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DEWEY & LEBOEUF

Focus on Tax Controversy and Litigation

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Editor's Note

Dear Readers,

On December 3, 2009, Dewey & LeBoeuf held its Fifth Annual Year-End Tax Conference and Celebration. The event was a great success, and we would like to thank all who participated and attended.

One of the topics we covered at the conference was *Textron* and the IRS's policy of restraint with respect to tax accrual workpapers. Since the conference, we have heard rumors that the IRS may be announcing a new policy of restraint with respect to requests for tax accrual work papers early next year. The details of the new policy remain unknown, but we will keep you posted.

Dewey & LeBoeuf's Tax Controversy and Litigation Group would like to wish everyone a happy and healthy holiday season!

Dewey & LeBoeuf Holds Fifth Annual Year-End Tax Conference and Celebration

On December 3, 2009, Dewey & LeBoeuf hosted its Fifth Annual Year-End Tax Conference and Celebration. The Tax Controversy and Litigation Panel was moderated by Lawrence Hill and included partner Mark Allison, Jack Burns of Citigroup Global Markets Inc., Edward Grady Jr. of JPMorgan Chase & Co., Philip Jacobs of Barclays Capital Inc., and Edward Park of American Interna-

tional Group, Inc. Topics covered included a status update on foreign tax credit litigation, privilege developments, remarks Commissioner Shulman made at the Corporate Governance Conference, the IRS's offshore tax compliance initiative and international discovery mechanisms, economic substance doctrine developments, and developments with respect to withholding tax issues.



New Trend: Government Requesting Jury Trials in Tax Cases

In pleadings recently filed by the government in two foreign tax credit (“FTC”) generator tax cases, the government opted out of traditional bench trials and instead demanded that the cases be tried by jury. This is a noteworthy development and indicative of a new government strategy in tax litigation involving corporate taxpayers. The only previous civil tax case in recent memory involving the government’s demand for a jury trial was the *Fifth Third* case.¹

Fifth Third involved a series of lease-in lease-out transactions (“LILLO” transactions) in which Fifth Third reported rent income received and deducted rent, amortization, and interest expenses. The IRS challenged the LILLO transactions, arguing, in part, that the loans to Fifth Third did not constitute genuine indebtedness and the transactions lacked economic substance. The jury returned a verdict in favor of the government. The jury found that although Fifth Third obtained a genuine leasehold interest in the equipment, (i) the loans to Fifth Third did not constitute genuine indebtedness to support an interest expense deduction and (ii) the LILLO transactions did not appreciably affect Fifth Third’s economic interest, aside from providing tax benefits, and thus lacked economic substance.

1. *Fifth Third Bancorp & Subsidiaries v. United States*, No. 05-350 (S.D. Ohio Apr. 18, 2008).

The government seemingly believes that, in certain cases, a jury as the finder of fact (as opposed to a judge) would be beneficial to its case. The cases to date involving jury demands have one commonality — the taxpayers are financial institutions. The government must feel that there will be jury backlash against financial institutions because of the recent economic crisis. This trend is problematic because the complexity of the legal and factual issues in these cases is not conducive to ready comprehension by a jury that is likely drawn from a pool of people predominantly unsophisticated in tax and financial matters, many of whom may not be college educated. This hardly is representative of trial by a jury of “your peers.” And while it is common for plaintiffs in tort actions to demand jury trials against large corporations — because of the jury risk to corporate defendants — it is a different proposition when the government demands a jury in a tax refund suit. This is because the IRS’s charge is to collect the correct amount of tax due and owing, not a dollar more. The imposition of a jury in complex tax cases brings with it the legitimate risk that the IRS may obtain more than the amount to which it is legally entitled because of the lack of sophistication and inherent prejudices and predilections of juries. The IRS may win cases this way, but the system will lose if unfair or inequitable results are obtained in this regard.

The two cases in which the government has demanded jury trials include a suit filed by American International Group (“AIG”) pending in federal district court in the Southern District of New York in which AIG is seeking a tax refund related to so-called “FTC-generator” transactions. The Acting United States Attorney demanded a trial by jury pursuant to 28 U.S.C. § 2402.² Similarly, in *Sovereign Bancorp, Inc. v. United States*,³ a tax refund suit in the United States District Court for the District of Massachusetts also involving FTC generators, the Acting United States Attorney demanded a jury trial pursuant to Rule 38(b) of the Federal Rules of Civil Procedure.

Taxpayers have no constitutional right under the Seventh Amendment to a jury trial in a tax case. By statute, however, any refund action filed in federal district court against the United States under 28 U.S.C. § 1346(a)(1) shall, at the request of either party to the action, be tried by the court with a jury. The right to a jury trial in tax cases is limited to refund suits brought in federal district court. The district courts are bound by the decisions of the US Supreme Court and of the court of appeals

2. *American Int’l Group, Inc. v. United States*, No. 09 Civ. 1871 (S.D.N.Y. July 9, 2009).

3. For more information, see “*Sovereign Bancorp, Inc. v. United States: Bank Seeks Refund Following IRS Denial of Foreign Tax Credits*,” *Focus on Tax Controversy and Litigation*, July 2009, at 19-20.

New Trend: Government Requesting Jury Trials in Tax Cases (cont'd)

for the circuit in which the district is located.

Unlike the federal district courts, the Tax Court and the Court of Federal Claims are courts of limited jurisdiction in which taxpayers are not entitled to a jury trial. The Tax Court is bound by the precedent of the federal court of appeals in the geographic jurisdiction in which the taxpayer is located whereas the Court of Federal Claims is bound by the precedent of the US Court of Appeals for the Federal Circuit. Thus, forum selection in tax disputes is vitally important because, in addition to determining what precedents will govern the dispute, the forum selected determines the parties' rights to demand a jury trial.

Some earlier FTC-generator cases were filed in the Tax Court.⁴ However, in both *AIG* and *Sovereign Bancorp*, the taxpayers chose to litigate their

disputes in federal district court but, as is the norm, did not demand jury trials. In the case of FTC-generator transactions, the IRS has sought to challenge the transactions using (1) the substance over form doctrine; (2) the economic substance or sham transaction doctrine; (3) the step transaction doctrine; (4) debt versus equity principles; (5) section 269;⁵ (6) Treasury Regulation section 1.701-2, partnership anti-abuse rules; and (7) Treasury Regulation section 1.704-1, partnership substantial economic effect rules. These are difficult concepts to explain to a jury. The argument that a jury is incapable, inefficient, or error-prone often has been raised when the matter involves such complex transactions, and federal judges have denied jury trials in cases that were too complicated for a jury to decide.⁶

While many corporate taxpayers have often sought to litigate their tax claims in federal district court, satisfied with the opportunity to have the case decided by a federal judge, the government is complicating that choice by demanding jury trials. No doubt this is a tactic to steer taxpayers to the Tax Court and Court of Federal Claims — both courts of national jurisdiction. Decisions in those courts have far more precedential value than a decision in a federal district court, which is not even binding on another judge in the same federal district. The government views the judges in the Tax Court and Court of Federal Claims as more predictable and government friendly than judges in the federal district courts and is attempting to utilize the current economic crisis to its tactical advantage. Consequently, forum selection in tax cases has become more complicated and challenging than ever.

— L. Hill, R. Nessler

4. For more information, see "FTC Cases Currently being Litigated," *Focus on Tax Controversy and Litigation*, Dec. 19, 2008, at 14-15.

5. Unless otherwise indicated, section references are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), and references to the regulations are to the regulations promulgated thereunder.

6. See, e.g., *Bernstein v. Universal Pictures, Inc.*, 79 F.R.D. 59 (S.D.N.Y. 1978).

DOJ Seeking Identities of Stanford Group's US Investors

On December 2, 2009, the Department of Justice (the "DOJ") filed an ex parte petition with the District Court for the Northern District of Texas for leave to file a "John Doe" summons in connection with the government's proceedings against the Stanford Group Co. and related entities (the "Stanford Group").⁷ The DOJ is seeking to file the John Doe summons on the Stanford Group's court-appointed receiver to obtain the identities of US persons that directly or indirectly had an interest in, or signatory or other authority over, any foreign accounts at or through Stanford International Bank, Ltd., an affiliated offshore bank of the Stanford Group, from December 31, 2002 through December 31, 2008 (the "US investors"). In February, the Securities and Exchange Commission charged R. Allen Stanford, other Stanford Group executives, and three Stanford Group entities with orchestrating a multi-billion dollar investment fraud scheme centered on certificates of deposit.

