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DEWEY & LEBOEUF

Focus on Tax Controversy and Litigation

Editor's Note

Dear Readers,

IRS Commissioner Shulman has created quite a stir with the release of Announcement 2010-9 (uncertain tax position disclosures) and his corporate governance initiatives. This month's edition contains an article that addresses the corporate director's responsibility for tax oversight. Our tax controversy and litigation group is proud to have taken a leading role in commenting on many significant IRS and legislative initiatives, including Circular 230, economic substance codification, privilege issues, and return preparer penalties. We have formed a coalition of corporations that will be commenting on Announcement 2010-9 and have spoken and will be speaking to client tax departments and tax groups, such as the Wall Street Tax Association, Tax Executives Institute, and the Institute of International Bankers, on the impact of Announcement 2010-9 and the Commissioner's corporate governance initiatives.

We are interested in hearing your thoughts on the new proposed uncertain tax positions schedule (Schedule UTP) and instructions that the IRS released on April 19, so please do not hesitate to contact us about these or any other topics of concern.

Corporate Directors' Responsibility for Tax Risk Oversight¹

The job of a corporate director has never been more difficult.

Directors have always had fiduciary duties to shareholders, including a duty of care, but the parameters of that duty have expanded greatly in recent years. Scrutiny of directors increased dramatically in the wake of corporate scandals at Enron, WorldCom, and Adelphia, and expectations of director attentiveness to risk oversight have grown significantly.

Because the current trend toward more active director oversight was a reaction to massive corporate accounting frauds, the focus of much of directors' increased risk management responsibility has been upon monitoring the integrity of the corporation's books and records. Recently, however, a new area of risk has been added to the director's agenda: tax risk oversight.

Internal Revenue Service ("IRS") Commissioner Douglas Shulman has publicly identified tax risk as an area of oversight for directors and,

not surprisingly, plaintiffs' lawyers have already begun to file derivative actions alleging breaches of fiduciary duty by corporate directors for failing to monitor this risk. As a result, prudent directors will now want to ensure both that their corporations have appropriate policies and procedures in place for controlling tax risk and that their board has a system in place for monitoring management's efforts in this area.

The Duty of Oversight

Under Delaware law, corporate directors owe fiduciary duties to their shareholders.

One such duty is the duty of care, and, as the Delaware Chancery Court explained in *In re Caremark International Inc. Derivative Litigation*,² that duty includes a duty of oversight. In *Caremark*, a corporation pleaded guilty to criminal fraud and paid significant fines and restitution. Shareholders subsequently brought derivative claims against the directors, and the litigation eventually settled.

In approving the settlement, the court commented that directors have a "duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards."

Specifically, director liability may arise "from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss."

In this case, the court concluded that the evidence in the record indicated that the Caremark directors made a good faith attempt to be informed of the relevant facts and, thus, that the plaintiffs' duty of oversight claim was very weak. Indeed, the court stated that "only a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exists — will establish the lack of good faith that is a necessary condition to liability."

Still, notwithstanding this high legal hurdle and the factual weakness of

1. This article appeared in the online edition of *Corporate Counsel* on April 7, 2010. ©2010 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited.

2. *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

the claims, Caremark’s directors had to endure the burden and expense of litigation and Caremark itself had to agree to a settlement resulting in the payment of almost \$1 million in attorney’s fees and expenses.

IRS Commissioner Shulman Highlights Tax Risk Oversight as Part of the Duty of Care

In recent remarks before the National Association of Corporate Directors (“NACD”), Commissioner Shulman discussed the role of corporate directors in monitoring tax risk.

Shulman stressed 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 on this issue. Shulman pointed out both that mismanagement of tax risk can result in significant corporate losses and that tax risk was a major source of reputational risk. Indeed, as Shulman observed, in the current business climate, the public “has little tolerance for overly aggressive tax planning.”

Shulman specifically addressed FIN 48, the Financial Accounting Standards Board interpretation which governs financial statement

accounting for uncertain tax positions. FIN 48 requires companies to (i) identify material uncertain tax positions; (ii) quantify the company’s maximum exposure and estimated likelihood of winning if challenged by the IRS; and (iii) record reserves corresponding to these uncertain tax positions. According to Shulman, directors, and audit committee members, in particular, should monitor these reserves and, at the same time, assess whether the corporation’s tax positions are overly aggressive or risky.

Shulman recommended a number of measures for overseeing tax risk:

- Establishing a threshold confidence level for a tax position;
- Having an independent law firm review major tax positions and engage in direct dialogue with the board; and
- Specifically addressing transfer pricing and relative profit allocated to low-tax jurisdictions, and ensuring they reflect economic contributions made in those jurisdictions.

Shulman also provided examples of questions that directors should ask their tax directors and external auditors relating to FIN 48, including:

- What was the process for identifying uncertain tax positions?
- How do you know all material issues have been identified?
- How did you determine the maximum tax exposure for each uncertain tax position?
- How did you quantify the likelihood of sustaining uncertain tax positions? Does the external auditor or tax adviser agree with the tax director’s assessment?
- Could the company be subject to potential penalties? If so, are the potential penalties appropriately recorded, and, perhaps more importantly, what does the potential for penalties indicate about the aggressiveness of the company’s position?

Shulman noted that foreign governments are also emphasizing sound corporate management on tax matters as a vehicle for improving tax compliance.

For example, the Australian Tax Office publishes a “Governance Guide for Board Members and Directors” that suggests questions for corporate directors to ask management. Similarly, the Organization for Economic Cooperation and Development has charted a worldwide trend of increased director attention to tax issues.



Corporate Directors' Responsibility for Tax Risk Oversight (cont'd)

The need for tax risk oversight became more pronounced on January 26, 2010, when Commissioner Shulman unveiled perhaps the broadest tax disclosure initiative in history in the form of IRS Announcement 2010-9. The Announcement puts taxpayers who have filed a financial statement reflecting uncertain tax positions on notice that, starting in 2011, they will be required to disclose such uncertain tax positions annually to the IRS.

The disclosure must contain (i) a concise description of each uncertain tax position and (ii) the maximum amount of US income tax exposure if the taxpayer's position is not sustained on audit. These disclosures will impact which taxpayers and issues the IRS audits and what resources it devotes to audits. The schedules will undoubtedly be sought in discovery in tax and securities litigation.

Wells Fargo v. United States

While Announcement 2010-9 heralds future tax risks for corporations, many entities already face significant tax issues.

One recent example surfaced on January 8, 2010, when the Court of Federal Claims rejected Wells Fargo & Co.'s attempt to claim a \$115 million tax deduction for its participa-

tion in 26 sale in/lease out, or "SILO," transactions.³

According to the court, the SILO transactions "lack economic substance, and were intended only to reduce Wells Fargo's federal taxes." The court stated that the "heart of these transactions is that Wells Fargo paid a fee to tax-exempt entities to acquire valuable tax deductions that the tax-exempt entities could not use," and, therefore, it disallowed the deductions.

Derivative Litigation

Less than two weeks after the court's ruling in *Wells Fargo*, a shareholder derivative suit was filed in California state court claiming that Wells Fargo's officers and directors had violated their fiduciary duties by allowing the bank to participate in SILO transactions and by not accepting the IRS's earlier settlement offer.

In particular, the complaint in *Marshall v. Kovacevich*,⁴ alleges that millions of dollars in bonuses were paid to officers for "coming up with these sham transactions to defraud the government and taxpayers out of millions of dollars in tax revenues,"

and it asserts that, because of this purported mismanagement, Wells Fargo has sustained economic losses, including tax liabilities, tax penalties, legal fees, loss of profits, loss of interest, expenses arising from investigations, and loss of reputation and goodwill.

