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This month's newsletter also features articles about the Southern District of New York's decision denying AIG partial summary judgment in its foreign tax credit generator case, Amazon's transfer pricing case in the Tax Court, and the Supreme Court's decision to grant certiorari in *Gary Woods*.

Shearman & Sterling Secures Favorable Settlement of $807 Million IRS Claim Against Ambac Financial Group

Shearman & Sterling's tax controversy and litigation group successfully represented Ambac Financial Group, Inc. ("Ambac") in its litigation with the United States related to an $807 million tax claim. Ambac, debtor in a Chapter 11 proceeding pending in the US Bankruptcy Court for the Southern District of New York, was the principal in the first case involving the determination of the appropriate tax treatment of losses resulting from credit default swap ("CDS") contracts. The bankruptcy court approved the settlement on April 29, 2013. Ambac and the Internal Revenue Service ("IRS") closed their settlement on April 30, 2013, and Ambac emerged from bankruptcy the following day. Under the terms of its settlement with the IRS, Ambac and its subsidiary Ambac Assurance Corporation ("AAC") paid the IRS $101.9 million to settle the $807 million tax claim and Ambac will be permitted to utilize up to $3.4 billion of more than $4.4 billion of claimed net operating losses that were challenged by the IRS in court. The successful settlement follows extensive fact and expert discovery and mediation and reflects an 87-percent government concession.

The IRS's claim arose out of Ambac's tax accounting treatment of CDS contracts. Ambac suffered significant losses during the 2008 financial crisis. In 2007, Ambac switched from the "wait-and-see" tax accounting method to the "impairment" method to account for losses on its CDS contracts. Ambac received more than $700 million in "quickie" refunds associated with its treatment of the CDS contracts between 2008 and 2010 before filing for bankruptcy.

Before Ambac filed for bankruptcy, the IRS informed Ambac that it might take action to reassess Ambac's tax liability and demand a return of the tax refunds, which Ambac had already distributed to its subsidiary AAC. To prevent that from happening and the havoc it would wreak on Ambac's reorganization, Ambac sought and obtained a

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temporary restraining order and preliminary injunction ordering the IRS to provide prior written notice before taking any enforcement action pending a final determination of Ambac's tax liability. During the course of the litigation, Ambac successfully kept the case before the bankruptcy court when the government tried to withdraw the reference.

In a press release, Diana Adams, Ambac's President and Chief Executive Officer, said: "The IRS settlement came about through the diligent efforts and support of many interested parties involved in the case and we believe the terms are fair, equitable, and in the best interests of Ambac, its creditors and AAC. This settlement puts us in a favorable position to emerge from bankruptcy and move forward with managing our existing business and exploring new business opportunities."

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

AIG Case Requires Economic Substance for Transactions Generating Foreign Tax Credits

On March 29, 2013, the US District Court for the Southern District of New York denied American International Group's ("AIG") motion for partial summary judgment that it was entitled to certain foreign tax credits for taxes paid by foreign special purpose vehicle affiliates ("SPVs") for six transactions between an AIG subsidiary ("AIG-FP") and foreign financial institutions.[1] The IRS previously disallowed the credits and assessed additional taxes which AIG paid before seeking a refund that led to the motion in the District Court. In its decision, the court agreed with the government that transactions resulting in foreign tax credits are subject to a requirement of economic substance and found that AIG had not shown that it was entitled to partial summary judgment on the foreign tax credit issue.

AIG-FP entered into the six transactions at issue in the case from 1993 to 1997 by selling a foreign lender preferred shares in an SPV with a commitment by AIG-FP to repurchase those shares after a fixed term of years for the original purchase price. Primarily using the proceeds from the sale of shares, the SPV acquired investments that generated income over time for which it paid taxes to the local tax authority. The income was generally distributed to the lender, which paid little or no taxes on the distribution by characterizing the preferred stock as an equity investment and the distribution as a tax-exempt distribution from a subsidiary to its parent under the tax law in the lender's jurisdiction. AIG then claimed foreign tax credits for all foreign taxes paid by the SPV and applied the credit amounts in excess of its US tax liability on the transactions to other unrelated taxes. AIG argued that the sale of preferred stock

[1] *American International Group v. US*, No. 1:09-cv-01871, 111 A.F.T.R.2d 2013-1472 (S.D.N.Y. 2013).

was a loan and the SPV remained an AIG subsidiary under US tax law because there was an obligation to repurchase the stock. Accordingly, AIG deducted the amount of the distribution to the lender as interest and claimed foreign tax credits.