In the ex parte petition, the DOJ stated that as part of its Offshore Compliance Initiative the Internal

Revenue Service ("IRS") is investigating the Stanford Group's US investors. The DOJ argued that there is reasonable basis to believe that there has been significant noncompliance with the US internal revenue laws requiring the reporting of income earned in foreign financial accounts and the disclosure of interests in foreign accounts by the US investors. As part of the DOJ's filing, the IRS attested that approximately 15,000 to 17,000 Report of Foreign Bank and Financial Accounts ("FBAR") disclosures should have been filed annually by the US investors but that only 1,000 to 2,000 FBARs have been filed annually. According to the IRS and DOJ, these figures suggest significant noncompliance among the Stanford Group's US investors. Further, the DOJ argued that there was a reasonable basis for believing that in the vast majority of cases, interest income earned by the US investors on their foreign financial accounts was not reported to the IRS. In the petition, the DOJ argued that the John Doe summons is necessary because the information that the DOJ seeks to obtain is not readily available from other sources, but is available from the Stanford Group's court-appointed receiver.

The DOJ's attempt to obtain a John Doe summons with respect to the Stanford Group's US investors mirrors the use of similar petitions in other DOJ and IRS cases involving offshore accounts held by US persons, including the government's ongoing investigation of potential tax evasion by US accountholders of UBS.

– G. Green

7. *Sec. and Exch. Comm'n v. Stanford Int'l Bank Ltd. (In re Tax Liabilities of John Does)*, No. 3-09-CV-0298-N, (N.D. Texas filed Dec. 2, 2009).



Global Crackdown on Tax Evasion

Spurred by a call for action and the threat of sanctions from the Group of Twenty (“G-20”) and the Organisation for Economic Development and Cooperation (“OECD”),⁸ a global crackdown on offshore tax evasion has gained force in recent months, with a number of countries taking steps to increase transparency in bank records, track down taxpayers who are hiding money offshore, and penalize tax evaders.

The OECD and the G-20 have put significant pressure on countries to endorse and implement principles of transparency and exchange of information developed by the OECD’s Global Forum on Transparency and Exchange of Information (“Global Forum”). The principles generally provide for full exchange of information on request in all tax matters (the “OECD Standard”). As a result, a number of jurisdictions that had been unwilling to endorse the OECD Standard in the past, including several countries previously identified as uncooperative tax havens, have recently endorsed, and taken steps to implement, the OECD Standard. The OECD reports that the OECD

Standard is now endorsed by all countries surveyed by the Global Forum.⁹ Furthermore, between its September and December progress reports, the OECD identified 12 new jurisdictions — Aruba, Austria, Belgium, Bermuda, the British Virgin Islands, Bahrain, the Cayman Islands, Luxemburg, Monaco, Netherlands Antilles, San Marino, and Switzerland — as having made substantial progress on implementing the OECD Standard.¹⁰ More than 120 tax information exchange agreements have been announced or signed since last November, and more than 60 tax treaties have been negotiated or renegotiated since April, to incorporate principles of the OECD Standard.¹¹

In addition, individual countries have begun to implement various approaches to intensify the hunt for tax evaders. The United States recently launched its Global High Wealth Industry Group, a special task force that will target wealthy taxpayers in an attempt to shed light on the various techniques used to

hide income.¹² In November, South Korea launched a similar task force, the Offshore Compliance Enforcement Center (“OCEC”), which is charged with tracking down hidden assets abroad.¹³ The OCEC already has had some success: South Korea’s National Tax Service recently announced that it has identified 39 offshore tax evasion cases and imposed a total of 153.4 billion won (\$132 million) in back taxes on 313.4 billion won (\$269 million) of undeclared income.¹⁴ Another such task force, New Zealand’s High Wealth Individual unit (“HWIU”), collected NZ\$81 million (approximately \$59 million) this year, bringing its total amount collected since it was established in 2003 to NZ\$300 million (approximately \$218 million).¹⁵ The recent increase in collections by New Zealand’s HWIU may be linked

8. See “G-20 Continues Crackdown on Tax Havens as OECD Continues to Promote Tax Transparency,” *Focus on Tax Controversy and Litigation*, Sept. 2009, at 3-4.

9. Information Brief, Overview of the OECD’s Work on Countering International Tax Evasion 3 (Dec. 8, 2009), available at <http://www.oecd.org/dataoecd/32/45/43757434.pdf>.

10. *Id.*

11. *Id.* at 2.

12. See “IRS and Treasury Officials Discuss Intent to Focus on International Issues,” *Focus on Tax Controversy and Litigation*, Nov. 2009, at 17.

13. James Lin, “South Korea Launches Task Force to Crack Down on Offshore Cheats,” *BNA Daily Tax Report*, Nov. 19, 2009.

14. “South Korea Makes Headway in Crackdown on Tax Evasion, Seeks Millions in Back Taxes,” *BNA Daily Tax Report*, Dec. 11, 2009.

15. Inland Revenue Media Release, High Wealth Individuals Pay an Extra \$81 Million (Nov. 23, 2009), available at <http://www.ird.govt.nz/aboutir/media-centre/media-releases/2009/media-release-2009-11-23.html>.

Global Crackdown on Tax Evasion (cont'd)

to another method of combating tax evasion employed by France and Germany — securing names and account numbers from “rogue employees” in Swiss and Liechtenstein banks.¹⁶ Apparently a number of wealthy New Zealand citizens were named in banking information sold to German tax authorities.¹⁷ Meanwhile, Italy has employed yet another tactic — a series of raids on branches of Swiss banks in Italy.¹⁸

An additional approach taken by several countries, including the United States, Australia, the United Kingdom, and France, is the imposition of temporary tax amnesties to bring forward taxpayers who are hiding income offshore, generally in anticipation of increased penalties or enforcement going forward. The United States offered a voluntary disclosure program earlier this year that allowed taxpayers to come

forward and pay tax plus interest and penalties, which was considered a mitigating factor in the decision of whether or not to recommend criminal prosecution.¹⁹ Australia's program similarly allows taxpayers with undeclared income held in tax havens to approach the Australian Taxation Office anonymously for an indication of whether they would face criminal charges prior to what Tax Commissioner Michael D'Ascenzo has described as what will be an “all bets are off” crackdown after June 10, 2010.²⁰ The United Kingdom's program, referred to as the New Disclosure Opportunity, allows taxpayers to come forward and pay tax plus interest and limited penalties on money hidden in bank accounts abroad.²¹ The program runs until next March, after which penalties of up to 200 percent of the unpaid tax will be levied on taxpayers who fail to declare their offshore accounts.²² In France, the budget

minister warned that he has a list of 3,000 French citizens with money hidden in Switzerland and threatened prosecution for taxpayers who fail to come forward under their amnesty program, which is due to expire at the end of this month.²³

This recent upsurge of international laws on offshore tax evasion amounts, in the words of OECD Secretary-General Angel Gurría, to “a quiet revolution ... in international governance.”²⁴

— A. Anderson

16. Paul Betts, “The French Stocking Filler that Sheds Light on Tax Havens,” *Financial Times*, Dec. 10, 2009, available at <http://www.ft.com>; see also “Bank Confirms Employee Theft of Data from Switzerland Branch,” *BNA Daily Tax Report*, Dec. 9, 2009.

17. Rob Stock, “Rich Pickings for Taxman as Rich Pay Up,” *Sunday Star Times*, Nov. 22, 2009, available at <http://www.stuff.co.nz>.

18. Paul Betts, “The French Stocking Filler that Sheds Light on Tax Havens,” *Financial Times*, Dec. 10, 2009, available at <http://www.ft.com>.

19. See “Voluntary Disclosure Program Applicable to Offshore Accounts,” *Focus on Tax Controversy and Litigation*, Mar. 2009, at 6-9.

20. Ruth Williams, “Amnesty for Undeclared Offshore Income,” *Sydney Morning Herald*, Dec. 1, 2009, available at <http://www.smh.com.au>.

21. Ian Pollack, “Tax Dodgers Told ‘The Game is Up’,” *BBC News*, Sept. 21, 2009, available at <http://news.bbc.co.uk>.

22. “Offshore Tax Dodgers Face 200% Rise in Fines,” *BBC News*, Dec. 9, 2009, available at

<http://news.bbc.co.uk>.

