SHEARMAN & STERLING LLP

# Practice Group Newsletter

FOCUS ON TAX CONTROVERSY AND LITIGATION

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## Editor's Note

Dear Readers,

This issue features articles discussing the Tax Court's recent ruling for the taxpayer in the related party debt-equity case *NA General Partnership v. Commissioner*, the Federal Circuit's opinion in *Dominion Resources* invalidating a Treasury regulation because Treasury failed to articulate a cogent rationale for the regulation prior to its issuance, and the Tax Court's decision for the government in FTC generator case *Hewlett-Packard*.

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

## Tax Court Rules Against IRS in Related Party Debt-Equity Case

On June 19, 2012, the U.S. Tax Court ruled in favor of the taxpayer in *NA General Partnership v. Commissioner*,[1] holding that an advance made to NA General Partnership ("NAGP") by its parent company was appropriately characterized as a loan and NAGP was therefore entitled to interest expense deductions for payments on the loan notes.

### Acquisition of PacifiCorp and Subsequent Transactions

The advance at issue was made in connection with the acquisition of PacifiCorp, a U.S. utility company that was the common parent of a U.S. consolidated federal income tax group and indirectly owned interests in Australia. ScottishPower, a publicly-held "multi-utility business in the U.K." organized NAGP as a special-purpose entity to acquire PacifiCorp.

As part of the acquisition, Scottish Power organized two wholly owned U.K. subsidiaries (NA1 and NA2), which were disregarded entities for U.S. tax purposes. NA1 and NA2 contributed £100,000 to NAGP in exchange for 10 percent and 90 percent of NAGP's interests, respectively. NAGP then formed a subsidiary that merged into PacifiCorp. All of PacifiCorp's common stock was cancelled and converted into the right to receive ScottishPower ADSs or ScottishPower common shares, and PacifiCorp issued new common stock to NAGP. NAGP issued loan notes to ScottishPower equal to 75 percent of the transferred ADSs and common shares provided to PacifiCorp's shareholders, and NAGP pledged its PacifiCorp shares as security. NA1 and NA2 issued shares to ScottishPower for the remaining 25 percent.

The loan notes issued by NAGP consisted of $4 billion of fixed-rate notes maturing in 2011 and $895 million of floating-rate notes maturing in 2014. Both the fixed- and floating-rate loan notes paid interest quarterly. If NAGP failed to pay interest or principal within 30 days of the due date, ScottishPower had the right to require repayment of all the loan notes at market rate.

NAGP failed to make the only interest payment due in 2000 and the first interest payment due in 2001 but ultimately used PacifiCorp dividends to pay $333 million of the $335 million in interest that it had accrued for the 2001 tax year.

In 2002, ScottishPower temporarily suspended PacifiCorp's dividend payments pending regulatory approval to insert a holding company for PacifiCorp. NAGP made its first interest payment in 2002 from funds it borrowed from ScottishPower as a short term intercompany loan and its second interest payment through journal entries on the parties' books without transferring any actual funds. NAGP also entered into a $360 million credit facility with Royal Bank of Scotland ("RBS") which it used to repay the short-term intercompany loan to ScottishPower and to make interest payments on the loan notes while PacifiCorp's dividends were suspended. The RBS credit facility subordinated ScottishPower's right to repayment of the loan notes to RBS. NAGP paid off the RBS credit facility in 2002 after receiving PacifiCorp dividends and the proceeds from the sale of a PacifiCorp Australian subsidiary. At the end of the 2003 tax year, NAGP's interest obligations on the loan notes were current.

The floating-rate notes were capitalized in March 2002. In December 2002, the fixed-rate notes were partially capitalized, and the remaining amount was repaid by NAGP.

In total, NAGP claimed $932 million in interest expense deductions with respect to the loan notes. Claiming that the advance should be characterized as a capital contribution rather than a loan, the IRS disallowed the interest expense deductions.

[1] T.C. Memo. 2012-172 (2012).

## Debt-Equity Analysis

In its analysis of whether NAGP properly deducted as interest under sections 162[2] and 163(a) payments made to its parent ScottishPower, the Tax Court relied on the eleven-factor debt-equity test laid out by the U.S. Court of Appeals for the Ninth Circuit. The factors are: (1) the name given to the documents evidencing the indebtedness; (2) the presence of a fixed maturity date; (3) the source of the payments; (4) the right to enforce payments of principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of "dividend" money and (11) the corporation's ability to obtain loans from outside lending institutions.

The government argued that the advance by ScottishPower of its stock to NAGP was more properly characterized as a capital contribution (*i.e.* equity), while NAGP argued that it was a loan (*i.e.* debt).

The court briefly discussed the first two factors, noting that 1) the certificates that NAGP issued to ScottishPower were called "loan notes" and "contained terms and conditions typical of a promissory note" and 2) the loan notes had maturity dates. Thus, both of these factors supported characterization as debt.

Regarding the third factor and accepting the conclusions of NAGP's expert, the court observed that NAGP was obligated to pay the full principal amounts of the loan notes at their maturity dates, making the advance unlike an equity investment which is normally associated with payments that are contingent on earnings or come from a restricted source.

As to ScottishPower's creditor rights, the court noted that ScottishPower did have a right to enforce payment of the debt because, if NAGP failed to timely pay interest or principal, ScottishPower could compel repayment of the full amount of the debt. In addition, NAGP's PacifiCorp stock was security for the debt. The court found that this factor also favored debt characterization.

The court found the fifth factor to be neutral because ScottishPower was already NAGP's sole owner prior to the advance and thus could not have increased its right to participate in management.

In its discussion of ScottishPower's status as a creditor, the court was not persuaded by the government's argument that the advance resembled equity because the loans notes did not prohibit NAGP from taking on more senior debt. The court found that "certain creditor protections are not as important in the related-party context," and that ScottishPower, as sole shareholder of NAGP, could have prevented NAGP from taking on any additional debt.

