SHEARMAN & STERLING LLP

Practice Group Newsletter

FOCUS ON TAX CONTROVERSY AND LITIGATION

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Editor's Note

Dear Readers,

On Tuesday, December 4, 2012, Shearman & Sterling will host its Year-End Tax Conference and Celebration at our offices in New York. The conference will include panels comprised of Shearman & Sterling partners and client speakers. Topic areas will include: tax controversy, the taxation of financial products, and international and transactional tax. Ethics credits will be included. We hope that you will be able to attend.

This month's issue features articles discussing IRS Notice 2012-39 announcing forthcoming section 367(d) regulations, the Second Circuit's recent ruling in *Union Carbide* denying the taxpayer research credits, and the Tax Court's holding in favor of PepsiCo's equity characterization of advance agreements.

If you have comments or suggestions for future publications, please contact Lawrence M. Hill at lawrence.hill@shearman.com. They are very much appreciated.

IN THIS ISSUE

IRS Announces Forthcoming Section 367(d) Regulations

On July 13, 2012, the IRS released Notice 2012-39,[1] announcing that new regulations under section 367(d)[2] would be issued to address certain transactions that the Notice said "repatriate earnings from foreign corporations without appropriate recognition of income" and "raise significant policy concerns." According to the Notice, the forthcoming regulations will follow the rules described in the Notice. These new rules can be read to apply, however, not just to transactions that repatriate offshore earnings, but rather to any transfer of an intangible asset by a U.S. corporation ("U.S. transferor") to a non-U.S. corporation ("transferee foreign corporation" or "TFC") to which section 361 applies ("outbound section 367(d) transfer"). The forthcoming regulations will largely replace the rules of section 1.367(d)-1T(c) through (e) and (g),[3] Income Tax Regs., with respect to transactions occurring on or after July 13, 2012. The Notice appears to reflect an inclination on the part of the Treasury to harmonize the rules applicable under section 367(d) with those being developed under section 367(a)(5), which were issued in proposed form in 2008.[4]

The Notice separates property into two categories: intangible property described in section 936(h)(3)(B) ("section 367(d) property") and all other property ("section 367(a) property"); no additional guidance is provided in the Notice regarding the Service's interpretation of section 936(h)(3)(B). Thus, the Notice, like Proposed Income Tax Regs. section 1.367(a)-7 before it,[5] indicates that in an outbound reorganization, all property, including goodwill, workforce-in-place, and going concern value, is subject to either section 367(a) or section 367(d).[6]

In general, the Notice provides that the U.S. transferor will take three amounts into income. Two amounts are taken into account with respect to U.S. corporate shareholders of the U.S. transferor that hold stock of the transferee foreign corporation immediately after the reorganization; these shareholders are called "qualified successors". These two amounts are determined by reference to the "section 367(d) percentage", which is the ratio of (x) the fair market value of section 367(d) property transferred, to (y) the fair market value of all property transferred by the U.S. transferor in the transaction. The third amount is taken into account by the U.S. transferor with respect to its shareholders that are not qualified successors ("non-qualified successors").

The first two amounts taken into income by the U.S. transferor are (1) the section 367(d) percentage multiplied by the amount of boot received by the qualified successors (other than boot not traceable to the transferee foreign corporation), and (2) the section 367(d) percentage multiplied by the product of (i) the amount of "non-qualifying liabilities" assumed by the transferee foreign corporation in the reorganization and (ii) the percentage (by value) of the U.S. transferor owned by qualified successors immediately before the reorganization. (The category of "non-qualifying" liabilities is broadly defined, and the amount of liabilities considered to be non-qualifying is increased by the

1 IRS Notice 2012-39, § 1, 2012-31 IRB 95 (July 13, 2012) (the "Notice").

2 All section references are to the Internal Revenue Code and all references to the regulations are to the Treasury regulations issued thereunder, unless otherwise noted.