The government referred to this type of transaction, which aimed to "take 'advantage of the mismatch'"[2] between US and foreign tax law, as a foreign tax credit generator that lacked economic substance because it allegedly did not have purpose or utility beyond the expected tax benefits. AIG asserted that the economic substance doctrine should only apply where the doctrine's requirements "'can fairly be derived from the terms and purpose of the statute that is at issue.'"[3] Under AIG's theory, the economic substance rule should not apply here because the purpose of the foreign tax credit is to remedy double taxation and disallowing the company's credits would result in double taxation in contravention of Congressional intent. AIG further suggested that the tax law permits "'proper tax avoidance'" and that Congress intended certain tax relief to apply regardless of the parties' motives.[4] The court disagreed, however, noting that the Congressional purpose for the foreign tax credit was to eliminate disadvantage for "purposive activities" of foreign business operations resulting from US taxation of the worldwide income of US taxpayers who might also be subject to taxes on the same income in other jurisdictions.[5] Therefore, the court stated that Congress did not intend to provide credits for transactions that have no economic utility or purpose aside from tax benefits merely because foreign taxes were in fact paid.

Accordingly, in order to prevail, AIG needed to demonstrate economic substance for its transactions and that "what was done, apart from the tax benefits, is what was intended by Congress."[6] Toward that end, the court noted the importance of the taxpayer's motives and business purpose for the transaction as well as an objective determination of whether there was a reasonable possibility of profit beyond the tax benefits. AIG argued that it anticipated a pretax profit of $168.8 million for the transactions in question. It reached this amount by considering the SPV's investment income and subtracting payments to the purported lender and operational costs. However, the court noted that this calculation took into account the effects of the tax exempt payments to the purported lender, which in turn provided a more favorable dividend rate to AIG-FP because of its anticipated tax benefit. The government's expert opined that there would be no gain for AIG if the dividend were taxable to the lender. AIG argued that the transaction should not be rewritten by the government as if

[2] *Id.* (citing the Reply at 7).

[3] *Id.* (citing AIG's statements).

[4] *Id.*

[5] *Id.* (citing *Goldstein v. Commissioner*, 364 F. 2d 734, 742 (2d Cir. 1966)).

[6] *Id.* (citing *Gregory v. Helvering*, 293 US 465, 469 (1935)).

in a fictional "world without taxes", but the court disagreed, stating that the tax exempt status of the dividend was significant to the transactions and should be reflected in the profit calculation.

The court found that the evidence in the record was not sufficient to satisfy AIG's burden for partial summary judgment on the foreign tax credit issue. A trial will be scheduled in which AIG will attempt to demonstrate that its transactions had the required economic substance to support claiming the foreign tax credits.

—Dan Smith

Amazon Fights Service Over Transfer Pricing Issues

Online retail giant Amazon.com Inc. ("Amazon") is contesting a $2 billion transfer pricing adjustment asserted by the IRS for years 2005 and 2006.[7] The adjustment relates to a qualified cost-sharing arrangement between Amazon and a European subsidiary, Amazon Europe Holding Technologies SCS ("AEHT"). As a result of the proposed adjustment, the IRS asserts an additional tax liability of $234 million.

Amazon launched its first European websites in 1998 and managed those sites from its headquarters in Seattle. Between 2004 and 2006, Amazon reorganized its European operations after discovering that it could not "simply re-launch the Amazon.com website in foreign countries" but needed to launch sites that were specifically tailored to its European markets and develop new technologies to support European sales. In 2005, Amazon entered into a qualified cost-sharing arrangement with AEHT and other related parties. Under the agreement the parties agreed to pool their resources to enhance the value of existing intangible property and develop new intangible property. The parties further agreed to share costs in proportion to each party's reasonably anticipated benefits.[8]

In its proposed adjustment, the IRS asserts, among other things, that Amazon incorrectly valued pre-existing intangible assets that it contributed to the cost-sharing arrangement for purposes of calculating a buy-in payment. Amazon valued the intangible assets at $217 million. The IRS relied on a valuation report by an external economics consulting firm to determine the value of the pre-existing intangibles as $3.6 billion.[9]

[7] *Amazon.com Inc. & Subs.*, T.C. Docket No. 31197-12 (petition filed Dec. 28, 2012).

