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Editor's Note

Dear Readers,

This issue features articles containing an analysis of the Tax Court's recent debt-versus-equity decisions in *Hewlett-Packard*, *PepsiCo*, and *ScottishPower*, an examination of the latest developments with respect to FATCA, and a synopsis of the FTC generator cases. The issue also features an article that takes a closer look at pre-filing agreements.

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

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A Closer Look at Pre-Filing Agreements

The Pre Filing Agreement program ("PFA") creates an opportunity for a taxpayer cooperatively and economically to resolve issues likely to be disputed with the IRS before the taxpayer files its returns. Under the PFA program, a taxpayer may request consideration of an issue before the tax return is filed. Taxpayers who participate in this program estimate that they save 48 percent by using PFAs instead of participating in traditional audits.[1]

The PFA program is available to all taxpayers under the jurisdiction of LB&I, including C corporations, S corporations, and partnerships with assets greater than $5 million. A taxpayer may request a PFA for the current taxable year, any prior taxable year for which the original return is not yet due (including years for which the taxpayer sought extensions of time to file), and for future taxable years up to four taxable years beyond the current taxable year. An open exam is not a prerequisite – a taxpayer may elect to be considered for the program regardless of whether such taxpayer is in exam.

Appropriate Issues for PFAs

PFAs provide an economical way for taxpayers, their counsel, and the IRS to resolve a number of complex issues before filing. According to Revenue Procedure 2009-14, the IRS will generally consider entering into a PFA on any issue that requires either a determination of factual issues or the application of well-established law to known facts.[2] Further, the IRS will also consider entering into a PFA regarding a methodology used by a taxpayer to determine the appropriate amount of an item of income, allowance, deduction, or credit.[3] The Service reserves the right to decline entering into a PFA based on considerations of sound tax administration.[4]

Issues that have been accepted into the program include research credit issues and complex valuation issues, for example a valuation related to the sale of assets and stock of a subsidiary to an unrelated third party.[5] The Service has provided a list of excludable issues, which includes, transfer pricing; issues involving a change in accounting method; issues of reasonable cause, due diligence, and good faith; issues that involve a tax shelter described in 6662(d)(2)(C)(ii); and issues relating to transactions that have not yet occurred. PFAs cannot be used to resolve uncertain legal issues.

Introduction to the PFA Process

Generally, the taxpayer and the taxpayer's counsel will begin the PFA process by preparing and filing an application for a PFA. The guidelines provide no form, but the application must be in writing, contain specific identifying information, and be signed by an authorized party under penalties of perjury. The criteria for selecting taxpayers into the PFA program include the impact of a PFA upon other years, issues, taxpayers, or related cases, IRS resources, the taxpayer's willingness and ability to participate in the PFA process, the possibility for whipsaw, and the time remaining until the filing deadline. Early submission before the returns become due is a key consideration.

The final decision of acceptance or nonacceptance is made by the IRS. Once a request has been accepted and the taxpayer is notified, the taxpayer must pay a $50,000 user fee.

Upon acceptance, the taxpayer, taxpayer's counsel, and the IRS will work together to develop the issue or issues. Because a PFA requires extensive cooperation between the IRS and the taxpayer, the IRS must have access to the taxpayer's employees who are knowledgeable about the PFA issue and relevant books and records that relate to the issue. If the parties reach agreement, the taxpayer, the taxpayer's counsel, and the IRS will generally work together to prepare the initial draft of the PFA. On

[1] *See* http://www.irs.gov/Businesses/Fact-Sheet:-Pre-Filing-Agreement-(PFA)-Program-(May-2011).

[2] Rev. Proc 2009-14.

[3] *Id.*

[4] *Id.*

[5] *See* http://www.irs.gov/pub/irs-drop/a-02-54.pdf.

average, a PFA takes approximately one year to complete.[6] If the taxpayer cannot reach agreement with the IRS before the taxpayer files an associated return, the IRS and the taxpayer may still attempt to resolve the issue and enter into a PFA. If the filed return is inconsistent with the terms and conditions of the later PFA, the taxpayer must agree to file an amended return. At any time prior to the execution of the PFA, either the taxpayer or the IRS may withdraw from consideration all or part of the PFA request. Once an agreement has been reached, the taxpayer and the IRS will execute a closing agreement, which generally resolves the issue without any further compliance costs on the part of the taxpayer.

PFAs have become a more popular tool for resolving issues since the inception of Schedule UTP, creating certainty where it might otherwise not exist. Between the PFA program's inception in 2001 and May 2010, the IRS received 387 applications, accepted 269, and close 179 with an agreement.[7]

Practice Points: Why Seek a PFA

- Cost savings
- To enter into a closing agreement with respect to specific issues for current years
- To resolve the treatment of issues in future years (absent changes in laws)
- To create certainty for otherwise uncertain tax positions before filing a return

— Lawrence M. Hill,
Richard A. Nessler & Liz McGee

Making Sense of the Tax Court's Recent Debt-Equity Cases: *Hewlett-Packard*, *ScottishPower*, and *PepsiCo*

Introduction

Recently the Tax Court has used the multifactor debt/equity test to decide three significant cases: *Hewlett-Packard*,[8] *ScottishPower*,[9] and *PepsiCo*.[10] The court agreed with the taxpayer's characterization of the advances at issue in two cases, *ScottishPower* and *PepsiCo*, both of which involved intercompany lending transactions. As discussed below, both cases contained good and bad facts for the taxpayers, but the court, in each instance, accepted the taxpayer's position after discussing all factors in the debt/equity test. The court rejected Hewlett Packard's ("HP's") equity characterization of its preferred and priority share investment in Foppingadreef ("FOP"), an entity organized in the Netherlands-Antilles. HP's investment was challenged under three theories: debt/equity, economic substance, and step-transaction. The court did not reach the latter two but seems to have had them in the back of its mind when analysing the first theory.

This article attempts to make some sense of the cases as read together. With so many factors in play under the multifactor debt/equity analysis, it can be difficult to understand which factors were essential to the court's decision and which could have come out differently without changing the overall result. In addition, the government's assertion of economic-substance and step-transaction arguments in *Hewlett-Packard* adds another layer of uncertainty as to the factors that were critical to the outcome in that case, even though the court rested its decision solely on its debt/equity analysis. Thus, we have attempted to compare and contrast certain aspects of these cases that the court homed in on to

[6] *See* http://www.irs.gov/Businesses/Fact-Sheet:-Pre-Filing-Agreement-(PFA)-Program-(May-2011).

[7] *See* http://www.irs.gov/Businesses/Fact-Sheet:-Pre-Filing-Agreement-(PFA)-Program-(May-2011).

[8] *Hewlett-Packard v. Commissioner*, T.C. Memo 2012-135 (May 14, 2012).

[9] *NA General Partnership v. Commissioner*, T.C. Memo. 2012-172 (June 19, 2012).

[10] *PepsiCo Puerto Rico v. Commissioner*, T.C. Memo 2012-169 (Sept. 20, 2012).

answer the ostensibly simple questions of "why did HP lose?" and "why did PepsiCo and ScottishPower win?"

Case Synopses

Hewlett-Packard

Hewlett-Packard was the first of the three cases to be decided. AIG Financial Products Corp. ("AIG-FP") planned a US-dollar-linked Netherlands guilder stepped coupon contingent interest note ("CIN") transaction to take advantage of the Dutch income recognition rules for contingent interest, which were different from the applicable US federal income tax rules. The planned transaction included AIG-FP capitalizing a newly formed European entity, FOP, and receiving in return preferred stock and warrants for more stock; ABN Amro Bank N.V. ("ABN"),[11] a Dutch bank, simultaneously acquiring common stock with four times as much value as AIG-FP's preferred stock in FOP; and FOP lending money to ABN in exchange for CINs. The transaction that AIG-FP modelled would create a stream of preferred dividends and produce foreign tax credits for foreign taxes paid by FOP.

