SHEARMAN & STERLING LLP

FOCUS ON TAX CONTROVERSY & LITIGATION

Ninth Circuit Holds Law Firm Must Produce Client Documents Under "Foregone Conclusion" Rule

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This month's newsletter features articles discussing the Ninth Circuit's recent decision in *Sideman*, significant for its holding that the "foregone conclusion" exception applies to client documents in the possession of a law firm and the Federal Circuit's decision in *ConEd*, reversing the Claims Court's ruling that had held in favor of the taxpayer.

Ninth Circuit Orders Law Firm to Produce Client's Tax Records in Response to IRS Summons

On January 8, 2013, the United States Court of Appeals for the Ninth Circuit affirmed a decision by the United States District Court for the Northern District of California enforcing an IRS summons issued to the law firm of Sideman & Bancroft LLP ("Sideman") in a criminal investigation of one of the firm's clients in *United States v. Sideman & Bancroft LLP*.[1] Sideman refused to produce its clients' documents – arguing that production would violate its client's Fifth Amendment rights. The Ninth Circuit held that the "foregone conclusion" exception to the Fifth Amendment applied to the client's documents because the IRS knew with reasonable particularity of the existence and the law firm's possession of the documents and could independently establish their authenticity based on the taxpayer's tax preparer's familiarity with them.

"During its investigation, the IRS learned of the existence of tax files provided to Nolan's tax accountant."

The case involved a criminal investigation of taxpayer, Mary Nolan, regarding her alleged attempt to evade her tax liabilities related to tax years 2005 to 2008. During its investigation, the IRS learned of the existence of tax files provided to Nolan's tax accountant. Nolan's tax accountant had given the files to Nolan's civil tax attorney, who later delivered the files to Nolan's criminal attorneys at Sideman. Nolan's tax accountant provided the IRS with a detailed description of the documents in question.

[1] *United States v. Sideman & Bancroft LLP*, No. 11-15930 (9th Cir. Jan. 8, 2013).

Sideman refused to deliver the documents in response to the IRS summons, citing Nolan's Fifth Amendment rights. In response, the IRS filed a petition in district court seeking enforcement of the summons. The petition was supported by a declaration from Nolan's tax accountant providing a detailed description of the documents and opining that she could authenticate the documents based on the personal knowledge that she had obtained from reviewing and working with the documents to prepare Nolan's returns.

"For the foregone conclusion exception to apply, the Government must establish its independent knowledge of three elements: 'the documents' existence, the documents' authenticity, and respondent's possession or control of the documents.'"

The Circuit Court's analysis focused on Sideman's defense based on the Fifth Amendment, which grants persons the privilege not to provide the state with self-incriminatory evidence of a testimonial or communicative nature. The Fifth Amendment protection extends to oral questioning and applies to prevent an individual from having to produce documents to investigative bodies if the act of production itself would be testimonial. This privilege extends to an attorney to prevent him from being compelled to produce documents, the production of which would violate a client's Fifth Amendment rights. However, "where [t]he existence and location of the papers are a foregone conclusion and the taxpayer adds little or nothing to the sum total of the Government's information by conceding that he in fact has the papers[,]. . . enforcement of the summons' does not touch upon constitutional rights."[2] For the foregone conclusion exception to apply, the Government must establish its independent knowledge of three elements: "the documents' existence, the documents' authenticity, and respondent's possession or control of the documents."[3]

"The test is whether the Government has met its burden of demonstrating that it can independently verify that the summonsed tax documents are what they purport to be."

The Circuit Court had no difficulty finding that the Government had established that it had obtained substantial information prior to the issuance of the subpoena as to the existence and possession of the summonsed documents. Based on information provided by Nolan's tax accountant, the Government had precise knowledge of the location of Nolan's tax records and the identity of the documents. The Court also concluded that the Government could satisfy the document authenticity requirement.

The Circuit Court acknowledged that the "authenticity prong of the foregone conclusion doctrine requires the government to establish that it can independently verify that the compelled documents are in fact what they purport to be."[4] The test is whether the Government has met its burden of demonstrating that it can independently verify that the summonsed tax documents are what they purport to be. The Circuit Court acknowledged that during her interview with IRS agents, Nolan's tax accountant

[2] *United States v. Bright*, 596 F. 3d 683, 692 (9th Cir. 2010) (quoting *Fisher v. US*, 425 US 391, 411 (1976)).
[3] *Id.*
[4] *Sideman*, No. 11-15930, slip. op. at 10.

gave the IRS "a detailed description of the 2007-2008 documents that [she] had in [her] possession."[5] The tax accountant provided key details about the tax documents, including that "Nolan ran her business as a sole proprietorship; that Nolan's law practice grossed consistent income from month to month; that Nolan paid her individual and business expenses with hand-written checks she signed herself; that Nolan classified those working for her as independent contractors rather than employees; that Nolan recorded her billable time in a 'day planner' appointment book and used QuickBooks to create a bill for each client; and that Nolan owned several rental properties in addition to her residence."[6] The tax accountant also described in detail the number of boxes and folders in which the documents were stored. Based on the tax accountant's familiarity with Nolan's tax records, the Circuit Court concluded that the document authenticity requirement to the foregone conclusion exception was satisfied. Accordingly, enforcement of the IRS summons was upheld and Sideman was ordered to produce Nolan's tax records. Nolan could not claim the tax preparer confidentiality privilege of section 7525 because that protection does not extend to criminal tax matters.

