearly reflect income of the group. Further, these administrative provisions may result in the artificial recognition of items in tax years or by parties to the transaction that result in a mismatching of income and related expenses and may also fail to reflect the party that is the direct and proximate beneficiary of
certain items of income and expense. More importantly, these results may be at odds with other Code and regulatory provisions.

**Treatment of Transaction Costs**

Analyzing the treatment of transaction costs should be no different from analyzing any other service provider fees incurred in a business context. The proper tax treatment is controlled by several factors, including: (i) whether amounts may be deducted, amortized, or capitalized; (ii) which party may take amounts into account; and (iii) when the transaction costs may be taken into account.

First, a determination has to be made as to whether the transaction costs are deductible, amortizable, or capitalizable. Transaction costs may be deducted as business expenses under Section 162(a), which provides that deductions are allowed for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, or alternatively, as an abandonment loss under Section 165, if the costs relate to an abandoned corporate transaction. If the costs are incurred when an entity is creating a new trade or business, certain expenses are deductible through amortization in accordance with Section 195. In contrast, a cost that is otherwise deductible may not be deducted immediately if it is considered a “capital expenditure.” Section 263(a) prohibits the “deduction of any amount paid ... for permanent improvements or betterments ” and a taxpayer must capitalize an amount paid to facilitate the acquisition of an ownership interest in a business entity.

This determination is necessarily factual, evaluating whether the transaction costs produce benefits that are attributable to the current year or extend to future periods. Further, case law as well as IRS guidance, including the “transaction cost regulations,” permits the allocation of lump-sum and success-based transaction costs among the scope of services rendered. Moreover, the scope and timing of the services rendered affects whether service provider fees may be deducted or not. The transaction cost regulations must be considered when evaluating the scope and timing of services.

Among other things, these Regulations provide that capitalization is required for costs that facilitate certain transactions, and clarify that investigatory costs are considered facilitative. As such, capitalization may be required for transaction costs that are attributable to services provided in the process of investigating or pursuing a transaction. Importantly, the transaction cost regulations provide a significant exception to the general facilitate standard for “covered transactions.” Interpreting case law, the Regulations adopt a date, which is a safe harbor of sorts, designed to capture the point when a company makes a final decision to proceed with a corporate transaction. Under this provision, the costs of investigatory services provided before the “bright-line date” may be deducted.

The bright-line rule is somewhat arbitrary but is designed to capture the precise point when companies reach a final decision to proceed with a transaction. The final decision concept was set forth in legislative history to Section 195 and reinforced by case law. The transaction cost regulations attempt to capture the concept that investigatory costs are deductible when incurred prior to reaching a decision to proceed with a corporate transactions. Although the Regulations are more restrictive than previous authority, the rules attempt to simplify the analysis and clarify when cease to be deductible.

Second, which taxpayer may take transaction costs into account has to be considered. Specifically, it must be determined which taxpayer is the direct and proximate beneficiary of transaction costs. This issue arises most frequently when the transaction involves consolidated taxpayers, private equity entities, or when one party to the transaction is a foreign entity. In these situations, questions may occur regarding which entity may take a particular transaction cost into account.

The Tax Court addressed the issue in *Square D v. Commissioner*, finding in an acquisition context that expenses incurred by one taxpayer could actually be deducted by another. There, the taxpayer reimbursed certain expenses that it was not obligated to pay and the court found that the reimbursing taxpayer could deduct the expenses of the original obligor, when the costs were incurred on behalf of the reimbursing taxpayer and eventually paid by that taxpayer. *Square D* continues a line of decisions utilizing the direct and proximate benefit test. Even when courts have denied such deductions, the denials have been based on the direct and proximate benefit standard.

Third, when transaction costs may be taken into account must also be evaluated. As with any cost, a determination has to be made regarding the proper period when amounts may be recognized. For accrual basis taxpayers, this determination is made under the all events test of Section 461. Under Treas. Reg. Section 1.461-1(a)(2)(i), a liability is incurred for federal income tax purposes, in the tax year in which: (1) all the events have occurred establishing the fact of the liability for it to become “fixed”; (2)
the amount of the liability may be determined with reasonable accuracy; and (3) economic performance has occurred. 26

Whether a liability is “fixed,” all events related to the liability must have occurred to establish all the facts surrounding the liability. The liability must be “final and definite in amount.” 27 Also, a deduction is deferred until all the events have occurred that make it fixed and certain. 28 Thus, when a contingency or condition precedent exists, a deduction is premature and generally not allowed. 29 A condition precedent includes an event that must occur before the obligation will become binding. In the case of contingent fee arrangements, as often occurs with transaction costs, a taxpayer’s liability generally is not fixed until the contingency or specific event/transaction on which the fee arises has occurred. For example, in Bonnie Bros., Inc. v. Commissioner, 30 the taxpayer employed an attorney in 1919 to prepare an amended return for its 1918 tax year. The attorney’s fee was based on the amount of tax saved by the taxpayer by filing the amended return. The court held that in 1919, when the taxpayer received advice from the Treasury Department of its determination in respect of its 1918 tax and actually received a refund check, “all the events necessary under the terms of the contract had happened so as to fix the amount of the attorney’s fees and to enable the computation thereof.” 31 Thus, the taxpayer was able to accrue and deduct the attorney’s fee in 1919 (not 1918).32

In addition to being fixed, a liability must be determinable with reasonable accuracy. When a liability becomes fixed, the fact that an exact amount cannot be determined or may be adjusted at a later date does not prevent accrual as long as the amount is reasonably accurate. Thus, when a liability is determinable with reasonable accuracy before it becomes fixed, a deduction would not be appropriate, as the all-events test would not be met. For example, in United States v. General Dynamics Corp., 33 the United States Supreme Court stated that “[a] reserve based on the proposition that a particular set of events is likely to occur in the future [e.g., the filing of the claims] may be an appropriate conservative accounting measure, but does not warrant a tax deduction.” The determination of whether an amount is determinable with reasonable accuracy is based on all of the facts and circumstances.