[8] Petition (filed Dec. 28, 2012), *Amazon.com Inc. & Subs.*, T.C. Docket No. 31197-12 at 5a.

[9] Dolores W. Gregory, "Amazon Challenges $2 Billion Adjustment, Says IRS's Method Was Rejected in Veritas," *Daily Tax Report*, Jan. 15, 2013.

On December 28, 2012, Amazon filed a petition in the United States Tax Court asserting that the IRS made several errors in calculating the value of the intangible assets.[10] Most significantly, Amazon contends that the IRS valuation was based on a discounted cash flow method, which was a valuation method rejected by the Tax Court in *Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009).[11] Amazon's valuation of the intangible assets at $217 million was based on a useful life of seven years or less; Amazon asserts that the IRS's valuation of $3.6 billion was based on a perpetual useful life. Amazon also contends that the IRS failed to make separate allocations in quantifying intangible development costs with respect to pre-existing intangible property. Amazon made an affirmative claim that to reduce AEHT's cost-sharing payments to reflect the exclusion of the cost of stock-based compensation from the pool of intangible development costs subject to the cost-sharing arrangement.[12]

On March 8, 2013, the IRS filed its answer, affirming that it used the discounted cash flow method to value the pre-existing intangible property, but disputing that this method was inappropriate. The IRS denied that it used a perpetual life for the assets and asserted that the consulting firm that it retained to provide an expert opinion used a "terminal value" in calculating the value of the property. The IRS acknowledged that it did not separately value the items of pre-existing intangible property, but stated that under current law, it was not required to do so. Finally, the IRS disputed Amazon's affirmative claim to reduce cost-sharing payments based on excluding stock-based compensation from the costs subject to the cost-sharing arrangement.[13]

The case has not yet been set for trial.

—*Melissa Henkel*

Supreme Court Directs Parties to Argue Section 6226 Jurisdictional Issue in COBRA Case *Gary Woods*

The Supreme Court granted certiorari in *United States v. Gary Woods* on March 25, 2013.[14] The question presented is whether the section 6662[15] overstatement penalty

[10] See fn. 8 *supra*.

[11] The IRS did not acquiesce to the decision in Veritas. See Action on Decision 2010-005, 2010-49 I.R.B. (Dec. 6, 2010).

[12] Petition (filed Dec. 28, 2012), *Amazon.com Inc. & Subs.*, T.C. No. 31197-12.

[13] Answer (filed Mar. 8, 2013), *Amazon.com Inc. & Subs.*, T.C. No. 31197-12.

[14] *United States v. Gary Woods*, No. 12-562.

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

applies to an underpayment of tax resulting from a determination that a transaction lacks economic substance because the sole purpose of the transaction was to generate a tax loss by artificially inflating the taxpayer's basis in property. In addition to granting the petition for writ of certiorari, the Court directed both parties to brief and argue whether the federal district court had jurisdiction to consider the substantial valuation misstatement penalty under section 6226.

The taxpayer participated in a Current Options Bring Reward Alternatives ("COBRA") tax shelter developed and marketed by Jenkins & Gilchrist and Ernst & Young LLP. In its petition, the government stated that the COBRA shelter was one of a number of tax shelters designed to generate unlawful tax losses to offset the taxpayer's actual gains by artificially inflating the taxpayer's basis in a particular asset.

The IRS issued a Final Partnership Administrative Adjustment ("FPAA"), in which it disallowed ordinary and capital losses on various grounds, including that the transactions lacked economic substance, and imposed section 6662(h) substantial valuation misstatement penalties. Woods filed for a refund and sued in the Western District of Texas. The district court, asserting its jurisdiction under section 6662(a)(2) because the principal place of business of the shelter partnerships was San Antonio, upheld the IRS's determination that the transactions lacked economic substance but also held in a subsequent opinion that the taxpayer could not be liable for the valuation misstatement penalty under Fifth Circuit precedent, which provides that when the IRS disallows a deduction, it may not penalize the taxpayer for a valuation overstatement included in that deduction.[16] The district court exercised its jurisdiction under section 6226(a)(2) to decide the section 6662(h) penalty question in the partnership level proceeding, and the government did not contest jurisdiction. The Fifth Circuit affirmed the district court's opinion.[17]

