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FOCUS ON TAX CONTROVERSY AND LITIGATION

Tax Court Holds STARS Transaction Lacked Economic Substance

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In this issue:

This month's newsletter also features articles about the petitions for review to the Supreme Court in historic rehabilitation tax credit case *Historic Boardwalk* and R&D tax credit case *Union Carbide*, as well as the District Court decision in *Loving* that enjoins the IRS from enforcing the registered tax return preparer regulations.

Tax Court Disregards STARS Transaction as Lacking Economic Substance

On February 11, 2013, the Tax Court held that a structured trust advantaged repackaged securities ("STARS") transaction entered into by Bank of New York Mellon ("BNY") lacked economic substance.[1] Consequently, the court held BNY was not entitled to claim foreign tax credits or deductions for expenses related to the transaction, and income from the transaction was treated as US-source income.

The STARS transaction was structured to provide BNY with below market cost financing. The complex transaction structure involved BNY transferring income-producing property into a trust subject to UK tax. As part of the transaction, BNY entered into forward sale agreements, a zero coupon swap agreement, a credit default swap, and security arrangements with a British bank. The net effect of these arrangements was to create a $1.5 billion secured loan from the British bank to BNY.

As a result of the STARS transaction, in 2001 and 2002 BNY claimed foreign tax credits of approximately $199 million and expense deductions of approximately $7.6 million. BNY also reported the income from the assets transferred to the trust as foreign source.

[1] *Bank of New York Mellon Corp. v. Commissioner*, 140 T.C. No. 2 (Feb. 11, 2013).

Economic Substance of the Structure

"The Tax Court evaluated the STARS transaction structure under the two-prong economic substance doctrine. . ."

The Tax Court evaluated the STARS transaction structure under the two-prong economic substance doctrine to determine if: (1) the transaction had economic substance beyond tax benefits (the objective prong), and (2) whether the taxpayer had a non-tax business purpose for the transaction (the subjective prong). The Tax Court determined that the relevant portion of the transaction to be tested for economic substance was the STARS structure (rather than the loan) because the structure produced the disputed foreign tax credits.[2]

Under the objective prong, the Tax Court held that the STARS structure lacked economic substance because BNY did not have a reasonable expectation of making a non-tax profit by using the STARS structure. The court explained that the STARS structure did not increase the profitability of BNY's income-producing assets and the structure's main activity was circulating income. The Tax Court refused to take into account the profit from the STARS assets when evaluating the transaction, stating that "[e]conomic benefits that would result independent of a transaction do not constitute a non-tax benefit for purposes of testing its economic substance."[3]

When evaluating the structure under the objective prong, the Tax Court followed its holding in *Compaq Computer Corp. v. Commissioner*[4] that foreign taxes are treated the same as any other transaction cost when determining whether the transaction makes economic sense. Although the Tax Court noted that "the Courts of Appeals for the Fifth and Eighth Circuits have … held that foreign taxes should not be taken into account in evaluating pre-tax effects for purposes of the economic substance analysis,"[5] the Tax Court determined that it was not bound by the precedent in the Fifth and Eighth Circuits because the case would be appealable to the Second Circuit and neither the Supreme Court nor the Second Circuit has decided the issue.

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Furthermore, the Tax Court held that the STARS transaction lacked subjective economic substance because, although BNY asserted that it entered into the transaction to achieve low cost financing, the court found the financing was overpriced and required substantial transaction costs when compared to similar financing in the marketplace. The court explained that the British bank could have made the same loan to BNY with simply a loan agreement and a security agreement and, thus, without the

[2] Given that the overall effect of the STARS transaction was a borrowing arrangement between BNY and the British bank and the purported motivation for the transaction was low-cost financing, we note that it appears odd that the court determined the relevant part of the transaction for the purposes of the economic substance analysis was only the STARS structure. Rather, it would seem that the loan would also be relevant when analyzing the economic substance of the borrowing arrangement.

[3] *Id*. at 35.

[4] 113 T.C. 217(1999).

[5] *Bank of New York Mellon Corp.*, 140 T.C. No. 2 at 32 n.9.

additional transaction costs of the STARS structure. Significantly, the Tax Court disregarded the spread in the interest rate formula when evaluating whether the financing was low cost because the spread was attributable to the US and UK tax effect and the STARS arrangement would have been terminated if the tax effects were foreclosed.