As is the case when determining whether a contingent fee is fixed, a contingent fee is generally not determinable with reasonable accuracy until the contingency or event or transaction has occurred. For example, in Canton Cotton Mills v. United States, 34 the court held that attorneys’ fees paid in 1936 for legal services rendered over the preceding two years were deductible in the year of payment because at the end of 1934 and 1935, there was no basis on which the taxpayer could estimate the amount due within reasonable limits. Under the facts, the attorneys were retained in 1934 for a $500 retainer and a fee for services rendered to be determined at a later time. The taxpayer and its attorneys agreed to the fee in February 1936. In determining that the legal fees were not determinable and fixed until 1936, the court noted that “it is doubtful if plaintiff could have deducted any amount for attorneys’ fees in 1935; no fee arrangements had been made by the end of that year and the mere fact that some services had been performed would not establish an accrual. ... If the liability is contingent or its amount unsettled, the expense does not accrue.” 35 The court further noted that “[a]t the end of 1934 and at the end of 1935 plaintiff’s liability to its attorneys was not contingent in the sense that only later events could determine whether anything at all was due. But the amount was unsettled and indefinite. There was no basis on which the amount due could have been estimated within reasonable limits; the expense, therefore, had not accrued. ... The amount of the fee was not in fact determined until February 1936. The obligation became final and definite in amount at that time, and the expense was a proper accrual for that year.” 36

Analyzing transaction costs is really no different from other business costs; review involves evaluation of specific facts and important timing issues. However, because several distinctive determinations are required, if these factors are not considered, the proper amount of transaction may not be deducted. More importantly, transaction costs may not be taken into either by the correct party or they may not be taken into account in the correct tax year.

The IRS’s review of the success-based transaction costs in the GLAM is unclear. To satisfy the all events test, the amounts at issue must be fixed and determinable and satisfy economic performance.
In 2005, the IRS issued TAM 2005-48-022 (the TAM) addressing the application of the consolidated return Regulations to certain success-based transaction costs. The facts involved Taxpayer, whose consolidated parent acquired two target corporations. To complete these transactions, newly created and wholly owned subsidiaries of Parent were merged with and into the target corporations, with both Targets surviving. In accordance with the consolidation return Treasury Regulations, the Targets’ tax years closed. Parent also acquired all of the assets of a third company. According to the TAM, the Targets had engaged advisors prior to the acquisition on a success-fee basis. Taxpayer treated certain financial and other advisory fees as amortizable start-up expenditures under Section 195 on its originally filed consolidated return for the year of the transactions. During an examination, Taxpayer filed an informal claim seeking to change the treatment of these amounts from amortizable start-up expenditures to immediately deductible business expansion costs. Taxpayer argued, and the Exam Team agreed, that the success-based advisory fees associated with the transaction were incurred expanding an existing business, and as such, should have been treated as immediately deductible under Section 162.

In the TAM, the IRS asked a correct question, whether these amounts were start-up expenditures or business expansion costs, concluding that the costs were not start-up expenditures. The scope and timing of services controls the characterization of the costs as immediately deductible business expansion costs or amortizable start-up expenditures. Unfortunately, however, the TAM failed to provide a complete rationale for this conclusion and it is not apparent from the truncated facts. Additionally, the TAM may have considered, but does not elaborate, regarding an evaluation of whose expenses were at issue. It may be that Targets engaged the advisors but that services were actually rendered to Taxpayer or even that Taxpayer actually paid or reimbursed Targets for the services. Further, once it was determined which party should take these amounts into account, then it would be important to evaluate the proper tax year for taking these items into account under the all events test. The IRS’s evaluation of both of these issues was not apparent from the TAM.

Instead, the TAM relied on the consolidated return Regulations, in general, and the end of the day rule, in particular, to determine which entity should take the expense into account and the period for taking the deductions. The TAM summarily concludes that the services attributable to the success-based fees were rendered either prior to, or on, the respective acquisition date. Following the end of the day rule and without analyzing the next day rule, the IRS concluded that the transaction costs were allocable to the target companies and should have been taken into account on the target companies’ final separate tax returns. Perhaps the government took a very narrow view of the term “transaction” as it is used in the consolidated return Regulations and limited it to the corporation acquisitions that results in the change in status.

Regardless, with different facts or even with a fuller description of the instant facts, arguments support a different result.

In January, the IRS released the GLAM and again addressed the application of the end of the day and next day rules with respect to certain extraordinary deductions. Under the GLAM, an acquiring corporation (Acquiring) had a subsidiary that merged into an unrelated corporation (Target), with Target shareholders exchanging shares for cash. Target then became a member of Acquiring’s consolidated group on the acquisition date. The GLAM concludes that two of three extraordinary deductions should be deducted by Target on its last separate federal income tax return and not on Acquiring’s subsequent consolidated return.

The first item addressed by the GLAM was the treatment of non-qualified stock options (NQSOs) and stock appreciation rights (SARs), which were issued to Target employees prior to the acquisition. Under the terms of its agreements with its employees, Target was obligated to pay its employees certain amounts for and in cancellation of their NQSOs and SARs in the event of a change in control. Because Acquiring’s acquisition of Target caused a change of control, Target paid its employees (using its own funds or funds received from Acquiring) at or shortly after closing, the amounts required under the terms of the NQSOs and SAR agreements. The GLAM concludes, without analysis, that Target’s obligation to pay these amounts was fixed and determinable at the time of the acquisition and, as such, this item is properly deductible on Target’s last separate tax return. The GLAM’s analysis regarding the timing of the deduction and the party entitled to the deduction relies exclusively on the consolidated return provisions and the analysis turns on
the conclusion that these items are extraordinary, and therefore not subject to the ratable allocation rule. There is substantial agreement that based on the limited facts provided, the conclusion as to which party is entitled to the deduction (the Target) is correct, so long as the payments are made within 2½ months after closing.

