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DEWEY & LEBOEUF

Focus on Tax Controversy and Litigation

Editor's Note

Dear Readers,

The first meeting of the IRS Announcement 2010-9, Uncertain Tax Positions Coalition will be held on March 5, 2010 at Dewey & LeBoeuf's New York office. We will begin to identify the Coalition's particular concerns and discuss its strategy for submitting effective comments to the IRS. The meeting will start with breakfast at 9:00 a.m. and conclude with a lunch.

To join the Coalition and to participate in the meeting in person or by phone, please contact Lawrence M. Hill at +1 212 259 8330 or lhill@dl.com.

Coalition Formed to Address IRS's Disclosure Initiative on Uncertain Tax Positions

Dewey & LeBoeuf's Tax Controversy and Litigation Practice has taken a leading role in commenting on the IRS's landmark disclosure initiative presented in Announcement 2010-9. As reported in BNA's Daily Tax Report, Dewey & LeBoeuf has formed a Coalition to submit comments to the IRS on the uncertain tax positions development. The purpose of the Coalition is to seek clarification and practical application of the rules.

The first meeting of the Coalition will be held on Friday, March 5, 2010. For information on the Coalition, please contact Lawrence Hill, Chair of the Tax Controversy & Litigation Practice.

On Tuesday, March 16, 2010, Lawrence Hill will be addressing the Wall Street Tax Association on the topic of "Uncertain Tax Position Reporting and the Impact on Privilege." The breakfast seminar will take place at Credit Suisse, One Madison Avenue, NY, NY. Debbie Nolan and Chester Abell of Ernst & Young will serve as co-panelists, and the panel will be moderated by Ed Park of AIG. Lawrence Hill will also address the Tax Executives Institute on Announcement 2010-9 and tax accrual workpapers in the wake of *Textron* in Nashville on April 29, 2010.

Larry Hill, Others Interviewed by BNA Regarding Tax Controversy Outlook for 2010

Larry Hill, chair of Dewey & LeBoeuf's tax controversy practice, was recently interviewed by *BNA* for an article titled, "Economic Substance Doctrine to Be Prominent Issue for IRS, Courts, Congress." The article was published in the January 19, 2010 issue of *Daily Tax Report*. Mr. Hill, along with IRS officials and other tax practitioners, discussed various topics he believes may be critical issues in the coming year. The article was published before the IRS made its landmark announcement regarding the disclosure of uncertain tax positions.¹ In last month's issue of *Focus on Tax Controversy and Litigation*, Mr. Hill called Announcement 2010-9 "historic" and told readers that it was "the most significant, comprehensive disclosure proposal involving corporate taxpayers, bar none." He also warned readers that the "potential ramifications of the proposal are extraordinary. It will impact how returns are prepared; what positions are taken; the role and responsibilities of tax return preparers and tax advisors. It will also implicate privilege and raise shareholder liability and professional ethics questions."²

1. See the article on page 1 regarding the formation of a Coalition to provide comments on the Announcement to the IRS.

2. For more information on the proposal, see "So Much for Restraint," *Focus on Tax Controversy and Litigation*, Jan. 2010, at 2.

In the *BNA* article, Mr. Hill identified the following topics as being among those likely to be important in 2010:

- Proposed codification of the economic substance doctrine
- The IRS's interpretation of the economic substance doctrine
- Trends in Examination and Appeals
- International Issues
- Potential Supreme Court review of *Textron*

Economic Substance

Over the years, numerous attempts have been made to codify the economic substance doctrine. In 2009, proposals to codify the doctrine were included in the Affordable Health Care for America Act (H.R. 3962), the Stop Tax Haven Abuse Act (S. 506 and H.R. 1265), and the Obama Administration's Greenbook.

There are some differences among the proposals, but the use of strict liability penalties is a common feature. For example, H.R. 3962 imposes a 40 percent penalty on the underpayment attributable to any tax benefits disallowed due to a lack of economic substance if the transaction was not adequately disclosed on the taxpayer's return. H.R. 3962 reduces

the penalty to 20 percent if the facts relevant to the transaction's tax treatment were adequately disclosed. S. 506 imposes a 30 percent penalty on the understatement resulting from the tax benefits disallowed due to a lack of economic substance if the transaction was not adequately disclosed on the taxpayer's return. Similarly, this penalty is reduced to 20 percent if the transaction was adequately disclosed.

Differences among the proposals include the availability of defenses and deductibility of interest on underpayments resulting from a transaction that lacks economic substance. For example, H.R. 3962 provides that the reasonable cause exception described in section 6664(c)(1) would not apply to any portion of an underpayment that is attributable to a transaction that lacks economic substance.³

In his interview with *BNA*, Mr. Hill said he is "personally ... against codification of the doctrine," stating that the definitions in the proposed legislation are problematic and, even if the doctrine is codified, taxpayers will still be subject to courts' interpreta-

3. Unless otherwise indicated, all section references are to sections of the Internal Revenue Code of 1986, as amended (the "Code").



Larry Hill, Others Interviewed by BNA Regarding Tax Controversy Outlook for 2010 (cont'd)

tion of the law. Mr. Hill also voiced his concern that the proposed “legislation does not clarify anything.”

Furthermore, Mr. Hill told BNA that he is “very much against strict liability penalties” and asserted that “[r]easonable cause should always figure in.”