Not surprisingly, the complaint quotes extensively from the Court of Federal Claims' decision, which characterized the SILO tax shelters as "blatantly abusive" and "rotten to the core."

Conclusion

The derivative litigation against Wells Fargo's directors and officers is just beginning, and the plaintiffs will have many significant obstacles to overcome to establish liability.

Nonetheless, the very existence of the litigation drives home the reality that directors today will be expected to monitor the corporation's tax risks. With proper guidance and procedures, that duty of oversight need not be onerous, but it is one that the modern director should be sure to include on the board's agenda.

— L. Hill and S. Farber

3. *Wells Fargo & Co. v. United States*, No. 06-628T (Fed. Cl. Jan. 8, 2010).

4. *Marshall v. Kovacevich*, No. 10-496137 (Cal. Super. Ct. filed Jan. 21, 2010).

Dewey & LeBoeuf's Tax Litigation Group Prevents Certification of Proposed Class of BLIPS Tax Shelter Claimants

On March 29, 2010, the United States District Court for the Southern District of New York denied class certification of a proposed class of tax shelter investors, holding that the plaintiffs failed to establish that (i) questions of law or fact common to the class predominated over questions affecting individual members; and (ii) the class action mechanism was the superior method of adjudication where the putative class members were capable of litigating their claims individually.⁵

The tax shelter at issue was the Bond-Linked Issue Premium Structure ("BLIPS"), which is a transaction that purports to increase a taxpayer's basis in order to reduce the taxpayer's tax liability.⁶ The structure was developed and marketed in the late 1990s and early 2000s by KPMG and was one of the tax shelters at issue in *United States v. Stein*,⁷ which has been referred to as the largest tax shelter prosecution in US history. In *Stein*, the government

indicted 17 former KPMG executives and others who were charged with, *inter alia*, conspiracy to defraud the IRS by designing, marketing, and implementing the BLIPS transaction and with concealing the tax shelters from the IRS. In 2009, four individuals were convicted for their involvement in the tax shelters.

Plaintiffs initially commenced this action against KPMG LLP, Sidley Austin Brown & Wood LLP ("Brown & Wood"), Deutsche Bank AG, Deutsche Bank Securities, Inc., Bayerische Hypo Und Vereinsbank ("HVB"), Presidio Advisors LLC, and Presidio Growth LLC, seeking to recover on seven causes of action, including violations of the Racketeer Influenced and Corrupt Organizations Act ("RICO"),⁸ common law fraud, civil conspiracy to defraud, aiding and abetting fraud, unjust enrichment, breach of fiduciary duties, and aiding and abetting breach of fiduciary duties. In essence, the allegations claimed that KPMG and Brown & Wood, along with investment advisors and certain banking institutions, developed and fraudulently marketed the BLIPS structure to the putative class of individual, high net-worth taxpayers. In 2007, the KPMG and Brown & Wood defendants were voluntarily dismissed from this action after having settled with the class

plaintiffs in *Simon v. KPMG LLP*,⁹ a class action resolved in the District of New Jersey and related to the BLIPS transaction. Subsequently, this court dismissed the plaintiffs' RICO, common law fraud, and breach of fiduciary duty claims.¹⁰ Thereafter, the plaintiffs moved to certify a class consisting of all BLIPS investors who received tax opinions from KPMG or Brown & Wood that opined on the tax consequences of the BLIPS transaction. Ultimately, however, the court sided with the *Becnel* court, which in 2005 found that a similarly defined class of BLIPS plaintiffs had failed to satisfy the requirements of class certification.¹¹

In denying class certification, the court explained that although the plaintiffs satisfied the requirements of Rule 23(a) of the Federal Rules of Civil Procedure — the proposed class was sufficiently numerous, the class members' grievances shared common questions of law and fact, the arguments each class member

5. *Kottler v. Deutsche Bank AG*, 05 Civ. 773 (PAC), 2010 WL 1221809 (S.D.N.Y. March 29, 2010) ("*Kottler*") (Dewey & LeBoeuf represented Deutsche Bank AG and Deutsche Bank Securities, Inc. in this litigation).

6. See Notice 2000-44, 2000-44 C.B. 255 (Aug. 11, 2000).

7. See, e.g., *United States v. Ruble*, 2009 WL 911035 (S.D.N.Y. Apr. 2, 2009) (memorandum and opinion of the *Stein* court discussing defendant Ruble's motion for acquittal and the background of the case).

8. 18 U.S.C. § 1962 *et seq.*

9. No. 05-CV-3189 (DMC), 2006 WL 1541048 (D.N.J. June 2, 2006) (approving class settlement of certain BLIPS claims).

10. *Kottler v. Deutsche Bank AG*, 607 F. Supp. 2d 447 (S.D.N.Y. 2009).

11. See *Becnel v. KPMG LLP*, 229 F.R.D. 592 (W.D. Ark. 2005) (holding that putative class of BLIPS plaintiffs failed to satisfy the requirements of both Rule 23(a) and Rule 23(b)). Dewey Ballantine LLP, a predecessor of Dewey & LeBoeuf, represented Deutsche Bank AG and Deutsche Bank Securities, Inc. in this litigation.

Dewey & LeBoeuf's Tax Litigation Group Prevents Certification of Proposed Class of BLIPS Tax Shelter Claimants (cont'd)

6 | might make individually were typical of any other class member, and the class representative would fairly and adequately represent the unnamed members of the putative class—the plaintiffs were unable to satisfy the requirements of Rule 23(b). Under Rule 23(b)(3), the purported class representative must be able to demonstrate that questions of law or fact that are common to the class predominate over questions of law or fact unique to any class member and that the class action mechanism is the superior method for trying the case. The plaintiffs argued that common questions of law and fact predominated over individual questions because the materials allegedly used to market the transaction were uniform in nature, and, therefore, each member must have relied on those materials when investing in BLIPS. The court rejected the plaintiffs' argument and held that proving reliance or causation, central elements to the fraud-based claims against the defendants, would require individualized inquiry that would give rise to a "series of mini-trials within

a class-action framework."¹² Such evidentiary exploration, explained the court, was the essence of individualized inquiry and was absolutely necessary here to determine each BLIPS investor's motivation or reason for entering into the transaction. After examining these facts, the court held that while there is no *per se* rule regarding reliance by a class of tax shelter investors, generalized proof, such as the existence and use of uniform marketing materials, will be insufficient to establish class-wide reliance, and, thus, insufficient to support class certification.¹³

Furthermore, putting aside the plaintiffs' problems with predominance, the court held that the diversity of states in which KPMG partners pitched the BLIPS strategy, some 22 of them, would create trial manageability problems. Namely, the court expressed its concern that dealing with the variation in law among

the 22 relevant states would be unmanageable, which is a significant concern in nationwide class actions. This variation, stated the court, in combination with "variations in culpability among the conspirators and in damage determinations," supported its decision to deny class certification.

Lastly, the court stated that the underlying purpose of class actions — to save time, effort, and expense and to promote uniformity in decisions — could not be achieved here, where the proposed class members are "high net-worth investors with large claims" who are capable of litigating or settling claims on their own. Indeed, the court noted that many of the purported class members had already brought suit or settled with the named defendants, making certification inappropriate.

— J. Amato and A. Lounsbury

12. *Kottler*, 2010 WL 1221809, at *3.