3 It should be noted that the temporary § 367(d) regulations "do not address the tax consequences when the U.S. transferor goes out of existence pursuant to the transaction." T.D. 8770 (June 18, 1998) (clarifying the scope of § 367(d)). Treasury Decision 8770 stated that the IRS and the Treasury Department were "studying the manner in which the rules under § 367(d) should operate when the U.S. transferor goes out of existence contemporaneously with (or subsequent to) its outbound transfer of an intangible."

4 Proposed IncomeTax Regs. § 1.367(a)-7. *See* Alison Bennett, *Rules on Cross-Border Intangible Transfers Will Include Repatriation Notice, Officials Say*, BNA DAILY TAX REPORT, 183 DTR G-5 (Sept. 21, 2012) (quoting IRS official Ronald Dabrowski as saying "we believe that [the] same policy ought to apply to intangibles" as applies to asset transfers subject to § 367(a)(5)).

5 Proposed Income Tax Regs. § 1.367(a)-7(f)(9)-(10) (dividing all property between "§ 367(a) property" and "§ 367(d) property").

6 *See* Kristen A. Parillo, *ABA Meeting: Treasury, IRS Plan Guidance Addressing Soft Intangibles*, TAX NOTES TODAY, 2012 TNT 180-13 (Sept. 17, 2012) (quoting an IRS official, David Bailey, as recently stating, "we wanted to really reinforce the point" that soft intangibles are subject to either § 367(a) or § 367(d))

amount of any distributions by the U.S. transferor in the two years preceding the reorganization.)

The third amount is the percentage (by value) of the U.S. transferor owned by non-qualified successors immediately before the reorganization multiplied by the gain realized on the outbound section 367(d) asset transfers. Thus, the non-qualified successors' proportionate share of the section 367(d) property transferred offshore is treated somewhat like the portion an item of section 367(a) property attributed to a shareholder of a U.S. transferor that is not a "control group member" within the meaning of Proposed Income Tax Regs. section 1.367(a)-7.[7] One difference is that the income taken into account by the U.S. transferor under the Notice, including the portion with respect to non-qualified successors, is treated as ordinary income and as a royalty for purposes of applying the foreign tax credit provisions of section 904(d),[8] not as gain (as generally would be the case under Proposed Income Tax Regs. section 1.367(a)-7).

Although it states that any income taken into account must be commensurate with the income attributable the section 367(d) property transferred, the Notice neither limits the amount of income taken into account currently to the amount of income that is attributable to the section 367(d) property after the outbound transfer nor provides for any subsequent adjustments or clawback.[9]

If there are any qualified successors to the U.S. transferor, the Notice requires them to step into the shoes of the U.S. transferor in much the same way as the temporary section 367(d) regulations require related U.S. persons who acquire TFC stock to take the place of the U.S. transferor.[10] Each qualified successor will take annually into account its proportionate share of the contingent payments that the U.S. transferor would have been treated as receiving had the U.S. transferor remained in existence and retained the TFC stock received in the reorganization. However, the qualified successor's proportionate share of the contingent annual payments is excluded from the qualified successor's gross income to the extent of its proportionate share of income included by the U.S. transferor in the year of the reorganization as an advance of such payments.

Among other points not specifically addressed in the Notice, there is no indication as to whether the lump-sum sale election provided for by the temporary section 367(d) regulations[11] will be available when new regulations are issued. The Notice also does not provide guidance on how the consolidated group to which a U.S. transferor and a qualified successor belong would apply the consolidated return regulations to the income inclusions required by the Notice.

— L. Bambino
D. Kershaw

Circuit Court's Interpretation of Section 41 Denies Union Carbide Research Credits

On September 7, the U.S. Court of Appeals for the Second Circuit affirmed a decision of the U.S. Tax Court that denied Union Carbide Corporation's ("UCC's") claim to

7 *See* Proposed Income Tax Regs. § 1.367(a)-7(c)(2)(i) (the U.S. transferor recognizes gain equal to the product of the inside gain and the aggregate ownership interest (by value) in the U.S. transferor of all shareholders of the U.S. transferor at the time of the § 361 exchange that are not control group members).