The second item addressed in the GLAM was whether the transaction costs should be deducted by Target or Acquiring. In this regard, the fact pattern appears similar to the fact pattern in the TAM. Here, the transaction costs at issue included financial advisors and investment bankers that provided consulting services on the transaction. The advisors were engaged and paid a success-based fee at closing. The GLAM includes extremely limited facts and analysis finding that Target’s obligation to pay these amounts became fixed and determinable at closing.

Similar to the TAM, the GLAM’s analysis of the transaction costs relies exclusively on the consolidated return provisions. The GLAM simply concludes that these items did not arise in a transaction with respect to Acquiring’s stock, which is one of the factors in the reasonable and consistent test of the next day rule. The GLAM indicates that the fees relate to items from actions that precede the acquisition and that involve the performance of services for Target’s employees and consultants. The GLAM then notes that although consummation of the acquisition is the condition that fixes Target’s liability to make these payments, the corresponding deductions are not attributable to any “transaction” on the acquisition date other than the acquisition itself and therefore the next day rule is inapplicable concluding that the deductible items should be reflected on the Target’s final return. Unfortunately, the facts are truncated and the analysis is limited so it is challenging to appreciate what factors, other than the form of the transaction, were important to the IRS in reaching this conclusion. This conclusion would also seem to be at odds with the example in the Treasury Regulations that provides Treas. Reg. Section 1.1502-80(d) is applied after the acquisition of stock as it separates the treatment of the tax issue from the issuance of the stock.

The GLAM also addresses a third extraordinary item and comes to a different conclusion. As part of the acquisition, Acquiring required that some of Target’s outstanding debt be retired. Accordingly, Target and Acquiring agreed that Target would make a tender offer to its bondholders at a price at a premium over the adjusted issue price prior to the close of the acquisition with the payout occurring after the close of the transaction using its own funds or funds received from the acquiring. In contrast to the first two items, the GLAM concludes that the application of the next-day rule may be appropriate with the bond premium deduction properly reflected on Acquiring’s tax return. The GLAM’s rationale is that the deduction for this item arose as a result of a payment in the post-closing portion of the acquisition date based on a decision made by the Target corporation after the closing.

To take a deduction into account under an accrual method of accounting, Section 461 requires that the all events test has been met. Under Treas. Reg. Section 1.461-1(a)(2)(i), a liability is incurred for federal income tax purposes, in the tax year in which: (1) all the events have occurred establishing the fact of the liability; (2) the amount of the liability may be determined with reasonable accuracy; and (3) economic performance has occurred. If there is a contingency or condition precedent, the all-events test cannot be satisfied until the event occurs or the contingency is removed. Thus, a taxpayer must review all the facts and circumstances surrounding that liability including how the parties treated the liability in the contractual agreement and the parties’ intent at the time of the agreement.

Presumably, the GLAM refers to the cash out of the NQSOs and SARs as fixed and determinable because of a separate determination under the all events test that was not included in the memorandum. The deductibility of compensatory expenses is generally governed by Section 83(h) that allows an entity a deduction for compensation expenses in the year in which the item was included the employees’ compensation as income, as the timing of the income inclusion and the compensation deduction are tied together. This rule is, however, overridden for “short-term deferrals,” so that a company may take a deduction for a compensation amount in the year it is accrued, so long as it is paid within 2½ months of the end of the company’s tax year. The individual, however, has income in the year of receipt.

As the GLAM points out, an issue arises when the option is “cashed out” in a transaction. The consolidated return Regulations identify any compensation-related deductions in connection with a status change as characterized as an extraordinary item. Therefore, the question then becomes whether the amount becomes fixed and determinable in the tax year prior to the acquisition or in a subsequent tax year. This seems to be a very straightforward analysis. Compensation expenses are extraordinary items per the Treasury Regulations and are fixed and determinable at the time the transaction closes as they are a condition to closing.
The IRS’s review of the success-based transaction costs in the GLAM is, however, more unclear. As noted, to satisfy the all events test, the amounts at issue must be fixed and determinable and satisfy economic performance.

It is unclear precisely how the IRS viewed the contingent nature of the financial advisor and investment banking fees. The GLAM merely concludes that the acquisition is a condition that “fixes” the liability and does not address the other aspects of the all events test. However, relying on the GLAM conclusion that the amount is not fixed until closing, it seems possible that circumstances could exist under which the transaction closing is a required condition to satisfy the all events test and if so, it would also seem that the fees do not become deductible until after the subsidiary’s status change. If so, it is difficult to understand why the fees could become deductible prior to the transaction’s completion, under either the all events test or the next day rule.

It would seem that the factual complexities of the all events test, which would defer deductions until properly accrued under Section 162 and 461, are the type of issues contemplated by the consolidated return Regulations, which require “appropriate adjustments” to take into account other Code provisions.47 The GLAM, like the TAM, seems to oversimplify the analysis and to suggest that the consolidated provisions alone answer the questions. The GLAM fails to take into account the factual nature of the all events test. Facts could be present in a situation similar to the GLAM in which the transaction costs were not fixed at closing. For example, it may be that the company has not determined whether to pay any fees to the advisor as a result of the transaction and although the fees are success-based pursuant to an engagement letter, a decision is not reached to pay the advisor until post-closing. Alternatively, the payment amounts may not be determinable at closing, (e.g., transaction requires post-closing valuation to determine the amount of success-based payment). Further, it is common for the buyer to put the seller’s transaction costs in an escrow account that are paid at some point after the closing after contingencies have resolved. Does it matter if they are paid a day or month later under the next day rule? A situation may exist that the payment is not fixed because it is uncertain that the merged entities will proceed and payment cannot be made until post-closing action (e.g., some regulations industries require congressional approval and contingent fees may be withheld pending approval). In any of these situations it would seem erroneous to rely on the consolidated return provisions to determine which party to the transaction should be allocated the expense and the proper period for deducting the amount. These determinations should be made under Sections 162 and 461. More importantly, a resolution under Sections 162 and 461 could be at odds with the consolidation regulations determination.