13. See also *McLaughlin v. Am. Co.*, 522 F.3d 215 (2d Cir. 2008).

Obama Signs Bill Incorporating Economic Substance Doctrine Into the Code

On March 30, 2010, President Obama signed into law H.R. 4872, the Health Care and Education Reconciliation Act of 2010 (the “Act”), that, together with Public Law No. 111-148, the Patient Protection and Affordable Care Act, reform the US health care system. As an offset provision, the Act incorporates into the Code the economic substance doctrine and imposes a 20 percent strict liability penalty on underpayments attributable to a disclosed transaction lacking economic substance (increased to 40 percent if the transaction is not disclosed).¹⁴ The Joint Committee on Taxation (“JCT”) estimates that the provision will raise \$4.5 billion over the next ten years.¹⁵

Under new section 7701(o) of the Code, if the economic substance doctrine is “relevant” to a transac-

tion, the transaction will be treated as having economic substance only if it changes the taxpayer’s economic position in a meaningful way and has a substantial business purpose, apart from federal income tax effects.¹⁶ The provision does not, however, alter present law standards for determining when to utilize the economic substance doctrine.¹⁷ Accordingly, the tax treatment of “certain basic business transactions that, under longstanding judicial and administrative practice are respected [even though] the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages” should not be affected by the provision.¹⁸

Section 7701(o) does not provide much guidance on how a taxpayer may show a meaningful change in economic position or a substantial business purpose. The provision does provide that if a taxpayer relies on profit potential to demonstrate either of the two, “the present value of the reasonably expected pre-tax profit from the transaction [must be] substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.”¹⁹ In addition, a non-federal income tax purpose does not include any state or local income tax effect that is related to a federal income tax effect.²⁰ Similarly, a substantial non-federal income tax business purpose does not include achieving a financial accounting benefit if the origin of such benefit is a reduction of federal income tax.²¹

The provision applies to transactions entered into after March 30, 2010.²²

– K. Parsons

14. Health Care and Education Reconciliation Act of 2010, H.R. 4872, 111th Cong., § 1409(b)(1) and (2) (2010); see also I.R.C. § 6662(b)(6) and (i) (new penalty provisions).

15. Joint Committee on Taxation, *Estimated Revenue Effects of the Amendment in the Nature of a Substitute to H.R. 4872, the “Reconciliation Act of 2010,” as Amended, in Combination with the Revenue Effects of H.R. 3590, the “Patient Protection and Affordable Care Act (‘PPCA’),” as Passed by the Senate, and Scheduled for Consideration by the House Committee on Rules on March 20, 2010* (JCX-17-10), Mar. 20, 2010.

16. I.R.C. § 7701(o)(1). Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended (the “Code”).

17. I.R.C. § 7701(o)(5)(C) (“The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.”); see also Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the “Reconciliation Act of 2010,” as Amended, in Combination with the “Patient Protection and Affordable Care Act”* (JCX-18-10), Mar. 21, 2010, at 152.

18. Joint Committee on Taxation Report JCX-18-10, at 152. As examples of the “basic transactions” the provision is not intended to affect, the JCT cites the choice between capitalizing a business with debt or equity, reorganizations, and related party transactions that are arm’s length.

19. I.R.C. § 7701(o)(2)(A).

20. I.R.C. § 7701(o)(3).

21. I.R.C. § 7701(o)(4).

22. H.R. 4872 § 1409(e)(1).



Department of Justice Submits Brief Opposing Supreme Court Review of the First Circuit's *En Banc* Decision in *Textron v. United States*

On April 12, 2010, the Department of Justice submitted its brief²³ to the U.S. Supreme Court opposing the taxpayer's petition for *writ of certiorari* in the case of *Textron v. United States*.²⁴ The government, represented by Solicitor General Elena Kagan, argued that the *en banc* decision of the U.S. Court of Appeals for the First Circuit does not warrant review by the Supreme Court because it correctly holds that Textron's tax accrual workpapers are not privileged work product and because the ruling does not conflict with any decision of the Supreme Court or federal court of appeals.

8 | The issue in *Textron* was whether the taxpayer's tax accrual workpapers were protected by the work product doctrine and, thus, were immune from compelled disclosure to the IRS. In the lower courts, the taxpayer argued that its tax accrual workpapers, which detail its financial reserves for any contingent tax liabilities, were prepared in order to satisfy its reporting obligations as a publicly

traded corporation. The taxpayer contended that it would not have prepared the workpapers "but for" the threat of litigation with respect to each of its tax positions constituting a contingent tax liability. Thus, the taxpayer argued that its tax accrual workpapers served both litigation and non-litigation purposes, making them dual-purpose documents and privileged work product.

The U.S. District Court for the District of Rhode Island agreed with the taxpayer and held that the tax accrual workpapers were privileged work product. On appeal, the First Circuit affirmed the district court's decision. Rehearing the case *en banc*, however, the First Circuit reversed. The *en banc* decision of the First Circuit held that the taxpayer had no litigation purpose in preparing the tax accrual workpapers and, thus, the workpapers were not covered by the work product privilege.

On December 24, 2009, the taxpayer petitioned the Supreme Court for a *writ of certiorari* to the *en banc* decision of the First Circuit. In response, on April 12, 2010, the government submitted its brief opposing the taxpayer's request for review. Primarily, the government argued that the *en banc* decision of the First

Circuit (1) does not conflict with any decision of the Supreme Court or federal court of appeals; (2) correctly holds that the taxpayer's workpapers were not covered by the work product privilege; (3) is consistent with the language and purpose of the work product privilege; and (4) is not an appropriate case for resolving disputes regarding the application of the work product privilege to dual purpose documents. The government thus argued that the *en banc* decision of the First Circuit does not warrant review by the Supreme Court.

The *En Banc* Decision of the First Circuit Does Not Conflict with a Decision of the Supreme Court or Another U.S. Court of Appeals

The government argued that the *en banc* decision of the First Circuit does not conflict with any decision of the Supreme Court or of another federal court of appeals. According to the government, only one other court of appeals has considered the issue, and it too found that tax accrual workpapers are not privileged

23. Brief of the United States of America in Opposition to Petition for Writ of Certiorari, *Textron v. United States*, No. 09-750.

24. *Textron v. United States*, 577 F.3d 21 (1st Cir. 2009), *vacating en banc* 2009 U.S. App. Lexis 1538 (1st Cir. 2009), *aff'g* 507 F. Supp. 2d 138 (D.R.I. 2007)

as attorney work product.²⁵ Additionally, the Supreme Court in *United States v. Arthur Young* decided that the tax accrual workpapers of an independent accounting auditor were not privileged as work product, even though the auditor's workpapers were largely based on, and incorporated, those of the taxpayer being audited.²⁶ Thus, according to the government, the *en banc* decision of the First Circuit does not create a conflict of law requiring a resolution from the Supreme Court.

The Taxpayer's Workpapers Would Not be Privileged Work-Product in Other U.S. Courts of Appeals

The government disputed the taxpayer's contention that its tax accrual workpapers would have been privileged as work product in other U.S. courts of appeals. The government acknowledged the two

25. See *United States v. El Paso*, 682 F.2d 530 (5th Cir. 1982), *cert. denied*, 466 U.S. 944 (1984). The government acknowledged, however, that the Fifth Circuit, which rendered the decision in *El Paso*, applies a narrower standard (as explained in further detail below) than the First Circuit for determining whether documents are protected as work-product. Brief of the United States of America, *Textron*, No. 09-750, at 13.

26. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

standards used by the courts when applying the work product privilege: (1) the "because of" standard, which is used by the First Circuit and protects as privileged all documents produced *because of* the prospect of litigation; and (2) the "primary purpose" standard, which protects as privileged only documents produced for the *primary purpose* of preparing for litigation. Further, the government noted that even though dual purpose documents are occasionally protected as work product, the federal courts of appeals agree that documents prepared in the ordinary course of business for non-litigation purposes, even though prepared by lawyers, are not privileged as work product. Thus, the government argued that the *en banc* court correctly held that the taxpayer's tax accrual workpapers were not privileged because it found that the workpapers were prepared in the ordinary course of the taxpayer's business for purposes of complying with the reporting obligations required of all publicly traded corporations, not "because of" the prospect of litigation.