Section 6662(h) imposes a forty-percent penalty for an underpayment of income tax that is attributable to overstatement of the value or basis of property. The circuit courts are split over whether deductions disallowed from a transaction lacking economic substance can produce a deficiency that is attributable to an overstatement and therefore subject to the section 6662(h) penalty. Eight circuits have held that the section 6662(h) penalty still applies when the underpayment is attributable to deductions from a transaction lacking economic substance, but the Fifth and Ninth Circuits have held the opposite.

[16] 794 F. Supp.2d 714 (W.D. Tex. 2011); *Heasley v. Commissioner*, 902 F.2d 380 (1990).

[17] No. 11-50487 (5th Cir. 2012).

Other cases may be impacted by the Court's ruling – *Tigers Eye*[18] and *Petaluma*[19] are pending before the D.C. Court of Appeals. The government, anticipating that the Supreme Court decision in *Gary Woods* may preempt the appellate court's decision in *Tigers Eye*, has already moved to postpone argument in that case.[20]

—*Liz McGee*

Swiss Bank Wegelin Sentenced for Conspiring to Evade Taxes

On March 4, 2013, Wegelin & Co., the oldest and one of the most prestigious banks in Switzerland, was criminally sentenced for evading federal income taxes and conspiring with US taxpayers and others to hide approximately $1.5 billion in Swiss bank accounts.[21] In January 2013, the bank pleaded guilty to one count of conspiracy to defraud the IRS and was ordered to pay approximately $58 million to the US for conspiring to hide bank assets and the income generated in the accounts from the IRS. Wegelin had previously forfeited more than $16.2 million as a result of a civil forfeiture complaint filed by the US in 2012. This case represented the first time that a foreign bank had been indicted for facilitating tax evasion and the first guilty plea and sentencing of such a bank.

According to the superseding indictment and forfeiture complaint, from 2002 through 2011, Wegelin conspired with various US taxpayers to hide from the IRS the existence of bank accounts and the income generated in those secret accounts. Wegelin had no branches in the US but maintained an account at UBS to help US taxpayers with undeclared accounts repatriate money that they had hidden at Wegelin. When UBS became the subject of a US investigation involving hidden bank accounts, it is alleged that Wegelin took steps to capture the US clients lost by UBS. The US attorney alleged that Wegelin took the following steps to further the conspiracy:

- Opening and servicing undeclared accounts for US taxpayer-clients in the names of sham corporations and foundations formed under the laws of Liechtenstein, Panama, Hong Kong, and other jurisdictions for the purpose of concealing some clients' identities from the IRS;

[18] *Tigers Eye Trading LLC v. Commissioner*, 138 T.C. 67 (2012).

[19] *Petaluma FX Partners LLC v. Commissioner*, 135 T.C. 581 (2010).

[20] Shamik Trivedi, "Supreme Court to Hear Valuation Misstatement Case, Requests Briefs on Jurisdiction," Tax News Today, Mar. 26, 2013.

[21] *See* "Swiss Bank Sentenced In Manhattan Federal Court For Conspiring To Evade Taxes," DOJ Press Release, Mar. 4, 2013, available at http://www.justice.gov/usao/nys/pressreleases/March13/WegelinSentencingPR.php.

- Accepting documents that falsely declared that the sham entities were the beneficial owners of certain accounts when in fact the accounts were beneficially owned by US taxpayers and making the false documents part of Wegelin's client files;
- Permitting certain US taxpayer-clients to open and maintain undeclared accounts at Wegelin using code names and numbers to minimize references to the actual names of the US taxpayers on Swiss bank documents;
- Ensuring that account statements and other mail for US taxpayer-clients were not mailed to them in the US;
- Communicating with some US taxpayer-clients using their personal email accounts to reduce the risk of detection by law enforcement; and
- Issuing checks drawn on and executing wire transfers through its US correspondent bank account for the benefit of US taxpayers with undeclared accounts at Wegelin and at least two other Swiss banks. In so doing, Wegelin sometimes separated the transactions into batches of checks or multiple wire transfers in amounts that were less than $10,000 to reduce the risk that the IRS would detect the undeclared accounts.