23. Paul Betts, “The French Stocking Filler that Sheds Light on Tax Havens,” *Financial Times*, Dec. 10, 2009, available at <http://www.ft.com>.

24. Angel Gurría, “The End of the Tax-Haven Era,” *The Guardian*, Aug. 31, 2009, available at <http://www.guardian.co.uk>.

Details of Criteria Used to Identify Individuals to Be Turned Over to the US Government in UBS Litigation; United States Looking to Conduct Joint Audits with Treaty Partners

On November 17, 2009, the IRS released the previously unpublished annex to the US-Swiss agreement (“Annex”) that contains the criteria used to identify approximately 4,500 US taxpayers with accounts at UBS whose names will be turned over to the IRS.²⁵

According to the criteria set out in the Annex, the United States was required to send a request for exchange of information pursuant to the US-Swiss treaty, but was allowed to do so without the use of specific names or other clear identification ordinarily required when making such treaty requests. Instead, the following information was determined to be sufficient to satisfy the identification requirement: (1) any UBS client that is a US domiciliary and who directly held and beneficially owned “undisclosed (non-W-9) custody accounts” and “banking deposit accounts” with UBS during any part of 2001 through 2008 in excess of CHF 1 million (approximately \$960,000) and for which a reasonable suspicion of “tax fraud or the like” can be demonstrated; or (2) any US person (regardless of domicile) who established or maintained during

the period of 2001 through 2008 “offshore company accounts” at UBS that such person beneficially owned and for which a reasonable suspicion of “tax fraud or the like” can be demonstrated.²⁶

For purposes of the Annex, “tax fraud or the like” means (a) for purposes of those UBS clients described in (1), above, there is a reasonable suspicion that such taxpayers engaged in activities described in paragraph 10 of the US-Swiss protocol as presumptively fraudulent, including concealing assets and underreporting income through false documents or through a “scheme of lies” (in such cases, those persons with accounts in excess of CHF 250,000 (approximately \$240,000) would also be subject to the request); and (b) instances in which acts of continued and serious tax offense have been committed and for which the Swiss Confederation may obtain information under its laws and practices (as described in paragraph 10 of the US-Swiss protocol), including: (i) cases in which, for a period of at least three years (including at least

one year covered by the request), the US-domiciled taxpayer has failed to provide a Form W-9, and (ii) the UBS account generated an average annual revenue of at least CHF 100,000 (approximately \$96,000) for any three-year period that includes at least one year covered by the request.²⁷

In the case of “offshore company accounts” (described in (2), above), “tax fraud and the like” means (a) presumptively fraudulent conduct (as described in paragraph 10 of the US-Swiss protocol), including those activities that led to an underreporting of income and the concealment of assets based on a “scheme of lies” or the submission of incorrect or false documents (except those offshore company accounts holding assets less than CHF 250,000 during the relevant period); or (b) acts of continued and serious tax offense for which the Swiss Confederation may obtain information under its laws and practices (as described in paragraph 10 of the US-Swiss protocol), including cases where the US person failed to prove that such person has

25. For previous coverage of the US-Swiss agreement, see “Details of the UBS-IRS Settlement Released,” *Focus on Tax Controversy and Litigation*, Sept. 2009, at 2.

26. The complete text of the Annex can be found at “Annex to U.S.-Swiss Tax Information Exchange Agreement Providing Criteria for Granting Assistance Pursuant to Treaty Request,” *BNATaxCore-International Documents*, Nov. 18, 2009, available at <http://taxandaccounting.bna.com>.

27. The Annex defines revenues as gross income (interest and dividends) and capital gains (which, for purposes of assessing the merits of this administrative information request, are calculated as 50 percent of the gross sales proceeds generated by the accounts during the relevant period).

Details of Criteria Used to Identify Individuals to Be Turned Over to the US Government in UBS Litigation; United States Looking to Conduct Joint Audits with Treaty Partners (cont'd)

met his or her statutory tax reporting requirements in respect of the person's interests in such offshore company accounts upon notification by the Swiss Federal Tax Administration ("SFTA") (i.e., by providing consent to the SFTA to request copies of the taxpayer's FBARs from the IRS for the relevant years). Absent such confirmation, the SFTA would grant information exchange where (i) the offshore company account has been in existence for at least three years, including one year covered by the request, and (ii) generated on average annual revenues of at least CHF 100,000 for any three-year period that includes at least one year covered by the request.²⁸

Within a week of releasing the criteria set out in the Annex, the Swiss tax authorities announced that decisions had been made on the first 500 UBS accounts targeted under the US-Swiss agreement.²⁹ No details were given with respect to how many of those accounts would be subject

to the information exchange with the United States or the content of the decisions. Each account holder has 30 days in which to file an appeal with the Swiss Federal Administrative Court ("SFAC") following receipt of the SFTA's decision. If no appeal is filed, or if the appeal is filed but rejected, the SFTA will then turn the account holder's name and account information over to the IRS. So far, the SFAC has received two appeals.³⁰ To date, no account holder names or information have been turned over to the IRS.

During a teleconference in which the details of the Annex were released, IRS Commissioner Douglas Shulman also announced that, likely in response to the UBS litigation, approximately 14,700 taxpayers had participated in the IRS's voluntary disclosure program (as opposed to the 7,500 participant estimate announced in October).³¹ Shulman

noted that taxpayers from every continent except Antarctica participated and that the IRS was "flooded with people coming in during the final days of the program."

More recently, Shulman announced that the IRS is working with tax authorities in treaty partner countries to establish a method for conducting joint audits.³² Currently, the IRS is in the early stages of looking at protocols to facilitate the joint auditing process. Deputy IRS Commissioner Barry Shott said that he believes the Joint International Tax Shelter Information Center, a special agency created by the United States, Canada, Australia, Japan, and the United Kingdom to share information about tax shelters, will probably conduct the joint audits.

— E. Howard-Potter

28. Revenues are defined as described in the previous footnote.

29. Daniel Pruzin, "Swiss Authorities Say First 500 Decisions Made on Information Exchange in UBS Affair," *BNA Daily Tax Report* (Nov. 25, 2009). Pursuant to the terms of the US-Swiss agreement, the SFTA was required to issue decisions on the first 500 accounts by the end of November 2009.

30. David Jolly, "Swiss Report First Appeals Filed in UBS Tax Case," *N.Y. Times*, Dec. 16, 2008, available at <http://www.nytimes.com/2009/12/17/business/global/17ubs.html?emc=etal>.

31. Alison Bennett, "Shulman Says About 14,700 Taxpayers Voluntarily Disclosed Offshore Assets," *BNA Daily Tax Report* (Nov. 18, 2009). For previous coverage of the number of participants in the voluntary disclosure program, see "UBS Updates, US Government's Focus on Offshore Tax Evasion,

and Related Developments," *Focus on Tax Controversy and Litigation*, Nov. 2009, at 14; "Recent Developments Related to the UBS Litigation and Voluntary Disclosure," *Focus on Tax Controversy and Litigation*, Oct. 2009, at 5.

32. Ryan J. Donmoyer, "IRS Studying 'Protocols' for Joint Audits With Other Countries," *Bloomberg.com*, Dec. 10, 2009, at http://www.bloomberg.com/apps/news?pid=email_en&sid=afm_d0Ar1564.



IRS Commissioner Shulman Speaks on the Role of Corporate Boards of Directors with Respect to Overseeing Tax Risk

In recent remarks before both the 22nd Annual George Washington University International Tax Conference on December 10 and the 2009 National Association of Corporate Directors Corporate Governance Conference on October 19, Commissioner Shulman addressed issues pertaining to corporate governance and the roles of boards of directors with respect to the oversight and management of tax risk.³³ Noting that the IRS Commissioner customarily has not addressed the NACD's corporate governance conference, Shulman discussed the "important role that boards of directors can play in overseeing tax risk and the tax strategies of corporations" and stated his intent to engage corporate leaders about their roles and respon-

sibilities with respect to conducting appropriate assessment and oversight of tax risk. Shulman stated his proposition as follows:

"Tax expenses are like other major expenses. Manage them too loosely and you give up profit. Manage them too aggressively and there are bad consequences. The board must oversee how management manages them. That means some level of understanding, a set of policy principles and then a control system of reporting that assures the board that their policy is being carried out. Many corporate boards do have a regular dialogue regarding tax risk with their CFOs, tax directors and external tax advisors. My goal is to promote good corporate governance on tax issues and engage the corporate community in a dialogue about the appropriate role of the board of directors in tax risk oversight."