Regardless of whether the economic substance doctrine is codified, Mr. Hill observed that the IRS is “looking at each component part of the transaction and whether each component step makes independent sense.” Mr. Hill was critical of this approach, telling BNA that, “I think the better test is to look at what the transaction accomplishes as a whole rather than to pull out one step that may have been done for planning purposes.”

Trends in Examination and Appeals

During his interview with BNA, Mr. Hill identified a number of trends that he has observed at the Examination and Appeals levels:

- premature issuance of penalty Information Document Requests (“IDRs”),

- simultaneous return preparer penalty examinations and taxpayer examinations,
- constraints on Exam’s and Appeals’ ability to resolve cases, and
- a significant increase in the use of “e-discovery.”

Mr. Hill told BNA that “a trend that has been going on for some time is [for the IRS] to issue penalty IDRs before the transaction has really been examined.” Mr. Hill was critical of this practice, arguing that the IRS should analyze the transaction first, and determine whether penalties are appropriate after conducting that analysis.

Simultaneous return preparer penalty examinations and taxpayer examinations are another “inappropriate” practice that Mr. Hill is seeing with increasing frequency. Mr. Hill criticized this practice for putting “a wedge between the taxpayer and the preparer and put[ting] them in a potential conflict situation.”

Mr. Hill noted that National Office coordination of certain issues has had an impact on both Exam and Appeals.

At the Exam level, Mr. Hill said that, due to the effect of National Office coordination, examiners “just sit on the documents until they get guidance from somebody else on what to do. The examination phase is just relegated to document gathering.” Coupled with the significant increase in the use of “e-discovery” (requests for electronic documents such as e-mails, internal memoranda, and other electronically-maintained documents), it has become “tremendously expensive and time-consuming” for taxpayers to respond to document requests. In some cases, Mr. Hill told BNA, the documents produced by taxpayers at great expense and effort are not even reviewed by the government. Mr. Hill suggested that the government should “evaluate whether [it] really need[s] those documents or not” and, if it concludes that the requested documents are necessary, the government should consider entering into cost-sharing arrangements with taxpayers.

At the Appeals level, Mr. Hill noted that the coordinated issue approach and early involvement of IRS counsel appears to have impacted Appeals’ ability to resolve cases.

International Issues

Mr. Hill told BNA that “[t]he [S]ervice is getting much more aggressive on the international front” and “that’s going to continue. There will be a lot more controversy there.”

The IRS has increased the attention paid to a variety of international issues, including increasingly raising economic substance concerns in large, complex transactions and elevating the issue of withholding taxes on payments made to foreign persons to a Tier I issue.⁴ In addition to elevating withholding taxes to a Tier I issue, the IRS is aggressively auditing taxpayers who engaged in certain total return swap (“TRS”) transactions. On January 14, 2010, the IRS issued an industry director directive providing guidance to Exam teams auditing TRS transactions. The industry director directive provides model IDRs for Exam teams to use.

4. For more information, see “IRS and Treasury Officials Discuss Intent to Focus on International Issues,” *Focus on Tax Controversy and Litigation*, Nov. 2009, at 17-18; “IRS Explains Strategy to Improve Withholding Tax Compliance,” *Focus on Tax Controversy and Litigation*, Dec. 2009, at 12; and “New Total Return Swap Audit Guidelines Reveal Scope of IRS Query,” *Focus on Tax Controversy and Litigation*, Jan. 2010, at 6-7.

Moreover, the IRS has also made increased use of exchange of information provisions with foreign tax administrations in its examinations.⁵

Potential Supreme Court Review of *Textron*

Mr. Hill described the First Circuit’s *en banc* decision in *United States v. Textron, Inc.*, 577 F.3d 21 (1st Cir. 2009) (*en banc*), as “an unfortunately worded opinion.” In the opinion, a 3-2 majority held that Textron’s tax accrual workpapers (“TAWs”) were not protected from disclosure to the IRS by the work product doctrine because the TAWs were not prepared “for use” in litigation. Mr. Hill told BNA that, “in this case, the court went too far. Most lawyer workpapers are not used at trial.”

Textron has appealed the First Circuit’s controversial *en banc* decision to the Supreme Court.⁶ Mr. Hill believes that the Supreme Court may

5. For previous coverage on this topic, see “Additional Taxpayer Protections Are Needed With the Increase in Exchange of Information Between the IRS and Foreign Tax Administrations,” *Focus on Tax Controversy and Litigation*, March 2009, at 2-3.

6. For previous coverage, see “Textron Appeals First Circuit’s Decision to Supreme Court,” *Focus on Tax Controversy and Litigation*, Jan. 2010, at 13.

hear the case, noting that the Court may be concerned with the “anticipation of litigation” standard established by the First Circuit. In this instance, “[t]he courts are going to have to clarify the doctrine itself” because “the government will continue to challenge tax accrual workpapers.”

But Mr. Hill cautioned that the scale may be tipping in the government’s favor when it comes to privilege disputes. “Courts are considering privilege to be something that hides the truth. . . . That seems to be a trend. I do think there will be more litigation.”

Readers interested in learning more about these topics or others should contact Mr. Hill directly at (212) 259-8330 or lhill@dl.com.