Wegelin admitted at the time of entering its guilty plea that it conspired to help US taxpayers to evade US taxes by opening and maintaining accounts in Switzerland for US taxpayers who did not complete W-9 tax disclosure forms. Wegelin's Managing Partner admitted that "Wegelin intentionally opened and maintained non W-9 accounts for [certain US] taxpayers with the knowledge that, by doing so, Wegelin was assisting these taxpayers in violating their legal duties" and that "Wegelin was aware that this conduct was wrong." Wegelin will pay the $58 million representing restitution, forfeiture, and a fine from proceeds of the sale of its non-US banking business.

Charges remain pending against three former client advisors at Wegelin, all of whom reside in Switzerland.

—*Richard A. Nessler*

Supreme Court Hears Oral Arguments in *PPL Corp. v. Commissioner*

On February 20, 2013, the Supreme Court heard oral arguments in *PPL Corp. v. Commissioner* to resolve a circuit court split over whether the UK windfall tax on privatized utility companies is a creditable foreign income tax under section 901. The Third[22] and Fifth Circuits[23] disagree. In *PPL*, the Third Circuit

[22] See *PPL Corp. v. Commissioner*, 665 F.3d 60 (3d Cir. 2011), cert. granted (US Oct. 29, 2012) (No. 12 43).

reversed a Tax Court decision,[24] which held in favor of the taxpayer's substantive analysis of the statute's effects, and instead embraced the government's formalistic interpretation to deny the tax credit.[25] In *Entergy Corp. v. Commissioner*, the Fifth Circuit held that the tax was creditable under the case law interpreting Treasury Reg. sec. 1.901-2 and affirmed the decision of the Tax Court.

Section 901(b)(1) provides a tax credit for "the amount of any income, war profits, and excesses profits taxes paid or accrued during the taxable year to any foreign country." The dispute involves the word "income" in section 901(b)(1). Treasury Reg. sec. 1.901-2 explains section 901(b)(1) and defines the terms income, war profits, and excess profits taxes as an "income tax" if it has the "predominant character . . . of an income tax in the US sense."[26] Under the regulation, a foreign tax must, when "judged on the basis of its predominant character," satisfy each of three requirements: the realization requirement, the gross receipts requirement, and the net income requirement.[27] The realization requirement is that the tax is imposed only after the taxpayer has received income.[28] The gross receipts requirement is that the tax is imposed on gross receipts or an amount not greater than gross receipts.[29] The net income requirement is that computing the tax demands deducting from gross receipts the costs and expenses incurred in earning those receipts.[30]

The parties disagree about the base of the windfall tax. The UK windfall statute created a one-time 23 percent tax on the difference between each company's profit-making value over its flotation value. The profit-making value was statutorily defined as the company's average annual profit multiplied by its price-to-earnings ratio. Average annual profit was defined as the per day average over a statutorily-defined initial period multiplied by 365. The flotation value was the price for which the UK government had sold the utility.

In the lower court proceedings and on brief, the taxpayer argued that the UK windfall tax is, substantively, a tax on excess profits. The IRS proposed a more formal reading of the UK statute and argued that the tax should be characterized as a tax on value. PPL's response on brief was that "construing the domestic tax consequences of foreign

23 683 F.3d 233 (5th Cir. 2012), aff'g T.C. Memo. 2010-197.

24 135 T.C. 304 (2010).

25 665 F.3d 60 (3d Cir. 2011).

26 *Id.*

27 *Id.*

28 *Id.*

29 *Id.*

30 *Id.*

taxes is the last place in which a form-over-substance rule would make sense."[31] PPL further argued that the UK windfall tax's "predominant character is a straightforward excess profits tax" and it is therefore creditable.

The Supreme Court's decision is expected before the end of June.