In finding that the parties intended the advance to be debt (the seventh factor), the court relied on evidence showing that the loan notes were in the form of debt, called for payments of interest, had maturity dates, and were not subordinated to general creditors. The parties also recorded the loan notes as debt, referred to them as debt in correspondence, and represented to the SEC that they were debt. The court regarded NAGP's desire to minimize its tax burden as a business consideration and inconclusive of the characterization as debt or equity. The court rejected the government's argument that the parties' conduct, such as ScottishPower's failure to demand payment when NAGP had not timely paid, did not override the characterization of their relationship as debtor-creditor.

In its analysis of the eighth factor, the court agreed with NAGP's expert, who compared ScottishPower's acquisition of PacifiCorp to other large, highly leveraged acquisitions that occurred in the same time period, finding that similar transactions did occur and were financed by third-party lenders. The court concluded that this factor weighed in favor of characterizing the advances as debt, too, because the evidence did not establish that

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

NAGP was too thinly capitalized to repay the intercompany debt.

The court found that the ninth factor favored an equity characterization because ScottishPower was NAGP's sole shareholder, and its advance was therefore "more likely committed to the risk of the business than an advance from a creditor."

The court concluded that the tenth factor supported characterizing the advance as debt for reasons already discussed, *i.e.*, that NAGP was required to make interest payments, had sufficient anticipated cashflow to make interest payments, and in fact made regular interest payments.

Regarding the ability to obtain third-party financing, the government's expert concluded that NAGP could not have obtained financing from third-party creditors on the same terms and at the same price as the intercompany advance. The court, however, asserted that a precise matching of terms and price is not required,[3] looking instead to the analysis of NAGP's expert, who found that "fixed-rate notes would have been purchased by third-party fixed-income investors on substantially similar terms as the $4 billion fixed-rate notes." There were no facts in the record showing that the floating-rate notes would have been purchased by outside investors on similar terms but that did not affect the court's conclusion regarding the fixed-rate notes. The court found this factor supported debt characterization of the fixed-rate notes and was neutral as to the floating-rate notes.

The court concluded that, although the advance had both debt and equity features, overall it was more appropriately characterized as debt. NAGP's payments of interest on the loan notes were therefore deductible as interest.

*— N. Beekman*

[3] The court also noted that "the lender in the related-party context may understandably offer more flexible terms than could be obtained elsewhere," citing *C.M. Gooch Lumber Sales Co. v. Commissioner*, 49 T.C. 649, 659 (1968).

## Federal Circuit Reverses Court of Federal Claims in ***Dominion Resources***

The U.S. Court of Appeals for the Federal Circuit has reversed the U.S. Court of Federal Claims in *Dominion Resources, Inc.*[4] On May 31, 2012, the Federal Circuit reversed the Court of Federal Claims' grant of summary judgment against Dominion Resources, holding that the "associated property rule" of section 1.263A-11(e)(1)(ii)(B), Income Tax Regs., as applied to property temporarily withdrawn from service ("the regulation") was not a reasonable interpretation of section 263A under *Chevron*[5] and *Mayo*.[6] In a holding that could have a significant effect on challenges to Treasury regulations generally, the Federal Circuit further held that the regulation was invalid under the procedural "arbitrary and capricious" standard of *State Farm*[7] and section 706(2)(A) of the Administrative Procedure Act because Treasury failed to articulate a cogent rationale for the associated property rule prior to or upon issuing the final regulation. The three-judge panel unanimously found a fatal procedural flaw in Treasury's issuing of the regulation. Circuit Judge Clevenger was alone in finding that the substance of the associated property rule was a reasonable interpretation of the statute under *Chevron*.

### Section 263A

Under the uniform capitalization ("unicap") rules of section 263A, interest that is both allocable to property constructed, built, installed, manufactured, developed or improved by or for the taxpayer and paid or incurred during the production period of the property is capitalized if the property is of a type described in

[4] *Dominion Resources, Inc. v. United States*, Doc. No. 2011-5087, (Fed. Cir. May 31, 2012), rev'g Doc. No. 08-195T, 97 Fed. Cl. 239 (2011).

[5] *Chevron, U.S.A., Inc. v. Natural Res. Def. Council*, 467 U.S. 837 (1984).

[6] *Mayo Found. for Med. Educ. and Research v. United States*, 131 S.Ct. 704 (2011).

[7] *Motor Vehicles Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983).

section 263A(f)(1)(B).[8] The amount of interest allocable to property depends on the total amount of "production expenditures" with respect to the property;[9] the interest allocable to the property for unicap purposes is determined by reference to the average interest rate the taxpayer paid on its debt during the production period and the amount of production expenditures with respect to the property.

"Production expenditures" are defined as "the costs (whether or not incurred during the production period) required to be capitalized under [section 263A(a)] with respect to the property."[10] In relevant part, section 263A(a) provides that with respect to non-inventory property such costs "are the direct costs of such property, and such property's proper share of those indirect costs (including taxes) part or all of which are allocable to such property," provided, however, that any cost which (but for section 263A(a)) could not be taken into account in computing taxable income for any taxable year shall not be capitalized under section 263A(a).[11]

## The Regulation

The challenged regulation provides that production expenditures include:

> in the case of an improvement to a unit of real property. . .[f]or any measurement period, the adjusted basis of any existing . . .property that must be temporarily withdrawn from service to complete the improvement (associated property) during any part of the measurement period if the associated property directly benefits the property being improved, the associated property directly benefits from the improvement, or the improvement was incurred by reason of the associated property.

This rule is subject to a *de minimis* exception according to which production expenditures do not include the basis of associated property if the taxpayer reasonably expects that the production expenditures for the improvement (excluding costs of associated property) will not exceed 5 percent of the costs of associated property.[12] The only comment made by Treasury during the drafting of the regulation that was specifically addressed to the associated property rule was in the preamble to the final regulations, in which Treasury indicated that commentators' concerns about the rule were being addressed by the inclusion of the *de minimis* exception in the final regulations.[13]

## The Improvements

In 1996, Dominion Resources performed renovations at two coal-fired electric generating complexes, replacing coal burners in the complexes' boilers with low-nitrous-oxide burners to comply with requirements of the Clean Air Act. Replacing the burners required that Dominion Resources temporarily take out of service one generating unit at each complex. The units were out of service for two to three months. Not counting the cost or value of the property that was already part of the units prior to the improvements, the out-of-pocket costs of the two improvements were $5.3 million and $6.7 million. The adjusted bases of the property that was treated by the

[8] Section 263A(f) generally applies to real or tangible personal property with a long life or production period that the taxpayer will hold for resale, for use in its trade or business, or for the production of income. § 263A(b)(1) and § 263A(f)(1)(B).