Noting that taxes are one of the biggest expenses of a corporation and the importance in how they are managed, Shulman highlighted the fact that boards are a source of governance and oversight and hold management accountable. In that role, understanding the risk posture

of the company is critically important. Noting that many or most of his audience members are not tax experts and were not installed on boards of directors due to their tax expertise as well as the difficulty in understanding the tax consequences of complex transactions, Shulman expressed his view that board members are critically important in ensuring that the tax system "works well and is worthy of the confidence of the American people."

Shulman stated that in order to increase board oversight of tax compliance in the face of limited time and competing business issues, boards can assess their corporations' tax risk profiles, internal controls, and relationships with their tax departments to help determine the tax matters of which they should be aware. Noting that FIN 48 is a "significant window" into a company's tax risk, liability, and management, Shulman said that the reserve numbers reflect information that the audit committee needs to know and influence the tax posture taken by tax planners.

Shulman suggested that corporate leaders should have a mechanism to oversee tax risk as part of the governance process. Making clear that

33. Commissioner Shulman's prepared remarks are available on the IRS Web site. See "Prepared Remarks of Commissioner of Internal Revenue Douglas H. Shulman Before the 2009 National Association of Corporate Directors Corporate Governance Conference, Washington, DC, October 19, 2009," IR-2009-05, available at <http://www.irs.gov/newsroom/article/0,,id=214451,00.html>. Shulman spoke on the issue again on December 10, 2009 in his remarks before the George Washington University International Tax Conference. See "Prepared Remarks of Commissioner Douglas Shulman Before the 22nd Annual George Washington University International Tax Conference," IR-2009-116, available at <http://www.irs.gov/newsroom/article/0,,id=216981,00.html>.

IRS Commissioner Shulman Speaks on the Role of Corporate Boards of Directors with Respect to Overseeing Tax Risk (cont'd)

the IRS does not “intend to second-guess legitimate and thoughtful business decision-making by corporate leaders,” he provided the following examples of actions corporate directors may choose to take in order to better oversee tax risk as part of the governance process:

- Set a threshold confidence level for taking a tax position;
- Discourage or eliminate opinion shopping by tax departments by having an independent tax firm, which has some direct dialogue with the board of directors, review major tax positions; and
- Specifically address transfer pricing and the relative profit allocated to low-tax jurisdictions, and make sure they reflect real economic contributions made in those jurisdictions.

Shulman further provided the following examples of questions that corporate directors may ask their tax directors and external auditors relating to FIN 48:

- What was the process for identifying uncertain tax positions and how do you know all material issues have been identified?

- How did you go about determining the maximum tax exposure relating to each uncertain tax position? What makes you comfortable that it accurately reflects your maximum exposure?
- How did you go about quantifying the likelihood of winning or losing uncertain tax positions? Do you plan to litigate the issue if the IRS challenges the position? Does the external auditor or tax advisor agree with the tax director’s assessment?
- Could the company be subject to potential penalties, such as for underpayment of tax, negligence, or worse? If so, are they appropriately recorded, and perhaps more important, what does this say about how aggressive the company’s position is regarding those issues?

Shulman noted that there exist IRS programs currently in place that can provide boards with greater comfort that there will be no second-guessing in the future, including the compliance assurance program and the advance pricing agreement program.

He also explained that other governments, including that of Australia,

have taken action to help corporate taxpayers employ sound management and governance practices on tax matters. The Australian Tax Office publishes a guide entitled “Governance Guide for Board Members and Directors” that suggests questions which corporate directors can ask of management, such as the following: Is there a material difference between the losses reported for accounting purposes and the losses claimed for tax purposes? If so, can the difference be satisfactorily explained? Is the structure and financing for your business or a major transaction complicated, perhaps more complex than necessary to achieve the commercial objectives? In addition, the OECD recently released a guidance document outlining good corporate governance principles in relation to tax that is based on advice from governments worldwide.

– B. Harrison

IRS Explains Strategy to Improve Withholding Tax Compliance

The IRS has implemented a four-phase strategy to address foreign withholding, which was identified as a Tier I issue by the IRS Large and Midsize Business Division (“LMSB”) in December 2008.³⁴ Under current US law, all US persons (individuals, corporations, partnerships, etc.) making payments of certain types of US source income to foreign persons generally are required to report the payments to the IRS on a Form 1042, “Annual Withholding Tax Return for U.S. Source Income of Foreign Persons,” and to withhold tax on the payments at a rate of 30 percent. The US payer is often referred to as a US withholding agent.

The first phase of the IRS strategy is aimed at detecting US withholding agents who have not reported certain US source payments to foreign persons despite being required to do so. Nichols stated that a preliminary pilot program identified a “very, very large percentage of entities” that fell within this category. The IRS currently is refining that program to identify an even greater number of such entities.

amend or fail to timely file a Form 1042 will be required to append to their filing a statement made under penalty of perjury explaining reasonable cause for the change or delay. Nichols indicated that the IRS may also request a statement detailing how the entities will ensure future compliance.

– W. Kellogg

The second phase looks to whether those entities that have filed Forms 1042 did so correctly. Nichols indicated that this has generally been the case, but that some employers have been treating employees as independent contractors.

The third phase involves an IRS exploration of so-called “foreign withholding avoidance” using total return swaps and notional principal contracts. Nichols indicated that the IRS is focused on the “substance” of these transactions and on the relationships of the parties to the contracts.

For the fourth phase, the IRS has implemented an educational effort to inform taxpayers of their filing and reporting responsibilities. Entities that

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On November 9, Lori Nichols, the LMSB Director (International Compliance, Strategy, and Policy), explained that the phases focus on (i) US withholding agents who do not file Forms 1042, (ii) US withholding agents who do file Forms 1042, (iii) transactions involving total return swaps and notional principal contracts, and (iv) educational efforts geared towards US withholding agents and taxpayers.³⁵

34. IRS News Release, IR-2008-137 (Dec. 8, 2008) (announcing that withholding tax is a Tier 1 issue).

35. Amy S. Elliot, “IRS Explains Strategy for Improving Foreign Withholding Compliance,”

Tax Notes Today, Nov. 12, 2009.

Lawmakers Seek to Modify Tax Shelter Penalties Created in 2004

On November 16, 2009, Senate Finance Committee Chairman Max Baucus (D-MT), Ranking Member Chuck Grassley (R-IA), and Senator Mike Crapo (R-ID), along with House Ways and Means Oversight Subcommittee Chairman John Lewis (D-GA) and Ranking Member Charles Boustany (R-LA), introduced the “Small Business Penalty Relief Act of 2009” (“the Penalty Relief Act”) to limit the penalty for failure to disclose reportable transactions under section 6707A.³⁶ Under the Penalty Relief Act, the 6707A penalty would be commensurate with the tax benefit received by the taxpayer from the reportable transaction. Specifically, the Penalty Relief Act would do the following:

- Limit the 6707A penalty for failure to disclose any reportable transaction to 75 percent of the tax benefit received, with a minimum penalty in the case of failure to disclose a listed transaction of \$5,000 per transaction for individuals and \$10,000 per transaction for businesses;
- Cap the penalty for failure to disclose a listed transaction at \$100,000 per transaction for individuals and \$200,000 per transaction for businesses;

- Cap the penalty for all other reportable transactions at \$10,000 for individuals and \$50,000 for businesses; and
- Be effective for penalties assessed after December 31, 2006.

The Penalty Relief Act also would require the IRS, in consultation with the Treasury Department, to submit a report annually to the House Ways and Means Committee and the Senate Finance Committee on the penalties the IRS assessed during the preceding year under sections 6662A, 6700(a), 6707, 6707A, and 6708. The IRS would be required to submit the first report no later than June 1, 2010.

With the passage of the American Jobs Creation Act of 2004, Congress added section 6707A to the Code, which created a penalty for failure to disclose any reportable transaction. In the case of failing to disclose a listed transaction, the penalty is one of strict liability because the law imposes a fixed penalty of \$100,000 for individuals for each failure to report and \$200,000 for all other taxpayers, regardless of intent or culpability. Additionally, with respect to any listed transaction, the IRS has no authority to rescind the penalty.