—*Richard A. Nessler*

Federal Circuit Reverses Claims Court in *ConEd*

"In 1997, ConEd entered into a transaction with Dutch utility company N.V. Electriciteitsbedrijf Zuid-Holland (EZH) with respect to a utility plant in the Netherlands."

On January 9, 2013, the United States Court of Appeals for the Federal Circuit reversed the decision of the United States Court of Federal Claims in *Consolidated Edison Company v. US*.[7] The case concerned multiple deductions that Consolidated Edison Co. (ConEd) took as part of a lease-in/lease-out (LILO) transaction. Relying on its own precedent in *Wells Fargo v. US*,[8] the appellate court disallowed the deductions under the substance-over-form doctrine.

In 1997, ConEd entered into a transaction with Dutch utility company N.V. Electriciteitsbedrijf Zuid-Holland (EZH) with respect to a utility plant in the Netherlands. In the master lease agreement, EZH conveyed to ConEd a lease interest of an undivided 47.47 percent in the utility plant for a term of 43.2 years, and ConEd simultaneously conveyed the same property back to EZH, in which EZH subleased ConEd's undivided interest for a term of 20.1 years. EZH continued to service and maintain the plant as it would if it were the owner. EZH could purchase the remaining

[5] *Id.* at 11.
[6] *Id.*
[7] No. 2012-5040 (Fed. Cir. 2013), reversing 90 Fed. Cl. 228 (2009).
[8] 641 F.3d 1319 (Fed. Cir. 2011).

interest in the head lease (the Sublease Purchase Option) at the end of the 20.1 year term for $215 million, or exercise one of two options: renew for an additional 16.5 years, at the end of which it would operate the plant or find a sublessee, or EZH could return the remaining interest in the Head Lease Term to ConEd, allowing ConEd to take over the utility plant's operations for the remainder of the Head Lease Term.

ConEd made an immediate initial rent payment of $120 million, which consisted of a $40 million equity payment and an $80 million nonrecourse loan at a 7.1% interest rate. EZH was immediately entitled to the equity payment, but the next day, EZH was required to transfer $31 million to Credit Suisse First Boston to create an Equity Defeasance Account. The funds in this account were zero-coupon US-government Treasury bonds, and EZH pledged its interest in this account to ConEd to secure EZH's payment obligations under the loan. ABN Amro held the proceeds of the ConEd HBU Loan – the Debt Defeasance Account. EZH made annual withdrawals from the Debt Defeasance Account and at the same time made payments of identical amounts to HBU to pay down ConEd's HBU loan in order to satisfy the sublease rental obligations. The Debt Defeasance Account amount was equal to ConEd's remaining principal and interest payment obligations under the HBU Loan at all times, and the Debt Defeasance Amount earned 7.1% interest – this resulted in the HBU loan proceeds being deposited into the Debt Defeasance Account, and the principal and interest on the loan being paid from those proceeds.

"The government argued that ConEd's deductions should be disallowed because 'EZH was reasonably likely to exercise' the deal's sublease purchase option, and therefore the lease should not be treated as a true lease and the deductions from the lease should not be available to ConEd."

Government's Position

The government argued that ConEd's deductions should be disallowed because "EZH was reasonably likely to exercise" the deal's Sublease Purchase Option, and therefore the lease should not be treated as a true lease and the deductions from the lease should not be available to ConEd. The government disallowed the deductions and issued a statutory notice of deficiency assessing $328,066 for the 1997 tax year.

Claims Court Ruling

The Court of Federal Claims was not persuaded that EZH was "certain" to exercise the Sublease Purchase Option and concluded that the transaction could not be disregarded under the substance-over-form doctrine because it was a true lease.

"ConEd argued that the purchase option is significant only if 'certain' to be exercised."

Federal Circuit's Opinion

The Federal Circuit rejected ConEd's arguments that attempted to distinguish this case from *Wells Fargo*. ConEd argued that the purchase option is significant only if "certain" to be exercised. The appellate court held that the question was whether ConEd could have reasonably expected the tax-indifferent entity to exercise its repurchase option. ConEd also argued that the trial court applied the correct standard – EZH was not likely to exercise its purchase option and that even if "reasonable

expectation" was the correct standard and misapplied by the Claims Court, remand to the Claims Court was necessary because the record would not support a finding that EZH was not reasonably likely to exercise the Sublease Purchase Option. The appellate court rejected each of these arguments.