Rather than participating in the FOP transaction itself, "AIG-FP marketers began researching which of their clients were actively seeking investment opportunities." Because HP was in an excess limitation position with respect to its foreign tax credits, AIG-FP approached HP about investing in the transaction. After AIG-FP and ABN capitalized FOP, HP purchased AIG-FP's interest in FOP.

The issue in the case was whether HP's investment in FOP was debt or equity. Although the investment was clearly structured as equity, the court focused on a few particular features of the investment that it ultimately concluded were inconsistent with an equity characterization: the court believed that the parties always intended a seven-year exit from the transaction because HP had an option to put its shares in FOP to ABN in seven years when the tax benefits ceased; HP's financial risks were limited because company profits were fairly certain and HP did not think ABN would default; FOP would pay HP periodic, predetermined amounts and HP was assured principal; HP did not intend to absorb the risk of FOP but instead sought a definitive obligation; and, FOP could not have a material creditor, so HP's rights would never be subordinate to another creditor's.

ScottishPower

In the second case, *ScottishPower*, a foreign utility business, indirectly owned NAGP, a domestic special purpose entity that it had formed for purposes of acquiring PacifiCorp, a US utility company. ScottishPower organized NAGP as a special-purpose entity. NAGP issued $4 billion in fixed-rate and $896 million in floating-rate loan notes to ScottishPower in consideration for ScottishPower's transfer, on behalf of NAGP, of its ADS shares and common shares to PacifiCorp shareholders in connection with the acquisition. Both loan notes were transferable and had fixed maturity dates: the fixed-rate loan notes were to mature in November 2011, and the floating-rate notes were to mature in November 2014. Interest was payable quarterly in arrears, and the loan notes were unsecured and ranked equally and rateably with NAGP's other debt obligations. Under the note terms, ScottishPower could require NAGP to repay all or part of the loan notes at any time with proper notice, and NAGP had the right to redeem the notes without penalty at an agreed market rate. ScottishPower could require repayment of all the loan notes if any principal or interest was not paid within 30 days of the due date. ScottishPower treated the notes as debt on their books and records, represented to the US Securities and Exchange Commission that the notes were debt, and took interest expense deductions with respect to the notes.

At issue in the case was whether the advances made by ScottishPower to NAGP in connection with NAGP's acquisition of PacifiCorp were loans or capital contributions. The government claimed that

[11] The court stated that ABN's ethics committee, consistent with its policy of reviewing transactions with complex tax and economic features, had reviewed the FOP transaction before ABN participated. The ethics committee generally only approved transactions with economic purpose, noncircular funding flows, and viability under the law.

ScottishPower had improperly characterized the loan notes as debt as revealed by the fact that some intercompany payments had not been made on time. The court rejected the government's arguments, finding that NAGP's failure to make timely payments was not fatal to debt characterization and stating that despite the relatedness of the debtor and creditor, capitalization was adequate to support debt characterization and the other features of the notes—the maturity dates, requirement of interest payments, and unconditional right to demand repayment—supported debt characterization, as well.

PepsiCo

The issue in *PepsiCo*, the third of these cases, was again whether certain advance agreements were more appropriately characterized as debt than as equity for US federal income tax purposes. According to the court's narrative, in the mid-1990s, PepsiCo restructured its business operations to take advantage of foreign business opportunities and address a change in the US-Netherlands tax treaty. A PepsiCo-controlled entity issued advance agreements, providing for payment of principal after initial 40-year terms, to PepsiCo Puerto Rico in return for notes. The payments of base preferred return on the advance agreements were linked to interest received on other notes. The holders of the advance agreements could not demand immediate repayment in the event of default, and the advance agreements subordinated any obligations of the Dutch limited liability companies to pay unpaid principal or accrued, but unpaid, preferred return to all other indebtedness. The court stated that no third-party lender would have loaned the funds under the terms provided by the advance agreements. PepsiCo took the position that the advance agreements would be classified as debt in the Netherlands and treated as equity in the US. The Dutch Revenue Service provided a ruling that the advance agreements would be treated as debt for Dutch tax purposes. If the advance agreements were treated as debt for US federal income tax purposes, the debt-to-equity ratio would have been inconsistent with industry norms. The court agreed with the taxpayer that the advance agreements were equity.

Discussion

In the following discussion, we have focused on five factors that seemed to have the potential to explain the courts' decisions in these cases in a way that may have predictive value for future transactions and cases. The following discussion looks more closely at how those five factors affected the decisions in *Hewlett-Packard*, *ScottishPower*, and *PepsiCo*, and considers what those factors might say about how future cases may be decided.

1. Intent

The simplest explanation for "why HP lost" may be the "intent" factor. Although the "intent of the parties" is just one of the 13 factors in the debt/equity analysis, Judge Goeke's opinions in both *Hewlett-Packard* and *PepsiCo* placed special emphasis on the taxpayer's intent. For example, the *Hewlett-Packard* decision states, "Generally, the focus of the debt-versus-equity inquiry narrows to whether there was an intent to create a debt with a reasonable expectation of repayment and, if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship. . . . The key to this determination is primarily the taxpayer's actual intent, as revealed by the circumstances and condition of the transfer." The *PepsiCo* decision contains similar language. In *Hewlett-Packard*, the court found that "HP never intended to absorb the risk of the FOP venture. Rather, it sought a definite obligation, repayable in any event." In contrast, in *PepsiCo*, the court found that the taxpayer was "uncompromising" in refusing to allow its instruments to have terms that required the issuer to make annual payments. The court also stated that the long, and potentially perpetual, term of the instruments in *PepsiCo* demonstrated that the taxpayer did not intend to create a debt relationship.

In analyzing the parties' intent, the court took two different approaches to the parties' intended US tax treatment of the instruments. In *Hewlett-Packard*, the court dismissed the taxpayer's assertion that the parties

intended for it to be treated as an equity holder for US tax purposes, saying that it was concerned only with the parties' intent regarding the taxpayer's rights and obligations. The *ScottishPower* court similarly dismissed the government's argument that the taxpayer in that case intended for the instrument to be debt only to avoid tax. But in *PepsiCo*, the court observed, with apparent approval, that the taxpayers "designed the advance agreements with an expectation that the instruments would be characterized as equity for US Federal income tax purposes."

Despite the *Hewlett-Packard* court's emphasis on intent regarding the taxpayer's rights and obligations, it is unclear whether the cases turned on the taxpayers' intentions regarding their rights and obligations under the instruments in question or whether the cases turned on the rights and obligations that the court objectively found them to possess. That is, would the court's perception that HP intended to receive a definite obligation repayable in any event matter if the court also perceived that HP had not been successful in obtaining such an obligation? It is important for taxpayers to recognize Judge Goeke's focus on the taxpayer's intent, but it seems prudent to be cautious about elevating the intent factor above the others – especially when the other factors may inform the court's analysis of the taxpayer's true intent.

Finally, if a taxpayer seeks to follow these statements in *Hewlett-Packard* and *PepsiCo* and determine the debt or equity status of its instrument based on the parties' "intentions regarding the actual rights and obligations ascribed to them by their participation in the transaction," it must also ask for which rights and obligations the taxpayer's intentions matter. Is the taxpayers' intent regarding some rights and obligations more important than others? In *Hewlett-Packard*, the court seemed to focus on the taxpayer's right to be repaid in any event by exercise of its put option. In *ScottishPower*, the court, in considering the intent factor, addressed the form of the instruments, the requirement for interest payments, the stated maturity dates, lack of subordination, and non-tax treatment of the instruments. In *PepsiCo*, the court focused on whether the right to receive payments involved the issuer's discretion and the length of the instrument's term (which could potentially extend in perpetuity). Potentially, because it forces the court to discuss the parties' intentions regarding multiple rights and obligations, the "intent of the parties" factor might serve as a clue to understanding which of the other 13 factors were judged to be most important in a particular case.