– A. Minkovich



Switzerland Reacts to Setback to Agreement with United States, Stolen Bank Data

As covered last month,⁷ the Federal Administrative Court of Switzerland ruled on January 21, 2010 that, without Swiss parliament approval, the August 19, 2009 agreement between the United States and Switzerland cannot modify the existing tax treaty between the two countries. Thus, while international assistance can be granted in cases of suspected tax fraud, assistance is still prohibited in cases of suspected tax evasion. The Federal Council, the Swiss government's executive arm, indicated that the ruling impacts about 4,200 of the 4,450 UBS client names that were to be handed over to the United States in connection with the deferred prosecution agreement between the U.S. Department of Justice and UBS.

In light of the decision, the Federal Council said that it would hold urgent talks with the United States to resolve the impasse and that it might submit the August 19, 2009 agreement to

the Swiss parliament for approval.⁸ The IRS responded to the Swiss announcement by stating that “[t]he United States has an agreement with the Swiss government to produce information on US account holders at UBS. We expect the Swiss government to continue to honor the terms of the agreement.”⁹ Under the agreement, the 4,450 UBS client names must be disclosed to the US by August 2010.

At the same time, Switzerland continued separate treaty negotiations with Germany, France, Italy, and, most recently, Canada. In March 2009, under the threat of economic sanctions, Switzerland announced that it was ready to renegotiate its tax treaties to provide assistance in cases of suspected tax evasion in accordance with Organization for

Economic Cooperation and Development standards. However, recent reports of governments wanting to use data stolen from Swiss banks for tax enforcement have complicated some of these negotiations.

On February 1, 2010, the spokesman of Germany's Finance Ministry confirmed that Finance Minister Wolfgang Schaeuble would consider buying stolen Swiss bank account data of 1,500 German citizens from an unnamed source.¹⁰ Despite the revelation, the Swiss government said that it would continue treaty negotiations with Germany to allow for international assistance in cases of suspected tax evasion, but warned that “it will not provide administrative assistance based on stolen data, even to Germany”—an important economic partner of Switzerland.¹¹

8. Press Release, Federal Council, Federal Council Aims to Execute UBS Agreement with USA (Jan. 27 2010), available at <http://www.admin.ch/br/aktuell/00091/index.html?lang=en&msg-id=31329>.

9. See David S. Hilzenrath, “Swiss Halt Deal with U.S. that IDs Americans with Secret UBS Bank Accounts,” *Washington Post*, Jan. 28, 2010, available at <http://www.washingtonpost.com/wp-dyn/content/article/2010/01/27/AR2010012703556.html>.

10. See Patrick Donahue, “Germany to Buy Stolen Swiss Bank Data, Schaeuble Says,” *Bloomberg*, Feb. 2, 2010, available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a92Nr0w_IHL4

11. Press Release, Federal Council, Federal Council Takes Decision on Further Course of Action Concerning Germany (Feb. 3, 2010), available at <http://www.admin.ch/br/aktuell/00091/index.html?lang=en&msg-id=31473>.

7. See “Swiss Court Prevents Disclosure of Some UBS Data to the US; Same Court Earlier Found FINMA Exceeded Authority by Releasing Names of UBS Clients,” *Focus on Tax Controversy and Litigation*, Jan. 2010, at 3.

The German Cabinet confronts legal and privacy concerns in deciding whether to purchase the stolen data. In opposition, the Federal Council stressed that theft of bank client data “is a criminal offence in Switzerland. It violates public policy and the principle of good faith, and strains relations between constitutional states.”¹² Nevertheless, Schaeuble commented that it was in the public’s interest to uncover tax fraud and, on February 5, 2010, German Chancellor Angela Merkel expressed support for purchasing the data if it is found relevant.¹³ Previously, in 2008, the German government paid about 4.2 million euros for information stolen from LGT Bank, a Liechtenstein bank, as part of its investigation of tax fraud.

Similarly, after French authorities revealed that they had received information about secret accounts based on stolen bank data, the Swiss

12. *Id.*

13. See Patrick Donahue, “Germany to Buy Stolen Swiss Bank Data, Schaeuble Says,” *Bloomberg*, Feb. 2, 2010, available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a92Nr0w_IHL4

government suspended ratification of its revised treaty with France. On January 27, 2010, however, France agreed not to use the stolen data in its requests for international assistance.¹⁴ The revised tax treaty is now scheduled for its first Swiss parliament review in March.

Finally, Italian police officers conducted a raid of 76 banks last year, including many Italian branches of Swiss banks, in search of secret account information. This led Switzerland to suspend treaty negotiations with Italy on November 1, 2009.

Meanwhile, on February 4, 2010, a former UBS client pleaded guilty in the U.S. District Court for the Southern District of Florida to failing to report offshore accounts on his 2007 tax return.¹⁵ The defendant, a watch manufacturer and seller,

14. Press Release, Federal Department of Finance, Switzerland and France Have Clarified Unresolved Tax Issues (Feb. 12, 2010), available at <http://www.efd.admin.ch/aktuell/medieninformation/00462/index.html?lang=en&msg-id=31623>.

15. *United States v. Barouh*, S.D. Fla., No. 10-20034-CR-JORDAN.