Furthermore, the government contested the taxpayer's argument that the *en banc* court improperly limited the work product privilege to

documents having a litigation-related "use" or "purpose." The government contended that the taxpayer, in arguing that the "because of" standard requires all documents that would not have been created "but for" the prospect of litigation be privileged as work product, confuses a document's subject matter with its purpose. As the government explained, "[t]hat tax-accrual workpapers could (in some instances) describe potential litigation does not mean that they are generated 'because of' litigation."²⁷ Moreover, the government noted that other federal appellate courts have similarly applied the "because of" standard. Thus, given that the *en banc* court found that the taxpayer's workpapers were created for non-litigation purposes and that the "because of" standard requires a litigation purpose, the government argued that the workpapers would not be privileged in other circuits applying the "because of" standard.

Additionally, the government argued that if the taxpayer's workpapers are not privileged under the "because of" standard, then they necessarily must

27. Brief of the United States of America, *Textron*, No. 09-750, at 21.



Department of Justice Submits Brief Opposing Supreme Court Review of the First Circuit's *En Banc* Decision in *Textron v. United States* (cont'd)

be denied the privilege under the narrower “primary purpose” standard.

Thus, according to the government, the taxpayer's workpapers would not be privileged as work product under either of the standards used by federal appellate courts.

The *En Banc* Decision of the First Circuit is Consistent With the Language and Purpose of the Work-Product Privilege

The government argued that the decision of the *en banc* court is consistent with the language and purpose of the work product privilege as codified in Rule 26(b)(3)(A) of the Federal Rules of Civil Procedure (“FRCP”). Rule 26(b)(3)(A) protects as privileged all “documents and tangible things that are prepared in anticipation of litigation.” The taxpayer argued that the *en banc* decision incorrectly limits the work product privilege to documents prepared in anticipation of “trial” only. The government refuted the taxpayer's argument by referring

to the Advisory Committee Notes to the FRCP, which explain that documents created “in the ordinary course of business, or pursuant to public requirements unrelated to litigation”²⁸ are not privileged work product under Rule 26(b)(3)(A). Again, the government cited the *en banc* court's holding that the taxpayer created the tax accrual workpapers solely to comply with its reporting requirements as a publicly traded corporation and not for any litigation-related purpose. Thus, the government argued that, contrary to the taxpayer's contentions, the decision of the *en banc* court is consistent with the language of Rule 26(b)(3)(A).

Additionally, the government noted that the work product privilege is intended to allow a litigant to prepare for litigation prior to the formal commencement of a suit without fear that an opponent will obtain its preparation materials. Without the work product privilege, litigants, to the

28. Fed. R. Civ. Pro. 26(b)(3)(A) advisory committee note (1970).

detriment of the adversarial process, may not prepare for suit until the action has formally commenced. The government argued that the *en banc* decision is consistent with the purpose of the work product privilege, as it stated that “[t]here is no reason to suppose that the possibility of compelled disclosure to the IRS will induce publicly traded companies to breach their obligation to prepare tax-accrual workpapers.”²⁹

Thus, according to the government, the decision of the *en banc* court does not violate the language or purpose of the work product privilege.

Textron is Not an Appropriate Case for Resolving Conflicts Concerning the Application of the Work Product Privilege to Dual Purpose Documents

The government argued that *Textron* is not a good case for resolving conflicts regarding the application

29. Brief of the United States of America, *Textron*, No. 09-750, at 24-25.

of the work product privilege to dual purpose documents. The government argued that the taxpayer's workpapers had not been prepared in anticipation of litigation and, thus, should not be considered dual purpose documents. According to the government, the taxpayer incorrectly treats every dispute with the IRS, such as an audit and attempt for administrative resolutions, as a form of litigation for purposes of the work product privilege. According to the government, however, "the fact that petitioner (like all large corporations) reasonably anticipates an annual IRS audit does not mean that it reasonably anticipates litigation over any specific uncertain tax item."³⁰ And, in contrast to litigation, tax audits are intended to be cooperative, not adversarial.

Moreover, the government argued that even if the Supreme Court were to find that the tax accrual workpapers are dual purpose documents, *Textron* still remains a poor vehicle for

resolving conflicts over the application of the work product privilege to dual purpose documents because of the self-reporting nature of the US tax regime. The government noted that a taxpayer may choose to self-report its taxes in any manner, and it is the IRS's responsibility to sift through an oftentimes voluminous tax return to discover which tax positions, if any, need to be reviewed for potential adjustment. Given the unique circumstances of the tax enforcement system, the government contended that *Textron* is an inappropriate case for resolving conflicts concerning the application of the work product privilege to dual purpose documents.

– A. Treiser³¹

30. Brief of the United States of America, *Textron*, No. 09-750, at 27.

31. Adam Treiser is a tax associate in Dewey & LeBoeuf's Washington, DC office.



Draft Schedule and Instructions for Reporting Uncertain Tax Positions Released, IRS Commissioner Shulman Discusses Policy Underlying the Reporting Proposal

Draft Schedule and Instructions Released

On January 26, 2010, the IRS released Announcement 2010-9, announcing its landmark proposal to require large taxpayers to disclose their uncertain tax positions on a new schedule to be filed with their tax returns. Under the proposal, uncertain tax positions would include positions for which a tax reserve must be established in the taxpayer's financial statements under Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," or other accounting standards. Uncertain tax positions would also include positions for which a tax reserve has not been recorded because either the taxpayer expects to litigate the position or the taxpayer has determined that the IRS has a general administrative practice not to examine the position.³² On April 19, 2010, in Announcement 2010-30, the IRS unveiled a draft schedule, Schedule UTP, and draft instructions to be used to report these positions.

As proposed in the draft instructions, the following taxpayers would be required to file Schedule UTP beginning with the 2010 tax year:

- Corporations who are required to file Form 1120, "U.S. Corporate Income Tax Return;"
- Insurance companies who are required to file Form 1120-L, "U.S. Life Insurance Company Income Tax Return" or Form 1120-PC, "U.S. Property and Casualty Insurance Company Income Tax Return;" and
- Foreign corporations who are required to file Form 1120-F, "U.S. Income Tax Return of a Foreign Corporation."

The draft instructions provide that the IRS would not require a Schedule UTP in tax year 2010 from Form 1120 filers other than those identified on the previous slide, such as real estate investment trusts and regulated investment companies, pass-through entities, and tax-exempt organizations. Announcement 2010-30 indicates that the IRS will determine the timing of the requirement to file Schedule UTP for these entities after comments have been received and considered.

To determine if a tax position must be reported on a Schedule UTP attached to a particular tax year's return, the draft instructions provide that a tax position must be reported if:

- At least 60 days before filing the tax return a reserve has been recorded with respect to that tax

position, or at least 60 days before filing the tax return a decision was made not to record a reserve based on an expectation to litigate or an IRS administrative practice; and

- The tax position has been taken by the corporation in a tax return for the current tax year or a prior tax year.

If a tax position meets these requirements and was taken by the corporation in the current year's tax return, the tax position will be reported on Part I of the Schedule UTP. If a tax position meets these requirements and was taken by the corporation in a prior year's tax return, the tax position will be reported on Part II. A corporation does not have to report a tax position, however, if it reported that tax position on a Schedule UTP filed with a prior year tax return. Regarding a transaction that results in tax positions taken on more than one tax return (and that results in a decision to reserve in the taxpayer's financial statement), the draft instructions provide that the tax positions arising from the transaction must be reported on Part I of the Schedule UTP with each tax return on which a tax position resulting from the transaction is taken regardless of whether the transaction or a tax position resulting from the transaction was disclosed on a prior Schedule UTP.