—*Liz McGee*

Tax Court Erred in Holding Limitations Period Not Tolled

On March 1, 2013, the Second Circuit in *City Wide Transit Inc. v. Commissioner* held that the IRS was not time barred from collecting unpaid unemployment taxes from a corporation where the corporation's accountant filed fraudulent tax returns to embezzle money and evade the IRS.[32] This ruling reversed the Tax Court, which held that the period of limitations had expired because the IRS failed to prove that the corporation's accountant had the intent to evade or defeat the payment of taxes.[33]

City Wide Transit Inc. ("City Wide") provides transportation services for handicapped children in New York City. City Wide hired a payroll company to prepare its quarterly tax returns and hired Mr. Manzoor Beg, an accountant, to negotiate with the IRS on its behalf regarding outstanding employment tax liabilities.[34]

The payroll company prepared City Wide's returns. On these returns, City Wide did not claim advance earned income credit ("EIC") payments on behalf of its employees. City Wide provided Mr. Beg with certified checks made out to the IRS for the employment tax liability as determined on the returns prepared by the payroll company. Mr. Beg then submitted Form 941, Employer's Quarterly Federal Tax Return, altered to falsely claim advance EIC payments, to the IRS on City Wide's behalf. As a result, City Wide's tax liability reported to the IRS was less than the amount reflected on the returns prepared by the payroll company and Mr. Beg pocketed the difference. During the course of this scheme, Mr. Beg converted more than $280,000 of payments that petitioner intended to make to the IRS for his own use.[35]

In 2002, Mr. Beg pled guilty to charges of money laundering, knowingly and willfully signing false tax returns, and knowingly and willfully preparing and presenting false

31 Reply Brief for Petitioners, No. 12-43 (Feb. 12, 2013).

32 *City Wide Transit Inc. v. Commissioner*, No. 12-1040 (2d Cir. Mar. 1, 2013), *rev'g* T.C. Memo. 2011 279.

33 *City Wide Transit Inc. v. Commissioner*, T.C. Memo. 2011-279.

34 City Wide's president and sole shareholder, Ray Fouche, owned several other bus companies that had outstanding employment tax liabilities unrelated to those at issue in this case.

35 *Id.*

tax returns. In 2006, he died before being sentenced. On the basis of Mr. Beg's guilty plea, the IRS commenced an examination of City Wide and ultimately assessed unpaid taxes against City Wide after the section 6501(a) three-year period of limitations had expired. City Wide argued that the assessment was untimely, and the IRS argued that the period for assessment was unlimited under section 6501(c) because Mr. Beg had filed fraudulent returns with intent to evade taxes.[36]

In general, the IRS must assess taxes within a three-year period after the taxpayer files its return.[37] However, the IRS can assess at any time for false or fraudulent returns filed with the intent to evade tax or when there is a willful attempt in any manner to defeat tax.[38] It is irrelevant whether it is the taxpayer or the taxpayer's return preparer that had the intent to evade tax.[39]

The Tax Court found that the IRS's assessments were untimely because the IRS failed to prove by clear and convincing evidence that Mr. Beg intended to evade payment or collection of taxes. The court determined that Mr. Beg's filing of false returns was merely an incidental consequence or secondary effect of his embezzlement scheme, thus the three-year period of limitations under section 6501(a) governed.[40]

The Second Circuit disagreed with the Tax Court, holding that Mr. Beg intended to evade taxes, and therefore the extended period of limitations under section 6501(c) applied. The court found that Mr. Beg's ultimate goal was tax evasion and "tax evasion was not a subordinate element to a more grandiose scheme." Because the IRS proved that Mr. Beg intended to underpay City Wide's taxes when he filed false and fraudulent returns, the Tax Court clearly erred in holding that the three-year period under section 6501(a) applied. Accordingly, the extended period of limitations applies and the IRS is free to assess the unpaid taxes against City Wide at any time.[41]

—Melissa Henkel

Tax Court Hears Concurrent Expert Witness Testimony

On February 14, 2013, the US Tax Court issued an opinion in *Crimi v. Commissioner*, in which it praised the helpfulness of concurrent expert witness testimony.[42] At issue

[36] *Id.*

[37] Sec. 6501(a).

[38] Sec. 6501(c)(1)-(2)

[39] *Allen v. Commissioner*, 128 T.C. 37 (2007).

[40] *City Wide Transit Inc. v. Commissioner*, T.C. Memo. 2011-279.

[41] *City Wide Transit Inc. v. Commissioner*, No. 12-1040 (2d Cir. Mar. 1, 2013), *rev'g* T.C. Memo. 2011 279.