[9] The allocation rules provide that "interest on any indebtedness directly attributable to production expenditures with respect to. . .property shall be assigned to such property, and interest on any other indebtedness shall be assigned to such property to the extent that the taxpayer's interest costs could have been reduced if production expenditures (not attributable to indebtedness [directly attributable to production expenditures]) had not been incurred." § 263A(f)(2)(A).

[10] § 263A(f)(4)(C).

[11] § 263A(a)(2).

[12] § 1.263A-11(e)(2), Income Tax Regs.

[13] Treasury stated:

> Commentators indicated that sometimes property must be temporarily disconnected or otherwise taken out of service for health, safety, or regulatory reasons in order to make certain improvements (e.g., a power generating facility must be taken out of service in order to make capital improvements). Commentators suggested that the regulations provide that property is taken out of service only if the property is taken out of service for depreciation purposes. The final regulations do not adopt the suggestion concerning when property should be considered taken out of service. However, the final regulations provide a de minimis rule for property taken out of service.

Final Regulations – Dept. of the Treasury, 59 Fed. Reg. 67187, 67192-93 (§ 1.263A-11(e), Income Tax Regs.) (Dec. 29, 1994).

IRS as "associated property" for unicap purposes were roughly $10 million and $131 million respectively.

## Court of Federal Claims Opinion

The trial court upheld the regulation as a reasonable interpretation of the statute that was, under the standards set forth in *State Farm*, the product of reasoned decisionmaking. In applying *Chevron*, the Court of Federal Claims found that Treasury's choice of the associated property rule was a "policy choice" that the court was not to second-guess.[14]

With regard to *Chevron* step one, the court found that the meaning of the term "property" as used throughout section 263A, including section 263A(f), is vague and the Code therefore does not unambiguously address the issue of whether associated property should be treated as part of the property referred to in section 263A in the case of an improvement. The court then moved on to analyze the regulation under *Chevron* step two, despite seeming to acknowledge that the basis of associated property cannot be a production expenditure because it is not a cost that is required to be capitalized under section 263A(a).

With respect to *Chevron* step two, the government argued that the associated property rule was reasonable and permissible because (i) the interest that is capitalized because of the inclusion of associated-property basis in production expenditures is a reasonable approximation of the economic cost (*i.e.*, lost revenue or income) attributable to taking the associated property out of service at some point during the production period, and (ii) since associated property generally can be sold (for an amount that may be assumed to be equal to its basis), thus making funds available to pay down debt, the reutilization of the associated property has an opportunity cost that includes interest costs that "could have been reduced"[15] if associated-property sale proceeds had been received and used to pay down debt. The Court of Federal Claims found that the government's *post hoc* rationales were barely adequate to save the regulation from being found "arbitrary or capricious in substance or manifestly contrary to the statute,"[16] noting that the courts could not alter the government's policy choice.

The Court of Federal Claims also held that Treasury had cogently explained why it chose the associated property rule prior to or upon choosing it as Treasury must do under *State Farm* and *SEC v. Chenery*.[17] Stressing *State Farm*'s direction to future courts that a "decision of less than ideal clarity" should be upheld "if the agency's path may reasonably be discerned,"[18] the court found that the hints left by Treasury in the preambles to the proposed and final regulations were close enough to what could properly be called a cogent explanation.

## The Federal Circuit Decision

The Federal Circuit disagreed with the Court of Federal Claims' *Chevron* step two analysis, holding that the regulation directly contradicts the "avoided-cost" rule Congress intended to implement in section 263A. The Federal Circuit looked to legislative history to determine what would be a reasonable interpretation of the statute and found that the House and Senate reports indicated that the interest to be capitalized is the amount that could have been avoided if funds had not been expended for construction; this principle is referred to as the "avoided-cost rule." The court also noted that the plain meaning of two key words in the statute, "expenditures" and "incurred" in section 263A(f)(2)(A)(ii), cannot be stretched so as to include in "production expenditures. . .incurred" the basis of property taken out of service during an improvement. The court also found no reasonable economic basis for measuring the interest to be capitalized by reference to the entire basis of the property being improved, noting that the taxpayer engaged in two similar improvement projects on similar

[14] Doc. No. 08-195T, slip op. at 24.

[15] § 263A(f)(2)(A)(ii).

[16] Doc. No. 08-195T, slip op. at 18, quoting *Mayo*.

[17] 332 U.S. 194 (1947).

[18] Doc. No. 08-195T, slip op. at 25, quoting *State Farm*, 463 U.S. at 43.

pieces of property that the regulation nonetheless treated in a wildly disproportionate manner. The court regarded as an unreasonable and unrealistic fiction the government's theory that the basis of associated property should be treated as a production expense because such property, instead of being placed back in service, generally can be sold at a value equal to its basis. Because no "property owner would have sold the same unit that it removed from service for the sole purpose of improving," the inclusion of associate-property basis in production expenditures is not worthy of the "policy choice" label applied by the trial court.[19]

The Federal Circuit also disagreed, unanimously, with the Court of Federal Claims' holding that Treasury had provided a reasoned explanation for adopting the regulation. The court interpreted *State Farm* as requiring Treasury to explain how the use of associated-property basis "implements the avoided-cost rule" and concluded that Treasury did not do so in connection with issuing the regulation.[20] The court rejected the Court of Federal Claims' suggestion that Treasury satisfied *State Farm* merely by alerting "interested potential commentators that treatment of the basis of the property being improved was at issue insofar as capitalization was concerned."[21]

Although there was no doubt before *Dominion Resources* that *State Farm*, and relevant cases cited by *State Farm*, such as *Chenery*, apply to Treasury regulations,[22] the Federal Circuit's decision offers a valuable reminder of this. Treasury is required to explain why it has chosen each substantive rule within a regulation when the regulation is issued. The prolixity of most Treasury regulations means that each section contains many dozens of rules, including narrow rules like the associated property rule that are nested within one or more levels of broader rules. Some of these rules have not been cogently explained in the preambles to the proposed and final or temporary regulations. Each unexplained rule is subject to challenge, regardless of whether a Notice of Proposed Regulation gave the public an opportunity to comment upon the rule.