Since any transaction must be reported at both the entity and individual level, the penalty has hit S corporation and partnership taxpayers hard. In particular, it has been widely reported that section

6707A, as it stands, has had an onerous effect on small businesses that unknowingly invested in listed tax shelter transactions. After hearing stories of small businesses being assessed 6707A penalties as high as \$300,000 per year where the tax benefit received from the transaction was as little as \$15,000, Congress in July 2009 sent a letter to IRS Commissioner Douglas Shulman requesting that the IRS exercise its administrative authority and suspend collection efforts of the penalty imposed on small businesses while Congress worked on a legislative solution. In July, Shulman announced that the IRS would suspend collection efforts until September 30, 2009, for cases where the tax benefits resulting from any listed transactions are less than \$100,000 for individuals and \$200,000 for all others. In September, he announced that the moratorium had been extended through December 31, 2009. The IRS has not given any indication that a further extension will be announced.

Additionally, notably not contained in the Penalty Relief Act is a provision giving the IRS the authority to rescind or modify penalties for failure to disclose a listed transaction in certain cases. Nevertheless, according to Senator Baucus, the proposed 6707A legislation is about “tax fairness” and must move forward as quickly as possible.

—T. Ashford

36. The text of the Penalty Relief Act is available at http://waysandmeans.house.gov/media/pdf/111/LEWIGA_044_xml_6707A.pdf or at <http://finance.senate.gov/sitepages/leg/111609%20leg%20S.%202771.pdf>.

District Court Finds Partnership Contribution Constituted a Disguised Sale but Statute of Limitations Barred Assessment

On December 14, 2009, the US District Court for the District of New Jersey ruled in favor of the debtors in a bankruptcy tax case, *In re G-I Holdings, Inc.*,³⁷ holding that the statute of limitations barred the government from assessing tax even as the court agreed with the government that the 1990 transaction constituted a disguised sale rather than a valid partnership transaction.

The transaction involved the contribution of \$480 million in assets of a chemicals business by two subsidiaries of the GAF Corporation (collectively, "GAF") into a partnership ("RPSSLP") with affiliates of Rhone-Poulenc, S.A., a French corporation. GAF subsequently assigned its 49 percent partnership interest to a trust that pledged the interests as collateral for a nonrecourse \$450 million loan from an unrelated Swiss bank. Under the RPSSLP partnership agreement, the GAF trust was entitled to a priority return from RPSSLP sufficient to pay the interest due on the loan and the French general partner guaranteed the priority return. GAF subsequently declared bankruptcy and G-I Holdings, Inc. and other successors in interest (the "Debtors") assumed GAF's position in its dispute with the IRS over this and other transactions.³⁸

The debtors asserted that the transaction constituted a nontaxable contribution to a partnership under section 721(a) and that neither the contribution nor the receipt of the loan proceeds constituted taxable income. The government countered that the transaction was a disguised sale under section 707(a)(2)(B) when the contribution and the loan proceeds are analyzed together.

The court agreed with the government's characterization, finding that GAF's "true intent was to disguise an asset sale as to minimize taxation." In reaching its conclusion, the court examined the following factors: (i) GAF's risk of loss on the transaction was capped at \$26.3 million; (ii) restructuring the asset sale as a partnership transaction resulted in GAF receiving less money and incurring increased transaction costs, which would not make sense unless GAF could receive tax benefits from the structure; (iii) Rhone-Poulenc initially offered an asset purchase and the parties spent time negotiating such an agreement before switching to the partnership transaction; and (iv) all the elements of section 707(a)(2)(B) were present to create a disguised sale. While the court ultimately conceded that the partnership contribution, viewed in isolation, represented a valid equity contribution to a partnership, in the context of

the nonrecourse loan the provisions of section 707(a)(2)(B) compelled disguised sale treatment ("while the transactions were carefully structured to create the appearance that [the GAF trust] repaid the loan, all repayment came from the partnership or the other partners").

While prevailing on the economic substance issue, the government ultimately lost due to the expiration of the statute of limitations. The government's case rested on a finding that a six-year limitations period existed based on a greater than 25 percent omission of items of gross income under section 6501(e)(1). The dispute centered on the amount of "gross income" originally reported by the partnership, with the government arguing that the economic substance of the partnership essentially reduced the gross income of the partnership on GAF's tax return to the amount received by GAF. The court disagreed and stated that section 6501(e)(1) required the mechanical application of a rule and allotted portions of RPSSLP's gross income to GAF thereby reducing the understatement to less than the 25 percent required for an extension of the statute of limitations.

—E. Miller

37. No. 02-3082 (D.N.J. Dec. 14, 2009).

38. There is an outstanding dispute regarding certain 1999 repo and swap transactions also related to the RPSSLP partnership, but the

court bifurcated the 1990 and 1999 disputes and has yet to rule on the 1999 issues.

Current Status of Docketed Foreign Tax Credit Cases

Currently, there are half a dozen FTC cases docketed in the Tax Court and various district courts. No cases currently are docketed in the Court of Federal Claims but, after the recent taxpayer-favorable decision in *Consolidated Edison*, taxpayers may consider the Court of Federal Claims a potential option.³⁹

As discussed by members of the Tax Controversy and Litigation panel at Dewey & LeBoeuf's Fifth Annual Year-End Tax Conference and Celebration on December 3, 2009, an advantage to litigating in the Court of Federal Claims includes the fact that the court will conduct an analysis of the whole transaction when evaluating whether a transaction has economic substance. In contrast, the Tax Court is bound by the standard imposed by the court of appeals to which a particular case is appealable and, depending on the circuit, that standard may not be taxpayer-favorable.

Below is a list of currently-docketed FTC cases:

- *Sovereign Bancorp, Inc. v. United States*, No. 09-cv-11043: Docketed in the District of

Massachusetts, appealable to the First Circuit⁴⁰

- *Wells Fargo & Co. v. United States*, No. 09-cv-02764: Docketed in the District of Minnesota, appealable to the Eighth Circuit
- *Bank of New York Mellon Corp. v. Commissioner*, No. 26683-09: Docketed in the Tax Court, appealable to the Second Circuit
- *Hewlett-Packard Co. v. Commissioner*, No. 21976-07: Docketed in the Tax Court, appealable to the Fifth Circuit
- *American International Group, Inc. v. United States*, No. 09 Civ. 1871: Docketed in the Southern District of New York, appealable to the Second Circuit
- *Pritired 1 LLC v. United States*, Civ. No. 4:08-cv-00082: Docketed in the Southern District of Iowa, appealable to the Eighth Circuit.

Thus far, most of the cases are in the discovery stage and trials have been scheduled only in *Hewlett-Packard* (September 13, 2010) and *Pritired* (December 6, 2010). The government has requested a jury trial in both *Sovereign* and *AIG*.⁴¹ Another commonality shared by both *Sovereign* and *AIG* is that the IRS has

asserted accuracy-related penalties under section 6662 against these taxpayers.

A common feature across several of the cases is that, in addition to disallowing the FTCs claimed by the taxpayers on economic substance grounds and other judicial doctrines, the IRS has also disallowed interest expense and transaction cost deductions related to the transactions.

Although there are similarities shared by some of the cases—Wells Fargo and Bank of New York Mellon, for example, both entered into a financing transaction known as the “STARS Transaction” in which a third party acted as the counterparty—the differences among the cases suggest that the government may have difficulty crafting a coherent settlement policy for other taxpayers based on the outcome of these FTC cases. This may be due, in part, to the fact that the government did not designate all of the currently-docketed cases for litigation. The government previously had announced its intent to follow a “three and out” litigation strategy whereby it would identify what it believed to be the three most favorable FTC cases from the government’s perspective, litigate those cases, and establish a settlement policy for all other FTC transactions based on its expected victories in

39. *Consolidated Edison Co. of New York Inc. v. United States*, No. 06-305T (Fed. Cl. Oct. 21, 2009). For previous coverage of this case, see “Taxpayer Wins LILO Case in the Court of Federal Claims,” *Focus on Tax Controversy and Litigation*, Oct. 2009, at 15.

40. For previous coverage of this case, see “*Sovereign Bancorp v. United States*: Bank Seeks Refund Following IRS Denial of Foreign Tax Credits,” *Focus on Tax Controversy and Litigation*, July 2009, at 19.