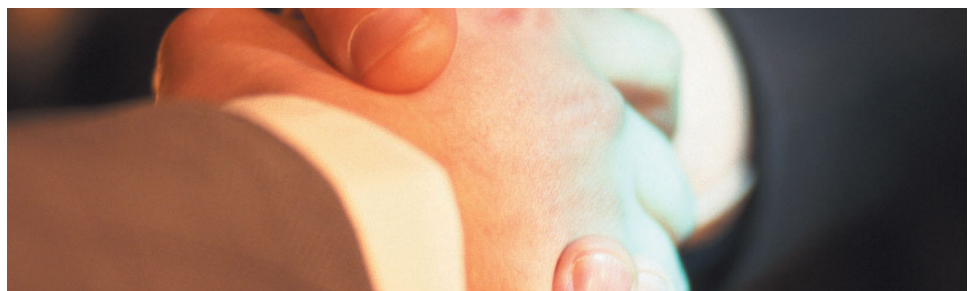
agreed to pay a \$5 million penalty, representing 50 percent of his account’s highest balance.¹⁶ He is the seventh former client to plead guilty since UBS entered into a deferred prosecution agreement in February 2009.¹⁷

– M. Levine¹⁸

16. Press Release, Department of Justice, Former UBS Client Pleads Guilty to Hiding \$10 Million in Offshore Bank Accounts (Feb. 4, 2010), available at <http://www.justice.gov/opa/pr/2010/February/10-tax-123.html>.

17. News Release, IRS, Offshore Tax-Avoidance and IRS Compliance Efforts, available at <http://www.irs.gov/newsroom/article/0,,id=110092,00.html>.

18. Max J. Levine is a tax associate in Dewey & LeBoeuf’s New York office. He is not yet admitted to practice.



Eleven *Amicus* Briefs Support Textron's Cert Petition

Eleven *amicus* briefs were filed in *United States v. Textron, Inc.*,¹⁹ supporting Textron's petition for a writ of certiorari²⁰ seeking review of the First Circuit's *en banc* decision.²¹ Briefs were submitted by the following *amici curiae*: The American Bar Association, Tax Executives Institute, Inc., Association of Corporate Counsel, Chamber of Commerce of the United States of America, New England Legal Foundation, Council on State Taxation, The Committee on Taxation and Committee on Corporate Reporting of Financial Executives International, DRI – The Voice of the Defense Bar, Washington Legal Foundation, Product Liability Advisory Council, Reed Smith LLP, Graybar Electric Company, Inc., and U.S. Steel Corporation.

The briefs raised similar arguments and focused on the application of the First Circuit's decision in both the tax and civil contexts. Many *amici* also provided practical policy reasons why the Supreme Court should

review the *Textron* decision that are specific to their areas of expertise. For example, briefs were written from the perspective of in-house lawyers, employees with responsibility for corporate financial reporting and tax return preparation, product manufacturers who frequently make litigation assessments, and companies operating in multiple jurisdictions. Below is a summary of the primary arguments asserted in the briefs.

Differing Standards Applicable to Dual Purpose Documents

Federal Rule of Civil Procedure 23(b) (3) protects as work product materials "prepared in anticipation of litigation or for trial." Several briefs explained that the phrase "in anticipation of litigation" has been interpreted by ten of the circuit courts of appeals in three different ways. The majority of circuits have adopted the "because of" test, which protects dual purpose documents prepared for business reasons and also "because of the prospect of litigation." The Fifth Circuit provides narrower protection for a dual purpose document, requiring that anticipation of litigation be the "primary motivating purpose" for the creation of the document. The First Circuit's *en banc* decision adopted a prepared "for use in" litigation test, which several *amici*

asserted essentially reads "in anticipation of litigation" out of FRCP 26(b) (3).

Many *amici* argued that the "for use in" litigation test is contrary to the purpose of the work product doctrine, which is intended to protect lawyer mental impressions and litigation assessments from adversaries. Several briefs cited *Delaney, Migdail & Young, Chartered v. IRS*,²² in which the government successfully asserted work product for documents analyzing the possible legal risks of a proposed program, as demonstrating that work product should protect litigation assessments such as Textron's tax accrual workpapers. Also, a few *amici* argued that the First Circuit adopted an unworkable standard, referring to it as a "know-it-when-you-see-it" test and noting that two of the five judges on the *en banc* court believed Textron's tax accrual workpapers should be protected.

Further, the differing standards are antithetical to the purpose behind the adoption of the Federal Rules of Civil Procedure, which was to create uniform federal procedural rules. *Amici* with multistate interests argued that the circuit split may also affect state court litigants because all states have adopted, the same or substantially similar work product privilege

19. No. 09-750 (S. Ct.).

20. See "Textron Appeals First Circuit's Decision to Supreme Court," *Focus on Tax Controversy and Litigation*, Jan. 2010, at 13.

21. *United States v. Textron, Inc.*, 577 F.3d 21 (1st Cir. Aug. 13, 2009); see Dewey & LeBoeuf's client alert on the *en banc* opinion, "United States v. Textron: First Circuit, Sitting En Banc, Denies Work Product Protection to Tax Accrual Workpapers," Aug. 14, 2009, available at <http://www.dl.com>.

22. 826 F.2d 124, 126 (D.C. Cir. 1987).

as FRCP 26(b)(3). Companies in the three states within the First Circuit that have adopted the “because of” test will be particularly affected because that test directly conflicts with the First Circuit’s “for use in” litigation test.