8 § 367(d)(2)(C). The earnings and profits of a foreign corporation to which the intangible property was transferred are reduced by amounts required to be included in the income of the transferor of the intangible property. § 367(d)(2)(B).

9 *Compare* Kristen A. Parillo, *ABA Meeting: Treasury, IRS Plan Guidance Addressing Soft Intangibles*, TAX NOTES TODAY, 2012 TNT 180-13 (Sept. 17, 2012) (quoting an IRS official, David Bailey, as recently stating, "if a taxpayer were to claim an overpayment for an intangible, we wouldn't necessarily allow a downward adjustment unless it was something that would be permitted under the [commensurate with income] rules of the 482 regs.")

10 *See* Notice § 4.04; *see also* Income Tax Regs. § 1.367(d)-1T(e)(1)(iv) ("The rules of paragraphs (d) and (e) of this section shall be reapplied in the case of any later transfer of the stock of the transferee foreign corporation by a related U.S. person that received such stock in a transfer that was subject to the rules of this paragraph (e). For purposes of reapplying the rules of paragraphs (d) and (e), each such related U.S. person shall be treated as a U.S. transferor . . .").

11 Temporary Income Tax Regs. § 1.367(d)-1T(g)(2).

Section 41 research credits for supplies – ordinarily used regardless of any research performed – that were used in the manufacturing process of various projects.[12] UCC argued that it was entitled to research credits for the entire amount spent for the supplies, including those supplies used to manufacture the product, because the supplies included raw materials, without which the research projects could not have been performed. The Second Circuit denied the research credits despite the fact that the qualified research and experiments could not have occurred without the supplies claimed by UCC.

Background

The disputed research expenses relate to three UCC projects: (i) the UCAT-J project; (ii) the anticoking project, and (iii) the sodium borohydride project. The UCAT-J project involved the use of UCAT-J in the place of M-1 as a catalyst in the production of high-grade polyethylene products. UCC employed UCAT-J in 19 production runs but discontinued use of UCAT-J because of operational problems. The anticoking project involved the use of a compound developed by Amoco to coat crackling coils to combat the formation of coke during the process to produce ethylene. UCC applied the compound twice but discontinued the use of the Amoco compound after finding that the compound did not reduce the creation of coke. The sodium borohydride project involved the introduction of sodium borohydride ("SB") in the manufacture of crude butadiene to reduce the presence of acetaldehyde, an undesirable byproduct of production. After initial testing, UCC found that SB reduced undesirable acetaldehyde and used the treatment for several years until it was discontinued for unrelated reasons.

Following a bench trial, the Tax Court held that the costs for supplies used by UCC for the anticoking project and for the UCAT-J project were not creditable as an "amount paid or incurred for supplies used in the conduct of qualified research" under Section 41 because they were "[r]aw materials used to make finished goods that would have been purchased regardless of whether [UCC] was engaging in qualified research."[13] The Tax Court rejected UCC's argument that the costs of supplies incurred during the Amoco anticoking and UCAT-J projects were qualified research expenses because the projects could not have occurred without the input of the raw materials. The Tax Court also held that the sodium borohydride project did not satisfy section 41 because it did not fulfill the "process of experimentation test" because UCC failed to perform any post-testing analysis on the data collected.[14] UCC appealed the Tax Court's decision related to all three projects.

Law and Analysis

Section 41 provides a tax credit for a "qualified research expense." A qualified research expense is defined in section 41(b) as the sum of the "in-house research expenses," and "contract research expenses" paid or incurred by the taxpayer in carrying on any trade or business of the taxpayer. Section 41(b)(2) defines "in-house research expenses" to mean, in part, "any amount paid or incurred for supplies used in the conduct of qualified research."