41. For a discussion of the government’s practice of requesting jury trials, see the article within this issue entitled “New Trend: Government Requesting Jury Trials in Tax Cases.”

General Electric Capital Canada, Inc. v. The Queen

those cases.⁴² The current roster of docketed FTC cases demonstrates that not all FTC transactions are the same. Nevertheless, these cases will doubtless be watched closely by other taxpayers with FTC transactions currently under audit.

– A. Minkovich

On December 4, 2009, in *General Electric Capital Canada, Inc. v. The Queen*,⁴³ a case of first impression,⁴⁴ the Tax Court of Canada ruled on the appropriate transfer pricing methodology to apply to a fee paid for a credit guarantee. Beginning in 1995, General Electric Capital Canada, Inc., a Canadian corporation (“GECC”), paid its indirect parent General Electric Capital Corporation, a United States corporation (“GECUS”), a 100 basis point fee in exchange for the guarantee by GECUS of GECC’s unsecured debentures and commercial paper. The amount of this fee was calculated on a quarterly basis and paid annually in the year following accrual. For the five tax years under consideration, the fee totaled approximately 136.4 million Canadian dollars.

GECC deducted the guarantee fees it paid each year in computing its Canadian taxable income and withheld tax at the rate of 10 percent from the guarantee fees paid to GECUS pursuant to the Canadian Income Tax Act (the “Act”) and Article XI of the income tax treaty between Canada and the United States. The Minister of National Revenue

disallowed the deductions for the guarantee fees in full and assessed additional withholding tax under Part III of the Act, based on the position that GECC received no economic benefit from the guarantee and the arm’s length price for the guarantee was consequently zero.

The parties and their experts presented several possible transfer pricing methodologies that a court might apply in determining a proper arm’s length price for a credit rating guarantee. The court ruled that determining an arm’s length price was a question of fact and “of identifying the economically relevant characteristics of the transaction that may influence the arm’s length parties in their negotiations.”⁴⁵ The court applied the “yield curve” approach presented by the Crown, which compares the rate at which the borrower could issue debt without a guarantee against the rate at which the borrower could issue debt with the guarantee.⁴⁶ The difference between these rates would represent an appropriate guarantee fee. In creating a hypothetical transaction between “arm’s-length parties” against which to judge the appropriateness of the fee charged in

42. See “IRS Plans to Apply ‘Three and Out’ Litigation Strategy to FTC-Generator Cases,” *Focus on Tax Controversy and Litigation*, Nov. 17, 2008, at 3.

43. [2009], 2009 TCC 563.

44. *Id.* at [284].

45. *Id.* at [198].

46. *Id.* at [14].

District Court Grants Government's Motion to Dismiss in Refund Case

the transaction under consideration, the court ruled that it first needed to determine what GECC's credit rating would have been with and without the guarantee, because the price of an arm's-length guarantee would vary depending on the creditworthiness of the party seeking the guarantee.⁴⁷

The court determined that GECC's credit rating without the guarantee would have been approximately BBB-/BBB+, whereas it was AAA with the guarantee.⁴⁸ The difference between the rates payable by debtors with those credit ratings was approximately 183 basis points. Therefore, the court determined that 100 basis points was "equal to or below an arm's length price in the circumstances, as [GECC] received a significant net economic benefit from the transaction."⁴⁹ Consequently, the court ordered that the assessments against GECC be vacated.

– K. Lucas⁵⁰

On September 14, 2009, the US District Court for the Central District of California granted the United States's motion to dismiss in a refund suit, holding the suit time-barred under 28 U.S.C. section 2401(a) which provides a general six-year limitations period for suits against the United States.⁵¹ The court rejected the taxpayer's argument, supported by a 1955 Court of Claims decision, that section 6532(a)(1) is the appropriate authority for the limitations period in a tax refund suit and, because it provides no time limit for a case in which the IRS never issues a notice of disallowance, the refund suit should be allowed.⁵²

The facts of the case are simple. Sometime in the 1980s, the IRS determined that taxpayer David J. Wagenet owed unpaid taxes, and in 1987 the IRS levied his bank account to satisfy the outstanding amount. In March 1988, however, the IRS determined that Wagenet was entitled to an abatement of taxes. Shortly thereafter, Wagenet filed a refund claim. The IRS never acted on Wagenet's

claim, however, and in 2008 he sued for a refund.

In granting the United States's motion to dismiss, the court first analyzed the interplay between 28 U.S.C. § 2401(a) and section 6532(a)(1). 28 U.S.C. § 2401(a) provides that "every civil action commenced against the United States shall be barred unless the complaint is filed within six years after the right of action first accrues." Section 6532(a)(1) states that a taxpayer's action for a refund shall not begin

"before the expiration of 6 months from the date of filing [an administrative claim for a refund] ... nor after the expiration of 2 years from the date of mailing ... by the [IRS] to the taxpayer of a notice of disallowance ..."

Putting the two statutes together, the court found that section 6532(a)(1) "establishes that an action for refund accrues 6 months from the date of filing the administrative claim" and, in cases in which a taxpayer has received a notice of disallowance, also provides a two-year limitations period. The court found that section 6532(a)(1)'s silence on the limitations period for a case in which no notice of disallowance is issued does

47. *Id.* at [247].

48. *Id.* at [305].

49. *Id.*

50. Kirstin Lucas is a tax associate in Dewey & LeBoeuf's New York office.

51. Order Granting Motion to Dismiss, *Wagenet v. United States*, No. 8:08 cv142 (C.D. Cal. 2009).

52. *Detroit Trust Co. v. United States*, 131 Ct. Cl. 223 (Ct. Cl. 1955).



District Court Grants Government's Motion to Dismiss in Refund Case (cont'd)

not give rise to an unlimited statute of limitations, however. Instead, the court found the “catchall statute of limitations period” in 28 U.S.C. § 2401(a) for “every civil case” would apply in such a situation.⁵³

The taxpayer cited *Detroit Trust Co.*, a case with similar facts that had been decided in favor of the taxpayer (and the only authority directly on point), for his position that section 6532(a)(1) provides the exclusive limitations period in refund suits. The court dealt with Wagenet's argument by briefly restating its analysis of the interplay between 28 U.S.C.

§ 2401(a) and section 6532(a)(1) and then stating that *Detroit Trust Co.* had been wrongly decided.

Although not raised by the taxpayer, the court discussed other tax cases that addressed 28 U.S.C. § 2401(a), which the court stated “contain language that seemingly supports a holding contrary to the Court's.” In those cases, courts held that 28 U.S.C. § 2401(a) “does not apply to actions for tax refunds.”⁵⁴ The court distinguished those cases on the ground that each involved taxpayers arguing that 28 U.S.C. § 2401(a) “allowed refund actions against the United States for six years after accrual despite the existence of other statutes with shorter limitations periods.” The court found that, in cases in which a shorter statute

of limitations applied, 28 U.S.C. § 2401(a) had no application. In this case, however, no such shorter limitations period could apply because of the absence of a notice of disallowance. Accordingly, the court held that the catchall six-year statute of limitations provided in 28 U.S.C. § 2401(a) governed the taxpayer's refund suit.

The taxpayer filed an appeal in the Ninth Circuit Court of Appeals on November 16, 2009.⁵⁵

– K. Parsons⁵⁶

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53. The court found that the words “every civil action” in 28 U.S.C. § 2401(a) “must be interpreted to mean what they say.” *Id.* (citing *Nesovic v. United States*, 71 F.3d 776, 778 (9th Cir. 1995)). The court also cited a 1941 Supreme Court opinion for the proposition that 28 U.S.C. § 2401(a) “places an outside limit on the period within which *all* suits might be initiated against the United States.” *Id.* (citing *United States v. A.S. Kreider Co.*, 313 U.S. 443, 448 (1941)).

54. *Bruno v. United States*, 547 F.2d 71, 74 (8th Cir. 1976); *Hampton v. United States*, 206 Ct. Cl. 422, 436 (Ct. Cl. 1975); *Phoenix State Bank & Trust Co. v. Bitgood*, 28 F. Supp. 899, 900 (D. Conn. 1939).

55. *Wagenet v. United States*, No. 09-56800 (9th Cir. 2009).