32. Announcement 2010-9, 2010-7 I.R.B. 408.

The draft instructions also provide a transition rule such that a corporation is not required to report on Schedule UTP a tax position taken in a tax year beginning before December 15, 2009 regardless of whether or when a reserve was recorded with respect to that tax position. In addition, the draft schedule includes a box for taxpayers to check if the corporation was unable to obtain sufficient information from one or more related parties and was therefore unable to determine whether a tax position is required to be reported.

Among other requirements, Parts I and II of the schedule require taxpayers to list up to three primary Internal Revenue Code sections and the maximum tax adjustment — an estimate of the maximum amount of potential United States federal income tax liability associated with the tax year for which the tax position was taken — that relate to each tax position. Significantly, a determination of a maximum tax adjustment amount is not required for valuation or transfer pricing tax positions. Instead, the maximum tax adjustment reporting requirement is satisfied by indicating whether the tax position is a valuation or a transfer pricing tax position and by providing a ranking of these tax positions based on either the amount recorded as a reserve for United States federal income tax for that tax position taken on the tax

return or the estimated adjustment to United States federal income tax that would result if the tax position taken on the tax return is not sustained.

In Part III of the draft Schedule UTP, taxpayers must report a concise description of the uncertain tax positions listed in Parts I and II. The concise description must include “information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the uncertainty.”³³ In addition, the description must include a statement that the position involves an item of income, gain, loss, deduction, or credit against tax; a statement whether the position involves a determination of the value of any property or right or a computation of basis; and the rationale for the position and the reasons for determining the position is uncertain. The draft instructions provide three examples of a concise description that are three to five sentences in length. They specifically identify the relevant factual background, the tax position taken by the corporation (e.g., “[t]he corporation deducted costs of investigating and partially negotiating potential business acquisitions that were not completed, and capitalized costs allocable to one business acquisition that was completed”), and

33. Internal Revenue Service, 2010 Instructions for Schedule UTP (Apr. 19, 2010 draft).

the issue giving rise to the uncertainty (e.g., “[t]he issue is the allocation of costs between failed acquisitions and the successful acquisition”).

For tax positions that are properly reported on Schedule UTP, the draft instructions provide that a taxpayer will be treated as having filed a Form 8275, “Disclosure Statement,” or Form 8275-R, “Regulation Disclosure Statement.” The IRS is considering other circumstances under which a tax position reported on Schedule UTP need not be separately reported elsewhere on the tax return or another disclosure statement.

IRS Commissioner Shulman Discusses Policy Underlying the Reporting Proposal

On April 12, 2010, prior to the release of the draft schedule and instructions, IRS Commissioner Douglas Shulman discussed the policy underlying Announcement 2010-9 at the Tax Executives Institute’s 60th Midyear Conference.

Shulman identified three goals underlying what he described as the IRS’s new approach to fair tax administration for large taxpayers: (1) certainty regarding a taxpayer’s obligations; (2) consistent treatment across taxpayers; and (3) an efficient use of

Draft Schedule and Instructions for Reporting Uncertain Tax Positions Released, IRS Commissioner Shulman Discusses Policy Underlying the Reporting Proposal (cont'd)

government and taxpayer resources. To further these goals, Shulman indicated that “[w]e are moving away from what I would describe as a contentious relationship where we spend too much of our time identifying issues, to one where we know the issues from the outset and spend our time engaging on appropriate issues.”³⁴

Acknowledging that uncertain tax positions are “uncertain for a number of reasons, including ambiguity in the law and a lack of published guidance on issues,” Shulman said he will work with IRS Chief Counsel William Wilkins “to eliminate as much uncertainty as possible through published guidance that is grounded in business realities and practical administration of the law.”³⁵ In addition, because fact-intensive issues are also resource-intensive, the IRS will audit these issues more quickly and efficiently by, for example, working with industry groups on Industry Issue Resolution requests instead of auditing every return. Moreover, the IRS is working to clearly delineate responsibility in the issue management process of the

IRS’s Large & Mid-Size Business Division (“LMSB”), the “tiered issue process,” so that taxpayers can engage in more meaningful discussions about the merits of a particular issue.

Shulman also clarified that “the schedule of uncertain tax positions is not intended as a list of issues for which deficiencies will always be established.”³⁶ Instead, agents would be trained to use the schedule to choose the right issues and taxpayers to audit. He further indicated that, because a major goal of the proposal is to select taxpayers to audit and not just to obtain information to be used within an audit, Announcement 2010-9 proposes that the new schedule request the maximum amount of potential federal tax liability attributable to each uncertain tax position. Shulman reiterated, however, that the IRS requests comments on alternative approaches for ascertaining materiality, including the use of ranges.

Speaking at the same conference on April 13, 2010, Heather Maloy, commissioner of LMSB, described the reaction to Announcement 2010-9 as skeptical and remarked that “in many cases [she] can’t even describe it as healthy skepticism.” Citing the IRS’s pilot Compliance

Assurance Process as an example where greater transparency has benefited both business interests and the IRS, Maloy described the skepticism as “unfortunate” and as “something we really need to get past if we’re going to implement this proposal effectively.”³⁷

Dewey & LeBoeuf’s Tax Controversy and Litigation Practice has taken a leading role in putting together a substantial Coalition to discuss and comment on the IRS’s proposal. For further information on the Coalition, please contact Lawrence Hill, Chair of the Tax Controversy and Litigation Practice.

– M. Levine³⁸

34. News Release, Internal Revenue Service, Prepared Remarks of Commissioner of Internal Revenue Douglas H. Shulman before the Tax Executives Institute 60th Mid-Year Meeting (Apr. 12, 2010), available at <http://www.irs.gov/newsroom/article/0,,id=221280,00.html>.

35. *Id.*

37. Heather M. Rothman, “Maloy Says IRS Working to Allay Skepticism Over Proposal on Uncertain Tax Positions,” *BNA Daily Tax Report*, Apr. 14, 2010.

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

United States and Switzerland Sign Protocol to Apply UBS Pact Provisionally, Swiss Parliament's Upper House Approves Revised Double Taxation Treaty with the United States

On March 31, 2010, the United States and Switzerland signed a protocol that will allow the Swiss Federal Tax Administration ("SFTA") to provisionally apply the August 2009 accord that the two countries entered into in connection with the deferred prosecution agreement between the U.S. Department of Justice and UBS.³⁹ Switzerland agreed in the August 2009 accord to transfer 4,450 sets of UBS account data to the United States, but the Swiss government still needs Swiss parliament approval in order to fulfill that promise because the existing 1996 Switzerland-United States double taxation treaty does not allow international assistance in cases of suspected tax evasion.⁴⁰ In separate decisions on January 21, 2010 and February 26, 2010, the Federal Administrative Court of Switzerland prevented the

disclosure of UBS client data, finding that the mere failure to file an IRS Form W-9, "Request for Taxpayer Identification Number and Certification," would constitute tax evasion, not tax fraud.

The Swiss Federal Department of Justice and Police announced that the new protocol gives the SFTA "the necessary legal basis . . . to issue final decisions even in cases of continued and serious tax evasion, and permits Switzerland to fulfill the obligations under international law that it entered into with the original [August 2009 accord]."⁴¹ Nevertheless, the actual transfer of account data will not occur until the Swiss parliament ratifies the August 2009 accord.

The protocol provides that the August 2009 accord constitutes an international agreement and is not merely a competent authority interpretation. If the Swiss parliament approves the August 2009 accord during its June session, the protocol will help the Swiss government meet its August 31, 2010 deadline to transfer the data to the IRS.