Uncertainty May Result in Forum Shopping and May Threaten the Adversarial System

Companies cannot be certain which work product standard may apply to litigation assessment materials at the time they are created. The First Circuit’s narrow interpretation will create an incentive for plaintiffs to forum shop among the numerous jurisdictions where companies may operate. Also, once a document is required to be produced to an adversary in a “for use in” litigation jurisdiction or is shared by the IRS with a state or between states, the company may no longer claim that the document is work product. The uncertainty over the applicable work product standard may result in lengthy and costly disputes over discovery, venue, or choice of law or forum and may pressure companies to settle even where a plaintiff’s claims are weak. Further, a company may be forced to comply with an adverse procedural ruling if the ruling is not immediately appealable.

Several *amici* argued that the Supreme Court’s decision in *Hickman v. Taylor*²³ was based on protecting the adversarial system by preventing an adversary from “free riding” off of a lawyer’s analysis. Many of the briefs noted that the government’s stated reasons for requesting Textron’s tax accrual workpapers are to obtain a road map of the weak spots on Textron’s return in order to more easily challenge Textron’s positions and to determine for how much Textron would settle the items.

Uncertainty May Chill Communication, Undermine Zealous Representation, and Affect Corporate Compliance

Companies are not only subject to increasing regulatory requirements but also regularly seek litigation hazard assessments for a wide range of contemplated business decisions and in response to potential violations. Because these assessments are frequently intended to be shared with third parties or are not communicated to the client, work product may be the only privilege applicable to the materials. As a result of the uncertainty discussed above, companies

and lawyers will likely operate under the First Circuit’s most restrictive work product standard.

The threat of production of litigation assessments to an adversary may negatively impact corporate compliance and the public interest if clients are discouraged from communicating with lawyers or if lawyers perform incomplete analyses or fail to memorialize or retain their advice. *Amicus* DRI also argued that a narrow work product privilege may result in a lawyer who prepares anticipatory materials becoming a witness in any ensuing litigation, which would likely result in the lawyer being disqualified from representing the client in the litigation.²⁴

– R. Partain

23. 329 U.S. 495, 516 (1947).

24. Brief of DRI-The Voice of the Defense Bar as Amicus Curiae Supporting Petitioners, at 18-20 (Jan. 27, 2010).

Obama Administration Releases Its 2011 Revenue Proposals

On February 1, 2010, the Treasury Department released its “Greenbook,” which provides details of the Obama Administration’s 2011 revenue proposals. While the bulk of the proposals remain essentially unchanged from last year’s, there were several new provisions, including the “Financial Crisis Responsibility Fee” levied on large financial institutions, a version of the so-called “Neal Bill” that would deny a deduction for “excess” reinsurance premiums to offshore affiliates, and a proposal to treat certain income shifting of intangible property to offshore entities as Subpart F income. The final provision is likely a partial substitute for proposed changes in the check-the-box rules that have been dropped from this year’s Greenbook in the face of substantial opposition from the business community and Congress. Discussed herein are several of the most notable business-related proposals, both new and repeated.

Codification of the Economic Substance Doctrine

The economic substance doctrine is a judicial doctrine that denies claimed tax benefits from transactions that do not effect a pre-tax alteration of the taxpayer’s economic posi-

tion. The Obama Administration’s 2011 budget proposal like the 2010 budget proposal would add a provision incorporating the doctrine into the Code. The proposed economic substance provision would treat a transaction as having economic substance, and therefore permit the claimed tax treatment, only if (1) the transaction changes the taxpayer’s economic position in a meaningful way (without consideration of the claimed tax savings), and (2) there is a substantial nontax purpose for the transaction. Transactions would not be treated as having economic substance solely by virtue of having a profit potential where the present value of the pre-tax profit is insubstantial in comparison to the claimed federal tax benefits.

The proposal would impose a 30-percent penalty on understatements (20 percent where the transaction was disclosed) attributable to transactions that lack economic substance. The IRS would have the ability to abate the penalty proportionate to the abatement of the underlying tax liability. The proposal also would deny any deduction for interest attributable to an understatement of tax arising from the application of the doctrine. It is not clear whether or not the penalty will

be a strict liability penalty and what the mechanism and defenses for abatement will be.

Notably, a version of the codification of the economic substance doctrine has been included as an offset for the House of Representative’s healthcare reform bill that passed in December 2009²⁵ and has also been included as an offset for the proposed Hiring Incentives to Restore Employment Act drafted by the Senate in February 2010.

Financial Crisis Responsibility Fee

The Administration proposes to assess a fee on certain large financial institutions to recover costs associated with the Troubled Asset Relief Program (“TARP”) established in 2008 to deal with the financial crisis. Starting on July 1, 2010, banks, thrifts, bank and thrift holding companies, brokers, securities dealers, or companies owning and controlling such entities (including non-US firms with US subsidiaries) would be required to pay an assessment calculated at 15 basis points of certain “covered liability” amounts.

25. America’s Affordable Health Choices Act of 2009, H.R. 3200.

Covered liability amounts would be worldwide liabilities of US based firms or liabilities of US subsidiaries of non-US firms less certain designated exceptions. These exceptions would include FDIC-insured deposits, insurance reserves, and “lending against certain high quality collateral.” Only firms with consolidated assets equal to or greater than \$50 billion would be subject to the fee.