Economic Substance of the Integrated Transaction

The Tax Court also analyzed whether the integrated STARS arrangement (*i.e.*, the structure and the loan) had economic substance, but still concluded the arrangement failed under both the objective and subjective prongs.

With respect to the objective prong, the Tax Court rejected the conclusion of BNY's expert that the STARS transaction could have expected a $1.6 billion profit before taking into account US and UK tax. According to the Tax Court, this expert analysis was flawed because it included the pre-existing cashflows from the STARS assets that were not attributable to the STARS transaction and were, therefore, irrelevant. The court also rejected the expert's inclusion of expected returns from asset-backed securities that BNY may have used the loan proceeds to acquire because income from investing the loan proceeds would not be a cash flow from the STARS transaction.

When evaluating the subjective economic substance of the integrated transaction, the Tax Court concluded BNY's contention that it expected a pre-tax profit from investing the loan proceeds was without merit because, as the court previously held, income from investing the loan proceeds would not be directly attributable to the STARS transaction.

"The Tax Court rejected BNY's argument that Congress intended for the foreign tax credit to apply to transactions such as the STARS arrangement."

Congressional Intent

The Tax Court rejected BNY's argument that Congress intended for the foreign tax credit to apply to transactions such as the STARS arrangement. The court explained that Congress enacted the foreign tax credit to alleviate double taxation and neutralize the effect of US tax on decisions involving where to conduct business activities. The court then concluded that Congress did not intend to provide foreign tax credits for transactions like STARS because STARS "was a complicated scheme centered around arbitraging domestic and foreign tax law inconsistencies" and the UK taxes involved were not a result of substantive foreign activity.[6]

Because the STARS transaction lacked economic substance, the Tax Court held that BNY could not claim foreign tax credits for the UK taxes incurred with respect to the transaction and the expenses associated with the transaction were not deductible. The court also concluded that, because the transaction was disregarded for US tax purposes, BNY should be treated as owning the STARS assets and the income from

[6] *Id*. at 52.

the STARS transaction should be treated as derived within the US. As a result, the court rejected BNY's argument that the US-UK tax treaty, which contains a resourcing provision, applied.

Next Phase: The Second Circuit?

If this case is appealed by BNY, it will be interesting to see whether the Second Circuit follows the holdings of the Fifth and Eighth Circuits that foreign taxes should not be taken into account when determining if a transaction has economic substance. If the Second Circuit were to decide to follow the Fifth and Eighth Circuits on this issue, it could find the STARS transaction has economic substance as the transaction could have had a pre-tax economic profit when foreign taxes are excluded.

In addition, the Second Circuit could view the interest rate spread on the loan differently than the Tax Court. If the Second Circuit were to hold that, even though the spread was determined by reference to UK taxes, it is still a component of the stated interest rate on the loan and, as such, cannot be disregarded, then the STARS transaction could be found to have economic substance.

—*Mary Jo Lang*

Tax Matters Partner Seeks Review of Third Circuit's *Historic Boardwalk* Decision

The New Jersey Sports and Exposition Authority ("NJSEA"), as tax matters partner for Historic Boardwalk Hall, LLC, has petitioned the Supreme Court to review the decision of the Third Circuit in *Historic Boardwalk Hall, LLC v. Commissioner*. The Third Circuit's opinion reversed the Tax Court's decision in favor of a partnership that had earned historic rehabilitation tax credits ("HRTCs") under section 47.[7] Section 47 provides that a taxpayer owning a property interest is eligible for a tax credit equal to 20 percent of the qualified rehabilitation expenditures with respect to any certified historic structure.

"According to NJSEA's petition, NJSEA and a limited liability company owned by Pitney Bowes formed a *bona fide* partnership, Historic Boardwalk Hall, LLC, to renovate a certified historic building located in Atlantic City."

Background

According to NJSEA's petition, NJSEA and a limited liability company owned by Pitney Bowes ("PBHR") formed a *bona fide* partnership, Historic Boardwalk Hall, LLC ("HBH"), to renovate a certified historic building located in Atlantic City. The renovation gave rise to HRTCs that were properly allocated to PBHR pursuant to the terms of HBH's operating agreement.

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

According to the petition, section 47 was first enacted with the express purpose of stimulating the investment of public corporations in the renovation and preservation of national historic structures, and since then public corporations have invested in many such rehabilitation projects through partnership transactions indistinguishable from the present case.