In a related development, on March 17, 2010, the Council of States, the upper house of Switzerland's parliament, approved revised double taxation treaties with the United States, Denmark, France, Mexico, and the United Kingdom. The revised treaties are in accordance with Article 26 of the Organization for Economic Cooperation and Development Model Tax Convention. Under that provision, Switzerland will begin providing cross-border information assistance in cases of suspected tax evasion in addition to its prior practice of providing assistance in cases of suspected tax fraud. Switzerland has signed 18 such revised treaties in the past year.

The Council of States approved the revised treaty with the United States by a vote of thirty-six to one, with one abstention. All five of the revised treaties must still be approved by the National Council, Switzerland's lower house of parliament, which is expected to vote on them in June.⁴²

– M. Levine⁴³

39. Press Release, Swiss Federal Department of Justice and Police, Amending Protocol to Treaty Request Agreement UBS-USA Signed (Mar. 31, 2010), available at <http://www.ejpd.admin.ch/ejpd/en/home/dokumentation/mi/2010/2010-03-311.html>.

40. For previous coverage, see "Swiss Government to Seek Parliamentary Approval of UBS Pact, German State Receives Secret Account Data," *Focus on Tax Controversy and Litigation*, Mar. 2010, at 21; "Switzerland Reacts to Setback to Agreement with United States, Stolen Bank Data," *Focus on Tax Controversy and Litigation*, Feb. 2010, at 6; "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.

41. Press Release, Swiss Confederation Federal Department of Justice and Police, Amending Protocol to Treaty Request Agreement UBS-USA Signed (Mar. 31, 2010), available at <http://www.ejpd.admin.ch/ejpd/en/home/dokumentation/mi/2010/2010-03-311.html>.

42. See Daniel Pruzin, "Swiss Parliament Upper Chamber Approves Tax Treaties With U.S., Four Other Countries," *BNA Daily Tax Report*, Mar. 18, 2010.

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

Expedited Guidance on Total Return Swaps Expected

Following the enactment of the Hiring Incentives to Restore Employment Act (“HIRE Act”) on March 18, 2010, senior officials from the Treasury Department on April 12, 2010 indicated that the Treasury Department and IRS are working to publish expedited guidance addressing abusive total return swaps used to avoid US tax, including dividend withholding tax.⁴⁴ The provisions of the HIRE Act addressing total return swaps carry effective dates beginning as early as September 14, 2010.⁴⁵

Current law provides that payments to foreign persons on notional principal contracts, including total return equity swaps, referencing stock of US corporations are generally treated (absent a recast of the transaction) as

foreign-source income and, therefore, not subject to US withholding tax. The HIRE Act addresses abusive uses of total return equity swaps to avoid US tax by re-sourcing “dividend equivalent” payments on such instruments as US-source income, thus subjecting such dividend equivalent payments to US withholding tax. The HIRE Act definition of “dividend equivalent” payments subject to re-sourcing includes, but is not limited to, any payment under a specified notional principal contract that references, or is contingent on, dividends paid from US sources. The HIRE Act provides, however, that the Secretary of the Treasury has the discretion to exclude from the re-sourcing rules certain types of contracts that do not have the potential for tax avoidance.

– G. Green

44. See Alison Bennett, “Government Expediting Guidance on Total Return Swaps, Official Says,” *BNA Daily Tax Report*, Apr. 13, 2010.

45. For additional coverage of this topic, see Client Alert, Dewey & LeBoeuf LLP, “HIRE Act Introduces Significant US Tax Law Changes,” Mar. 22, 2010, available at http://www.deweyleboeuf.com/en/Ideas/ClientAlerts/2010/03/20100322_HIREAct.aspx.

Treasury Confirms that Proposed Revised OECD Transfer Pricing Guidelines Move Away from Strict Hierarchy of Methods

David Ernick, Treasury Department associate international counsel, confirmed at the March 31, 2010 BNA Tax Management International Tax Luncheon that the new transfer pricing guidelines proposed by a working group at the Organization for Economic Cooperation and Development (“OECD”) in September 2009 would replace the traditional hierarchy of transfer pricing methods with a new focus on choosing the best method for a given taxpayer depending on that taxpayer’s circumstances and the availability of comparable data. Ernick was quoted by *Tax Notes Today* as saying that “[t]his is one area where it seems that the US is out front leading and the OECD guidance sort of converged later to get there.”⁴⁶

Section 482 requires that taxpayers allocate income and expenses between controlled entities based on the principle of arm’s-length pricing. Therefore, multinational taxpayers must allocate income and expenses between different countries for purposes of calculating how much tax is due in each country. Transfer pricing regulations under section 482 generally provide the mechanisms that US taxpayers must use for US purposes. Globally, tax administrators

have generally sought to harmonize transfer pricing rules across jurisdictions to avoid the under- or over-counting of taxable income in different jurisdictions. In 1995, the OECD published comprehensive transfer pricing guidelines to promote common transfer pricing methods across jurisdictions and improve tax administration.

Traditionally, the preferred method was the comparable uncontrolled price method which looked to analogous transactions between unrelated entities to determine how income and expenses would be allocated. Profit-based measurements, where the overall profit of a transaction was calculated and then divided up among the different entities based on one or more allocation methods, were disfavored and meant as a method of last resort.

In September 2009, the OECD issued draft revised guidelines opening up the traditional hierarchy of transfer pricing methods and proposing that taxpayers should use whichever method provided the most reliable measurement.⁴⁷ The revised guidelines recognized that reasonably comparable uncontrolled transac-

tions are very often not available for increasingly complex multinational transactions. While comparables may be available for commodities, simple products, or certain services, they are often impossible to find for intangibles. The OECD guidelines emphasized that the profit split should be maintained over the lifetime of any arrangement, even in loss years, and that the allocation method must be consistent and reliable. Allocation methods are usually based on assets or costs, but can include items such as head count, retail floor area, or even marketing expenditure between the different jurisdictions. Ernick confirmed, however, that when a comparable was readily available it would still be preferred over a profit-based method even under the revised OECD guidelines.

Ernick reported that the Treasury Department was very comfortable with the standards contained in the draft OECD guidelines. There remains no confirmed date for finalizing the new proposed OECD guidelines.

– E. Miller

46. David D. Stewart, “OECD Transfer Pricing Guidelines Converging with U.S. Rules, Treasury Official Says,” *Tax Notes Today*, Apr. 1, 2010.

47. Organization for Economic Cooperation and Development, Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines (Sept. 9, 2009), available at <http://www.oecd.org/dataoecd/1/57/43655703.pdf>.

IRS Provides Agents with Guidance on Auditing Distressed Asset Trust Tax Shelters

On March 23, 2010, the IRS released a coordinated issue paper providing agents with a road map to follow when auditing distressed asset trust (“DAT”) tax shelters.⁴⁸ The IRS defines DAT tax shelters as transactions that involve the use of trusts to shift built-in losses from a tax-indifferent party to a US taxpayer that has not actually incurred any economic loss.

In a DAT transaction, a tax-indifferent party (or related entity) transfers assets having little or no fair market value and a purported high tax basis (“distressed assets”) to a trust (the “main-trust”). The transfer is treated as a nontaxable contribution to a trust, and the main-trust claims a high carryover basis in the assets under section 1015(b) equal to that of the contributing party. A US taxpayer then invests by transferring cash or a note equal to the fair market value of the distressed assets, plus fees, to the main-trust in exchange for an interest in the trust. Following the investment, the trustee of the main-trust creates a sub-trust to which it allocates the distressed assets, and the US taxpayer is given powers

sufficient to be deemed the owner of the sub-trust.

If the distressed asset is a debt instrument, the sub-trust claims a bad business debt deduction under section 166 in an amount nearly equal to the purported high basis. If the distressed asset is not debt, the sub-trust sells the asset to a third party for its fair market value, incurring a loss deductible under section 165. In either scenario, the US taxpayer reports a loss greatly in excess of its cash investment and economic stake in the trust.