Moreover, it is somewhat difficult to reconcile the GLAM’s conclusions with other recent IRS guidance regarding transaction costs. In 2011, the IRS issued Rev. Proc. 2011-29 providing a safe-harbor election for success-based fee allocations under Section 263(a).48 The safe-harbor guidance allows taxpayers completing covered transactions to treat 70 percent of the success-based fee as an amount that does not facilitate the transaction—that is, a deductible expense with the remaining portion that must be capitalized as an amount that facilitates the transaction.49 In a recent Chief Counsel Advisory (CCA) involving success-based fees arising under the safe harbor of Rev. Proc. 2011-29, the IRS concluded that nonrefundable milestone payments, which are creditable to success-based fees, do not qualify for safe harbor provided by Rev Proc 2011-29.50

It seems incongruous to conclude in a GLAM that a success-based fee liability is not fixed until closing while finding in a CCA that a success-based fee has satisfied the all events test prior to closing. The milestone payments in the CCA were determined to be outside of the safe harbor because they were found to be fixed and determinable prior to the closing of transaction. In contrast, the success-based fees in the GLAM were subject to a pre-closing condition – the transaction close. In fact, closing was required in both scenarios so it is difficult to appreciate the distinction.

Another issue that the GLAM fails to address is whether these transaction costs were appropriately taken into account by Target. An important question for consideration with parties to a transaction is which party should take these amounts into account.51 If one party reimbursed the other for certain transaction costs, that may affect which party deducts the expenses. As noted, the facts in the GLAM are truncated and perhaps the success-based fees at issue provided a direct and proximate benefit to the Target. Unfortunately, however, this issue was not specifically addressed in the GLAM. It is not difficult to envision a situation in which Acquiring should have taken these expenses into account. Acquiring in the GLAM is acquisitive and it may be that the Acquiring has long-standing relationships with service providers and requires that when Acquiring is involved in an acquisition, it recommends particular advisors to the Target so
that issues arising in the transaction may be addressed. Like the taxpayer in *Square D*, it could be that Acquiring actually engages advisors or it may that advisors meet with and provide reports and materials to Acquiring. Acquiring might even have paid (or reimbursed Target) for the success-based fees. Consequently, to accurately evaluate the situation at issue, it would be important to evaluate whose expenses are at issue. If these expenses were incurred for the direct and proximate benefit of the Taxpayer as distinguished from the Target, then it would seem that these amounts could have been deducted on the consolidated return.

**PePPer Perspective**

*The economic consequences of requiring seller to claim extraordinary deductions on its return as opposed to the buyer can be significant. It is quite common that these costs are funded by the buyer, and not the seller, which compounds the inequity in the tax treatment. A number of companies who have taken positions contrary to the GLAM will need to evaluate for FIN 48 whether or not a reserve needs to be established in light of the IRS’s position.*

*The GLAM appears to be results-oriented under the prism of the consolidated return provisions. A deduction will be respected under the next day rule if it is reasonable and consistent. The GLAM seems to conclude that any transaction cost or option cash-out that is not reported on the target’s return is not reasonable. The GLAM focuses its analysis on the end-of-the-day rules and does not address the reasonable element of the test. The GLAM also fails to address a number of important issues raised by the facts under a broad range of other Code and regulatory provisions that would indicate whether such an allocation was reasonable.*

*For example, the GLAM does not fully consider: (1) the timing of deductions provided in Section 461 as established under the all events test; (2) cost capitalization and allocation principles under Sections 162, 195, and 263; and (3) case law addressing which entity is the direct and proximate beneficiary of an expense and hence may take various expenses into account. More importantly, the GLAM does not provide a complete analysis of all regulatory factors for determining whether the allocation is reasonable and consistent under the next day rule. Because the GLAM was drafted with a dearth of facts and limited analysis, these issues are not separately addressed, which leaves significant ambiguity regarding the GLAM’s conclusions. The ambiguity leaves taxpayers in the unfortunate position of being unable to fully evaluate the GLAM’s effect to a range of fact patterns. Taxpayer must take the GLAM into consideration at the time of a significant corporate transaction. Without additional analysis, it is unclear how to apply the GLAM. As a result, there is a question whether a different result would have been reach if all of these issues had been considered. It is also unclear how and whether the GLAM’s results could or should be extended to different circumstances.*

**ENDNOTES**

1. See Treas. Reg. §1.1502-76(b)(1)(ii)(A), which describes the “end of the day” rule. Unless otherwise stated, all references to “Code” are to the Internal Revenue Code of 1986, and all references to “Regulations” or “Treas. Reg. Section” are to the Treasury Regulations promulgated thereunder.

2. See Treas. Reg. §1.1502-76(b)(1)(ii)(B), which describes the “next day rule.”

3. AM 2012-010 (January 31, 2013). Note that the GLAM is limited to the acquisition of a C corporation by another C corporation.


6. Treas. Reg. §1.1502-76(b)(1)(ii)(B) provides that if on the day of the change in member’s status, a transaction occurs that is properly allocable to the period after the change in status, then the member (and all parties related to the member under Section 267(b) immediately after the change in status) must treat the transaction for all federal income tax purposes as occurring at the beginning of the following day.