The issue on appeal was whether UCC's supplies used in the undisputed qualified research qualified as an "in-house research expense" when such supplies would have been used in the course of UCC's manufacturing process regardless of any such research. Although the language of section 41(b)(2) unambiguously states that "any amount paid or incurred for supplies used in the conduct of qualified research" is a research expense, the Second Circuit rejected the taxpayer's plain reading of the words, finding ambiguity in the phrase "in the conduct of qualified research."[15] To understand the meaning of the phrase, the Second Circuit looked to the title of section 41,

12 *Union Carbide Corp. v. Commissioner*, Doc. No. 11-2552 (2nd Cir. Sept. 7, 2012), *aff'g* T.C. Memo 2009-50, 97 T.C.M. (CCH) 1207 (2009).

13 97 T.C.M. (CCH) 1207, 1273 (2009).

14 *Id.* at 1262.

15 Doc. No. 11-2552, slip op. at 6 - 7.

"Credit for increasing research activities," which the court found to be persuasive that supplies used in the ordinary process for manufacturing goods were not to be credited. Moreover, the court pointed to section 1.41-2(b)(2), Income Tax Regs., which excludes from the definition of qualified research expense, "indirect research costs." While the Treasury regulation is silent on the definition of "indirect research costs", the court accepted the IRS's litigation claim that "indirect research costs" are costs incurred regardless of any research activities. The Second Circuit deferred to the IRS's interpretation, concluding that it was "entirely consistent with the purpose of the research tax credit, which is to provide a credit for the cost that a taxpayer incurs in conducting qualified research that he would not otherwise incur."[16] The Second Circuit remarked that "[a]ffording a credit for the costs of supplies that the taxpayer would have incurred regardless of any qualified research . . . simply creates an unintended windfall."[17]

Despite the Second Circuit's view, there appears to be nothing missing or unclear about the language of section 41(b)(2)(ii)—a research expense includes "any amount paid or incurred for supplies used in the conduct of qualified research." The court's acceptance of the IRS's interpretation, ignoring the plain words of the statute, will require taxpayers to parse each expense and identify and exclude any indirect research cost, whatever that phrase may mean to the IRS in future litigation. Rather than clarity, the *Union Carbide* decision may produce widespread confusion and uncertainty for taxpayers—certainly not what Congress intended to help promote research.

— R. Nessler

16 *Id.* at 8.

17 *Id.* at 9.

Tax Court Holds Advance Agreements with Subsidiaries Were Equity, Not Debt, in *PepsiCo*

On September 20, the Tax Court held in favor of PepsiCo and its subsidiary PepsiCo Puerto Rico, Inc. (PRR) with respect to the issue of whether advance agreements issued by PepsiCo's Netherlands subsidiaries to certain PepsiCo domestic subsidiaries and PPR were more appropriately characterized as debt than as equity.[18] The court's facts-and-circumstances analysis acknowledged that substance controls the characterization of a transaction but "emphasize[d] that the form of a transaction often informs its substance." Accordingly, while the advance agreements had attributes of debt, the court held that PepsiCo properly had treated them as equity.

Background

According to the court's findings of fact, between 1998 and 2002, PRR was a wholly owned subsidiary of PepsiCo that elected the benefits of sections 936 and 30A. Another PepsiCo subsidiary owned stock in two subsidiaries, both of which were organized under the law of the Netherlands Antilles and treated as controlled foreign corporations. PepsiCo held notes (the "pre-1996 notes"), the interest payments on which were subject to de minimis taxation in the Netherlands Antilles and exempt from U.S. withholding tax under the U.S.-Netherlands tax treaty then in effect. Interest due on the notes was also deductible for U.S. income tax purposes under section 163. PepsiCo held interests in foreign entities that were treated as foreign partnerships and were located in foreign countries where PepsiCo was generating losses, which reduced the amount of interest includable by PepsiCo as subpart F income.

18 *PepsiCo Puerto Rico, Inc. v. Commissioner*, T.C. Memo. 2012-269 (Sept. 20, 2012).