The IRS challenged the allocation of HRTCs to PBHR in the Tax Court, where the court held for NJSEA, as tax matters partner, and rejected all of the IRS's arguments. The IRS appealed the Tax Court's decision to the Third Circuit, where it relied primarily on the argument that PBHR was not a *bona fide* partner in HBH. The Third Circuit reversed the Tax Court and denied NJSEA's petition for a rehearing.

Petition for Supreme Court Review

"[I]t is the first litigated case in the country in which the IRS has challenged the allocation of federal HRTCs from a partnership to a partner in the exact type of rehabilitation project that Congress had intended with the HRTC legislation."

In its petition, NJSEA argues that the case involves issues of tax law of national importance, as it is the first litigated case in the country in which the IRS has challenged the allocation of federal HRTCs from a partnership to a partner in the exact type of rehabilitation project that Congress had intended with the HRTC legislation. The NJSEA states three reasons that the Supreme Court should grant the petition:

First, the Third Circuit's finding that PBHR, which had no right to a return of its capital from HBH, had no risk with respect to its capital, and therefore was not a partner for US federal income tax purposes, is in conflict with the Supreme Court's holding in *Commissioner v. Culbertson*.[8]

Second, the Third Circuit's finding that the allocation of HRTCs by operation of law from HBH to PBHR should be considered a "sale" or "repayment" of property from HBH to PBHR is at odds with the Supreme Court's holding in *Randall v. Loftsgaarden*.[9]

Third, the Third Circuit's consideration of the HRTCs themselves as a component of its "substance over form" analysis, which led it to find that PBHR's entitlement to the HRTCs should itself be used as a basis for denying the HRTCs, stymies the specific Congressional purpose for HRTCs as well as the Supreme Court's substance-over-form jurisprudence.

—*Judy Fisher*

[8] 37 US 733 (1949).

[9] 478 US 647 (1986).

Union Carbide Seeks Supreme Court Review of Research Expenses

On December 4, 2012, Union Carbide filed a petition for certiorari, asking the Supreme Court to review the decision of the Second Circuit that rejected Union Carbide's research credit claim under section 41. The Government filed its response urging the Supreme Court to deny certiorari on February 3, 2013. The Circuit Court denied Union Carbide's claim to section 41 research credits for supplies used in the manufacturing process – supplies ordinarily used regardless of any research performed.[10] Union Carbide 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.[11]

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Section 41 provides a tax credit for increased spending on "qualified research expenses." There was no dispute that Union Carbide's plant research projects were qualified research. The issue on appeal was whether Union Carbide's supplies used in the undisputed qualified research qualified as an "in-house research expense" when such supplies were used in the course of Union Carbide's manufacturing process regardless of any research performed. 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 circuit court rejected Union Carbide's plain reading of the words, finding ambiguity in the phrase "in the conduct of qualified research."[12] To understand the meaning of the phrase, the circuit court looked to the title of section 41, "Credit for increasing research activities," which suggested to the court that supplies used in the ordinary process for manufacturing goods are not to be credited. Moreover, the court was persuaded by Treasury Regulation section 1.41-2(b)(2), which excludes from the definition of qualified research expense, "indirect research costs." While the Treasury regulation is silent on the meaning of "indirect research cost," the circuit court accepted the Commissioner's litigation claim that indirect research costs are costs incurred regardless of any research activities. The circuit court deferred to the Commissioner's interpretation concluding that it was "entirely consistent with the purpose of the research tax credit,

"The circuit court deferred to the Commissioner'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.'"

[10] *Union Carbide Corp. v. Commissioner*, 697 F.3d 104 (2nd Cir., 2012), *aff'g* T.C. Memo 2009-50, 97 T.C.M. (CCH) 1207 (2009).

[11] http://www.shearman.com/files/Publication/3c645c04-2f1f-484f-b484-e94b70b1b378/Presentation/PublicationAttachment/94e53ca6-a291-4a71-894f-b58e9611a967/Focus_on_Tax_Controversy_and_Litigation_Sept_Newsletter_TAX_09-12.pdf

[12] *Union Carbide Corp. v. Commissioner*, 697 F.3d at 108.

which is to provide a credit for the cost that a taxpayer incurs in conducting qualified research that he would not otherwise incur."[13]

Union Carbide's certiorari petition poses two questions: 1) the substantive tax question whether, in the context of a production process experiment, the research credit is limited to the costs of supplies that would not have been incurred but for the experiment; and 2) whether the circuit court erred in deferring to the IRS's interpretation of its own research credit regulations because the Government has a financial interest in the outcome of this case. Union Carbide argues that these two questions are related and that the circuit court's error in deferring to the IRS's interpretation led it to misapply those regulations and deny the research credit.