8. Treas. Reg. §1.1502-76(b)(2)(ii)(C) defines “extraordinary items” as:

   (1) any item from the disposition or abandonment of a capital asset as defined in Section 1221 (determined without the application of any other rules of law)

   (2) any item from the disposition or abandonment of property used in a trade or business as defined in Section 1231(b) (determined without the application of any holding period requirement)

   (3) any item from the disposition or abandonment of an asset described in Section 1221(1), (3), (4), or (5), if substantially all the assets in the same category from the same trade or business are disposed of or abandoned in one transaction (or series of related transactions)
(4) any item from assets disposed of in an applicable asset acquisition under Section 1060(c)
(5) any item carried to or from any portion of the original year (e.g., a net operating loss carried under Section 172), and any Section 481(a) adjustment
(6) the effects of any change in accounting method initiated by the filing of the appropriate form after S's change in status
(7) any item from the discharge or retirement of indebtedness (e.g., cancellation of indebtedness income or a deduction for retirement at a premium)
(8) any item from the settlement of a tort or similar third-party liability
(9) any compensation-related deduction in connection with S's change in status (including, for example, deductions from bonus, severance, and option cancellation payments made in connection with S's change in status)
(10) any dividend income from a nonmember that S controls within the meaning of Section 304 at the time the dividend is taken into account
(11) any deemed income inclusion from a foreign corporation, or any deferred tax amount on an excess distribution from a passive foreign investment company under Section 1291
(12) any interest expense allocable under Section 172(h) to a corporate equity reduction transaction causing this paragraph (b) to apply
(13) any credit, to the extent it arises from activities or items that are not ratably allocated (e.g., the rehabilitation credit under Section 47, which is based on placement in service), and
(14) 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.

9 See e.g., TAM 2010-34-017 (August 27, 2010) (Parent cannot include Target’s and Target subsidiaries’ qualified research expenses in Parent’s computation of its Section 41 calculation under the end of day rule).

10 See e.g., TAM 1999-50-005 (December 20, 1999) (retail sales of inventory were not extraordinary items).
12 See e.g., Deputy v. DuPont, 308 U.S. 488 (1940).
13 See Section 263(a) and INDOPOCO v. Comm'r, 503 U.S. 79 (1992), which required target in a friendly acquisition to capitalize certain service provider fees, including investment banking and legal fees. The Court found that the “a taxpayer’s realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate treatment is immediate deduction or capitalization” at 86-88. See also Treas. Reg. Section 1.263(a)-5(a)(2).
14 See e.g., Badger Pipeline Co v. Comm'r, 74 T.C.M. (CCH) 856 (1997) (finding that “whether an expenditure is deducted or must be capitalized is a question of fact.”)
15 See, e.g., Staley v. Comm’r, 119 F.3d 482 (1997); Wells Fargo v. Comm’r, 224 F.3d 874 (8th Cir. 2000), rev’d in part and aff’d in part, Norwest Corp. v. Comm’r, 112 T.C. 89 (1999). In December 2003, the Internal Revenue Service and the Department of Treasury issued final regulations under Section 263(a), which interpreted case law regarding the treatment of corporate transaction costs, known as the “transaction cost regulations.” Treas. Reg. §1263(a)-5 (setting forth rules relating to transaction-related costs for amounts paid or incurred to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions).
16 Id.
17 Under Treas. Reg. §1.263(a)-5(a), a taxpayer must capitalize an amount paid to facilitate any one of ten specified transactions. The list of specific transactions includes: amounts paid to facilitate an acquisition by the taxpayer of an ownership interest in a business entity; the acquisition of an ownership interest in the taxpayer (other than an acquisition by the taxpayer of an ownership interest in itself, whether by redemption or otherwise); and amounts associated with debt issuance.
18 The term “facilitate” is defined in Treas. Reg. §1.263(a)-5(b) (1) as an amount paid “in the process of investigating or otherwise pursuing the transaction.” It is also important to note that the regulations provide that the costs a taxpayer
pays or incurs in relation to borrowing funds to finance a transaction are costs that facilitate the borrowing only. Treas. Reg. §1.263(a)-5(c)(1). Also, the transaction cost regulations provide clarifying guidance that certain ordinary and necessary costs are deductible, including for example: amounts treated as employee compensation (including salary, bonuses, and commissions) that a taxpayer pays to its employees [Treas. Reg. §1.263(a)-5(d)(1) and (2)]; integration costs [Treas. Reg. §1.263(a)-5(c)(6)]; and de minimis costs [Treas. Reg. §1.263(a)-5(d)(3)].

19 Treas. Reg. §1.263(a)-5(e) provides a significant exception to the general facilitate standard for “covered transactions,” which are: (i) taxable acquisitions by the taxpayer of assets that constitute a trade or business, (ii) taxable acquisitions of an ownership interest in a business entity (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) if, immediately after the acquisition, the acquirer and the target are related within the meaning of Sections 267(b) or 707(b), and (iii) reorganizations described in Section 368(a)(1)(A), (B), or (C) or a reorganization described in Section 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction that qualifies under Sections 354 or 356.

20 Costs attributable to investigatory services do not have to be capitalized if they relate to services performed before the earlier of: (i) the date on which the parties execute a letter of intent, exclusivity agreement, or similar written communication (not including a confidentiality agreement), or (ii) the date on which the material terms of the transaction are authorized or approved by the taxpayer’s board of directors (or other appropriate governing officials). Treas. Reg. §1.263(a)-5(e)(1). Inherently facilitative services must be capitalized even if they are performed prior to the bright-line date. These services include: (i) securing an appraisal or fairness opinion; (ii) structuring the transaction; (iii) preparing or reviewing documents affecting the transaction; (iv) obtaining regulatory approval; (v) obtaining shareholder approval; and (vi) conveying property. Treas. Reg. §1.263(a)-5(e)(2).