PepsiCo Restructuring

The court found that in the mid-1990s, PepsiCo saw that it would need to make significant investments overseas to take advantage of business opportunities. At the same time, the U.S. and the Netherlands signed a protocol amending the U.S.-Netherlands tax treaty by terminating its extension to residents of the Netherlands Antilles. All interest payments on the pre-1996 notes would become subject to U.S. withholding tax in 1996 unless PepsiCo reorganized. With these two considerations in mind, PepsiCo restructured its international operations.

In reorganizing, PepsiCo transferred ownership of certain foreign partnerships from Netherlands Antilles holding companies to Netherlands holding companies, where the U.S.-Netherlands treaty was still in effect. The tax treaty would allow PepsiCo to take advantage of reduced withholding taxes on dividends and Dutch corporate income tax laws, which exempted profit distributions to Dutch holding companies from Dutch corporate income tax. PepsiCo's subsidiaries also transferred some of their interests in the foreign partnerships to two Irish corporations that transferred the interests to two Dutch private limited liability companies, PGI and PWI. PepsiCo then issued new notes in exchange for the pre-1996 notes. The new notes had a minimum 7.5-percent interest rate, initial 15-year maturities with the option to extend the maturity for an additional 25 years, and a provision providing that to the extent the borrower failed to pay accrued interest when required, the lender had the right to the immediate payment of unpaid principal and accrued interest or the immediate execution of a new five-year note for the full amount of the accrued or unpaid interest. The notes were then transferred to an indirect subsidiary, Kentucky Fried Chicken International Holdings ("KFCIH").

Next the notes were transferred to PGI and PWI in exchange for an advance agreement from each of the Dutch private limited liability companies. PepsiCo then engaged in a public spin-off of certain businesses, including the indirect subsidiary KFCIH, and the advance agreements were transferred to Beverages, Foods & Service Industries, Inc. ("BFSI"), another PepsiCo indirect subsidiary.

Subsequently in 1997 PGI issued an advance agreement to PRR in return for notes, originally issued in 1994, 1995, and 1996, with terms ranging from three to five years. In 1998, one note was paid in full, and the maturities of the remaining notes were extended.

The court found that PepsiCo intended to effect its reorganization in a fashion that would preserve the tax attributes of the Netherlands Antilles holding company structure before the protocol amending the U.S.-Netherlands treaty. The advance agreements would be classified as debt in the Netherlands and treated as equity in the U.S. PepsiCo and PRR anticipated that the structure would reduce the Dutch corporate income tax of PGI and PWI from accrued interest from the new notes by the amount of interest expense pursuant to the advance agreements. PepsiCo expected that payments to the U.S. entities would be treated as distributions on equity and planned to avoid subpart F income or dividend treatment on distributions because the foreign partnerships' losses would reduce the Dutch private limited liability companies' earnings and profits in the foreseeable future.

After extensive communications regarding draft advance agreements with PepsiCo, the Dutch Revenue Service provided a ruling that the advance agreements would be treated as debt for Dutch tax purposes. The final versions of the advance agreements provided for payments of principal after initial 40-year terms. The Dutch private limited liability companies had unrestricted options to renew the advance agreements for ten years and could delay principal payments for five years more. The advance agreements would become perpetual to the extent of any uncured defaults on loan receivables held by the Dutch private limited liability companies from related parties. A preferred return accrued on any unpaid principal amounts pursuant to the advance agreements and consisted of "base preferred return," which accrued unconditionally, and "premium preferred return," which accrued under specific circumstances. Any accrued preferred return that was not paid when due would be capitalized into "capitalized based preferred return" and "capitalized premium preferred return" amounts, the payments of which were limited by aggregate net cash flow restrictions. The obligations of the Dutch private limited liability to repay these amounts were subordinate to all other indebtedness.

Regular payments of principal and preferred returns occurred, and the Dutch limited liability companies received interest on the new notes at the same time during the years at issue.