2. Activities of the Issuer

Another possible explanation for the differences in outcomes of the cases is the activity level of the issuer of each instrument. In *ScottishPower* and *PepsiCo*, the issuers engaged in holding-company activities beyond the holding of a fixed set of assets and the issuance of a fixed set of instruments. The issuer in *ScottishPower* engaged in an acquisition and a restructuring and borrowed funds under a third-party credit agreement. The issuer in *PepsiCo* was funding other entities engaged in PepsiCo's international activities. In *Hewlett-Packard*, however, the issuer appeared to have little opportunity to engage in other activities with its holdings, and the court almost viewed it as an automaton programmed from the beginning rather than as an active entity. It did not believe there was real meaning to HP's voting rights in the entity. Thus, the court's decision is reminiscent of how the transaction would be treated if the issuer had not been respected as a business entity (*e.g.*, as a grantor trust). The court did not state its decision in that way, but it made reference to the "predictable and consistent" cash flows of the entity and the "predetermined" nature of the entity. Although the court rested its decision on debt/equity analysis, if one views the lack of activity of the entity as the critical fact for the outcome, then *Hewlett-Packard* may not be particularly relevant for debt/equity analysis in most other cases that involve issuers that are more clearly business entities, such as in *PepsiCo* and *ScottishPower*.

3. Nature of the Investor's Business

Another possibility, somewhat related to the last point, is that *Hewlett-Packard* differed from the taxpayer victories

in *ScottishPower* and *PepsiCo* in that HP's investment less obviously related to its normal businesses. In *ScottishPower*, it was clear that the issuer was to undertake a highly substantive acquisition, and the question was simply whether the issuer was funded by its parent company with debt or equity financing. Similarly, in *PepsiCo*, the court did not question that the intercompany agreements were functionally related to PepsiCo's risky investments in international food and beverage business activities, even though they were issued in exchange for intercompany notes that were successors to other pre-existing intercompany notes. The loans to ABN made by FOP in *Hewlett-Packard*, however, were not the type of assets that one would typically think of a technology company like HP acquiring. That impression may have caused the court to scrutinize the transaction more skeptically. This explanation, if correct, might lead to a similar case involving a financial institution that more commonly invests in instruments similar to those issued by ABN reaching a different result from *Hewlett-Packard*, even on similar facts.[12] The court was careful not to tip its hand with respect to this point, and it is unclear from the discussion whether the *Hewlett-Packard* court considered the nature of HP's business distinct from the pre-determined nature of FOP transaction. Furthermore, since HP was no more likely to invest in debt of FOP than equity of FOP, it is unclear that the fit of the investment with the taxpayer's usual activities should affect a debt/equity analysis in many cases.

4. Marketed Transaction

Yet another difference between *Hewlett-Packard* and the other cases is that the transaction entered into by HP was proposed to HP by AIG-FP. In *ScottishPower*, the taxpayer's tax advisers were not mentioned until several years after the initial transaction, at which point PwC advised the taxpayer's parent company to capitalize some of the intercompany notes that it held. It was also clear that the acquisition planned by the taxpayer's parent was not one that would be done merely for tax purposes – it was done to facilitate a corporate acquisition. In *PepsiCo*, while the taxpayer appeared to have advisers involved from the beginning of its planning for the advance agreements, the court made no mention of the agreements being promoted or marketed to the taxpayer by any outside party. The court also viewed the restructuring work done by the PepsiCo tax department, in conjunction with outside advisers, as involving a "unique confluence of both tax and business factors" rather than as a solely tax-driven transaction. Thus, these cases would be consistent with a belief that marketed transactions that would not be considered but for tax consequences are subject to higher scrutiny simply because they are marketed. That belief may provide another reason to underplay the importance of *Hewlett-Packard* for debt/equity analysis more generally.

5. Sharing of Tax Benefits

One striking difference between *Hewlett-Packard*, on the one hand, and *PepsiCo* and *ScottishPower*, on the other, is that HP's transaction was with an unrelated person, while in *PepsiCo* and *ScottishPower*, the taxpayers transacted with related persons. Typically, the courts more closely scrutinize transactions between related parties than those between unrelated parties. In these cases, however, the court rejected the taxpayer's characterization of the *un*related-party transaction.

The impetus for the court rejecting HP's characterization may have been, in part, a distaste for sharing tax benefits among unrelated persons. In *Hewlett-Packard*, the court observed that AIG-FP intended to market the transaction to taxpayers who had excess capacity under the foreign tax credit limitation calculation. HP was one of those taxpayers. The court also observed that HP did not earn a pre-tax return on the transaction that matched the risk-free return it could earn in other investments. These observations suggest that HP was, in effect, entering into a transaction that allowed it to monetize its excess foreign tax credit limitation capacity, a part of its tax attributes, and split the fruits of that excess capacity with ABN by

[12] Indeed, this is one of several factors distinguishing the *Hewlett-Packard* transaction from some of the other so-called FTC generator cases. All section references are to the Internal Revenue Code and all references to regulations are to the Treasury regulations thereunder, unless otherwise noted.

providing below-market financing to ABN. The Service, Congress, and the courts often balk at the sharing of unused tax attributes among unrelated taxpayers. On the other hand, the intercompany nature of the *ScottishPower* and *PepsiCo* transactions meant that those taxpayers used any benefits generated themselves (or within their related groups). Thus, the holdings establish that the court considered the intercompany transactions more deserving of respect.

Conclusion

A close read of the cases reveals that no single factor is conclusive – indeed, the courts repeat that refrain in every case. *ScottishPower* and *PepsiCo* at least, show that the court does not share the Service's concern that taxpayers will inevitably mischaracterize intercompany advances, but *Hewlett-Packard* reaffirms the court's mistrust of so-called marketed transactions and the sharing of tax benefits in many instances.

— Nathan Tasso & Liz McGee

Treasury Releases Model II FATCA Agreement, Announces Initialing of Intergovernmental Agreement with Switzerland

On November 14, 2012, the Treasury Department published[13] a second model intergovernmental agreement ("Model II") for the implementation of the Foreign Account Tax Compliance Act ("FATCA"). Like the previously published Model I agreement, the Model II agreement presupposes that the foreign country entering into the agreement (the "FATCA partner country") has an income tax treaty or information exchange agreement in force with the US pursuant to which information about taxpayers may be exchanged.

Unlike the Model I agreement, however, the Model II agreement will require foreign financial institutions ("FFIs") in the FATCA partner country to report information directly to the IRS. This approach was anticipated in Treasury's joint statements with Japan and Switzerland in June 2012. It addresses certain conflicts between FATCA reporting requirements and the relevant partner country's privacy laws. On December 4, 2012, it was announced that the United States and Switzerland had initialed an agreement that is expected to be based upon the Model II approach.[14]

Background

FATCA generally requires FFIs to enter into an agreement (an "FFI Agreement") with the IRS in order to avoid 30 percent withholding with respect to a wide range of withholdable payments from, or realized on the disposition of instruments giving rise to, US source payments. Pursuant to such an FFI Agreement, the FFI would then report to the IRS information about accounts with, and certain investments in, the FFI that are owned by US individuals and certain other US persons ("US accounts"). Under proposed Treasury regulations, however, certain classes of FFIs ("deemed-compliant FFIs") generally would not be required to enter into an FFI Agreement to avoid 30 percent FATCA withholding.