*— D. Kershaw*

## Tax Court Rules in Favor of Government in Second FTC Generator Case

On May 14, 2012, the U.S. Tax Court ruled in favor of the government in *Hewlett-Packard Co. v. Commissioner*,[23] the second of the so-called "FTC generator" cases to be decided, following an earlier government victory in *Pritired 1, LLC v. United States*.[24] In *Hewlett-Packard*, the Tax Court applied a debt-versus-equity analysis to disallow Hewlett-Packard's ("HP's") claimed capital loss deduction, finding that HP's investment in FOP was, in substance, a loan.

### The FOP Transaction

The court found that the transaction at issue was structured to benefit from a discrepancy in American and Dutch income realization rules. In 1996, AIG-FP partnered with ABN, a Dutch financial institution, to create the foreign entity Foppingadreff (FOP). AIG-FP and ABN both invested capital in FOP; ABN's investment was four times greater than AIG-FP's. In exchange for its contribution, AIG-FP received class B preference shares and class D priority shares – together representing approximately 20 percent of FOP's voting power – and warrants to purchase additional stock. The warrants, which were never exercised, allowed FOP to qualify as a controlled foreign corporation. ABN received common shares representing approximately 80 percent of FOP's voting power. FOP then lent money to ABN and its

19 Doc. No. 2011-5087, slip op. at 10.

20 Id. at 12.

21 Id.

22 *See, e.g.*, *Carpenter Family Investments, LLC v. Comm'r*, 136 T.C. 373 (2011) (invalidating § 6501(e) regulations) (majority op. relies on *Chenery*; concurring op. (Halpern and Holmes, JJ.) cites *State Farm* and *Chenery*); *Mannella v. Comm'r*, 631 F.3d 115 (3d Cir. 2011) (J. Ambro dissenting) (relying on *State Farm* and *Chenery*).

23 T.C. Memo. 2012-135 (2012).

24 Civ. No. 4:08-cv-00082, slip op. (S.D. Iowa Sept 30, 2011).

affiliates in exchange for contingent interest notes (CINs). The CINs paid three types of interest: (1) base interest payable semiannually, (2) contingent interest payable at maturity in 2006, and (3) compounded interest on the contingence interest, payable at maturity. The interest was paid in NLG but indexed to the U.S. dollar, and it was calculated in such a way that the dollar value of difference between the base interest received and the Dutch taxes paid by FOP would almost always remain constant.

The governing transactional documents – FOP's articles of incorporation and the shareholders agreement – prohibited FOP from investing in any assets other than the CINs (or other highly-rated short term debt) and from taking on debt in excess of $1 million in aggregate. The preference shareholders were entitled to semiannual payments of a "cumulative variable dividend" which generally equaled 97 percent of the cash FOP received less Dutch taxes and expenses. FOP's failure to timely pay dividends was defined as a "Change of Control Event." If a "Change of Control Event" occurred, the class D shareholders were authorized to convene a shareholders meeting to cause FOP to 1) reduce its capital to redeem or repurchase the preference shares, or 2) dissolve. Class B and D shareholders would have a majority of votes at any such meeting.

AIG-FP also purchased a put option from ABN allowing AIG-FP to put its class B shares in January 2003 or January 2007. The price paid on an option exercised in 2003 or later would equal the fair market value of the shares. FOP's articles of incorporation contained a dividend reset provision which, starting in 2003, would "cause the Shares B, insofar as possible, to have a market value that is equal to their par value."

In March 2006, HP bought out AIG-FP's interest in FOP. HP's purchase price included a "premium" of over $15 million, a portion of which AIG-FP would be required to return to HP if HP was unable to realize the desired tax results. HP's expected return from the FOP transaction was to come from the dividends received from FOP and the foreign tax credits claimed for Dutch taxes paid by FOP. HP, however, was unable to use the foreign tax credits that it claimed in the years at issue in this case (1999, 2000, and 2003) because of section 904 limitations, although it reported the section 78 gross-up for those years and filed a separate suit in federal district court seeking to carry back its unused foreign tax credits to prior years. HP exited the FOP transaction in 2003, claiming a capital loss of $15,569,004.

## Debt-Versus-Equity Analysis

As a preliminary matter, the Tax Court considered whether HP's put option should be considered together with the terms of its preference shares for the purpose of the debt-equity analysis. HP argued that the put option was irrelevant because it was a third-party agreement enforceable against ABN rather than FOP. The court rejected this argument because "the put agreement was one of many transaction documents signed as a package at the FOP closing and is referenced in the shareholders agreement" to which FOP was a party. The shareholders agreement obligated FOP to take all "necessary or appropriate actions" to implement the valid exercise of the put option. The court interpreted this provision, in the context of the FOP transaction as a whole, as "inextricably connect[ing] FOP to the exercising of the put option." Therefore the court treated the put option as an integrated part of the transaction.

In determining the appropriate characterization of HP's investment in FOP, the Tax Court applied the eleven factors used by the U.S. Court of Appeals for the Ninth Circuit to distinguish debt from equity. These are: (1) the labels on the documents evidencing the alleged indebtedness; (2) the presence or absence of a maturity date; (3) the source of payments; (4) the right of the alleged lender to enforce payment; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) the adequacy of the (supposed) borrower's capitalization; (9) whether stockholders' advances to the corporation are in the same proportion as their equity ownership in the corporation; (10) the payment of interest out of only "dividend money"; and (11) the borrower's ability to obtain loans from outside lenders.

In its brief discussion of the first factor, the court noted that HP's investment was undoubtedly equity in form, but discounted the importance of this factor on the ground that substance, rather than formal documentation, controls.