The Parties' Positions

For U.S. tax purposes, PepsiCo treated the payments of preferred return on the advance agreements as nontaxable distributions on equity, all interest due on the new notes as deductible, interest payments on the notes to the Dutch limited liability companies as exempt from U.S. withholding taxes, and interest on the notes as subpart F income on PepsiCo's consolidated U.S. Federal income tax returns to the extent of E&P. PPR reported no subpart F income during the years at issue.

The IRS challenged the transactions, claiming that the substance of the transactions reflected a creditor-debtor arrangement, as made clear by PepsiCo's communications to secure the tax ruling from the Dutch Revenue Service. PepsiCo argued that the advance agreements were legitimate equity instruments.

The Court's Analysis

The court acknowledged the import of the substance-over-form doctrine but "believed it prudent to emphasize that the form of a transaction often informs its substance.... An analysis focused myopically on the 'substance of a transaction, but devoid of any consideration of the obligations engendered by the terms of the governing instruments, would typically result in deficient, or wholly flawed, determinations." Further, the court conceded the difficulty in distinguishing loans from capital investments. The court indicated that it would focus on whether "there was an intent to create a debt with a reasonable expectation of repayment and, if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship."

The court analysed the advance agreement's substance through the thirteen-factor debt-versus-equity test outlined in *Dixie Dairies Corp. v. Commissioner*: (1) names or labels given to the instruments; (2) presence or absence of a fixed maturity date; (3) source of payments; (4) right to enforce payments; (5) participation in management as a result of the advances; (6) status of the advances in relation to regular corporate creditors; (7) intent of the parties; (8) identity of interest between creditor and stockholder; (9) "thinness" of capital structure in relation to debt; (10) ability of the corporation to obtain credit from outside sources; (11) use to which advances were put; (12) failure of debtor to repay; and (13) risk involved in making advances.[19]

Despite a variety of factors indicative of a debtor relationship, the court held that the advance agreements were appropriately characterized as equity. The factors suggesting that the advance agreements were equity instruments included: the extended maturity dates of the advance agreements made repayment speculative; the holders of the advance agreements could not demand immediate repayment in the event of default; the advance agreements subordinated any obligation of the Dutch limited liability companies to pay unpaid principal or accrued, but unpaid, preferred return to all other indebtedness; the parties intended the instruments to be treated as equity for U.S. tax purposes; and no third-party lender would have loaned the funds under the terms provided by the advance agreements. Accordingly, the Tax Court agreed with the taxpayers and held that the advance agreements were more appropriately characterized as equity than debt.

— E. McGee

[19] 74 T.C. 476, 492 (1980).

Proposed Revisions to Circular 230 Written Advice Standards

On September 14, the Treasury Department proposed modifications of the regulations governing practice before the IRS, which are contained in Treasury Department Circular 230 ("Circular 230"). In particular, the proposed regulations would eliminate many of the complex rules governing "covered opinions" in Section 10.35 of Circular 230, while also expanding the requirements and applying a single standard for written advice under proposed Section 10.37 of Circular 230.

Practitioners have expressed a number of concerns with the existing "covered opinion" rules, which have been in place since 2004, and there is a general consensus that the existing rules are overbroad and difficult to apply (and thus do not necessarily produce higher quality tax advice). Many practitioners have stated that the existing rules impose ethical standards that are not easily understood, and some have suggested that the existing rules may even reduce, rather than enhance, tax compliance by increasing the likelihood that practitioners will provide oral advice (which is not governed by Section 10.35). In addition, the notice of proposed rulemaking expressed concern over the unrestrained use of disclaimers on nearly every practitioner communication regardless of whether the communication contains tax advice.