"Union Carbide argues that the Second Circuit inappropriately expanded the concept of the '*Auer* deference' (that is, deference to an agency's interpretation of its own regulations)."

With respect to the first question, Union Carbide emphasizes the importance of the section 41 credit to production process research. Union Carbide alleges that production process experiments must be done in the production plant itself because it is not sufficient to prove the viability of a process innovation in a laboratory alone. Therefore, the costs of the supplies that would not be incurred but for the experiment are "trivial" in comparison to the supplies that must be placed at risk of loss when conducting process production research. Union Carbide argues that the result of the Second Circuit's decision "is that the [research] credit is rendered trivial for the type of plant-scale production process research that is so important to manufacturing industries generally, and the chemical industry in particular."[14]

With respect to the second question, Union Carbide argues that the Second Circuit inappropriately expanded the concept of the "*Auer* deference" (that is, deference to an agency's interpretation of its own regulations).[15] The petition asserts that the court mistakenly applied Supreme Court precedent "as requiring a seemingly extraordinary deference to the government's interpretation of a regulation in a case in which the government itself is a financially interested party, [which] amounts to affording a naked preference to a government litigant over its non-governmental adversaries — permitting the government to place its thumb on the scales of justice."[16] In *Auer v. Robbins*,[17] the Supreme Court deferred to an agency's interpretation as set forth on *amicus*; here, the Second Circuit deferred to the IRS's interpretation as set forth on brief in a matter to which it was a party. Union Carbide apparently hopes that the Supreme Court will use this opportunity to revisit the question of judicial deference to an agency's interpretation of its own ambiguous regulations. In response, the Government contends that the circuit court's reliance on *Auer* "does not appear to have

[13] *Id*. at 109.

[14] Petition for Writ of Certiorari, at 12, *Union Carbide v. Commissioner* (No. 12-684)

[15] *See Auer v. Robbins*, 519 US 452 (1997)

[16] Petition for Writ of Certiorari, at 13, *Union Carbide v. Commissioner* (No. 12-684)

[17] 519 US 452 (1997).

been necessary to the court's decision."[18] According to the Government, the circuit court's decision represents nothing more than a "straightforward matter of statutory construction."[19] In the end, four votes are needed to grant certiorari, which may prove difficult to obtain in this matter dealing with a technical tax question on which there is no circuit conflict.

—*Richard A. Nessler*

District Court Enjoins IRS From Enforcing Registered Tax Return Preparer Regulations

On January 18th, the US District Court for the District of Columbia issued its decision in *Loving v. Internal Revenue Service*,[20] which enjoins the Internal Revenue Service ("IRS") from enforcing the regulations governing paid tax return preparers (other than CPAs and attorneys) that took effect in 2011. The rules at issue require such tax preparers to pass a competency examination, fulfill annual continuing education requirements, and pay fees to the IRS for administering the program.

"The IRS argued that its authority to issue these regulations derives from 31 USC. section 330, a statute originally passed in 1884 that grants the Treasury Department authority to regulate those who 'practice' before it."

The IRS argued that its authority to issue these regulations derives from 31 USC section 330, a statute originally passed in 1884 that grants the Treasury Department authority to regulate those who "practice" before it. The IRS already relied upon the same authority when it issued the Circular 230 rules that regulate practicing attorneys and CPAs. In 2011, the IRS expanded its regulations to include an estimated 600,000 to 700,000 people whose only "practice" is the compensated preparation of tax returns or claims for refund.[21] In *Loving*, three such previously unregulated preparers sought injunctive and declaratory relief to remedy the costs and injury to their businesses caused by the new regulations.

The *Loving* court analyzed the regulations to see if they were *ultra vires* under the Administrative Procedure Act by using the two-step test from *Chevron USA., Inc. v. NRDC*.[22] Under the *Chevron* test, the court first looks to whether Congress has directly spoken on the issue. If the statute is ambiguous or silent, the court proceeds to step two and analyzes whether the agency interpretation of the statute is reasonable, meaning that it is based on a permissible interpretation. For step two, administrative construction of the statute is generally permissible if it is not "arbitrary or

[18] Brief for the Respondent in Opposition, at 11-12, *Union Carbide v. Commissioner* (No. 12-684)

[19] *Id*. At 12.

[20] No. 12-385, 2013 WL 204667 (D.D.C. Jan. 18, 2013).

[21] *Id*. at 5.