Proposals to Reform the US International Tax System

Deferral of Interest Deductions Related to Foreign-Source Income

One proposal would prevent US taxpayers from taking immediate deductions for interest expenses that are properly allocated and apportioned to foreign source income that has not been subject to tax in the United States. The proposal is designed to reduce the perceived incentive for US businesses to shift investments and operations overseas; subject to certain recapture rules, currently, domestic companies are able to deduct expenses related to unrepatriated earnings even where that income has not been taxed

in the United States. Interest not currently deductible would be carried forward and allowed as a deduction when the related foreign income becomes subject to US tax.

Last year’s version of the proposal encompassed all expenses (except for certain research and development expenses) whereas the current proposal is limited to interest expenses. The intersection of this proposal and the currently delayed implementation of the worldwide interest expense apportionment legislation (the “WWIA”) is unclear. The WWIA legislation was originally enacted in 2004 but has been repeatedly delayed by Congressional action and is now effective starting in 2018.

Foreign Tax Credit Reform

The American Jobs Creation Act of 2004 reduced the number of “baskets” of income for purposes of foreign tax credit determinations from nine to two: passive category income and general category income. Taxpayers currently can cross credit income and expenses into these two baskets while also being able to separate high tax and low tax earnings in different affiliates. This allows taxpayers to “blend” and repatriate

high-taxed income, bringing with it incremental foreign tax credits while deferring inclusion of low-taxed earnings. The Administration’s proposal, repeated from last year, would require a US corporation to calculate its deemed-paid foreign tax credit on a consolidated basis, looking at the foreign taxes and E&P of all foreign subsidiaries in the aggregate. The Administration has also proposed a matching rule that would prevent the separation of foreign taxes paid from the income to which the taxes relate to stop a perceived abuse that results when such creditable taxes and foreign income are severable. This planning technique, however, has been largely addressed by Treasury regulations; it will be interesting to see which anti-abuse provisions will be proposed in addition to those regulations.

Prevention of Avoidance of Dividend Withholding Taxes

Dividends paid to nontreaty foreign investors with respect to stock held in domestic corporations are generally subject to a 30 percent withholding tax as fixed or determinable annual or periodical (“FDAP”) income. Unlike dividends paid with respect to stock in a US corporation, which are considered US-source income



Obama Administration Releases Its 2011 Revenue Proposals (cont'd)

12 | subject to withholding taxes, substitute dividend payments made to a foreign person with respect to an equity swap generally are treated as foreign-source (i.e., according to the residence of the recipient), and therefore not subject to withholding taxes even if the swap is with reference to US stock. The proposal outlined in the Greenbook would generally treat income from equity swaps that reference US equities as US-source income subject to withholding to the extent that such income is reflective of dividends paid by domestic corporations. The proposal is intended to curtail the ability of certain foreign investors to enter into equity swaps prior to the underlying stock's ex-dividend date for the purpose of receiving substitute dividend payments without being subject to the 30 percent withholding tax. An exception to the source rule would apply to swaps "which are unlikely to reflect avoidance of US gross-basis taxation."

The previous year's Greenbook provision was substantively similar but provided greater specificity to the exceptions permitted. The current version appears to leave the relevant exceptions to the Treasury Department's regulatory authority.

Disallow the Deduction for "Excess" Reinsurance Premiums

The proposal denies a deduction for part of the cost of reinsurance paid by a US insurer to an affiliated non-US insurer. Because insurers receive a deduction for reinsurance premiums, they can effectively shift income to affiliates through reinsurance transactions. There is currently a US federal excise tax on insurance premiums ("FET") that is designed to compensate the government when US risks are insured or reinsured outside the US and the income from such premiums escape US taxation.²⁶ The proposal suggests that the FET is inadequate to protect the US tax base, and therefore a US insurance company will be denied a deduction for the "excess" amount of any reinsurance premiums paid to an affiliated non-US insurer. An excess amount is defined as an amount that exceeds 50 percent of the total direct premiums received by the US insurer for the relevant line of business.

The proposal is similar to certain congressional proposals that have been introduced, including the so-called "Neal Bill," H.R. 6969,

which was most recently reintroduced on July 30, 2009. Unlike the Administration's proposal, the Neal Bill would calculate the excess amount based on the average amount of reinsurance coverage retained in non-affiliate transaction.

Outbound Transfers of Intangibles under Subpart F

In response to concerns that taxpayers have been transferring intangible property (such as patents and trademarks) to related parties in low-tax jurisdictions, resulting in an erosion of the US tax base, the proposal creates a new category of Subpart F income that attempts to tax such income currently. Some taxpayers have shifted valuable intangible property to controlled foreign corporations ("CFCs") in lower-tax jurisdictions. Under the transfer pricing regulations of section 482, income of the US transferor must be commensurate with the income attributed to the transferred asset. In response to the perceived inadequacy of such transfer pricing regulations, the proposal creates a new category of Subpart F income for the "amount equal to the excessive return" received by the CFC from the intangible asset. US shareholders of a CFC must currently include

26. I.R.C. §§ 4371-4374.

the amount of a CFC's Subpart F income in their US taxable income. The proposal is vague on how such "excessive return" would be calculated. A separate foreign tax credit limitation basket will also be created for "excessive return" income.