21 H.R. Rep. No. 1278, 96th Cong., 2d Sess. 10-11 (1980); S. Rep. No. 1036, 96th Cong., 2d Sess. 11-12 (1980). The legislative history to Section 195 describes investigatory costs as the “costs of seeking and reviewing prospective businesses prior to reaching a decision to acquire or to enter any business.” 1980 House Report at 9; 1980 Senate Report at 10. These costs include “expenses incurred for the analysis or survey of potential markets, products, labor supply, transportation facilities, etc.” Id.

22 121 T.C. 168 (2003). In Square D, the acquiring corporation negotiated a loan commitment and agreed to pay the loan commitment and related legal fees on behalf of its to-be-organized transitory subsidiary corporation, Acquisition Co. After Acquisition Co.’s creation, the taxpayer, which was the surviving entity following its merger with Acquisition Co., formally assumed some of the costs (the legal fees), which it paid directly, and agreed to (and did) reimburse acquiring company for other costs (the commitment fee). The Tax Court concluded that the costs related to services performed for the taxpayer even though these services were provided under a contract to which the taxpayer was not a party. Therefore, the court concluded that when acquisition costs were incurred on behalf of the taxpayer and then paid by the taxpayer, it is appropriate to allow the taxpayer to deduct the costs it paid.

23 See also PLR 2009-53-014, which concluded that a target company in a private equity transaction could deduct the type of costs at issue here to the extent that the target was the direct and proximate beneficiary of the expense. The ruling cites several cases discussing and applying the direct and proximate benefit standard, including Dinardo v. Comm’r, 22 T.C. 430 (1954), acq. 1954-2 C.B. 4, acq. 1954-2 C.B. 5 (permitting a medical partnership to deduct payments for a hospital subsidiary’s current operating costs because the subsidiary’s survival was for the direct and proximate benefit of the medical partnership, i.e., it could continue to earn fees from hospitalized patients) and Fishing Tackle Products Co. v. Comm’r, 27 T.C. 638 (1957), acq. 1964-2 C.B. 5 (permitting a parent corporation to deduct costs incurred by a subsidiary corporation as trade or business expenses when it reimbursed the subsidiary for operating losses). See also Catholic News Publishing Company v. Comm’r 10 T.C. 73 (1948) (permitting a corporation to deduct payments made to reimburse an officer for expenses incurred to settle a personal claim against the officer).

24 For example, the Tax Court found that costs paid by the taxpayer were properly viewed as the expenses of the taxpayer’s subsidiary corporations—those costs directly benefited and were proximately related to the business of the subsidiary corporations. Any deduction was only appropriate at the

25 In this regard, economic performance occurs as services are rendered, so presumably economic performance would be met in this context.

26 In this regard, economic performance occurs as services are rendered so economic performance should have occurred.

27 *Security Flour Mills Co. v. Comm'r*, 321 U.S. 281, 287 (1944) (“The rule that a taxpayer (on the accrual basis) may not accrue an expense the amount of which is unsettled or the liability for which is contingent is applicable to a tax the liability for which he denies and payment of which he is contesting.”)


29 See *Hitachi Sales Corp. v. Comm'r*, 64 T.C.M. 634 (1992), for example, the court denied a deduction for liabilities incurred in the future because such liabilities were not fixed within the year of deduction. See also *Brown v. Helvering*, 291 U.S. 193, 200 (1934); accord, *Dixie Pine Products Co. v. Comm'r*, 320 U.S. 516, 519 (1944). In Rev. Rul. 60-237, 1960-2 C.B. 164, the IRS cited Treas. Reg. Section 1.461-1(a)(2) and further explained that when a liability is substantially in controversy, accrual of income or deduction must await resolution of the controversy. Thus, an accrual method taxpayer may not accrue as income or deduct as a liability an amount that is contingent or subject to a condition precedent. See also *Lucas v. American Code Co.*, 280 U.S. 445 (1930); *American Nat'l Co. v. U.S.*, 274 U.S. 99 (1927); *U.S. v. Anderson*, 269 U.S. 422 (1926); *Lustman v. Comm'r*, 322 F.2d 253 (3d Cir. 1963); and *Noxon Chemical Products Co. v. Comm'r*, 78 F.2d 871 (3d Cir. 1935). These cases hold that if all of the events necessary to establish the fact of the liability have not occurred, the liability is contingent and may not be deducted.

30 15 B.T.A. 1231 (1929).

31 Id. at 1236.

32 See also *Highland Farms Corp. v. Comm'r*, 42 B.T.A. 1314 (1940), *acq. and nonacq.* 1941-1 C.B. 5 (holding that when an attorney’s fee is contingent on the outcome of litigation, accrual of such amount is delayed until the judgment becomes final); *U.S. v. Texas M. R. Co.*, 263 F.2d 31 (5th Cir. 1959) (holding that the taxpayer may accrue a deduction only in the tax year in which the liability was fixed, i.e., in the year of judgment).


34 94 F. Supp. 561 (Ct. Cl. 1951).

35 Id. at 565-566.

36 Id. at 566. See also *Sico Foundation v. U.S.*, 295 F.2d 924 (Ct. Cl. 1961) (holding that professional fees paid by the taxpayer for services provided in 1950 were deductible in 1951 when the amount of the fees became fixed; until such time, the taxpayer did not know the amount of the fees and whether it would agree or disagree with such amounts). Note, however, a different result may occur with respect to the 2½ month rule. See Treas. Reg. § 1.404(b)-1T.