56. Kenneth Parsons is a tax associate in Dewey & LeBoeuf's Washington, DC office.

Fifth Circuit Affirms Decision Upholding the Disallowance of a “Midco” Tax Shelter Transaction

On November 10, 2009, the United States Court of Appeals for the Fifth Circuit affirmed the United States District Court for the Southern District of Texas’ summary judgment decision in *Enbridge Energy Co., Inc. v. United States*,⁵⁷ holding that the “Midco” tax shelter transaction of Enbridge Energy Company Inc. (formerly known as Midcoast Energy Resources, Inc. (Midcoast)) was a sham conduit transaction and that Midcoast was subject to the substantial understatement penalty under section 6662(d). The Fifth Circuit’s decision marks the first appellate court to disallow a Midco tax shelter transaction.

The transaction at issue was substantially similar to the transaction described in Notice 2001-16.⁵⁸ In Notice 2001-16, the IRS first targeted Midco or intermediary shelters. The notice dealt with the use of an intermediary for the avoidance of corporate tax triggered on the sale of assets. The notice postulates a seller who wants to sell the stock of a corporation, a buyer who wants to purchase the assets, and an intermediary corporation. As described in the notice, the parties, pursuant to a

plan, undertake the following steps. The seller purports to sell the stock of his target corporation to the intermediary corporation. The intermediary corporation, in turn, sells the target corporation’s assets to the buyer. The buyer claims a basis in the target corporation assets he now owns equal to his purchase price (i.e., a stepped-up basis). In one form of the transaction, the intermediary corporation has tax losses or credits and the target corporation and the intermediary corporation are members of an affiliated group that thereafter files a consolidated return to make use of those losses or credits against the corporate level gain triggered on the sale of the assets. In another form of the transaction, the intermediary corporation is an entity not subject to tax and the target corporation will liquidate in a transaction that is not intended as a taxable liquidation, resulting in no reported gain on the intermediary corporation’s sale of the assets.

According to the notice, depending on the facts of the particular case, the IRS might challenge the purported tax results of the just described transactions on several grounds, including but not to one of the following:

- The intermediary is an agent for the seller and consequently for tax purposes, the target corporation has sold assets while it is still owned by the seller;
- The intermediary is an agent for the buyer and consequently for tax purposes the buyer has purchased the stock of the target corporation from the seller; or
- The transaction is properly recharacterized (e.g., to treat the seller as having sold assets or the target corporation as having sold assets while it is still owned by the buyer).

Alternatively, the IRS states in the notice that it might examine the intermediary corporation’s consolidated group to determine whether it may properly offset losses (or credits) against the gain (or tax) from the sale of assets.

The notice further states that the IRS might impose penalties on participants in these transactions, or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under section 6662, the return preparer penalty under section 6694, the promoter penalty under section 6700, and the aiding and abetting penalty under section 6701. Finally, the

57. 2009 U.S. App. LEXIS 24713 (5th Cir. 2009), aff’g 553 F.Supp.2d 716 (2008).

58. 2001-1 C.B. 730 (Feb. 26, 2001).

Fifth Circuit Affirms Decision Upholding the Disallowance of a “Midco” Tax Shelter Transaction (cont’d)

notice warns that the IRS views the transaction and substantially similar ones as listed transactions, triggering the disclosure, registration and list maintenance requirements.

The transaction at issue in the present case was entered into between Midcoast, the sole shareholder of The Bishop Group, Ltd (Bishop), and K-Pipe Merger Corporation (K-Pipe). Midcoast and Bishop were in the business of owning and operating natural gas pipelines. Beginning in 1999, Bishop’s sole shareholder decided he wanted to sell Bishop. Midcoast was an interested buyer but it desired to purchase Bishop’s assets with a cost basis. Bishop’s sole shareholder insisted on a direct stock sale because such a sale would be substantially more beneficial to him from a tax perspective than a sale of only Bishop’s assets. Midcoast consulted with an outside tax advisor who suggested that Midcoast pursue a Midco transaction whereby the sole shareholder of Bishop would sell his stock to a third party, and the third party would in turn sell Bishop’s assets to Midcoast. The advisor suggested that Midcoast use Fortrend International LLC (Fortrend), an investment bank, as the intermediary to the transaction.

Upon Midcoast agreeing to do this, Fortrend began negotiating with Bishop’s sole shareholder, with Midcoast and its tax advisor participating in the negotiations. Fortrend created an entity, K-Pipe, specifically for the transaction. K-Pipe had no assets of its own, nor did it conduct any prior business. Financing for the purchase of the Bishop stock was set up, with a loan to K-Pipe being secured by Midcoast’s assets. In October 1999, K-Pipe purchased all of the sole shareholder’s stock in Bishop. After a downstream merger of K-Pipe into Bishop, Bishop (which changed its name to K-Pipe Group) sold the Bishop assets to Midcoast the day after the stock purchase. K-Pipe apparently offset the gain from the sale of the Bishop stock from high basis, low fair market value assets its parent company contributed to K-Pipe. Midcoast claimed a cost basis in the Bishop assets and began taking depreciation and amortization deductions in accordance with this basis in 1999.

The IRS partially disallowed Midcoast’s claimed deductions, determining that the form of the transaction should have been disregarded and treating it as though Midcoast had directly purchased the stock of Bishop (and to have

liquidated Bishop). The IRS allowed Midcoast to claim a carryover basis in the assets and make deductions based on that amount. The IRS assessed a 20 percent penalty due to the substantial understatement of taxes.

On appeal, relying primarily on *Commissioner v. Court Holding Co.*,⁵⁹ *United States v. Cumberland Pub. Serv. Co.*,⁶⁰ *Davant v. Commissioner*,⁶¹ *Blueberry Land Co. v. Commissioner*,⁶² and *Reef Corp. v. Commissioner*,⁶³ the court undertook a substance over form analysis and analyzed the transaction at issue under the conduit theory of the substance over form doctrine. The court found that the uncontroverted evidence supported the determination that the IRS properly disregarded the form of the transaction and treated it as a direct stock sale because it was a sham conduit transaction and Midcoast could offer no adequate non-tax reasons for using K-Pipe. Midcoast, therefore, was not entitled to claim a stepped-up basis in the Bishop assets.

59. 324 U.S. 331 (1945).

60. 338 U.S. 451 (1950).

61. 336 F.2d 874 (5th Cir. 1966).

62. 361 F.2d 93 (5th Cir. 1966).

63. 368 F.2d 125 (5th Cir. 1966).

Fifth Circuit Affirms Decision Upholding the Disallowance of a “Midco” Tax Shelter Transaction (cont’d)

Specifically, the court pointed to the following uncontroverted facts. Bishop’s sole shareholder sought to sell his stock in Bishop, knowing that a direct asset sale would have negative tax consequences for him. When the sole shareholder rejected Midcoast’s offer, Midcoast asked its tax advisor for suggestions about improving its bid. The advisor suggested that the parties use a third-party intermediary for the transaction and suggested Fortrend, a corporation that had done a number of conduit transactions. The advisor then brought Fortrend into the picture. Rather than purchasing the stock and selling the assets itself, Fortrend formed a special purpose entity, K-Pipe, which existed for no other reason than to accomplish the transaction and it did no business before or after the transaction. K-Pipe’s financing to purchase the Bishop stock was wholly secured by Midcoast’s assets. Thus, the only inference to be made was that K-Pipe was merely an intermediary without a bona fide role in the transaction.

The court also rejected Midcoast’s three purported business reasons why it engaged in a Midco transaction. Midcoast first argued that K-Pipe sought to earn a profit. The court, however, observed how this assertion “did not answer the question of why any party was willing to pay K-Pipe to be an intermediary” and the fact that an intermediary receives a fee or makes a profit does not prevent finding that the transaction was a sham, in any event. Midcoast also argued that it engaged in a Midco transaction because it “wanted to acquire and operate the Bishop pipeline assets at a price it was willing and could afford to pay.” The court summarily rejected this argument, stating that this was not a tax-independent business consideration. Lastly, Midcoast contended the transaction limited its exposure to litigation because “had it purchased the Bishop stock, it would have been liable for claims against Bishop. By purchasing the assets ..., it could avoid liability on known and unknown claims that might be asserted against the Bishop corporate entity.” The

court again summarily rejected Midcoast’s last argument, noting that this does not explain why an intermediary was necessary.