[22] 467 US 837 (1984).

capricious".[23] The district court noted that 31 USC section 330 was the relevant statute, and since the plaintiffs did not argue that the IRS regulations were arbitrary or capricious, the only question was whether the statute was ambiguous about whether tax-return preparers are "representatives" who "practice" before the IRS. In the court's view, Congress unambiguously excluded such preparers from the authority granted in the statute. Therefore, the *Loving* court held that the IRS regulations are invalid and *ultra vires*.

"Therefore, the Loving court held that the IRS regulations are invalid and ultra vires."

To reach this result, the district court provided an analysis of the relevant statutory language and framework. The court noted that the absence of specific definitions for "practice" and "representative" in 31 USC section 330(a)(1) did not render the terms automatically ambiguous. Instead, the court looked to 31 USC section 330(a)(2) for guidance as to the definitions, citing canons of construction that presume that identical terms have the same meaning in all subsections of a statute and must be read in the context of the whole statutory scheme. 31 USC section 330(a)(2) demonstrates that representatives "advise and assist persons in presenting their cases." Merely filing tax returns should not be considered presenting a case, under the court's analysis, because there is no dispute or case at the time of filing. Rather, the dispute or case develops later in the process, if at all, during examination, appeals, and litigation.

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The *Loving* court also focused on the Congressional intent demonstrated by 31 USC section 330(b), which authorizes the IRS to penalize and disbar representatives for misconduct, and other provisions in Title 26. First, the court noted that Title 26 provides a number of specific penalty provisions that apply to tax return preparers. If the IRS had broad authority under 31 USC section 330(b) to penalize preparers, the specific and controlled penalty regime provided by Congress throughout Title 26 would be "trample[d]."[24] Stating that when statutes overlap, the more specific statute should supersede the general statute, the court suggested that 31 USC section 330(b) should not be interpreted as the IRS claimed in connection with its new regulations. As another indication of Congressional intent on this point, the court observed that section 6103(k)(5) did not include 31 USC section 330(b) in a list of preparer penalties that the IRS is authorized to disclose to state regulatory agencies.

Similarly, the *Loving* court discussed section 7407, which allows the IRS to seek an injunction against a tax preparer for misconduct but includes procedural hurdles and protections. If 31 USC section 330(b) covered tax preparers as the IRS claimed, the IRS could avoid this more difficult process by simply disbarring the preparer for misconduct as a "representative". Although the remedy under each statute is different,

[23] *Loving*, No. 12-385 (quoting *Mayo Found. For Med. Educ. & Research v. US*, 131 S. Ct. 704,711 (2011)).

[24] *Loving*, No. 12-385 at 14.

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the court thought that the Congressional purpose for section 7407 would be significantly undercut if the IRS's interpretation of 31 USC section 330 was upheld.

Concluding that "together the statutory text and context unambiguously foreclose the IRS's interpretation of 31 USC section 330," the district court quickly disposed of the IRS's remaining arguments that focused on policy, legislative history, and administrative regulations.[25] The *Loving* decision therefore granted a declaratory judgment stating that the IRS lacks the statutory authority to enact or enforce its "registered tax return preparer" regulations.

The plaintiffs also requested an injunction against the IRS to prevent enforcement of the regulations at issue. The district court issued the injunction after finding that the plaintiffs demonstrated the traditional four factors required for such issuance, including: (1) an irreparable injury, (2) the inadequacy of remedies available at law, such as monetary damages, (3) the balance of hardships favor an injunction, and (4) the public interest will not be disserved by such issuance. In the court's view, the plaintiffs' claims that their businesses would be harmed and would likely close were sufficient to show irreparable injury. The court stated that no remedy at law could adequately compensate the plaintiffs. The balance of hardships favored the plaintiffs because their livelihood was at risk while the IRS had only an invalid regulatory scheme on its side. Lastly, the court found that the public interest would be served by an injunction that would enjoin IRS activity that goes beyond its statutory authorization.

After the *Loving* decision, some tax practitioners were confused as to the effect of the judgment and injunction on other rules, such as the tax preparer registration program (PTIN).[26] Even the IRS apparently thought the decision affected the PTIN program, as it temporarily shut down its registration system website.[27] To remedy this confusion, on February 1st the district court modified its injunction to clarify its effect.[28] In its order, the court stated that PTIN registration was specifically authorized by Congress and is unaffected by the injunction, except that PTIN eligibility cannot be conditioned on being "authorized to practice" under 31 USC section 330. Accordingly, the IRS may still require preparers to register and obtain PTINs, and may charge a fee for both. The injunction, nevertheless, prevents the IRS from enforcing certain other requirements on preparers (who are not CPAs, attorneys, or enrolled agents), including the passing of competency examinations and continuing education requirements.