Current Section 10.35 provides detailed rules for tax opinions that constitute "covered opinions", which include written advice concerning (i) a listed transaction, (ii) a transaction with the principal purpose of tax avoidance or evasion, or (iii) a transaction with a significant purpose of tax avoidance or evasion (and if the advice is a "reliance opinion", a "marketed opinion", or if the advice fits within other specified categories of opinion). The notice of proposed rulemaking notes that many practitioners attempt to exempt advice from the "covered opinion" rules by making a prominent disclosure or disclaimer stating that the opinion cannot be relied upon for penalty protection. The existing rules are highly technical and detailed, and the notice of proposed rulemaking indicates that there is no direct evidence to suggest that the existing rules are particularly effective at preventing individuals from promoting frivolous transactions or transactions without a reasonable basis. The proposed regulations thus would eliminate the "covered opinion" rules and instead subject all written tax advice to streamlined standards under proposed Section 10.37. By eliminating the "covered opinion" rules in current Section 10.35, the proposed regulations would also eliminate the detailed provisions concerning disclosures in written opinions. Accordingly, the Treasury Department expects that the amendments, if adopted, will eliminate the use of a Circular 230 disclaimer in e-mails and other writings.

Proposed Section 10.37 requires, among other things, that a practitioner must (i) base written advice on reasonable factual and legal assumptions (including assumptions as to future events), (ii) reasonably consider all relevant facts that the practitioner knows (or should know), (iii) use reasonable efforts to identify and ascertain the facts relevant to written advice on each U.S. federal tax matter, (iv) not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable, and (v) not, in evaluating any U.S. federal tax matter, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit. Proposed Section 10.37 would also provide a more flexible standard in determining the extent of written advice based on the scope of the engagement and the type and specificity of advice sought by the client (whereas current Section 10.35 provides a more rigid standard).

— J. Tate

Iowa District Court Grants Taxpayer's Motion to Amend Judgment in ***Pritired 1***

The district court that rejected a taxpayer's foreign tax credit-based refund claim in *Pritired 1, LLC v. United*

States[20] granted the taxpayer's motion to amend judgment on September 12, 2012.

Background

In *Pritired 1*, the Principal Life Insurance Company claimed foreign tax credits in connection with its investment, through Pritired 1, LLC ("Pritired"), in a French special purpose entity that invested in portfolio debt securities. The French company was subject to entity-level tax in France but treated as a partnership for U.S. federal income tax purposes. Pritired, as a "partner" in the investment vehicle, claimed foreign tax credits for the foreign taxes imposed on the income generated by the debt securities. The foreign tax credits would have added significantly to the below-market return that Principal otherwise earned from its investment. The district court, however, denied the taxpayer's claim to foreign tax credits on two grounds. First, the court concluded that Pritired was not a partner in a French partnership but instead should be viewed as a creditor of the French company. Second, the court found that Pritired's investment in the partnership could be disregarded as lacking economic substance. Third, the court decided that the partnership could be disregarded under the partnership anti-abuse rule in section 1.701-2, Income Tax Regs.

Motion to Amend Judgment

In its motion to amend judgment, the taxpayer contended that the income of the French company should not be included in the income of the taxpayer because, under the court's 2011 decision, the taxpayer was not an equity holder in the French company. The taxpayer asserted that Pritired's distributive share of income from the French company, which had been reported as $24,480,335 in 2002 and $23,232,878 in 2003, should be eliminated, and Pritired should only be required to report as income the amount of cash that Pritired received from the French company. The cash amounted to only $1,262,583 in 2002 and $161,194 in 2003.

[20] 816 F. Supp.2d 693 (S.D. Iowa 2011).

The government contended that Pritired, as a creditor of the French investment vehicle, should be required to include interest in income at the nominal rate of return applicable to Pritired's shares in the company, which equalled LIBOR plus one percent. As noted in the district court's 2011 opinion, however, Pritired entered into an offsetting swap with the investment vehicle, under which Pritired agreed to pay the same rate of return back to the French company. As a result, Pritired did not, as an economic matter, receive the LIBOR-based return from its investment. Its primary return from the transaction was to come from its allocations of foreign tax credits. In granting the taxpayer's motion to amend judgment, the court recognized this, stating, "Pritired was not formed to get a yield on investment of Libor plus one percent interest. It did not receive that in cash. Its benefit to Principal came largely in the form of the foreign tax credits that have not been disallowed." Accordingly, the court said, Pritired should be taxed on the amount of cash that it received from the investment vehicle but nothing more.