Proposals to Combat Under-Reporting of Income Through Use of Accounts and Entities in Offshore Jurisdictions

The 2011 Greenbook contains proposals related to reporting requirements of non-US financial institutions, trusts, and corporations on information about US customers. These provisions have been revised since the 2010 Greenbook to substantively conform to the current version of the Foreign Account Tax Compliance Act of 2009 ("FATCA") that has passed the House of Representatives as an offset for the tax extenders bill.²⁷

These proposals generally include the following: (1) imposition of a 30 percent withholding tax on any withholdable payment to a foreign financial institution ("FFI") unless

the FFI accepts new reporting and diligence obligations with respect to accounts held by US persons or non-US entities with US owners or elects to be treated as a US financial institution for tax-reporting purposes; (2) imposition of the same withholding tax on withholdable payments to non-financial foreign entities unless the owner certifies that it has no substantial US owners or provides information on its US owners; (3) repeal of certain foreign-targeted exceptions to the registration requirements for debt obligations; (4) enhancement of the disclosure requirements for US holders of "specified foreign financial assets" including an extension of the statute of limitations for any substantial omission and an increase in penalties; (5) expansion of the scope of foreign grantor trust provisions and related reporting; and (6) a requirement of third-party reporting on asset transfers to non-US accounts.

A more detailed description of FATCA is contained in the November 2009 issue of *Focus on Tax Controversy and Litigation*.

– E. Miller

27. The Senate Finance Committee included FATCA as an offset in their draft of the Hiring Incentives to Restore Employment Act in February 2010.



D.C. Circuit Holds that the Tax Court Lacked Jurisdiction to Determine Partners' Outside Bases

On January 12, 2010, the United States Court of Appeals for the District of Columbia Circuit reversed the Tax Court's holding that it had jurisdiction to determine that the partners in Petaluma FX Partners, LLC had no outside bases in the partnership.²⁸ The D.C. Circuit also set aside the Tax Court's holding that it had jurisdiction to determine the application of the accuracy-related penalties and the valuation misstatement penalties. However, the court affirmed the Tax Court's conclusion that it had jurisdiction to determine that the partnership was a sham and should be disregarded for tax purposes.

Tax Court, Petaluma and the IRS entered a settlement of stipulated issues in which Petaluma conceded the reduction of the line items on the partnership return to zero. However, Petaluma maintained its argument that the Tax Court lacked jurisdiction to consider certain issues in the FPAA and the application of the valuation misstatement penalties.

On October 23, 2008, the Tax Court granted the IRS's motion for summary judgment and held that (1) it had jurisdiction to determine whether Petaluma should be disregarded for tax purposes because the issue of whether Petaluma is a sham is a partnership item; (2) since Petaluma is disregarded for tax purposes, the Tax Court had jurisdiction to determine that that partners' outside bases in Petaluma were zero; (3) it had jurisdiction to determine the accuracy-related penalty under section 6226(f); and (4) the gross valuation misstatement penalty applied because the adjusted bases were reduced to zero and the partners had claimed adjusted bases in a greater amount.²⁹

On appeal, the D.C. Circuit held that the Tax Court did have jurisdiction to determine that the partnership should be disregarded for tax purpose because the determination whether the partnership was a sham is a partnership item. The court relied on section 6233 and section § 301.6233-1T(a) of the Temporary Treasury regulations in granting the Tax Court jurisdiction to determine whether an entity was a partnership during a taxable year. Subsequently, the court found that under section 6231(a)(3), the determination of whether the partnership was a sham is a partnership item because it is based on whether the item is more appropriately determined at the partnership level. Rejecting Petaluma's argument that the term "item" should be narrowly defined to include only accounting elements such as income, deduction, credit, gain, loss, and basis, the court concluded that the definition of the "'partnership item' extends well beyond technical accounting elements." The court further found that because the definition of partnership items also includes "the legal and factual determinations that underlie the amount, timing and characterization of items,"³⁰ "the determination that a valid partner-

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Petaluma stems from an alleged Son of BOSS transaction, in which the partners contributed a pair of offsetting long and short foreign currency options to the partnership in exchange for a partnership interest. In a final partnership administrative adjustment (the "FPAA"), issued to Petaluma for the partnership's 2000 tax year, the IRS disallowed all partnership items reported on the partnership's information return and reduced the partners' outside bases in Petaluma to zero. In the

28. *Petaluma FX Partners LLC v. Commissioner*, No. 08-1356 (D.C. Cir. Jan. 12, 2010).

29. *Petaluma FX Partners LLC v. Commissioner*, 131 T.C. No. 9 (Oct. 23, 2008).

30. *Citing* Treas. Reg. § 301.6231(a)(3)-1(b).

ship exists is a *sine qua non* for determining the amount and characterization of all other partnership items.” Thus, the court concluded that a finding that a partnership is a sham and lacks economic substance is a partnership item because “it is a legal determination that underlies the amount and characterization of other partnership items.” The court further added that “it makes perfect sense to determine whether a partnership is a sham at the partnership level” because a “partnership cannot be a sham with respect to one partner, but valid with respect to another.”