"In its order, the court stated that PTIN registration was specifically authorized by Congress and is unaffected by the injunction, except that PTIN eligibility cannot be conditioned on being 'authorized to practice' under 31 USC section 330."

[25] *Id.* at 19.

[26] William Hoffman, *Questions Remain Following Modification to Injunction on PTINs*, 2013 T.N.T. 28-5 (Feb. 11, 2013).

[27] *Id.*

[28] *Loving v. I.R.S.*, No. 12-385, Memorandum Opinion and Order (Feb. 1, 2013),Tax Analysts Document Service 2013-2510.

While clarifying the scope of its injunction, the district court also denied an IRS motion to stay the injunction pending appeal of the decision.[29] The court discussed four factors that are relevant to a motion to stay an injunction, including (1) the likelihood of success on the merits, (2) the likelihood of irreparable harm for the movant, (3) the prospect that others will be harmed if the stay is granted, and (4) the public interest. The court doubted that the IRS would be significantly harmed, as it could choose to keep its testing centers and was not required to "dismantle its entire scheme."[30] The order downplays IRS concerns over expenses and potential refunds to preparers, in part because the IRS estimated expenses included the PTIN program that did not need to be shut down. Moreover, the court noted that the potential for refund claims would be even worse if the court granted the stay but the injunction was later affirmed. For the third factor, the court observed that a stay would harm the plaintiffs and other preparers who would need to decide between skipping the regulatory requirements and hoping for an affirmance by the Court of Appeals, or satisfying the requirements and potentially wasting their time, effort, and expense. Lastly, although the IRS claimed the injunction would harm the "public fisc," the court noted that the harm to preparers would be worse, particularly for certain preparers with limited resources. Therefore, the district court found the balance of factors to weigh against staying the injunction and denied the IRS's motion.

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The district court's modification order brought some temporary clarification to tax preparers, who are now once again able to register for PTINs on the reopened IRS system at the beginning of their busy season.[31] Although the *Loving* decision struck a big blow against the new registered tax return preparer program, only time and the impending appeal by the IRS will reveal the final outcome.

—*Daniel Smith*

Eleventh Circuit Joins Three Others in Upholding Application of the Required Records Exception to Foreign Financial Accounts

On February 7, 2013, the Eleventh Circuit unanimously concluded that subpoenaed records relating to foreign bank accounts of a taxpayer (identified only as "Target") and his wife fell within the Required Records Exception to the privilege against self-

[29] *Id.*

[30] *Id.*

[31] Diane Freda, *Tax Practice: IRS Reopens PTIN Registration for Tax Preparers, Restoring Order to Filing Season*, 32 BNA TAX MGMT. WEEKLY REPORT 6 at 183 (Feb. 11, 2013).

incrimination.[32] This ruling is consistent with recent rulings in the Fifth, Seventh, and Ninth Circuits.[33]

District Court Decision

"In 2011, a grand jury investigating the Target and his wife issued a subpoena requiring them to produce any foreign financial account records that they were required to keep pursuant to the Bank Secrecy Act of 1970 and accompanying regulations."

In 2011, a grand jury investigating the Target and his wife issued a subpoena requiring them to produce any foreign financial account records that they were required to keep pursuant to the Bank Secrecy Act of 1970 and accompanying regulations.[34] The Target and his wife initially refused to produce the records on Fifth Amendment grounds, on the basis that both the act of producing the records and the records themselves could be incriminating. After the Target and his wife refused to comply with an order from the district court, they were held in contempt. The district court, however, stayed enforcement of the contempt order pending the outcome of appeal.[35]

Eleventh Circuit Decision

"'. . .'(1) [T]he purposes of the United States' inquiry must be essentially regulatory; (2) the information is obtained by requiring the preservation of records of a kind which the regulated party has customarily kept; and (3) the records themselves must have assumed public aspects which render them at least analogous to public documents.'"