The court also upheld the imposition of the 20 percent understatement penalty and because the transaction at issue was a “tax shelter” as defined in section 6662(d)(2)(C), the substantial authority exception did not apply. The court noted that, in any event, there was not substantial authority because the available authority from Supreme Court and Fifth Circuit cases indicated that the transaction, motivated solely by the avoidance of tax, would be disregarded and that Midcoast would not be entitled to claim a stepped-up basis in the Bishop assets.

– T. Ashford

IRS Coordinates Its Position Regarding Six-Year Statute of Limitations Regulations

As we previously reported,⁶⁴ the Treasury Department and the IRS issued temporary and proposed regulations with respect to sections 6501(e)(1)(A) and 6229(c)(2) on September 24, 2009. The regulations provide that an overstatement of basis constitutes an omission of gross income for purposes of the extended statute of limitations provisions. The temporary regulations are effective for taxable years for which the “applicable period for assessing tax” had not expired prior to September 24, 2009.

On November 23, 2009, the Office of Chief Counsel issued Notice CC-2010-001. The notice indi-

cates that the “applicable period for assessing tax” should be interpreted in accordance with the temporary regulations. Thus, the temporary regulations are effective for taxable years for which a six-year limitations period had not expired prior to September 24, 2009. The notice also establishes procedures by which the IRS will “coordinate Counsel’s position” for docketed Tax Court cases in which the temporary regulations apply. Specifically, “[the IRS’s office of Chief Counsel (Procedure and Administration)] has assembled a cadre of attorneys” to monitor the cases and to provide the Tax Court with notice of the issuance of the temporary regulations through such means as filing motions or amending answers.

– R. Partain

64. “Regulations Issued with Respect to the Six-Year Statute of Limitations for Omissions from Gross Income,” *Focus on Tax Controversy and Litigation*, Oct. 2009, at 11.

Overview of the Treasury Department's 2009-2010 Priority Guidance Plan

On November 24, 2009, the Department of the Treasury issued its 2009-2010 Priority Guidance Plan containing 315 projects that Treasury seeks to complete over a twelve-month period spanning from July 2009 until July 2010.⁶⁵ Treasury further announced its intent to update and republish the Priority Guidance Plan throughout the year.

Among others, the following anticipated projects were listed in the 2009-2010 Priority Guidance Plan:

- Guidance on issues relating to the foreign tax credit, including treatment of foreign and domestic losses, the computation of earnings and profits, and final regulations under section 905(c) regarding foreign tax redeterminations;
- Guidance under section 1441 on qualified intermediaries and other withholding issues;
- Regulations under sections 6229(c) (2) and 6501(e) regarding the definition of "omission from gross income" (temporary and proposed regulations were published September 28, 2009);
- Final regulations under section 6231 regarding the special enforcement exception to the application of the TEFRA partnership procedures (proposed

regulations were published February 13, 2009);

- Guidance relating to rescission of notices of determination issued under sections 6320 and 6330;
- Regulations under section 6501(c) (10) regarding the extension of the statute of limitations for assessment relating to failures to report listed transactions (interim guidance issued as Revenue Procedure 2005-26);
- Regulations under sections 6662A, 6662, and 6664 regarding accuracy-related penalties relating to understatements (interim guidance issued as Notice 2005-12);
- Guidance under sections 6694 and 6695 relating to return preparer penalties (final regulations were published December 22, 2008);
- Guidance pertaining to enhancing return preparer compliance;
- Guidance under section 6702 relating to reduction of penalties for frivolous tax submissions;
- Regulations under section 6707 regarding the penalty for failure to furnish information as required by section 6111 (proposed regulations were published December 19, 2008);
- Guidance under section 6707A regarding the penalty for failure to disclose reportable transactions (prior guidance was contained in Notice 2005-11, Revenue Procedure 2005-51, Revenue Procedure 2007-21, and Revenue Procedure 2007-25; temporary

and proposed regulations were published September 11, 2008);

- Regulations under section 6708 regarding the penalty for failure to make a list of advisees available as required under section 6112 (interim guidance contained in Notice 2004-80);
- Revisions to Circular 230 regarding practice before the IRS;
- Guidance regarding the procedures for the imposition of a monetary penalty under Circular 230 (prior guidance contained in Notice 2007-30);
- Proposed regulations under section 6015 updating the existing regulations regarding relief from joint and several liability;
- Guidance under section 9100;
- Guidance on prepaid forward contracts (earlier guidance contained in Notice 2008-02 and Revenue Ruling 2008-01, both published January 14, 2008);
- Regulations and guidance with respect to consolidated returns; and
- Regulations and guidance with respect to employee benefits and executive compensation.

– Z. Ziering

65. The complete version of the 2009-2010 Priority Guidance Plan is available on the IRS Web site at www.irs.gov/foia/article/0,,id=181687,00.html.

Personnel Changes

On December 7, 2009, the IRS announced that Victor Song will become the new chief for IRS Criminal Investigation, the IRS's law enforcement arm responsible for investigating and assisting in the prosecution of criminal tax evasion, money laundering, and narcotics-related financial crime cases. Mr. Song, who currently serves as CI deputy chief, will be replacing Eileen Mayer, who is retiring from the IRS in January. Rick Raven will take over as CI deputy chief.

Upcoming Events

On January 14, 2010, partners Lawrence M. Hill and Hershel Wein will serve as faculty for a Strafford CLE/CPE webinar/teleconference on "*Castle Harbour* Decision: Legitimacy of Partnerships with Tax Benefits: Structuring the Entity to Withstand IRS Scrutiny and Maximize Tax Advantages." The panel will address the following key questions: How will the *Castle Harbour* ruling impact the way courts view the legitimacy of partnership structures with tax benefits? Will this decision impact future IRS challenges of partnership structures with tax benefits? What proactive steps should counsel take on behalf of current and prospective clients in light of the *Castle Harbour* ruling? For additional information, visit www.straffordpub.com.

Beginning on January 25-26, 2010 at the Westin Colonnade in Coral Gables, FL, Lawrence M. Hill and counsel Tamara Ashford will be speaking at a series of BNA/CITE conferences on "Resolving IRS Tax Controversies: How to Prepare for Audits and Appeals, Resolve IRS Disputes, Mitigate Penalties and Understand Alternative Dispute Resolution Methods." The second conference in the series will be held on February 22-23, 2010 at the Treasure Island Hotel and Casino in Las Vegas, NV. Additional conferences will be held in April, May, and June in New York, Dallas, and Washington, DC, respectively.

Dewey & LeBoeuf's Tax Controversy Practice



Dewey & LeBoeuf's Tax Controversy practice, led by partner Lawrence M. Hill (pictured above), is centered on large-case tax controversy examinations, tax litigation matters, and government investigations. Our lawyers represent taxpayers at the audit and appeals stages before the Internal Revenue Service, and our prominent team of nationally recognized trial lawyers litigates on behalf of taxpayers in the federal courts, from the U.S. Tax Court to the Supreme Court of the United States.

In addition, our tax controversy lawyers are active members of the American Bar Association Section of Taxation ("ABA Tax Section") and the New York State Bar Association Tax Section ("NYSBA Tax Section"). Mr. Hill recently ended his term as Chairman of the ABA Tax Section's Court Procedure and Practice Committee, and several of our lawyers are subcommittee chairs of the committee. Our lawyers are also active participants in ABA Tax Section and NYSBA Tax Section comment projects regarding new and proposed rules and tax policy matters. Most recently, our tax controversy lawyers assisted in drafting the ABA Tax Section comments regarding the proposed Tax Court rules and both the ABA Tax Section and the NYSBA Tax Section comments regarding revised section 6694, Tax Return

Preparer Penalties, and the proposed regulations thereunder.

Our tax controversy lawyers frequently participate in panels at tax law conferences and publish articles regarding significant tax controversy and litigation developments.

For more information about Dewey & LeBoeuf's tax controversy practice, please contact Lawrence M. Hill at lhill@dl.com or (212) 259-8330, Mark Allison at mallison@dl.com or (212) 259-6866, or your Dewey & LeBoeuf relationship partner.

Dewey & LeBoeuf's Tax Controversy Practice

To ensure compliance with the requirements of Treasury Department Circular 230, any tax advice contained in this newsletter is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties or (ii) promoting, marketing, or recommending to another party any matter(s) addressed herein.

This publication is intended only as a general discussion of these issues.

It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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