The coordinated issue paper instructs auditors that the built-in losses claimed by the US taxpayer upon disposition of distressed assets should be disallowed under judicial doctrines such as the economic substance, step transaction, and substance over form doctrines. The guidance further directs auditors to assess accuracy-related penalties against US taxpayers under sections 6662 and 6662A unless the taxpayer can establish reasonable cause and good faith.

The coordinated issue paper also offers guidance on a variety of other issues, including the need for adequate documentation to

substantiate the contributing party’s adjusted basis in distressed assets, a limitation on the application of the section 1015(b) carryover basis rule when worthless debt is contributed to a trust, and the characterization of trusts and sub-trusts as business entities.

– A. Ferris

48. IRS Coordinated Issue Paper, “Distressed Asset Trust (DAT) Tax Shelters” (Mar. 23, 2010), available at <http://www.irs.gov/businesses/article/0,,id=220505,00.html>.

District Court Holds Severance Payments Exempt from FICA Tax

On February 23, 2010, the U.S. District Court for the Western District of Michigan held that severance payments paid by Quality Stores, Inc. to its former employees were not “wages” subject to tax under the Federal Insurance Contributions Act (“FICA”).⁴⁹ In reaching its conclusion, the district court chose not to follow judicial precedent and IRS guidance under which the severance payments would have been characterized as FICA wages.⁵⁰

As part of its severance program, Quality Stores made payments to its terminated employees that were not connected to the employees’ receipt of state unemployment compensation. The severance payments were included in the employees’ gross income and were reported as wages on the employees’ Forms W-2, “Wage and Tax Statement.” The company withheld federal income tax and each employee’s share of FICA tax from the severance payments and paid its share of the FICA tax. Quality Stores then filed suit for a refund of approximately \$1 million dollars⁵¹ of allegedly overpaid FICA taxes.

Quality Stores’ entitlement to a refund hinged on whether the severance payments were taxable wages for purposes of FICA. FICA defines “wages” as “all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash.”⁵² None of the statutory exceptions to FICA’s broad definition of wages were at issue in *Quality Stores*.

In Revenue Ruling 90-72, the IRS ruled that supplemental unemployment compensation benefit payments (“SUB payments”) would be excluded from the definition of wages for FICA purposes if, *inter alia*, they were linked to the receipt of state unemployment compensation. If, however, such a link did not exist, the SUB payments would be subject to FICA tax.

Based on its interpretation of section 3402(o), however, the district court declined to follow Revenue Ruling 90-72 and instead held that the SUB payments at issue were not subject to FICA tax even though they were not linked to the receipt of state unemployment compensation. Section 3402(o) provides that any SUB payment to an individual

“shall be treated as if it were a payment of wages by an employer to an employee for a payroll period” for federal income tax withholding purposes.⁵³ Relying primarily on *Rowan Cos. Inc. v. United States*,⁵⁴ the *Quality Stores* court determined that section 3402(o) also controlled the determination of whether the severance payments at issue were taxable for purposes of FICA. The court then concluded that section 3402(o) necessarily implies that supplemental unemployment compensation benefits are not in fact wages and, accordingly, the severance payments were not subject to FICA tax. In interpreting section 3402(o) in this manner, the *Quality Stores* court rejected the interpretation of section 3402(o) as set forth by the U.S. Court of Appeals for the Federal Circuit in *CSX Corp.*

– W. Kellogg

49. *Quality Stores Inc. v. United States*, No. 1:09-cv-44 (W.D. Mich. Feb. 23, 2010).

50. See *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008); Rev. Rul. 90-72, 1990-2 C.B. 211.

51. This amount includes the employer’s share of FICA taxes paid by Quality Stores and the employee’s share of FICA taxes for those

employees who allowed Quality Stores to make a refund request on their behalf.

52. I.R.C. § 3121(a).

53. The district court concluded that the severance payments at issue fell within the scope of the definition of “supplemental unemployment compensation benefits” in section 3402(o).

54. 452 U.S. 247 (1981). In *Rowan*, the U.S. Supreme Court concluded that the definition of wages should be interpreted in the same manner for FICA and federal income tax withholding purposes.

Federal Circuit Finds IRS's Failure to Issue Notices of Deficiency Was Harmless Error

On March 31, 2010, the United States Court of Appeals for the Federal Circuit ruled that the IRS's failure to issue notices of deficiency constituted harmless error and affirmed the United States Court of Federal Claims decision denying the taxpayers a refund.⁵⁵

The two cases before the court had been selected for briefing and representative resolution from 30 lawsuits brought by partners in various partnerships marketed by the Greenberg Brothers Partnership.⁵⁶ In both cases, the IRS issued Notices of Final Partnership Administrative Adjustment disallowing deductions reported on partnership returns.⁵⁷ While the partnership-level suits were pending in the Tax Court, the taxpayers and the IRS executed separate closing agreements on IRS Form 906, "Closing Agreement on Final Determination Covering Specific Matters," that resolved various partnership-level and individual partner-level issues.⁵⁸ The IRS made deficiency assessments against the taxpayers pursuant to the closing agreements,

and the taxpayers paid the assessed taxes.⁵⁹ The IRS did not issue any notices of deficiency prior to making the assessments and did not initiate any collection proceedings.⁶⁰ The taxpayers filed refund claims with the IRS for the assessed tax plus interest and, after the IRS denied the claims, the taxpayers filed suit in the Court of Federal Claims.⁶¹

The taxpayers argued that the failure of the IRS to issue notices of deficiency rendered the tax assessments against them invalid and therefore entitled them to a refund. The government contended that the IRS was not required to issue notices of deficiency because the assessments were "computational adjustments" and exempt from deficiency procedures under section 6230(a)(1). In each case, the Court of Federal Claims granted the government's motion for summary judgment, holding that the notices of deficiency had not been required.⁶²

On appeal, the Federal Circuit concluded, contrary to the Court of Federal Claims, that the IRS was required to issue notices of deficiency because the assessments were not "computational adjustments" under section 6231(a)(6).⁶³ In interpreting the statute, the court found that a computational adjustment only exists if the partner's individual liability changes to reflect treatment of a partnership item. The court found that there were no such changes by virtue of the closing agreements.⁶⁴

The court then turned to the issue of whether the IRS's failure to issue notices of deficiency constituted prejudicial error. The taxpayers argued that the failure constituted prejudicial error because it deprived them of an opportunity to litigate in the United States Tax Court.⁶⁵ The court disagreed, noting that the purpose of the deficiency provision is to prevent the IRS from initiating collection proceedings without giving the taxpayer the opportunity to contest the assessment in Tax Court.⁶⁶ While a failure to do so would undoubtedly entitle the taxpayer to injunctive

55. *Bush v. United States*, Nos. 2009-5008, 2009-5009, slip op. (Fed. Cir. Mar. 31, 2010) (consolidated).

56. *Id.* at 6.

57. *Id.* at 6, 10.

58. *Id.* at 6-7, 10.

59. *Id.* at 8-9, 10.

60. *Id.* at 8.

61. *Id.* at 9, 10.

62. See *Bush v. United States*, 78 Fed. Cl. 76, 86 (2007); *Shelton v. United States*, Nos. 02-1042T, 04-159T, slip op. at 6 (Fed. Cl. Aug. 17, 2007) (consolidated).

63. See *Bush*, Nos. 2009-5008, 2009-5009, slip op. at 11, 16.

64. *Id.* at 11-16.

65. *Id.* at 17.