The Eleventh Circuit affirmed the district court's determination that the Fifth Amendment privilege against self-incrimination did not apply to the subpoenas in question and upheld the order of contempt for failing to produce the requested records.[36] This decision was based on the applicability of the Required Records Exception, which eliminates the Fifth Amendment privilege when the government is authorized to regulate an activity and the recordkeeping requirements are required to be maintained by law. The court articulated the requirements of the Required Records Exception as: "(1) the purposes of the United States' inquiry must be essentially regulatory; (2) the information is obtained by requiring the preservation of records of a kind which the regulated party has customarily kept; and (3) the records themselves must have assumed public aspects which render them at least analogous to public documents."[37] The court found that the purpose of the record keeping requirement of the Bank Secrecy Act was "essentially regulatory" because it does not target inherently illegal activity or persons inherently suspected of criminal activity. Further, the court found that the records were of a type normally kept in connection with the activity because they consist of "basic account information that bank customers would customarily keep."[38] Finally, the court found that the requested records had assumed

[32] *In re: Grand Jury Proceedings*, No. 4-10, 11th Cir., No. 12-13131 (Feb. 7, 2013); see Robert T. Zung, "Eleventh Circuit Joins Other Circuits On Getting Foreign Financial Account Records," *Tax Notes Today*, Feb. 11, 2013.

[33] *See In re: Grand Jury Investigation, M.H.*, 648 F.3d 1067 (9th Cir. 2011), *cert. denied*, 133 S.Ct. 26 (2012); *In re: Special Feb. 2011-1 Grand Jury Subpoena Dated Sept. 12, 2011*, 691 F.3d 903 (7th Cir. 2012); *In re: Grand Jury Subpoena*, 696 F.3d 428 (5th Cir. 2012).

[34] *In re: Grand Jury Proceedings*, No. 4-10, 11th Cir., No. 12-13131 (Feb. 7, 2013).

[35] *Id.*

[36] *Id.*

[37] *Id.* (citing *Grosso v. United States*, 390 US 62, 67-68 (1968)).

[38] *Id.* (citing *In re: M.H.*, 648 F.3d 1067, 1076 (9th Cir. 2011)).

"public aspects" because the records were required to be kept as part of a valid regulatory scheme.[39] Therefore, the court found that the Required Records Exception applied and both the documents sought and the act of producing them fell outside the scope of the Fifth Amendment.[40]

—*Melissa Henkel*

Seventh Circuit Dismisses UBS Account Holders' Suit

The Seventh Circuit dismissed a class action suit brought by plaintiff account holders seeking damages from UBS for a variety of common law claims, including malpractice, negligence, breach of fiduciary duty, breach of contract, unjust enrichment, fraud, constructive fraud, and disgorgement.[41]

"The plaintiffs, all US citizens, held undisclosed accounts ranging in value from $500,000 to $2 million in 2008 when the UBS tax-evasion controversy erupted and had failed to report on their tax returns the interest income earned on those accounts."

The plaintiffs, all US citizens, held undisclosed accounts ranging in value from $500,000 to $2 million in 2008 when the UBS tax-evasion controversy erupted and had failed to report on their tax returns the interest income earned on those accounts. They ultimately disclosed their accounts through the IRS's Offshore Voluntary Disclosure Program. In connection with their participation in the program, the plaintiffs paid the taxes that they owed plus interest and a 20 percent penalty. The plaintiffs sought to recover from UBS the interest, penalties, costs, and profits (hundreds of millions of dollars) that they claimed UBS earned through inducing them to maintain their accounts.

The appellate court emphatically rejected the plaintiffs' claims, calling the plaintiffs "tax cheats." The plaintiffs argued that UBS should have prevented them from violating the law, which Judge Posner, writing for the unanimous three-judge panel, likened to "suing one's parents to recover tax penalties one has paid, on the ground that the parents had failed to bring one up to be an honest person who would not evade taxes and so would not subject himself to penalties."

The plaintiffs argued that they were third-party beneficiaries of an agreement that UBS entered into with the IRS as part of the IRS's Qualified Intermediary Program (the "QI Agreement"), which was created to help the IRS ferret out income tax earned by American taxpayers overseas. As a consequence of their supposedly being beneficiaries, the plaintiffs claimed that they were entitled to enforce the QI Agreement and obtain damages for the breach by UBS. The appellate court also rejected this line of argument: "It's unlikely that the IRS would want the tax cheats

[39] *Id.*

[40] *Id.*

[41] *Thomas v. UBS AG*, No. 12-2724 (7th Cir Feb. 7, 2013). The basis for the federal court's jurisdiction was diversity jurisdiction. The court stated that the parties failed to make clear the source of law applicable to the case and claims and cited Arizona, California, New York, and Illinois law without explaining why.

that the contract was intended to deter, by requiring foreign banks to report their income to it, to be able to shift the burden of the penalties that the IRS imposes on tax cheats to the foreign banks."