The court then went on to consider the presence or absence of a maturity date and HP's creditor rights together. The court was unconvinced by HP's assertion that there was no maturity date because there was no mandatory redemption provision requiring FOP to purchase HP's shares. The court found that the 2003 put option exercise date effectively functioned as a maturity date. Since FOP was expected to have negative earnings and profits after 2003, and thus HP would no longer be able to claim foreign tax credits, HP had no economic incentive to remain in the transaction after 2003. The court also pointed to evidence showing that both HP and ABN expected that HP would exit the transaction in 2003.

The court rebutted HP's claim that it was not assured the return of principal by citing the dividend reset provision which, beginning in 2003, made the fair market value of the class B shares equal to their par value, "insofar as possible." In effect, this meant that HP could expect to receive full return of principal upon exercise of its put option in 2003. Although HP posited scenarios in which it would not receive the full amount, such as severe instability of FOP's assets due to an ABN bankruptcy, the court noted that, even then, HP would be assured of return of principal. If ABN went bankrupt and could not pay interest, FOP would not be able to pay dividends, thus triggering HP's right to cause FOP to redeem or repurchase HP's preference shares or to dissolve. Upon redemption, repurchase, or dissolution, HP would receive par plus premium on its shares. Thus, the court concluded that provisions in the transactional documents provided mechanisms whereby HP could enforce its creditor rights.

The Tax Court then considered factors three and ten, relating to the source of payment. Generally, payments in the form of dividends that are contingent upon earnings suggest an equity investment. The payments HP received from FOP took the form of dividends contingent upon earnings. The court reasoned, however, that under the articles of incorporation and the shareholder's agreement, FOP's board had no discretion in declaring dividends. FOP was required to pay dividends; if it did not, HP would have had legal remedy against both FOP and ABN. Additionally, the transactional documents effectively limited FOP's business activities to purchasing CINs, and the terms of the CINs fixed the dollar amount that FOP, and thus HP, received. The court found that these transactional documents, taken together, "obligated FOP to pay HP periodic, predetermined amounts, and that HP was assured to be repaid the principal amount of its investment at the end of the transaction's term, if not sooner."

Turning to factor five, the court observed that the right to participate in management often indicates an equity investment. HP, as the owner of shares representing 20 percent of FOP's voting power, had the right to participate in the management of FOP. The court discounted these "objectively meaningful voting rights" because HP gave no evidence that its representatives had ever attended a board meeting and thus "did not value those rights." In addition, the rights granted HP upon occurrence of a "Change of Control Event," although significant, merely provided a way for HP to exit the transaction rather than participate in the management of FOP.

The Tax Court then analyzed HP's status relative to other creditors, noting that the rights of equity investors are generally subordinate to those of creditors. Under the articles of incorporation, HP's rights were junior to any claims of indebtedness of FOP. But because FOP was prohibited from borrowing any amount over $1m, FOP could not have any material creditors. Thus, the court found that HP's claims to FOP assets were effectively senior to any others.

In its discussion of the intent of the parties, the court discounted the parties' intent as to the form of the transaction, looking instead to their actual rights and

obligations. In viewing the transaction as a whole, the court concluded that the parties intended "a limited term investment of HP's funds at a specified rate of return to be repaid in full in 2003."

The court found that the adequacy of capitalization also weighed in favor of debt treatment because ABN's investment in FOP was four times greater than HP's, effectively ensuring that HP could be repaid in full.

The court declined to discuss factor 9, finding it irrelevant in the context of the transaction at issue.

Finally, the Tax Court discussed factor eleven (ability to obtain financing). In general, finding that outside investors would have lent money to the entity on the same terms as the shareholder indicates that the investment is debt. In this case, the analysis was complicated by HP's expectation that its investment would generate foreign tax credits. Absent the FTCs, the annual return to HP would have been very low (1.53 percent to 1.91 percent at a time when the seven-year U.S. Government bond rate was 6.40 percent), and clearly no outside lenders would have lent money on those terms. When the expected FTCs were taken into account, however, HP projected an after-tax IRR of 9.1 percent. Because of the "unique circumstances," the court found this factor to be neutral. The court also observed that "placing significant emphasis on this factor would allow taxpayer's tax advantaged investment to elude debt characterization solely because their returns were deficient."

Accordingly, the court concluded that HP's investment was more appropriately characterized as debt.

## Conclusion

Commentators have noted that it is unclear what significance *Hewlett-Packard* will have, particularly because it deals with an unusual structure and was decided on a factual debt-equity analysis. It may also be significant that the Tax Court in *Hewlett-Packard* chose not to use the economic substance doctrine.[25] This is not the last word: courts have yet to decide at least three other FTC generator cases, *Bank of New York Mellon Corp. v. Commissioner*,[26] *Sovereign Bancorp Inc. v. United States*,[27] and *AIG v. United States*.[28]

*— N. Beekman*

## BDO USA To Pay $50 Million as Part of Tax Shelter Settlement

On June 13, 2012, the IRS announced a settlement with accounting firm BDO USA, LLP ("BDO"), formerly known as BDO Seidman, LLP.[29] BDO agreed to pay $50 million to the U.S. for its involvement in fraudulent tax shelters, including a civil penalty of approximately $34.4 million and a forfeiture of nearly $15.6 million.[30] As part of the settlement, the U.S. Attorney's Office filed a criminal information charging BDO with tax fraud conspiracy. BDO admitted to wrongdoing and will comply with certain conditions in a deferred prosecution agreement ("DPA"). The government will defer criminal prosecution of BDO under the DPA until December 2012. If BDO continues to meet its obligations after the deferral period, the government will move to dismiss the information without prejudice. A violation of the terms of the agreement could lead to prosecution or an extension of the deferral period.

The agreement specifies certain restrictions and controls on BDO and its practice. BDO, which has cooperated with the government since 2006, will continue to work

[25] Amy Elliott, "Government Gets Another FTC Generator Win in *Hewlett-Packard*," *Tax Notes*, May 21, 2012.

[26] No. 026683-09 (T.C.).

[27] No. 1:09-cv-11043-GAO (D.Mass. 2009).

[28] No. 09-cv-1871 (S.D.N.Y.).

[29] BDO USA, LLP to Pay IRS a $34.4 Million Penalty for Violating Tax Laws, IRS News Release, IR-2012-61 (June 13, 2012).