37 TAM 2005-48-022 (December 2, 2005).

38 A deduction may be available when an expense directly relates to the taxpayer’s business and the taxpayer pays or reimburses such expense. The taxpayer must prove that the specific services or activities giving rise to the claimed deduction were performed for the taxpayer’s direct and proximate benefit. See, e.g., *Square D v. Comm'r*, 121 T.C. 168 (2003).

39 For example, see Treas. Reg. §1.6050I-1(c)(3)(i), which defines a “transaction” as any event requiring a transfer of cash from a payor to the payee-recipient. Transactions include, but are not limited to purchases of property (real, personal, or intangible); payments toward retiring an existing debt or loan; and purchases of a negotiable instrument for cash. In this context, the term is not limited to a corporate transaction.

40 AM 2012-010 (January 31, 2013).

41 This GLAM notes that it applies generally to situations where a C corporation becomes or ceases to be a member of a consolidated group. These facts illustrate just one of many situations to which this GLAM potentially applies. For example, the results would be the same if target were acquired in a tax-free transaction or if target were acquired out of another consolidated group.

42 The GLAM notes that the NQSOs did not have a readily ascertainable fair market value when they were granted and the NQSOs and SARs did not provide for a deferral of compensation as defined in Treas. Reg. Section 1.409A-1(b).
Under Treas. Reg. §1.1502-76(b)(2)(ii)(C)(9), any compensation-related deduction in connection with the subsidiary’s change in status (including, for example, deductions from bonus, severance, and option cancellation payments made in connection with the status change) is an extraordinary item not subject to the ratable allocation method.

TAM 2005-48-022 (December 2, 2005).

Id.

Section 404(a).


CCA 2012-34-027 (August 24, 2012). The CCA concludes that because the nonrefundable milestone payments are not contingent on the successful closing of a transaction, they are not eligible for the safe harbor for success-based fees. Rather, these payments are treated as guaranteed payments incurred upon the occurrence of a specified milestone or upon some other date or event.


In September 2011 the Internal Revenue Service (IRS) announced a new voluntary relief program for worker status termed the voluntary classification settlement program (VCSP). Announcement 2011-64, 2011-41, I.R.B. 503. On December 17, 2012, the IRS modified four aspects of the VCSP, in Announcement 2012-45, and also temporarily expanded the program through June 12, 2013 (the VCSP Temporary Eligibility Expansion) in Announcement 2012-46.

The VCSP allows employers to voluntarily reclassify workers who were treated as independent contractors (ICs) prospectively in exchange for immunity for the past. The prospective voluntary classification is not required to be made for all workers, but must cover all of a class or type of worker. As part of the VCSP, an employer cannot have similarly situated workers who were reclassified as employees while others continue as independent contractors.

There are two primary benefits to the VCSP. First, there are no penalties and no interest, and the payment involved is very nominal. The amount due is calculated using the reduced rates of §3509 of the Internal Revenue Code (IRC), and is based on compensation paid in the most recently closed tax year determined when the VCSP application is filed. For 2012, under IRC §3509, the effective tax rate for compensation up to the Social Security wage base is 10.28 percent, and for compensation above the Social Security wage base it is 3.24 percent. For VCSP applications filed in 2013, the most recently closed tax year will be 2012, and therefore these 2012 rates will apply. The VCSP payment is 10 percent of the IRC §3509 rates. The IRS estimates that the 10 percent payment will equal just over 1 percent of the income the employer paid to its reclassified workers for the prior year.

The second benefit is that the employer and the IRS enter into an agreement stating that there will be no audit for payroll taxes related to these workers for past years. Therefore participants in the program will relinquish the independent contractor classification prospectively without implicating the past.
One negative aspect to the VCSP is that the employer must agree to extend the period of limitations for assessment of employment taxes. This extension is implemented as part of the VCSP closing agreement with the IRS.

To qualify for the VCSP, the employer must consistently have treated the workers in the past as independent contractors. The worker must have always been paid an as an independent contractor and not have been given the same benefits and same rights given to employees. The employer must have filed all required Forms 1099 for the workers for the previous three years. Finally, the employer may not currently be under audit by the IRS, the Department of Labor, or a state agency concerning the classification of these workers.

To apply for the program, an employer must file Form 8952, Application for VCSP. The IRS asks prospective participants to file the application at least 60 days before the employer wants to begin treating the affected workers as employees. The IRS will review the application and inform the employer if it is accepted into the program. The IRS and the employer will sign a closing agreement and pay the amount due, as calculated in Form 8952, at the time of the closing.

The IRS stated that to date it has received 700 applications covering about 15,000 workers. However, the IRS had stated previously that it was considering changes to remove barriers to entering the program.

Four modifications have been made to the VCSP by Announcement 2012-45, based on taxpayer feedback. First, an employer under an IRS audit can participate in the VCSP as long as the audit is not an employment tax audit. The announcement also eliminates the requirement that an employer agree to extend the statute of limitations on assessment of employment taxes as part of its VCSP closing agreement. The announcement clarifies two other eligibility requirements. An employer is not eligible to participate if it is contesting in court the classification of workers from a previous IRS or Department of Labor audit, or if it is a member of an affiliated group in which any member of the affiliated group is under audit.

The VCSP Temporary Eligibility Expansion permits employers that do not meet all of the conditions for the original VCSP to reclassify workers for federal employment tax purposes. The VCSP Temporary Eligibility Expansion is available to employees who meet all of the conditions to participate in the original VCSP, except that they have not previously filed all required Forms 1099 consistent with non-employee treatment for workers proposed for reclassification. The settlement payment under the original VCSP is 10 percent of the employment tax liability that may have been due on compensation paid to the workers for the most recent tax year, determined under the reduced rates of IRC §3509. The settlement payment under the VCSP Temporary Eligibility Expansion is 25 percent of that amount. In addition, the employer must pay a reduced penalty for unfiled Forms 1099 for the previous three years. As under the VCSP, the employer is not liable for interest and penalties on the employment tax liability and will not be subject to an employment tax audit with respect to worker classification of the class or classes of reclassified workers for prior years.