After FATCA was enacted, Treasury entered into consultation with foreign governments that resulted in the adoption of the Model I agreement. Under this agreement, FFIs in the partner country are not required to enter into FFI Agreements and instead report the FATCA-relevant information to governmental authorities of the partner country, which in turn automatically transmit the information to the IRS. Treasury has signed agreements with the UK, Denmark, and Mexico that are based on this Model I framework.

Model II Agreement Provisions

The Model II agreement provides that, in order to avoid FATCA withholding, FFIs in the partner country generally will be required to obtain, and report to the IRS,

[13] US DEPT. OF THE TREASURY, Model 2 Template - Agreement Between the United States of America and [FATCA Partner] for Cooperation to Facilitate the Implementation of FATCA, November 14, 2012. (hereinafter "Model II Agreement").

[14] *See* THE FEDERAL AUTHORITIES OF THE SWISS CONFEDERATION, Switzerland and the US Initial the FATCA Agreement (press release), Dec. 4, 2012.

information on US accounts and account holders pursuant to an FFI Agreement.[15] If an account is treated under Treasury regulations as held by a recalcitrant account holder (*i.e.* an account holder that does not provide information required to determine whether it is a US account or a non-US account), it must be treated as a US account by FFIs in the partner country.

Because Model II is intended for use by partner countries with privacy laws that may conflict with FATCA's reporting obligations, the agreement specifically addresses those accounts that the FFI has identified as US accounts and for which the account holder has not given the consent required under the laws of the partner country for the FFI to report account information to the IRS ("non-consenting US accounts").[16] FFIs must report aggregate information with respect to non-consenting US accounts annually to the IRS. The IRS may make so-called "group requests", under the applicable tax treaty, to the competent authority of the partner country requesting information that identifies and describes these non-consenting US accounts and their holders. The Model II agreement stipulates that, for purposes of the applicable tax treaty, the information requested shall be deemed to be "relevant", "foreseeably relevant", or "necessary" for the administration or enforcement of US law,[17] which is designed to obligate the competent authority, under the treaty, to obtain and exchange the requested information.[18]

The competent authority is required, under the Model II agreement, to provide the information requested by the IRS within six months. While FFIs in the partner country will be required to ask for TINs from each US account holder, if the TIN or date of birth of an account holder is not in the reporting FFI's records, the competent authority will not be required to obtain it and provide it to the IRS.[19]

A participating FFI must also report to the IRS information about its payments of fixed or determinable annual or periodical income ("foreign reportable amounts") to all nonparticipating FFIs, regardless of their location. Proposed regulations would require the reporting of foreign reportable amounts paid by a participating FFI to a nonparticipating FFI in lieu of withholding, at least through the end of 2016,[20] and this reporting may be required under the FFI Agreements that must be entered into by FFIs under the Model II agreement. Participating FFIs in a Model II agreement country must report, in lieu of withholding, the number of nonparticipating FFIs that do not consent under partner country law to the reporting of information to the IRS to which it pays foreign reportable amounts during each of 2015 and 2016 and the aggregate value of such payments.[21] The group-request rules that govern how the IRS will obtain information about non-consenting US accounts will also govern how the IRS obtains information about payments to non-consenting nonparticipating FFIs.[22]

Under the Model II agreement, the IRS will notify the competent authority of the partner country of significant non-compliance by any FFI and will treat such FFI as a nonparticipating FFI if the significant non-compliance is not resolved within 12 months. Payments of certain US source amounts to nonparticipating FFIs are subject to 30 percent withholding that is generally not refundable except to the extent required by a tax treaty.[23]

The due diligence requirements of the Model II agreement are substantially the same as the Model I agreement. An FFI may not rely on certifications or documentary evidence that the FFI knows, or has reason to know, are incorrect or unreliable. The requirements for

[15] Model II Agreement, art. 2(1)(a).

[16] Such accounts will generally be treated in the same way as accounts for which the FFI has been unable to obtain the account holder's TIN. *See Id.*, art. 1(u) (definition of "non-consenting US account").

[17] *Id.*, art. 2(2)(b).

[18] *See* US-Switzerland Income Tax Treaty, art. 26(1) (obligating governments to exchange information that is "necessary for carrying out the provisions of the present Convention or for the prevention of tax fraud or the like").

[19] Model II Agreement, art. 2(2)(d).

[20] *See* Prop. Reg. § 1.1474-1(d)(2)(ii).

[21] Model II agreement, art. 2(1)(c)(ii).

[22] Model II Agreement, art. 2(2)(a).

pre-existing accounts differ from the requirements for new accounts.[24] FFIs doing business in a partner country are prohibited from opening an account that would be a "US account" for FATCA purposes for any person that does not consent to the reporting of their information to the IRS.[25] Similarly, a participating FFI may not open a new account for, or incur an obligation to, a nonparticipating FFI on or after January 1, 2014, unless the participating FFI expects not to pay a foreign reportable amount in connection with the account or obligation, or the nonparticipating FFI consents to the reporting of information to the IRS.[26]

FFIs that comply with the requirements of the Model II agreement and their FFI Agreement will be treated as complying with FATCA. As long as the competent authority in their jurisdiction provides information to the IRS about their non-consenting US account holders, these FFIs will not be required to withhold on payments made to such holders or to close accounts of such holders. FFIs must withhold upon payments made to a non-consenting US account holder only if the competent authority has failed to provide information about the account to the IRS within six months of an IRS request. If the competent authority cures by providing the requested information to the IRS more than six months after the request, the FFI is thereafter not obligated to withhold on payments to the account holder.[27]

The Model II agreement also contains a fairly detailed list of partner country FFIs and financial products that will be exempted from FATCA. The deemed -compliant FFIs include small financial institutions with a local client base and collective investment vehicles that are owned by one or more compliant FFIs.[28]

Under the Model II agreement's "most favored nation" provision, if the US enters into a Model II-type agreement with another country that is more favorable to FFIs, the partner country and its FFIs will automatically receive the benefit of those more favorable terms, unless the partner country declines the application of those rules.[29]

The US and the partner country to a Model II agreement further agree to work on (1) alternative procedures that will achieve the objectives of FATCA's imposition of withholding on foreign pass-thru payments and gross proceeds and (2) multilateral international rules for the automatic exchange of information, including reporting and due diligence standards for financial institutions.[30]

Forthcoming US-Switzerland Agreement

The FATCA agreement between Switzerland and the US was initialed in Washington on December 3.[31] The text of this agreement will be released after it is signed. The agreement will closely track the Model II agreement and will require direct reporting by Swiss FFIs to the IRS. Accounts held by US persons at Swiss FFIs will be reported either with the consent of the account holder or through "administrative assistance channels" on the basis of Article XXVI of the US- Switzerland income tax treaty, which provides that the competent authorities will exchange information available under domestic law that "is necessary for carrying out the provisions of the present Convention or for the prevention of tax fraud or the like in relation to" income taxes.

According to the Swiss government, the US-Switzerland FATCA intergovernmental agreement exempts from FATCA Swiss Social Security and private retirement funds, as well as casualty and property insurance. Certain collective investment vehicles and FFIs with a predominantly local client base will be subject to a registration requirement, but will otherwise be treated as

[23] *See* Prop. Reg. § 1.1474-5(a)(2).

[24] Model II Agreement, Annex I.

[25] *Id.*, art. 2(1)(d).

[26] *Id.*, art. 2(1)(e).

[27] *Id.*, art. 3(2).

[28] *Id.*, Annex II.

[29] *Id.*, art. 6.

[30] *Id.*, art. 5.

[31] *See* THE FEDERAL AUTHORITIES OF THE SWISS CONFEDERATION, Switzerland and the US Initial the FATCA Agreement (press release), Dec. 4, 2012.

deemed-compliant FFIs, which is consistent with Annex II of the Model II agreement.

The Swiss agreement will become effective upon approval by the Swiss parliament and may be subject to a popular referendum in Switzerland.