66. *Id.*

relief to stay collection procedures, this was not the situation in the instant cases.⁶⁷ In these cases, on the contrary, there was no demand for payment by the IRS, and the taxpayers did not seek to prevent payment or to obtain a refund of funds improperly collected.⁶⁸ Rather, the taxpayers paid the assessed tax and sued for a refund solely on the basis that the IRS had failed to issue notices of deficiency.⁶⁹ The court found that there was no existing right to an automatic refund in such situations.⁷⁰

In discussing the application of the harmless error rule of 28 U.S.C. § 2111, the court found that the taxpayers had failed to meet their burden of showing that their “substantial rights” were affected as a result of being denied access to the Tax Court.⁷¹ The taxpayers did not argue that there were issues they could have litigated in the Tax Court that were sacrificed as a result of the refund suit. The taxpayers also did not make any showing that litigating in the Tax Court as opposed to the

Court of Federal Claims would have resulted in a different outcome.⁷²

The court further explained that “it is essential to make clear the limited nature of our holding. The IRS continues to have an obligation to issue a notice of deficiency where the statutes provide for such notice, and the taxpayer has tools at his disposal to resist illegal collection or to seek a refund . . . if amounts are improperly collected. What the taxpayer may not do is forgo his right to resist collection, voluntarily pay the tax, and then secure a refund of tax admittedly owed without showing prejudice.”⁷³

Judge Sharon Prost wrote separately and criticized the majority for creating a “new harmless error ‘exception’ *never raised or advocated by anyone.*”⁷⁴ Judge Prost said that while she agreed with the ultimate result of the majority, she would have affirmed the Court of Federal Claims on the basis that these were “computational adjustments” under the statute and not on the basis of the harmless error “exception.”⁷⁵ She

stated that the harmless error exception announced by the court was “broad and sweeping”⁷⁶ because it would apply whenever the IRS fails to give a taxpayer notice that taxes are owed.⁷⁷ According to Judge Prost, the effect of the opinion would be to deny the statutorily-guaranteed right of taxpayers to receive notices of deficiency, a rule in conflict with that of every other circuit court to have considered the issue.⁷⁸

– A. Ferris

67. *Id.* at 17-18.
68. *Id.* at 19.
69. *Id.*
70. *Id.*
71. *Id.* at 21.

72. *Id.* at 21-22.
73. *Id.* at 23-24.
74. See *Bush*, Nos. 2009-5008, 2009-5009, concurring op. at 2 (Prost, J., concurring) (emphasis in original).
75. *Id.*

76. *Id.* at 3.
77. *Id.* at 4.
78. *Id.* at 3, 4-5.



NYU LL.M. in Taxation Graduation

In January 2010, Rachel Partain, an associate in the Tax Controversy and Litigation Group, graduated from New York University School of Law with an LL.M. in Taxation. Congratulations, Rachel!

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 fourth and fifth conferences will be held in Dallas on May 3 and 4, and in Washington, DC on June 7 and 8.

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*.

The ABA Section of Taxation will host its 2010 May Meeting on May 6-8 at the Grand Hyatt in Washington, DC. On Saturday, May 8, Gordon E. Warnke will participate in a panel titled “Form or Recharacterization? – An Evolving Landscape.” On Friday, May 7, Rachel Partain will speak on current developments in court procedure and practice.

On Tuesday, May 18, 2010, Lawrence Hill will participate in a panel at the Reinsurance Association Tax Conference in Philadelphia. The panel will discuss the impact of Announcement 2010-9 on companies, including property-casualty reinsurers.

On May 25, 2010, from 11am to noon, Larry Hill and Seth Farber will speak at a Tax Director’s Roundtable Webinar on the topic “Partnering with the Board for Proper Tax Risk Oversight.”

The BNA/SFI Third Annual Conference on Taxation of European & U.S. Cross-border Financial Products will take place on June 17 and 18, 2010, in London. The conference will focus on understanding the tax, legal, legislative, and regulatory

issues in utilizing financial products by financial institutions and corporations in Europe and cross-border with the United States. Lawrence Hill will speak on Thursday, June 17 on the topic of “Regulatory Developments Regarding Tax Advantaged Financial Products.”

On Friday, June 18, 2010, NYU will hold its Second Annual Tax Controversy Forum at the Westin New York. Mark Allison will participate in a panel discussion titled “Straight from the Bench: How to Prepare Your Case for Tax Court.”

The Institute of International Bankers’ annual seminar on US taxation of international banks will be held on Monday, June 21 and Tuesday, June 22 in the Proshansky Auditorium at the City University of New York Graduate Center. Lawrence Hill will participate in a panel discussion on “FIN 48: The IRS Version,” scheduled from 4:15 p.m. to 5:15 p.m. on Monday, June 21.

Dewey & LeBoeuf's Tax Controversy Practice



Dewey & LeBoeuf's Tax Controversy and Litigation 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"), the New York State Bar Association Tax Section ("NYSBA Tax Section"), the Wall Street Tax Association, and the Institute of International Bankers. 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 attorneys 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.

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Members of Dewey & LeBoeuf's Tax Controversy and Litigation Practice

Lawrence M. Hill, Chair
+1 212 259 8330
lhill@dl.com

Jonathan W. Miller
+1 212 259 7040
jmiller@dl.com

Jovanna V. Bello
+1 202 346 7938
jbello@dl.com

William E. Kellogg
+1 212 259 7341
wkellogg@dl.com

Kenneth W. Parsons
+1 202 346 8019
kparsons@dl.com

George R. Abramowitz
+1 202 346 8090
gabramow@dl.com

Abraham N.M. Shashy
+1 202 346 7900
ashashy@dl.com

Molly M. Donovan
+1 212 259 7394
mdonovan@dl.com

Aaron C. Lang
+1 212 259 6759
alang@dl.com

Rachel L. Partain
+1 212 259 6358
rpartain@dl.com

Mark D. Allison
+1 212 259 6866
mallison@dl.com

Tamara Ashford
+1 202 346 8017
tashford@dl.com

Greg W. Featherman
+1 202 346 7910
gfeatherman@dl.com

Max J. Levine
+1 212 259 6437
malevine@dl.com

Christina M. Petrella
+1 212 259 7119
cpetrella@dl.com

Suzanne Jaffe Bloom
+1 212 259 7362
sbloom@dl.com

Richard A. Nessler
+1 212 259 8356
rnessler@dl.com

Anya J. Ferris
+1 212 259 6782
aferris@dl.com

Artyom Linnik
+1 202 346 7879
alinnik@dl.com

Dawn M. Rhea
+1 213 621 6474
drhea@dl.com

John F. Collins
+1 212 259 7080
jcollins@dl.com

Benjamin Sokoly
+1 212 259 6926
bsokoly@dl.com

Graham Green
+1 202 346 7930
ggreen@dl.com

Adam Lounsbury
+1 212 259 7155
alounsbury@dl.com

Staci Yablon
+1 212 259 6363
syablon@dl.com

Seth C. Farber
+1 212 259 7227
sfarber@dl.com

Jeffrey J. Amato
+1 212 259 6379
jamato@dl.com

Brittany L. Harrison
+1 202 346 8754
bharrison@dl.com

Eric C. Miller
+1 212 259 8364
emiller@dl.com

Erin Ziaja
+1 312 794 8022
eziaja@dl.com

Felix B. Laughlin
+1 202 346 7840
fiaughlin@dl.com

Jonathan Amoona
+1 212 259 6684
jamoona@dl.com

Morgan W. Holtman
+1 202 346 7912
mholtman@dl.com

Alexandra Minkovich
+1 212 259 7823
aminkovich@dl.com

Zhanna A. Ziering
+1 212 259 6177
zziering@dl.com

Kelly Librera
+1 212 259 6451
klibrera@dl.com

Amy K. Anderson
+1 212 259 8079
akanderson@dl.com

Erica Howard-Potter
+1 212 259 6252
ehowardpotter@dl.com

Matthew C. Oxman
+1 212 259 6397
moxman@dl.com