Holding for the government, the Federal Circuit held that EZH was reasonably likely to exercise the purchase option and no genuine leasehold interest had been demonstrated. Accordingly, the court held that ConEd was not entitled to the deductions and remanded to the Claims Court solely to recalculate ConEd's proper refund.

—*Elizabeth A. McGee*

IRS Reports on Schedule UTP Filing Statistics

The IRS has completed its second year of processing returns with Schedule UTP, Uncertain Tax Position Statement and has reported that for tax year 2011, 1,783 taxpayers filed Schedule UTP (this compares to 1,761 taxpayers at this time last year).

"The asset threshold for filing Schedule UTP fell to $50 million for 2012 and will drop to $10 million in 2014."

Schedule UTP was introduced in order to capture information that taxpayers reported to their financial auditors for the purpose of establishing a reserve for an uncertain tax position. Starting with the 2010 tax return, certain corporate taxpayers with assets equal to or exceeding $100 million were required to file Schedule UTP. The asset threshold for filing Schedule UTP fell to $50 million for 2012 and will drop to $10 million in 2014. Schedule UTP is centrally processed and reviewed by the IRS's Large Business and International Division.

The IRS has reported that for the 2011 tax year, 4,120 tax positions have been disclosed on Schedule UTP. Nearly 83 percent of returns filed with Schedule UTP were filed by industry case taxpayers reflecting, on average, two positions per UTP Schedule. Returns filed by coordinated industry case taxpayers averaged 3.8 uncertain tax positions. Almost half of all Schedule UTP returns filed reported only one uncertain tax position. The IRS reported that it is still compiling data regarding the top code sections reported with the 2011 tax year filing but does not expect much variation from tax year 2010. In 2010, the top issues reported by UTP filers involved transfer pricing, research credits, trade or business expenses, and capitalization.

—*Richard A. Nessler*

UK Supreme Court Declines to Extend Legal Advice Privilege to Accountants

"The legal advice privilege 'only applies to communications in connection with advice given by members of the legal profession.'"

The Supreme Court of the United Kingdom has refused to extend the scope of the legal advice privilege to accountants.[9] The ruling follows Prudential's assertion of the legal advice privilege with respect to documents involving Prudential's request for legal advice from PricewaterhouseCoopers (PwC) and PwC's legal advice to Prudential in connection with marketed tax avoidance transactions. According to the ruling, the legal advice privilege "only applies to communications in connection with advice given by members of the legal profession." The court reasoned that extending the privilege to cover advice given by non-lawyers would cause uncertainty and inconsistency, and it was therefore the province of Parliament, not the UK courts, to address the policy matters surrounding the issue and better define the scope of the privilege.

—*Elizabeth A. McGee*

Final FATCA Regulations Issued

The Treasury Department issued on January 17, 2013 final regulations (the "Final Regulations") implementing the Foreign Account Tax Compliance Act or FATCA, which was enacted in 2010 in order to reduce perceived offshore tax evasion by US persons through the use of offshore accounts and investments. The Final Regulations make some material changes to the regulations proposed in 2012 and establish new effective dates for the implementation of the rules.

FATCA generally requires a foreign payee of a withholdable payment (as defined in the article, a link to which appears below) to provide certain information to the withholding agent. In addition, a foreign payee that is a foreign financial institution (an "FFI") is generally required either (1) to enter into an agreement with the IRS relating to such reporting or (2) to comply with local laws that implement an intergovernmental agreement relating to FATCA between its country and the United

[9] *R (on the Application of Prudential plc and another) v. Special Commissioner of Income Tax*, Jan. 23, 2013.

States. If a foreign payee does not satisfy the requirements, withholdable payments are subject to withholding at a rate of 30%. FATCA information reporting and withholding requirements generally do not apply to FFIs that are treated as deemed-compliant because they present a relatively low risk of being used for tax evasion or that are otherwise exempt or excepted from FATCA withholding.

For a discussion of the new changes and effective dates, please see http://www.shearman.com/files/Publication/0f57fb3e-0d43-4766-b8a8-187fbeb9490f/Presentation/PublicationAttachment/a6e97c42-0a8e-4c8f-a606-08e0a870bdbc/Final-FATCA-Regulations-Issued_TX_012513.pdf. In addition, a detailed memorandum is forthcoming that will more thoroughly summarize the FATCA regime in light of the Final Regulations and the increasing role of intergovernmental agreements between the US and certain foreign countries in relation to FATCA.

—*Ansgar A. Simon*

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Tax Controversy and Litigation at Shearman & Sterling

Shearman & Sterling's Tax Controversy and Litigation practice is centered on large case tax controversy examinations, tax litigation matters, and government investigations. Our prominent team of nationally recognized trial lawyers represents taxpayers at the audit and appeals stages before the Internal Revenue Service and litigates on behalf of taxpayers in the federal courts, from the US Tax Court to the Supreme Court of the United States. Shearman & Sterling's tax lawyers also represent clients in obtaining rulings from tax authorities and in competent authority proceedings and work with clients to obtain advance pricing agreements.

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.

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