— Ansgar Simon & Derek Kershaw

Ninth Circuit Holds That Discovery of Wrongful Disclosure of Taxpayer Information Triggers the Running of the Statute of Limitations

On November 15, 2012, the US Court of Appeals for the Ninth Circuit in *Aloe Vera of America, Inc., v. United States*,[32] affirmed in part and reversed in part a district court's summary judgment in favor of the United States in an action claiming that the United States improperly disclosed taxpayer information to Japanese tax authorities during the course of a joint investigation into taxpayer's business. The Ninth Circuit ultimately held that the plaintiff's discovery of a wrongful disclosure triggers the running of the two-year statute of limitations on wrongful disclosures of taxpayer information provided in section 7431(d).

Background

Aloe Vera of America ("AVA") processes and sells aloe vera products in the United States, Japan, and other countries. Forever Living Products Japan, Inc. ("FLPJ"), regularly purchased AVA products for sale in Japan, and paid royalty-based income to AVA, and AVA would pay royalty-based income and commissions to the respective individual owners of AVA and FLPJ. The IRS began investigating whether the income paid to the owners during 1991 and 1992 was properly reported in the United States. On April 26, 1996, the IRS sent a letter to the Japanese National Taxing Authority ("NTA"), proposing that the NTA also examine the tax reports of AVA, FLPJ, and AVA and FLPJ's owners. In the letter, the IRS estimated that the owners failed to report more than $32 million of income from AVA product sales to FLPJ. In August of 1996, the IRS and NTA met to discuss the joint examination. On August 15, 1996, the IRS notified AVA and its owners of the investigation.

At the end of 1996, the NTA made an audit proposal to FLPJ, which was rejected. In early 1997, the NTA sent correction notices to FLPJ regarding its tax liabilities, and the IRS sent letters to AVA and its owners proposing tax adjustments. Shortly thereafter, AVA and its owners filed Freedom of Information Act ("FOIA") requests seeking documents exchanged by the IRS and the NTA. AVA received documents pursuant to that request in August of 1998 and shared that information with counsel for FLPJ and its owners shortly thereafter.

Meanwhile, the Japanese media began reporting that AVA had failed to report $60 million in income to tax authorities, citing sources within the IRS. AVA responded to these reports by lodging a complaint with the United States Competent Authority, accusing the NTA of disclosing taxpayer information to the public.

On October 6, 1999, AVA, along with FLPJ and the owners, filed a complaint in US district court under section 7431(a), alleging that (i) the IRS violated section 6103(a) by disclosing false information to the NTA ("Count I"), and (ii) the IRS violated section 6103 by disclosing tax information to the NTA even though it knew or should have known that the NTA would leak the information to the media ("Count II").

Procedural History

The government moved for summary judgment on both Counts I and II, raising the statute of limitations among other grounds for judgment. After the plaintiffs amended their complaint to identify when they discovered wrongful disclosures, the district court ruled that the statute of limitations was not jurisdictional and therefore the district court had subject matter jurisdiction over the claims and also granted summary judgment to the government on certain of the claims in Counts I and II.

On the first appeal to the Ninth Circuit, the Court reversed the district court's ruling on the statute of limitations,

[32] No. 10-17136 (D.C. No. 2:99-cv-01794-JAT); 110 AFTR 2d 2012-6654.

holding that the district court lacked subject matter jurisdiction should the complaint be time-barred, and remanded to the district court to make factual findings as to the dates of discovery of wrongful disclosure and to determine whether the statute of limitations had in fact run. On remand, the district court ruled that FLPJ and its Owner's claims in Count I, and all plaintiff's claims in Count II, were barred by the statute of limitations. On this second appeal to the Ninth Circuit, the taxpayers challenged these rulings, along with the district court's prior grants of summary judgment on Counts I and II.

Court's Discussion

The Court first discussed the question of the application of the statute of limitations. The Court had previously held that the period of limitations begins to run on the date the plaintiff discovers that the unauthorized disclosure has taken place and had remanded to the district court the issue of when the dates of discovery occurred. Here, the Court ruled that the date of discovery that starts the period of limitations under section 7431 is the date on which the plaintiff knew, or reasonably should have known, about the government's unauthorized disclosures of taxpayer information. In doing so, the Court reasoned that the "date of discovery" for section 7431 purposes should accord with the general federal rule, which the Court had applied in numerous other statutory contexts. The Court also cited the Supreme Court's recent holding that the term "discovery" for statute of limitation purposes "encompasses not only those facts the plaintiff actually knew, but also those facts a reasonably diligent plaintiff would have known."[33] The Court further concluded that the plaintiff's notice is not triggered by a single event, but rather the plaintiff's actual or constructive knowledge of each particular disclosure. In that regard, because section 7431 provides damages for each act of unauthorized disclosures, the Court reasoned that it would be "incongruous for us to interpret [section] 7431(d) as being limited to a single act, encompassing collective disclosures."[34]

Applying its conclusions to the two allegations raised by AVA, the Court ruled that Count I was not barred by the statute of limitations (reversing the district court as to certain claims in Count I), but that Count II was barred (affirming the district court). With respect to Count I, the Court found that FLPJ and its owners had learned of the alleged false disclosures only upon receiving the FOIA request documents from AVA, determining that a taxpayer generally should have no reason to suspect that the IRS has disclosed false information until it knows of the substance of the specific IRS disclosures. The Court rejected the district court's finding that these plaintiffs had "somehow discovered the [disclosures] before their counsel had learned of it" (*i.e.*, from the FOIA documents), reasoning that because on summary judgment it must view the factual record in the light most favorable to plaintiffs, a hypothetical having no support in the record should not be considered.[35]

With respect to Count II, the Court ruled that the district court did not err when it found that the taxpayers should have known that the IRS had disclosed to the NTA information contained in their tax returns once the investigations had concluded and their tax liabilities for the relevant years were adjusted. Because the plaintiffs each knew of proposed adjustments to their tax liabilities by early 1997, their complaint filed in December 1999 was untimely.

Having disposed of Count II, the Court then returned to Count I to determine if the district court properly granted summary judgment on the taxpayer's claims that the IRS had supplied false taxpayer information to the NTA. While section 6103(a) generally forbids the IRS from

[33] *Id.* at 12, citing *Merck & Co. v. Reynolds*, 130 S. Ct. 1784, 1796 (2010).

[34] *Id.* at 14. To demonstrate its reasoning, the Court stated that the government had argued that the statute of limitations began to run once AVA had notice of the joint investigation. AVA had alleged, however, that the IRS wrongfully disclosed information in November 1996. The Court reasoned that if the government's proposed date of discovery were correct, AVA would not have had the full two-year period to file a claim based on disclosures made in the November 1996 meeting.

[35] *Id.* at 17.

disclosing tax return information, section 6103(k)(4) provides that tax return information may be disclosed with foreign governments who have bilateral tax treaties with the US, subject to the terms and conditions of the relevant treaty. The US-Japan income tax permits the IRS to disclose any return information that is "pertinent" to "preventing fraud or fiscal evasion."[36] The government argued that even false taxpayer information may be "pertinent" and therefore protected pursuant to section 6103(k)(4). The Court rejected that argument, reasoning that because section 6103 is intended to prevent malevolent disclosure of taxpayer information, defining "pertinent" to "allow[] the IRS to knowingly disclose false taxpayer information would eviscerate the statute's purpose."[37] As to the plaintiffs' factual claims of the IRS's disclosure of false information, the Court ruled that the plaintiffs had demonstrated material issues of fact, and as such granting summary judgment to the government on Count I was improper.