Employers that wish to participate in the VCSP Temporary Eligibility Expansion must submit an application on or before June 30, 2013 using IRS Form 8952, with the phrase “VCSP Temporary Eligibility Expansion” inserted at the top of the Form. The original VCSP (with the modifications discussed above) continues to be available for employers who have timely filed Forms 1099 for workers it seeks to reclassify.

Employers who have not filed Forms 1099 for non-employee service providers may consider this reclassification opportunity as an alternative to other strategies to achieve compliance with federal tax laws governing employee classification, including bona fide restructuring of the relationship between service providers and service recipients, the use of a third-party employee leasing or staffing company, and voluntary reclassification outside of any government program. Those alternatives can be analyzed using IC Diagnostics™ and other proprietary compliance tools of Pepper’s Independent Contractor Compliance Practice. Taxpayers may also be eligible for a safe harbor from liability from employment taxes under Section 530 of the Revenue Act of 1978. Additional background on these alternatives can be found in Pepper’s Client Alert on minimizing IC misclassification liability (available online at http://www.pepperlaw.com/publications_article.aspx?ArticleKey=2365).

Whether an employer should participate in the VCSP Program or Temporary Eligibility Expansion requires consideration of a number of factors, including (i) participation in the VCSP only addresses potential employment tax exposure and does not eliminate the potential exposure to other enforcement actions relating to overtime, unemployment taxes, workers compensation premiums and state and local income taxes, and (ii) the risk that reclassified workers will be alerted to the issue and use the
reclassification to assert claims before administrative agencies and in private litigation seeking overtime pay, unpaid employee expenses, and/or employee benefits that would have been available to them if previously classified as employees. Neither the VCSP nor the Temporary Eligibility Expansion offers protection from these exposures. It should be remembered that the seminal Microsoft case, *Vizcaino v. Microsoft Corp.*, 120 F.3d 1006 (9th Cir. 1997), regarding the collateral consequences of reclassification, commenced shortly after Microsoft resolved its employment tax liabilities with the IRS. Consequently, employers must weigh carefully the pros and cons of participating in the VCSP or Temporary Eligibility Expansion.

As Foreign Banks May Disclose U.S. Depositors, Foreign Account Holders Should Consider IRS OVDI Program

**JOAN C. ARNOLD | ARNOLDJ@PEPPERLAW.COM**  
**KEVIN M. JOHNSON | JOHNSONKM@PEPPERLAW.COM**

In December, Bank Leumi le-Israel BM issued a letter notifying its U.S. account holders about the IRS Offshore Voluntary Disclosure Initiative (the OVDI).1 The IRS OVDI is a type of amnesty program under which U.S. citizens and residents are given the opportunity to come clean about their foreign financial accounts. There is speculation that the letter is an indication that Bank Leumi will soon be disclosing a list of U.S. depositors to the IRS as other foreign banks, including most notably the Swiss bank UBS, have done. The IRS has prosecuted a number of U.S. taxpayers for tax evasion based on information received in similar foreign bank disclosures.

A U.S. citizen or resident with foreign financial accounts totaling more than $10,000 in the aggregate during any calendar year must file Form TD 90-22.1 (more commonly known as the “FBAR”) disclosing the accounts by June 30 of the following year. A U.S. citizen or resident who fails to disclose foreign financial accounts can be subject to criminal prosecution if the individual has purposefully evaded U.S. income tax, and may also be subject to substantial civil penalties. For example, the maximum penalty for willfully failing to file a FBAR is the greater of $100,000 or 50 percent of the highest amount in the foreign account during the year for each violation. When an individual has multiple violations over a number of years, the penalty can be greater than the amount of funds in the foreign account.

Under the IRS OVDI program, individuals who make a voluntary disclosure of their foreign accounts and any unreported income related to the accounts generally will avoid criminal prosecution and will be subject to reduced civil penalties.

A U.S. citizen or resident with an undisclosed bank account at Bank Leumi should consider making a disclosure under the IRS amnesty program before his or her name is disclosed to the IRS. An individual is no longer eligible to participate in the program after a foreign bank discloses to the IRS that the individual has a foreign financial account.

Pepper Hamilton’s Tax Practice Group has experience in representing clients in the IRS OVDI amnesty program and can help clients navigate through this comprehensive and complicated disclosure process.

If you have any questions, please contact either of the authors.

**ENDNOTES**

Pepper Hamilton’s Tax Practice Group

Federal and International Tax Issues

Brian Allen 215.981.4523 allenbr@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
Annika M. Chin 215.981.4484 china@pepperlaw.com
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
Kevin M. Johnson 215.981.4152 johnsonkm@pepperlaw.com
Timothy J. Leska 215.981.4008 leskat@pepperlaw.com
Ellen McElroy 202.220.1589 melroye@pepperlaw.com
Lisa B. Petkun 215.981.4385 petkunj@pepperlaw.com
Todd B. Reinstein 202.220.1520 reinsteint@pepperlaw.com
Joan M. Roll 215.981.4515 rollj@pepperlaw.com

State and Local Tax Issues

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

Sign Up to Receive Your Tax Update Sooner

We are encouraging our readers to switch to e-mail delivery. E-mail delivery means faster delivery of updates to you, reduced printing and postage costs for us, and reduced environmental impact for everyone. Please subscribe online at www.pepperlaw.com, or send your request, name, company and e-mail address to phinfo@pepperlaw.com. Please be assured that we will respect your privacy — please see our privacy policy at www.pepperlaw.com/Privacy.aspx.