"As for the plaintiff's other claims, the court was also unpersuaded."

As for the plaintiff's other claims, the court was also unpersuaded. With respect to a second breach of contract claim – an implied contract claim – the court held that the plaintiffs failed to state the minimum information for the defendant to answer the complaint. The court labeled "frivolous" the plaintiff's allegation of fraud, which was based on the claim that the bank deceived the plaintiffs in concealing the QI Agreement in order to keep them as clients. The court stated that the plaintiff's unjust enrichment claim against UBS "lack[ed] the minimum specification that UBS would need to prepare an answer" and was "redundant." The plaintiff's other claims were not addressed by the court, except that the court called them "frivolous squared."

"The court remarked that it was 'surprised that UBS hasn't asked for the imposition of sanctions on the plaintiffs and class counsel.'"

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—*Liz McGee*

LAWRENCE M. HILL
Editor, *Focus on Tax Controversy & Litigation*

Tax Controversy and Litigation at Shearman & Sterling

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 US 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.

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LAURENCE M. BAMBINO
599 Lexington Avenue
New York, New York 10022-6069
lbambino@shearman.com
+1.212.848.4213
United States

LAURENCE E. CROUCH
Palo Alto Square
6th Floor
Palo Alto, California 94306-2155
lbambino@shearman.com
+1.212.848.4213
United States

ALFRED C. GROFF
801 Pennsylvania Avenue, NW
Suite 900
Washington, DC 20004-2634
agroff@shearman.com
+1.202.508.8090
United States

DON J. LONCZAK
801 Pennsylvania Avenue, NW
Suite 900
Washington, DC 20004-2634
dlonczak@shearman.com
+1.202.508.8080
United States

MICHAEL B. SHULMAN
801 Pennsylvania Avenue, NW
Suite 900
Washington, DC 20004-2634
mshulman@shearman.com
+1.202.508.8075
United States

MARY JO LANG
801 Pennsylvania Avenue, NW
Suite 900
Washington, DC 20004-2634
maryjo.lang@shearman.com
+1.202.508.8175
United States

MELISSA HENKEL
801 Pennsylvania Avenue, NW
Suite 900
Washington, DC 20004-2634
melissa.henkel@shearman.com
+1.202.508.8029
United States

ROGER J. BANEMAN
599 Lexington Avenue
New York, New York 10022-6069
rbaneman@shearman.com
+1.212.848.4894
United States

KRISTEN M. GARRY
801 Pennsylvania Avenue, NW
Suite 900
Washington, DC 20004-2634
kgarry@shearman.com
+1.202.508.8186
United States

LAWRENCE M. HILL
599 Lexington Avenue
New York, New York 10022-6069
lawrence.hill@shearman.com
+1.212.848.4002
United States

DOUGLAS R. MCFADYEN
599 Lexington Avenue
New York, New York 10022-6069
dmcfadyen@shearman.com
+1.212.848.4326
United States

RICHARD A. NESSLER
599 Lexington Avenue
New York, New York 10022-6069
richard.nessler@shearman.com
+1.212.848.4003
United States

JUDY FISHER
801 Pennsylvania Avenue, NW
Suite 900
Washington, DC 20004-2634
judy.fisher@shearman.com
+1.202.508.8067
United States

PETER H. BLESSING
599 Lexington Avenue
New York, New York 10022-6069
pblessing@shearman.com
+1 212 848 4106
United States

CRAIG GIBIAN
801 Pennsylvania Avenue, NW
Suite 900
Washington, DC 20004-2634
cgibian@shearman.com
+1.202.508.8034
United States

THOMAS D. JOHNSTON
801 Pennsylvania Avenue, NW
Suite 900
Washington, DC 20004-2634
thomas.johnston@shearman.com
+1.202.508.8022
United States

ROBERT A. RUDNICK
801 Pennsylvania Avenue, NW
Suite 900
Washington, DC 20004-2634
rrudnick@shearman.com
+1.202.508.8020
United States

ELIZABETH MCGEE
599 Lexington Avenue
New York, New York 10022-6069
liz.mcgee@shearman.com
+1.212.848.4005
United States

DANIEL B. SMITH
599 Lexington Avenue
New York, New York 10022-6069
daniel.smith@shearman.com
+1.212.848.7139
United States