— Gerald M. Feige

NYC Transfer Tax Not Applicable to Mitchell-Lama Conversion

On October 3, 2012, the Appellate Division, Second Department denied the City of New York's motion for summary judgment, awarded judgment to the taxpayer, and held that the voluntary dissolution, reconstitution, and termination of Trump Village Section 3's participation in the Mitchell-Lama housing program was not a taxable transfer under Tax Law section 1201(b) and Administrative Code of the City of New York section 11-2102(a).[38] The decision addressed a novel issue of state-wide import and will negatively impact the City's ability to assess a transfer tax on thousands of tenants in Mitchell-Lama buildings who have recently exited the government housing program.

The taxpayer, Trump Village, owned a residential housing cooperative complex housing hundreds of apartments in Brooklyn, New York, near Coney Island. In the early 1960s, the taxpayer took title to the real property pursuant to the Mitchell-Lama housing program.

The Mitchell-Lama housing program was established after World War II as a New York State affordable housing program. It was created to encourage and facilitate the construction and continued operation of affordable rental and cooperative housing in the State of New York for moderate and middle income families. Approximately 269 Mitchell-Lama developments, representing over 100,000 apartments, were built in New York State under the program.

As a Mitchell-Lama cooperative housing corporation, taxpayer enjoyed significant government benefits, including a low-interest government mortgage loan and substantial exemptions from municipal real property taxation. In return for these benefits, various restrictions encumbered the cooperative corporation's tenant-shareholders, including restrictions on resale to third parties. Taxpayer remained in the Mitchell-Lama program until October 2005, when it fully repaid the governmental mortgage loan that financed its development.

In early 2007, by vote of its shareholders, and with the permission of the State of New York, taxpayer terminated its participation in the Mitchell-Lama program, and, pursuant to Private Housing Finance Law section 35(3), "reconstituted" itself as a corporation under the Business Corporation Law by amending its certificate of incorporation. While the amendments to taxpayer's certificate of incorporation removed all references to the Private Housing Finance Law, taxpayer's name, the number of and names of its shareholders, the number of shares owned by each shareholder, and its tax identification number all remained the same. Taxpayer further amended its certificate of incorporation. However, it neither issued new shares of stock nor transferred

[36] *Id.* at 20 (*quoting* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, US-Japan, art. 26, para. 1 (1971)).

[37] *Id.* at 21-22.

[38] *Trump Village Section 3 v. City of New York*, Index No. 26572/10 (A.D. Second Department, Oct. 3, 2012).

shares to the reconstituted corporation. Following its exit from Mitchell-Lama, the City issued a Notice of Determination to taxpayer for failure to pay a real property transfer tax ("RPTT") pursuant to Tax Law section 1201(b)(1)(6) and the Administrative Code of the City of New York.

Administrative Code of the City of New York section 11-2102(a), provides that "[a] tax is hereby imposed on each deed at the time of delivery by a grantor to a grantee when the consideration for the real property and any improvement thereon (whether or not included in the same deed) exceeds twenty-five thousand dollars." Taxpayer posited that the RPTT is inapplicable to an act of reconstitution pursuant to the Mitchell-Lama housing program, because there was no deed, no delivery, no grantor, and no grantee involved in corporate reconstitution. However, the City maintained that taxpayer's termination of its participation in the Mitchell-Lama housing program by way of voluntary dissolution and reconstitution fell within section 11-2102(a), and that a provision added to the RPTT exemption section of the Administrative Code in 1994 warranted the imposition of the RPTT to taxpayer's voluntary dissolution and reconstitution. The City essentially contended that, by voluntarily dissolving and subsequently reconstituting, the taxpayer became a new corporation and that, accordingly, the amended certificate of incorporation constituted a deed. The Appellate Division, however, found no support in either case law or the record for the City's interpretation of the law.

The appellate court found that upon amending its certificate of incorporation, the taxpayer remained the same entity, although it was relieved of various restrictions previously imposed upon it by the Mitchell-Lama housing program. Moreover, the court said that the "Administrative Code's definition of the term '[d]eed,' does not encompass taxpayer's amendment to its certificate of incorporation."[39] Accordingly, the court held that the City failed to establish that the RPTT was applicable to the taxpayer's actions and, thus, failed to establish that the RPTT was properly imposed.

— Richard A. Nessler

Second Circuit Reverses Convictions of Two Tax Attorneys in *Coplan*

On November 29, 2012, the United States Court of Appeals for the Second Circuit reversed the convictions of two former Ernst & Young tax attorneys Richard Shapiro and Martin Nissenbaum who had been tried and convicted for their activities as part of E&Y's VIPER (Value Ideas Produce Extraordinary Results) Group.[40] Another E&Y attorney, Robert Coplan, and an E&Y accountant, Brian Vaughn, had their convictions affirmed. The sentence of a fifth defendant, Charles Bolton, an investment advisor, was vacated and remanded with respect to a $3 million fine.

The VIPER group designed four tax shelters, all marketed to E&Y clients, that were at the center of the criminal case. Coplan, Nissenbaum, and Shapiro all personally invested in a fifth tax shelter.

All five defendants had been convicted of impairing the lawful governmental functions of the IRS (also known as a *Klein* conspiracy), tax evasion, and making false statements to the IRS. Nissenbaum and Coplan were convicted on counts of obstructing the IRS, and Vaughn and Coplan were also separately charged with and convicted of making false statements to the IRS.

On appeal, the five defendants raised ten challenges to their respective convictions. Among the issues raised was the validity of the government's *Klein* conspiracy theory. The Second Circuit discussed the defendants' *Klein* challenge at length, stating, in part: "The Government thus appears implicitly to concede that the *Klein* conspiracy is a common law crime, created by the courts rather than by Congress. That fact alone warrants considerable judicial skepticism. . . . Although the defendants argue forcefully on appeal that we should

[39] *Id.* at 5.

follow the example of *Skilling v. US*, 130 S.Ct. 2896, 2928 (2010), and 'pare' the body of section 371 precedent 'down to its core,' *id.*, such arguments are properly directed to a higher authority." Accordingly, the Second Circuit did not reverse the convictions of any of the defendants on this ground; it did, however, reverse the convictions of Shapiro and Nissenbaum based on insufficient evidence to support the convictions.

— Liz McGee

In Civil FBAR Penalty Case, Burden of Proof Standard is Preponderance of the Evidence

A federal district court in Utah has held that the government must meet the preponderance of the evidence standard with respect to the civil foreign bank account report (FBAR) penalty,[41] agreeing with the court in *Williams*, the only other federal district court to directly address the question of the correct burden of proof in civil FBAR penalty cases brought under 31 U.S.C. section 5321(b)(2).[42]

The government brought civil suit against Jon McBride, alleging that he had participated in a complex scheme to launder money through the use of shell foreign companies and that he had failed to properly report his interest in foreign bank accounts during 2000 and 2001. The court addressed McBride's "willful" failures to file the required reports and found that McBride's behavior – engaging in a plan to avoid income taxes through the use of shell companies and other behavior exhibiting a recklessness of a known legal duty – rose to the level of such willfulness.

— Liz McGee

[40] *United States v. Coplan*, 10-583 (2d. Cir. Nov. 29, 2012).

[41] *United States v. McBride*, No. 2:09-cv-00378 (D. Utah 2012).

[42] *United States v. Williams*, No. 1:09-cv-00437 (E.D. Va. 2010), rev'd on other grounds, No. 10-2230 (4th Cir. 2012).

IRS Advice Concludes Economic Substance Doctrine May Apply to Securities Lending Transactions

In a recent generic legal advice memorandum, the IRS concluded that the common law economic substance doctrine may be applied to securities lending transactions designed to avoid US withholding tax on US source dividends.[43] The memorandum applies to securities lending transactions entered into before May 20, 2010, when Notice 97-66, 1997-2 C.B. 328 was withdrawn and replaced by Notice 2010-46, 2010-24 I.R.B. 757.