[30] *Id.*; Manhattan U.S. Attorney Announces Agreement With BDO USA LLP to Pay $50 Million to Resolve Federal Tax Fraud Investigations, Dep't. of Justice, U.S. Attorney's Office, Southern District of New York, Press Release (June 13, 2012).

with the IRS under the DPA on various civil matters, including audits and litigation in connection with its tax shelters. In addition, BDO will implement an effective compliance and ethics program.

The agreement stems from an investigation into BDO's involvement in various tax shelters, particularly between 1997 and 2003. The government determined that BDO violated federal tax laws during that time period by failing to register the tax shelters or maintain lists of investors in connection with the transactions, some of which were abusive and fraudulent. According to the government's determination, although fraudulent, the tax shelters were designed to appear as legitimate investments to the IRS, and in some cases, BDO promoted the shelters through false correspondence, legal opinions, consulting agreements, and other documents to hide the true nature of the transactions and its fees. BDO also reportedly filed false tax returns for clients and gave false information to the IRS at both its own promoter penalty examination and audits for its clients.

The tax shelters in the investigation are known by a variety of names, including SOS, Short Sale, Currency Option Investment Strategy or "COINS," Digital Options, G-1 Global Fund, FC Derivatives, Distressed Asset Debt, POPS, OPIS, and OID Bond.[31] According to the DOJ press release, BDO primarily marketed these transactions through an intrafirm group known as the Tax Solutions Group, which targeted wealthy individual clients with reportable income or gains over $5 million. Together, these clients claimed at least $6.5 billion in artificial losses that enabled them to evade around $1.3 billion of individual income taxes.

In its announcement, the IRS indicated that it is pleased with BDO's agreement to cooperate and ensure ongoing compliance with the tax laws. IRS Commissioner Douglas Shulman noted that the BDO "enforcement action is another reminder that taxpayers can't hide behind complicated schemes or corporate tax shelters."[32] Shulman added, "The IRS is strongly committed to stopping illegal tax shelters."[33]

*— D. Smith*

## Court Grants Motion for New Trial for Daugerdas and Two Others, Denies New Trial for Fourth Defendant

Judge William H. Pauley III of the U.S. District Court for the Southern District of New York granted a motion for a new trial filed on behalf of Paul Daugerdas and Donna Guerin, formerly partners with Jenkins & Gilchrist, and Denis Field, the former chief executive officer of BDO Seidman after a juror, Catherine M. Conrad, disclosed that she had lied during *voir dire*.[34] Judge Pauley upheld the conviction of a fourth individual, David Parse, because his lawyers knew of the juror's misconduct before the jury rendered its verdict and did not disclose the juror's background to the court.

### *Voir Dire*

Before the trial began, 450 prospective jurors reported to the courthouse for possible selection, and on March 1, 2011, *voir dire* began. Approximately 175 jurors, Conrad among them, swore to answer truthfully regarding their qualifications to serve on the jury. Conrad's answers during *voir dire* contained lies and gross omissions about her background. Her lies and omissions included telling the court that her highest level of education was a bachelor's degree when she in fact had a law degree and that she had been a "stay-at-home wife" when she in fact had practiced law until her law license was suspended. She also concealed her and her husband's extensive criminal histories.

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] Memorandum & Order, *United States v. Daugerdas*, 09 CR 581 (S.D.N.Y. Jun. 4, 2012).

## Verdict

On May 24, 2011, following a ten week trial that included testimony from 41 witnesses and eight days of jury deliberations, the jury returned a split verdict against the defendants. Daugerdas and the three others were convicted for their roles promoting and marketing a multibillion-dollar tax shelter scheme. A fifth defendant was acquitted.

## Investigation into Conrad

Following the convictions, Conrad sent a two-page letter to one of the government attorneys, praising his and his co-counsel's work during the trial and discussing the strengths and weaknesses of the government's case. The government forwarded this letter to the court and defense counsel. According to the defendants' counsel in their memorandum of law in support of the motion for a new trial, this letter caused Parse's trial counsel to investigate Conrad's background and ultimately to file a motion for new trial based on Conrad's lies and omissions during *voir dire*.

In response to the defendant's motion for a new trial, the court conducted an evidentiary hearing. During that hearing, Conrad displayed erratic behavior, explained that she lied to the court to make herself a more "marketable" juror, claimed that she could not remember facts and understand questions, and made numerous statements revealing her "animus toward lawyers." She acknowledged to the court that she knew that if she had truthfully disclosed her background during *voir dire* she would not have been allowed to sit on the jury.

Following the hearing, the court asked the attorneys for the government and the defendants when they had become aware of Conrad's background. The government attorneys represented that they had no knowledge of the facts in the defendants' motion for a new trial. Attorneys for Daugerdas, Guerin, and Field told the court that they were unaware of Conrad's background until the post-verdict investigation. Parse's attorney's revealed that they had begun investigating Conrad's background earlier and that they would not have disclosed any of their investigation into Conrad but for the court and the government's inquiry. Ultimately, Parse's counsel revealed that they had in fact begun looking into Conrad's background before *voir dire*, abandoned the research after she was questioned during *voir dire*, but conducted further research after she asked for a jury instruction regarding a legal term that had not been raised during trial. The next day Parse's counsel discovered Conrad's Suspension Orders from the New York Supreme Court Appellate Division, First Department. A Westlaw Report contained additional information about Conrad's background. According to Parse's counsel, she reviewed the Westlaw Report and found it unreliable, and she and the attorneys with whom she worked concluded that Conrad could not be the suspended attorney. Parse's attorneys did not bring the information to the attention of the court or the government during the jury's deliberations, nor did they raise the issue when the jury returned its verdict.

Not until they received a copy of Conrad's letter to the government following the verdict did Parse's attorneys "realize[], for the first time, that it was no longer 'inconceivable' that Conrad was not who she claimed to be during *voir dire*." At that time they brought to the court's attention Conrad's misrepresentations.

## Impartial Jury

A criminal defendant has a Sixth Amendment right to a trial by an impartial jury. Through *voir dire*, a defendant has the opportunity to expose veniremen's biases, and a juror who provides false statements or willfully evasive answers during *voir dire* undermines the fairness of the judicial process.