— *N. Tasso*

IRS Whistleblower Offices Pays $104 Million Award

In September 2012, the IRS issued its largest ever whistleblower award—$104 million—to former banker Bradley C. Birkenfeld.[21] The award was issued pursuant to section 7623, which authorizes payments to individuals who provide information to assist the IRS in detecting underpayments.

Section 7623 was overhauled in 2006 when Congress created a new framework for review of whistleblower submissions and established the Whistleblower Office

[21] Jeremiah Coder, "IRS Pays Birkenfeld $104 Million Whistleblower Award", *Tax Notes Today* (Sept. 12, 2012).

within the IRS.[22] Today, the Whistleblower Office analyzes claims and makes award determinations, which generally range from 15 percent to 30 percent of collected proceeds. Prior to 2006, awards were discretionary and ranged between 1 percent and 15 percent of collected proceeds. Under section 7623(b)(3), the IRS may reduce awards if it determines that the claimant "planned and initiated the actions that led to the underpayment of tax." Claimants can appeal a denial of award or the amount of the award in Tax Court.[23] In 2011, the IRS paid out 97 claims under the whistleblower program—the first paid out under the amended regime.

Birkenfeld received $104 million for providing information related to offshore banking accounts that ultimately assisted the IRS in collecting more than $5 billion from banks and individuals. According to the IRS's award report, Birkenfeld provided information on taxpayer behavior that the IRS had previously been unable to detect and led to unprecedented actions by the IRS. The information provided by Birkenfeld allowed the IRS to initiate a collection action against the target of the claim, led to the discovery of the names of thousands of U.S. taxpayers holding offshore accounts, and resulted in collections from almost 15,000 individuals who came forward under the IRS's voluntary disclosure program.

Prior to this award, the whistleblower program had been criticized as being unfriendly to claimants and having a long review process. Senator Charles Grassley (R-IA), the primary author of the 2006 amendments to section 7623, viewed the award to Mr. Birkenfeld as evidence of the value of the whistleblower program, but he cautioned that "if the IRS is serious about encouraging future whistleblowers, it needs to continue to honor the spirit and intent of the law and issue awards in a timely manner."[24] Dean Zerbe, one of Birkenfeld's attorneys, acknowledged that "the path to getting this announcement was long and frustrating, it is a groundbreaking case for all future whistleblowers," and hailed Birkenfeld as the "most important tax whistleblower in history."[25]

— M. Henkel

22 Internal Revenue Service, Fiscal Year 2011 Report to the Congress on the Use of § 7623, *available at* http://www.irs.gov/pub/irs-utl/fy2011_annual_report.pdf.

23 § 7623(b)(4).

24 Jeremiah Coder, "IRS Pays Birkenfeld $104 Million Whistleblower Award", *Tax Notes Today* (Sept. 12, 2012).

25 *Id.*

Shearman & Sterling's Tax Controversy Practice

Shearman & Sterling's Tax Controversy and Litigation practice is centered on large-case tax controversy examinations, tax litigation matters, and government investigations. Our prominent team of nationally recognized trial lawyers represents taxpayers at the audit and appeals stages before the Internal Revenue Service and litigates on behalf of taxpayers in the federal courts, from the U.S. Tax Court to the Supreme Court of the United States.

Shearman & Sterling's tax lawyers also represent clients in obtaining rulings from tax authorities and in competent authority proceedings and work with clients to obtain advance pricing agreements.

In addition, our tax 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 Institute, and the Institute of International Bankers. Peter Blessing recently served as chair of the NYSBA Tax Section. Lawrence M. Hill recently ended his term as Chair of the ABA Tax Section's Court Practice and Procedure Committee and was recently elected as a Fellow of the American College of Tax Counsel. The American College of Tax Counsel is a nonprofit professional association of tax lawyers in private practice, law school teaching positions, and government, who are recognized for their excellence in tax practice and for their substantial contributions and commitment to the profession. 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 newsletter is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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