The memorandum analyzes a securities lending transaction between a US borrower and a foreign securities lender that is structured to allow the foreign securities lender relief from US withholding tax under Notice 97-66, even though no prior withholding tax was paid. The purpose of Notice 97-66 was to avoid multiple levels of withholding on substitute dividend payments in securities lending transactions by limiting the aggregate US gross-basis tax on a chain of securities lending transactions to 30 percent of the substitute dividend. Some financial institutions, however, used Notice 97-66 to structure securities lending transactions that entirely eliminated US withholding tax on the substitute dividend payments.

In a typical transaction, a foreign customer that owned US stock would transfer the stock to a foreign affiliate of a US financial institution in a securities lending transaction. The foreign affiliate would pay 70 percent of the substitute dividends to the foreign customer without withholding for US tax because the substitute dividend was purportedly already subject to 30 percent US withholding tax and, thus, Notice 97-66 was satisfied. The foreign affiliate, however, would enter into a swap transaction with respect to the loaned shares, and the substitute dividend payment received by the foreign affiliate under the swap would not be subject to US withholding tax under Treas. Reg. § 1.863-7(b)(1). The foreign affiliate would

[43] Advice Memo. 2012-009 (Nov. 5, 2012). See "Economic Substance Doctrine May Apply to Securities Lending Scheme," Tax Notes Today, Dec. 5, 2012.

then pay the foreign customer an "enhancement fee" based on a percentage of the dividend, essentially allowing the parties to split the tax savings from the elimination of US withholding tax on the securities lending transaction.

The memorandum concludes that these types of securities lending transactions may be disregarded as lacking economic substance because the transactions do not have a business purpose or pre-tax motivation. As a result, the IRS may treat such a transaction as if, in substance, the foreign customer retained the US stock and received a US source dividend payment subject to 30 percent US withholding tax. Furthermore, under the memorandum, the foreign affiliate would be treated as a withholding agent liable for the 30 percent tax.

— Mary Jo Lang

IRS Updates Disclosure Rules for Accuracy-Related Penalty in Revenue Procedure 2012-51

On November 26, 2012, the IRS issued Rev. Proc. 2012-51, which updates Rev. Proc. 2012-15.[44] Rev. Proc. 2012-51 identifies circumstances under which disclosure on a taxpayer's income tax return is adequate to reduce or eliminate a section 6662 accuracy-related penalty and to avoid a section 6694(a) return preparer penalty for an unreasonable position. The revenue procedure does not apply with respect to any other penalty provisions.

Section 6662(a) imposes a penalty of 20 percent on any portion of an underpayment of tax that is attributable to a substantial understatement of income tax.[45] If an item is not attributable to a tax shelter, an understatement is reduced to the extent that the relevant facts relating to the item's treatment are disclosed on the return or on a statement attached to the return and there was a reasonable basis for the treatment.[46]
Section 6694(a) imposes a penalty on a return preparer who prepares a return or a claim for refund reflecting an understatement of tax due to an "unreasonable position" if the preparer knew or reasonably should have known of the position. A position is generally treated as unreasonable unless (1) substantial authority for the position existed or (2) the position had a reasonable basis and was properly disclosed under section 6662(d)(2)(B)(ii).[47]

Rev. Proc. 2012-51 lists items for which there is no need for disclosure of additional facts beyond what is included on the taxpayer's return, so long as appropriate forms and attachments are completed according to instructions. These items include certain itemized deductions included on Schedule A, certain trade or business expenses, differences in book and tax income reporting, certain foreign tax items, and several miscellaneous items. If the revenue procedure does not include an item, disclosure is adequate with respect to that item only if it is made on a properly completed Form 8275 or 8275-R attached to the return for the year at issue. Monetary amounts entered on the return and accompanying forms must be verifiable. An amount is verifiable if the taxpayer can prove the origin of the amount and can show good faith in entering that number on the applicable form. When an amount of an item is shown on a line that does not have a pre-printed description identifying that item, the taxpayer is required to include a description clearly identifying the item.

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[44] Rev. Proc. 2012-51, 2012-51 I.R.B. __ (Nov. 26, 2012), revises Rev. Proc. 2012-15, 2012-7 I.R.B. 369 (Feb. 13, 2012). Editorial changes were made to the prior guidance, but no substantive changes were made.

[45] An understatement is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. Section 6662(d)(1)(A). In the case of a corporation (other than an S corporation), an understatement is substantial if it exceeds the lesser of 10 percent of the tax required to be shown on the return (or, if greater, $10,000) or $10,000. Section 6662(d)(1)(B).

[46] Section 6662(d)(2)(B)(ii).

[47] Section 6694(a)(2)(A)-(B). A position with respect to a tax shelter or a reportable transaction is treated as an unreasonable position unless it is reasonable to believe that the position would more likely than not be sustained on the merits. Section 6694(a)(2)(C).

Even if a taxpayer complies with the disclosure requirements of Rev. Proc. 2012-51, the disclosure will not have an effect for purposes of section 6662 if the item or position on the return: (1) does not have a reasonable basis as defined in Treas. Reg. § 1.6662-3(b)(3); (2) is attributable to a tax shelter item as defined in section 6662(d)(2); or (3) is not properly substantiated or the taxpayer failed to keep adequate books and records with respect to the item or position. Disclosure will have no effect for purposes of section 6694(a) if the position is with respect to a tax shelter as defined in section 6662(d)(2)(C)(ii) or a reportable transaction to which section 6662A applies.

The revised revenue procedure applies to any income tax return filed on a 2012 tax form for a taxable year beginning in 2012 or in 2013 for a short taxable year beginning in 2013.

— *Melissa Henkel*

Foreign Tax Credit Generator Update and Chart

While the IRS has stated that it will continue to review FTC generator cases on a case-by-case basis, recent motions filed in the Lehman Brothers bankruptcy case may indicate the IRS's position on FTC generator settlements, according to a recent article by Matthew Dalton in *Tax News International*.[48] Motions filed in the Lehman Brothers case in March and in September for the approval of settlements with the IRS include information on the settlement terms for 17 FTC generator transactions.[49] The terms vary with the type of FTC generator transaction and the tax year, with the IRS allowing between 25 and 40 percent of the claimed foreign tax credits and allowing deductions for the disallowed credits for only some of the transactions.[50]

The chart appearing on the next page provides a summary of these cases.

— *Judy Fisher*

[48] "Lehman Bankruptcy Filings May Hold Clues on FTC Generator Settlements," Nov. 19, 2012.

49 *Id.*

50 *Id.*

"FTC Generator" Cases — Status Chart

	CASE	DECIDING COURT	DECISION
OVERVIEW	*Bank of New York Mellon Corp. v. Commissioner*	Tax Court	Not yet decided
	Hewlett-Packard Co. v. Commissioner	Tax Court	Decision in favor of the government
	American International Group Inc. v. United States	S.D.N.Y.	Not yet decided
	Pritired 1 LLC v. United States	US District Court for the Southern District of Iowa	Decision in favor of the government
	Sovereign Bancorp Inc. v. United States	D. Mass.	Not yet decided
	Wells Fargo & Co. v. United States	D. Minn.	Not yet decided