The court did not mince words in its order, labeling Conrad's actions a "calculated, criminal decision to get on the jury." Her lies "directly affected her qualifications to serve as a juror," and her explanation of her lies during the evidentiary hearing revealed a bias against the attorney-defendants. The court stated that it would have removed her for cause had it known of her background

and biases earlier because she was incapable of being an impartial juror.

A defendant may waive his right to challenge the partiality of a jury verdict based on a juror's alleged misconduct during *voir dire* through the actions of his attorneys, even if he is unaware the conditions giving rise to the waiver. The court stated that counsel must raise with the court evidence of juror misconduct in a timely manner. "Ultimately, a defendant waives his right to an impartial jury if defense counsel were aware of the evidence giving rise to the motion for a new trial or failed to exercise reasonable diligence in discovering that evidence." The court explained that Parse's attorneys were aware of evidence that should have been brought to its attention regarding Conrad's background and failed to conduct reasonable diligence.

Accordingly, although the court granted the motion for a new trial for Daugredas and two of his other co-defendant's, Parse's motion for a new trial was denied.

*— E. McGee*

## Indian Government Identifies Vodafone as Potentially Subject To Retroactive Tax

Proposed Indian Finance Bill 2012 would amend the Income Tax Act, 1961 to allow the reopening of cross-boarder mergers and acquisitions involving Indian assets. This could allow the Indian government to reopen the Vodafone case, which was decided in Vodafone's favor in January.

On May 30, the Indian Finance Minister pledged that the Indian Income Tax Department would not reopen any tax case settled before April 1, 2012.[35] However, despite this pledge, the Indian government has now identified several closed transactions, including the Vodafone transaction, that could be subject to retroactive tax. It is estimated that retroactive taxes on the identified transactions could generate as much as INR 400 billion (approximately $7.13 billion) in revenue.

Vodafone's victory in January (which avoided a $2.2 billion tax bill) related to Vodafone's purchase of an Indian mobile telephone company. The Indian Supreme Court rejected the Indian government's tax assessment on the basis that the purchase was between Dutch and Hong Kong entities, and thus not under Indian tax jurisdiction.[36] However, because the assets purchased were Indian, Finance Bill 2012 could retroactively impose a tax on the transaction.

Vodafone intends to bring the retroactive tax amendment before an international arbitration body claiming that the amendment is in violation of an investment treaty between India and the Netherlands.[37]

*— D. Jones*

## U.S. Demands Taxpayer Information from Liechtenstein

The IRS and the U.S. Department of Justice ("DOJ"), following the lead of the U.K., which anticipates that more than £3bn will be raised from U.K. taxpayers with hidden accounts in Liechtenstein, is expanding its search for offshore tax evaders to Liechtenstein, a tiny landlocked European nation of 36,000 residents that borders Switzerland. Despite its tiny size, merely twice the size of Washington, D.C., Liechtenstein is a well-known tax haven with a reputation for not cooperating with international tax investigations. The IRS's interest in Liechtenstein is in line with the Service's goal of finding taxpayers hiding assets overseas and pursuing criminal prosecutions of international tax evasion.

U.S. citizens who have interests in, or signature or other authority over, financial accounts in a foreign country with assets in excess of $10,000 are required to disclose

[35] *See* Randall Jackson, "India Eyes Vodafone on Prior-Year Transactions," *Tax Notes International*, June 11, 2012.

[36] *Vodafone Int'l Holdings B.V. v. Union of India*, Civil Appeal No. 733 of 2012 (Jan. 20, 2012).

[37] *See* Randall Jackson, "India Eyes Vodafone on Prior-Year Transactions," *Tax Notes International*, June 11, 2012.

the existence of such accounts on Schedule B, Part III of their individual income tax returns. Additionally, American citizens must file a Report of Foreign Bank and Financial Account ("FBAR") with the U.S. Treasury, disclosing any financial account in a foreign country with assets in excess of $10,000 in which they have a financial interest or for which they have signatory or other authority. Many taxpayers failed to file the FBAR and the IRS has made the investigation of offshore accounts a top priority.

The U.S. has requested that the Principality of Liechtenstein turn over documents and the names of U.S. persons connected with accounts at Liechtensteinische Landesbank ("LLB"), Liechtenstein's oldest bank. This disclosure is pursuant to a "Request for Administrative Assistance in Tax Matters" dated May 11, 2012, from the DOJ to the Liechtenstein Tax Administration, for information related to all accounts at LLB since January 2004, valued in excess of $500,000, with U.S. beneficial owners. It has been reported that the DOJ seeks information on whether "U.S. persons violated criminal laws of the United States by . . . not declaring their non-declared accounts to the IRS and failing to pay taxes on income gained on such accounts." The DOJ's May 11, 2012 request is not a specific request for information about known, named taxpayers. Rather, it is a broad request for unnamed, unknown taxpayers. In addition, the U.S. is also targeting lawyers, accountants, asset managers, and others who worked with or provided assistance to tax evading account holders.

The Liechtenstein Tax Administration is acting pursuant to the 2008 "Agreement Between the Government of the U.S.A. and the Government of the Principality of Liechtenstein on Tax Cooperation and the Exchange of Information Relating to Taxes." The treaty originally disallowed DOJ or IRS broad requests for information on a class of unknown U.S. taxpayers. Under the 2008 treaty, Liechtenstein was only to provide information if asked about a specific, known taxpayer identified by name. However, on March 21, 2012, Liechtenstein bowed to international pressure and amended the 2008 treaty and the Liechtenstein Parliament passed an internal law, the result of which is that information regarding unknown U.S. taxpayers may now be collected and released. The Liechtenstein government accepted the O.E.C.D. standards on transparency and information exchange in tax matters. Accordingly, with regard to Liechtenstein, the U.S. government was not required to issue a "John Doe" summons to obtain information on unknown taxpayers. This will expedite disclosure and likely broaden the scope of information collected and released.

U.S. taxpayers whose Lichtenstein accounts are subject to the information disclosure agreement are not completely without recourse, however. Per the Liechtenstein Tax Administration, LLB account holders have until June 14 to challenge the release of the documents in Liechtenstein courts.