However, the D.C. Circuit disagreed with the Tax Court’s finding that it had jurisdiction to determine that partners’ outside bases in *Petaluma* were zero. *Petaluma* argued that outside basis is not a partnership item, but rather is an affected item, and thus the Tax Court lacked jurisdiction to determine that the partners’ outside bases were zero. On appeal, the IRS conceded that outside basis is an affected item rather than a partnership item but argued that the Tax Court had jurisdiction to state an “obvious conclusion” that a partner cannot have basis in a disregarded partnership. The D.C. Circuit disagreed with the IRS, finding that under section 6226(f), the Tax

Court did not have jurisdiction to determine affected items. The court noted that “[t]he fact that a determination seems obvious or easy does not expand the court’s jurisdiction” beyond the statutory provision. The court further added that “it does not matter how low the fruit hangs when one is forbidden to pick it.” However, the court did note that inconsistent treatment of the partners’ bases at the individual partners’ level is unlikely where the invalidity of the partnership was conclusively established at the partnership-level proceeding.

Finally, the court agreed with *Petaluma*’s argument that the Tax Court also lacked jurisdiction to determine that penalties applied with respect to the outside basis, because those penalties did not related to an adjustment of a partnership item. As a result, the court vacated the Tax Court’s penalty computations because neither the record nor the IRS on appeal provided the court with any basis for the Tax Court’s jurisdiction over affected items. The court concluded that “[w]hile it may be that some penalties could have been assessed without partner-level computations, [this court] cannot affirm a decision that has not yet been made.”

The D.C. Circuit’s opinion in *Petaluma* may have a broad application in future cases before the Tax Court. Under section 7482(b)(1), when a partnership has no principal place of business, as in cases of terminated partnerships, the Tax Court’s decision “may be reviewed by the Court of Appeals for the District of Columbia.” As a result, under the *Golsen* rule, the Tax Court may be bound by the D.C. Circuit’s decision in *Petaluma* in cases where partnerships have no principal place of business.³¹

– Z. Ziering

31. See *Golsen v. Commissioner*, 54 T.C. 742 (1970), aff’d 445 F.2d 985 (10th Cir.).



IRS Updates Guidance Related to What Constitutes Adequate Disclosure for Reducing an Understatement

On January 27, the IRS released Revenue Procedure 2010-15, which identifies circumstances under which the IRS will consider the disclosure on a taxpayer's return adequate for purposes of reducing the understatement of income tax under section 6662(d), relating to the substantial understatement aspect of the accuracy-related penalty, and section 6694(a), relating to understatements due to unreasonable positions.

The revenue procedure updates Revenue Proc 2008-14 and applies to income tax returns filed on 2009 tax forms for a taxable year beginning in 2009 and to any income tax returns filed on 2009 tax forms in 2010 for short taxable years beginning in 2010. The guidance describes

a new schedule required of taxpayers filing Form 1120 or Form 1065 Schedule M-3s and reflects changes made to section 6694(a) by the Tax Extenders and Alternative Minimum Tax Relief Act.

The revenue procedure provides that the money amounts entered on the forms must be verifiable, which means that the taxpayer must be able to prove the origin of the amount and show good faith in entering the number on the applicable form.

The revenue procedure appeared in Internal Revenue Bulletin 2010-7, dated February 16.

– B. Harrison

In Memoriam



We dedicate this issue of *Focus* to our colleague and friend, David Owens, who passed away on January 16, 2010. David was Counsel in the Dewey & LeBoeuf Litigation Department and a dear friend who aspired to excellence with unparalleled devotion. A graduate of New York University School of Law, David joined Dewey Ballantine

in 1995. During his accomplished career at the firm, he worked on many of the firm's largest cases, and during his last few years he applied his legal talents to numerous tax controversy matters. David was thoughtful, was always cheerful, saw humor in everyday events, and for those of us privileged to work with him, was always a pleasure to be around. David will be remembered for his upbeat attitude, his tireless enthusiasm, his dry humor, his integrity, and his incredible work ethic. He was a wonderful mentor, and we all remember David as a kind, devoted friend and colleague. He will be greatly missed.

Congratulations on the New Additions to the Dewey & LeBoeuf Family

Dewey & LeBoeuf congratulates three members of the firm's tax department on the births of their children.

Lori Spett, a tax associate in Dewey & LeBoeuf's New York office, and Peter Spett welcomed their son Benjamin Richard Spett on January 5th, 2010.

Erica Howard-Potter, a tax associate in Dewey & LeBoeuf's New York office, and Jack Howard-Potter welcomed their daughter Skylar Rohe on January 25, 2010.

Hisu Chang, Tax Department Practice Manager, and Peter Chang welcomed their son Nathan Chiu Chang on February 4, 2010.

Congratulations to all the families!

Upcoming Events

Beginning on January 25-26, 2010 at the Westin Colonnade in Coral Gables, FL, Lawrence M. Hill and counsel Tamara Ashford have been 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 third conference in the series will be held April 19 and 20 in New York at KPMG's Heritage Center. Additional conferences will be held in May and June in Dallas and Washington, DC.

On Tuesday, March 16, 2010, Lawrence Hill will be addressing the Wall Street Tax Association on the topic of "Uncertain Tax Position

Reporting and the Impact on Privilege." The breakfast seminar will take place at Credit Suisse, One Madison Avenue, NY, NY. Debbie Nolan and Chester Abell of Ernst & Young will serve as co-panelists, and the panel will be moderated by Ed Park of AIG. To register for the seminar, please contact Laura Carrillo at lcarrillo@odmd.com.

On Thursday, April 29, 2010, Lawrence Hill will be addressing the Tax Executives Institute in Nashville, Tennessee, on the topic of Announcement 2010-9 and tax accrual workpapers in the wake of *Textron*.

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 Chair 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.

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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