CASE	BACKGROUND	BENCH/JURY	STATUS
Bank of New York Mellon Corp. v. Commissioner. Appealable to the Second Circuit.	Designated for litigation by the IRS on September 30, 2008 as part of a closing agreement. The IRS asserts that the transaction lacked economic substance. The IRS has not asserted accuracy-related penalties.	Bench	Oral arguments heard 4/2012. Opening and reply briefs filed in July and September, respectively. The IRS asserts that the transaction lacked economic substance. The IRS has not asserted accuracy-related penalties.
Hewlett-Packard Co. v. Commissioner. Appealable to the Ninth Circuit.	The IRS disallowed claimed FTCs arguing that the substance of the transaction was a loan, not an equity investment. In the alternative, the IRS argued that the transaction lacked economic substance and business purpose.	Bench	Court held in favor of the government. According to the court, HP's investment in the foreign corporation was more appropriately characterized as debt. The court did not engage in an economic substance analysis, which was difficult because of some positive cash return and uncertainty regarding counting credits in measuring profits.
American International Group Inc. v. United States. Appealable to the Second Circuit.	Taxpayer seeks $306 million refund of taxes, penalties, and interest related to its 1997 tax return. Approximately $61 million relates to the IRS's disallowance of AIG's FTCs. The IRS asserted accuracy-related penalties related to the claimed FTCs under section 6662.	Jury	Taxpayer renewed its motion for partial summary judgment on its claims for foreign tax credits on 8/1/2012 after the 6/30/2012 discovery deadline for items 1-154 of the amended complaint. Earlier, on March 29, 2011, the US District Court for the SDNY denied, without prejudice, taxpayer's motion for partial summary judgment. Taxpayer argued that it engaged in domestic transactions in similar form to the foreign transactions at issue, demonstrating that the purpose of the transactions was to generate a profit by borrowing funds at favorable

CASE	BACKGROUND	BENCH/JURY	STATUS
			rates and investing in assets that produced better returns. The only distinction between the domestic and the foreign transactions, the taxpayer argued, was that the foreign transactions were also subject to foreign tax and therefore the taxpayer was entitled to foreign tax credits. Judge Louis L. Stanton agreed with the IRS that there had not been enough discovery for the IRS to fully examine and understand the comparable domestic transactions. Accordingly, the court deferred decision until further discovery.
Pritired 1 LLC v. United States. Appealable to the Eighth Circuit.	The IRS issued a Notice of Final Partnership Administrative Adjustment (FPAA) for the 2002 and 2003 taxable years, disallowing foreign tax credits by Pritired in the amounts of $24 million and $18 million, respectively, arguing that the Pritired transaction lacked economic substance and substantial economic effect. Among other reasons, the taxpayer's complaint alleged that the FPAA was erroneously issued because it was contrary to IRS guidance applicable when the partners entered the transaction.	Bench	Court held in favor of the government, recharacterizing Principal Life Insurance's purported partnership equity investment as debt, observing that there was no possible "upside potential" because the returns were capped and Principal intended to recover its original investment, regardless of the performance of the underlying investment. The court found that the transaction had neither objective nor subjective business purpose and only generated a positive return on investment to the US taxpayers when foreign tax credits were included – without the FTCs, there was no reasonable possibility of profit from the transaction.
Sovereign Bancorp Inc. v. United States. Appealable to the First Circuit. Sovereign Bancorp Inc. changed its name to Santander Holdings USA Inc. on February 3, 2010.	The taxpayer sought a refund of $275 million in federal income taxes, penalties, and interest related to its 2003, 2004 and 2005 tax returns. The IRS disallowed FTCs along with other deductions, arguing that it lacked economic substance. The IRS asserted accuracy-related penalties under section 6662.	Jury	Court granted the government's motion to compel production of tax reserve work papers and advice relating to the IRS audit, but denied the government's motion to compel production of post-closing advice regarding changes in law and the unwinding of the transaction. Motions filed with respect to subpoena issued to Raymond J. Ruble; on May 22, 2012, Plaintiff filed Withdrawal of Opposition to Defendant's Fed. R. Civ. P. 30(a)(2)(B) Motion for Leave to Depose an Inmate. On Aug. 6, 2010, the US's motion for centralization of *Sovereign Bank* and *Wells Fargo* actions in the District of Mass. was denied. On Nov. 8, 2010, Santander Holdings and the US jointly moved to apply to the case forthcoming amendments to FRCP

CASE	BACKGROUND	BENCH/JURY	STATUS
			26 on the limits of discovery on expert witnesses.
Wells Fargo & Co. v. United States. Appealable to the Eighth Circuit.	Taxpayer seeks a $162 million refund of taxes, penalties, and interest related to its 2003 tax return. Approximately $70 million of that amount relates to the IRS's disallowance of claimed FTCs. The IRS asserted a negligence penalty related to the claimed FTCs under section 6662.	Jury	Fact discovery was to have been completed by July 27, 2012. Dispositive motions were to have been served and heard by Nov. 16, 2012. The case was to be ready for trial on Mar. 1, 2013.

Shearman & Sterling's Tax Controversy Practice

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

In addition, our tax lawyers are active members of the American Bar Association Section of Taxation ("ABA Tax Section"), the New York State Bar Association Tax Section ("NYSBA Tax Section"), the Wall Street Tax Institute, and the Institute of International Bankers. One partner recently served as chair of the NYSBA Tax Section; another recently ended his term as Chair of the ABA Tax Section's Court Practice and Procedure Committee. Our tax controversy lawyers frequently participate in panels at tax law conferences and publish articles regarding significant tax controversy and litigation developments. Shearman & Sterling was just named "2012 Americas Banking Tax Firm of the Year" at the seventh annual *International Tax Review (ITR)* International Tax Awards. Shearman & Sterling also has been selected as the Tax Law Firm of the Year in New York for the 2013 Global Law Experts Practice Area Awards.

Tax Group Wraps Up 2012 with Successful Tax Conference

On December 4, Shearman & Sterling hosted its Annual Tax Conference and Year-End Celebration in our New York office. Well over 100 clients from financial institutions, corporations, and firms attended the event, which included panel discussions about recent developments and other items of interest in areas of federal tax and European tax law. Speakers from six Shearman & Sterling offices and ten client firms participated on the panels.

The event opened with welcoming remarks from firm Chairman, Creighton Condon and a lunchtime discussion of tax ethics, including Circular 230 developments, ethical issues in cross-border taxation, and tax reputational risk. This was followed by a panel on tax controversy and litigation and panels on financial products, recent international tax developments, European tax issues, and monetization transactions. After these discussions, there was a reception and raffle.

Client panelists included Dan Breen, Citigroup; Jack Burns, Citigroup; Kathleen Dale, General Electric; John DeRosa, Deutsche Bank; William S. Dixon, Citigroup; Elissa Shendalman Johnson, Bank of America; Ben Lopata, JPMorgan Chase; Ed Park, AIG; Anthony Porcaro, Credit Suisse; Alvin Shrago, UBS; Bonnie Tellgmann, Barclays and Phil Tretiak, Wells Fargo.

The following Shearman & Sterling lawyers also participated on the panels: Larry Bambino (NY), Roger Baneman (NY), Bodo Bender (FR), Peter Blessing (NY), Larry Crouch (SF/PL), Kristen Garry (WA), Craig Gibian (WA), Al Groff (WA), Larry Hill (NY), Don Lonczak (WA), Doug McFadyen (NY), Rob Rudnick (WA), Iain Scoon (LO), Michael Shulman (WA), of counsel Kevin Dolan (WA), counsel Ansgar Simon (NY), and associate Anne Sophie Maes (PA). “The Tax Conference and Year-End Celebration was a tremendous success,” said Tax partner Larry Hill (NY). “The tax directors and senior tax professionals of many of the world’s premier financial institutions and corporations participated in the conference. The program showcased the breadth and depth of Shearman & Sterling’s global tax practice and the superb quality and strength of our client base. The feedback from attendees was overwhelmingly positive. Everyone found the panels to be highly instructive and enjoyed catching up with old friends and colleagues. We look forward to next year’s Tax Conference and Year-End Celebration which will be held on December 3, 2013.”

To ensure compliance with the requirements of Treasury Department Circular 230, any tax advice contained in this newsletter is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties or (ii) promoting, marketing, or recommending to another party any matter(s) addressed herein.

This newsletter is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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