LLB now follows the Swiss banks in providing once-secret bank account details to the IRS and DOJ for use in investigations and prosecutions of U.S. taxpayers.

Against the background of tax investigations, the IRS re-opened its Offshore Voluntary Disclosure Initiative ("OVDI") in January 2012 to encourage taxpayers with undeclared foreign accounts to become tax compliant and avoid criminal prosecution. The IRS has already collected more than $4.4 billion from the two previous international voluntary disclosure programs, which included more than 33,000 taxpayers. The first round of the program began in 2009 and a second round was offered in 2011. The current OVDI does not provide a cut-off date, but the terms of the program are subject to change at any time.

Back taxes and penalties will be due under OVDI, but the penalties for U.S. taxpayers disclosing offshore accounts are likely to be far lower than the civil and criminal penalties that may ensue if the IRS learns of the account from other sources. Basic terms of the 2012 IRS Amnesty program require (i) taxpayers pay a 27.5-percent penalty of the undisclosed offshore account that is based on the highest aggregate balance in the foreign account/entity or value of foreign assets over the past eight-year period (this is up from 25 percent in the 2011 program);

(ii) taxpayers must pay back taxes and interest on any unreported income for up to eight years as well as accuracy related and/or delinquency penalties, and (iii) taxpayers must file all original and amended tax returns and include payments for taxes, interest, and accuracy related penalties. Individuals whose offshore accounts or assets do not surpass $75,000 in any calendar year covered by the new OVDI will qualify for a 12.5-percent penalty.

The new 2012 voluntary disclosure rules provide taxpayers with foreign accounts the opportunity to come forward and become compliant with FBAR requirements. Participants who successfully complete the IRS Voluntary Disclosure Program may avoid criminal prosecution and substantial civil penalties. However, for some Liechtenstein account holders, it may be too late.

*— R. Nessler*

## Tax Court Holds in Favor of Taxpayer in Section 269 Case

The U.S. Tax Court held in *Love v. Commissioner*[38] that the taxpayers' acquisition of the stock of an S corporation, when the failure of the taxpayers to take some action would have subjected them to significant adverse tax consequences under newly issued regulations, was not made for the principal purpose of evading or avoiding income tax by obtaining a deduction which the taxpayers would not otherwise have enjoyed within the meaning of section 269. The taxpayers acquired the S corporation in order to unwind their prior structure, in which the S corporation was owned by an employee stock ownership plan ("ESOP"), following the issuance of temporary regulations that would have caused the ESOP to lose its tax-exempt status and subjected the taxpayers to an excise tax.

### ESOP Structure

The taxpayers, who owned several McDonald's restaurants, formed a subchapter S corporation to employ and manage the restaurant employees. All of the shares of the S corporation were acquired by an ESOP, and the taxpayers and approximately 275 other employees became participants in and beneficiaries of the ESOP.

In exchange for managing the employees, the S corporation received fees from another domestic corporation controlled by the taxpayers, which was responsible for operating the restaurants. The income of the S corporation flowed through to its sole shareholder, the ESOP, which enjoyed tax-exempt status.

The S corporation also established a nonqualified deferred compensation plan ("NQDCP"). The taxpayers were the only employees to participate in the NQDCP, and the taxpayers' deferred compensation, though not currently deductible, represented a significant portion of the S corporation's income. The deferred compensation liability limited the value of the S corporation stock and minimized the value of the ESOP to the corporation's other employees.

### Taxpayers' Acquisition

In 2003, Treasury and the IRS issued temporary regulations, to be effective one year later, under which the taxpayers' deferred compensation accounts would have become immediately taxable to the taxpayers, the S corporation would have been subject to a 50-percent excise tax on the amount of the deferred compensation and the ESOP would have ceased to be tax exempt.[39]

To avoid the adverse consequences of the temporary regulations, the taxpayers decided to purchase the S corporation stock from the ESOP for its fair market value, approximately $100,000, and the ESOP was terminated. The taxpayers made an election under section 1377(a)(2) to close the S corporation's taxable year on the acquisition date. Following the acquisition, more

[38] T.C. Memo 2012-166 (June 13, 2012).

[39] § 1.409(p)-1T(h)(1), Temporary Income Tax Regs.

than $3 million of deferred compensation owed to the taxpayers was paid. The taxpayers included such amount as income on their tax return and the S corporation took a corresponding deduction. Because the taxpayers owned the S corporation when the compensation was paid, the S corporation's compensation deduction would flow up to the taxpayers provided that they had sufficient basis in their shares. Within a few months of receiving the deferred compensation, the taxpayers contributed almost $3 million to the S corporation, and acknowledged that they had done so for the purpose of increasing their basis in the corporation in order to obtain the benefit of the compensation deduction.

## Section 269

The IRS relied on section 269 to disallow the taxpayers' claim to the compensation deduction. Under section 269(a), the IRS may disallow a deduction, credit, or other allowance that a taxpayer would otherwise enjoy if the taxpayer acquires control of a corporation and the principal purpose of the acquisition is the evasion or avoidance of federal income tax by obtaining such deduction, credit, or allowance. At issue was the taxpayers' principal purpose for acquiring stock of the S corporation.

The court concluded that the taxpayers had "legitimate nontax business reasons" for acquiring the stock of the S corporation. In particular, the taxpayers determined the ESOP structure had "become more complicated and costly and less effective than they had anticipated."[40] The court also noted that the issuance of the temporary regulations compelled the taxpayers to take action, and that the taxpayers' subsequent contribution of the deferred compensation to the S corporation was a real economic transfer from the taxpayers to the S corporation. Based on these points, the court held that the taxpayers did not acquire the S corporation stock for the principal purpose of avoiding or evading federal income tax. It reached that decision even though it characterized the taxpayers' establishment of the ESOP structure as "aggressive tax planning."

*— N. Tasso*

[40] In addition, though not mentioned in the Tax Court opinion, certain arrangements in which an ESOP acquired the stock of an S corporation established to receive income generated by a business had been designated as a listed transaction by the IRS in Revenue Ruling 2003-6, 2003-1 C.B. 286, which was issued in the period after the taxpayers had established their ESOP structure but prior to the issuance of the temporary regulations.

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