[42] T.C. Memo. 2013-51.

in the case was the valuation of a 65-acre tract of undeveloped land in New Jersey that petitioners had transferred in 2004 for $1.55 million in what they claimed was a part-sale/part-gift transaction. Petitioners claimed that the value of the land was $2,950,000 and claimed a $1.4 million tax deduction for a charitable contribution under section 170(a)(1) in relation to the transaction.

One of the IRS's principal arguments was that the taxpayers had failed to obtain a qualified appraisal of the subject property, as required by the strict substantiation requirements under section 170(a)(1) and the corresponding regulations. (In addition to contemporaneous written acknowledgment from the donee required for contributions exceeding $250, a taxpayer claiming a deduction of more than $500,000 for a contribution of property must obtain and attach to the Federal income tax return a qualified appraisal of the property.)[43]

The record included five appraisals: a 2000 appraisal, a 2004 appraisal, a 2007 appraisal, an appraisal from the taxpayers' expert, and an appraisal from the IRS's expert. The appraisals ranged in value from $660,000 to $5,225,000.

Federal Rule of Evidence 702 governs expert witness testimony in the Tax Court. Under that Rule, an expert witness may be allowed to testify in a proceeding before the Tax Court when his scientific, technical, or other specialized knowledge might help the court to understand the evidence or decide a fact. Expert witnesses are to testify candidly and neutrally, but the court is mindful of the "'cottage industry of experts who function primarily in the market for tax benefits,' [sic] and our concerns about the helpfulness of expert testimony . . . ."[44]

Within the past few years, the court occasionally has used concurrent expert testimony.[45] According to the court, "The concurrent testimony in these cases enabled us to more easily separate the reliable portions of the expert reports from the unreliable, and consequently, to expedite our decision making process." In *Crimi*, once again, the court acknowledged that the use of concurrent testimony was helpful:

> To be sure, the importance of concurrent testimony in these cases cannot be overstated; the experts' dialogue straightaway focused on the core issues in dispute, namely, the subject property's highest and best use, the impact of pending environmental legislation, and the role of preliminary and final approvals in comparable properties under the market approach. Additionally, the concurrent testimony elucidated shortcomings with the [expert] reports

[43] Sec. 170(f)(11)(D).

[44] T.C. Memo. 2013-51.

[45] *See Rovakat, LLC v. Commissioner*, 2011-225 (Sept. 20, 2011).

> and resulted in the experts' reaching agreement as to at least two issues in dispute. . . .

After hearing the concurrent testimony and reviewing the evidence, the court rejected the analysis of the government's expert and generally accepted, with minor adjustments, the analysis of the taxpayers' expert. The court found that the value of the subject property was $2,965,840 and held that the taxpayers were entitled to the charitable contribution deductions that they had claimed.

—Liz McGee

US and Switzerland Sign Intergovernmental Agreement to Implement FATCA

On February 14, 2013, the United States and Switzerland signed an intergovernmental agreement ("IGA") for the implementation of the Foreign Account Tax Compliance Act ("FATCA").[46] The Swiss IGA puts forth the business-to-government approach for implementing FATCA and is based on the Model II template released by Treasury in November. Importantly, the Swiss IGA allows Swiss financial institutions to comply with FATCA without violating Swiss bank secrecy laws.

The Swiss IGA has an enabling clause that allows Swiss financial institutions to enter into foreign financial institution ("FFI") agreements with the IRS or be deemed compliant FFIs without being subject to penalties under the Swiss Criminal Code. The Swiss IGA approach differs from the Swiss withholding agreements, which generally preserve Swiss bank secrecy. Under the Swiss withholding agreements, tax revenue is collected through anonymous withholding on Swiss bank accounts without the disclosure of information regarding the accounts. Under the Swiss IGA, the IRS will receive information about the Swiss bank accounts.

The Swiss IGA contains some deviations from the Model II template. Unlike the Model II template, the Swiss IGA does not include a commitment to work with other countries on a model for automatic information exchange, which may be a reflection of the Swiss government's cautious approach to cooperation agreements with other countries. The Swiss IGA also deviates from the Model II framework by setting forth a shorter deadline (January 31st) for Swiss financial institutions to report the number and value of non-consenting US accounts and the number of non-consenting, non participating financial institutions that are paid foreign reportable accounts and the aggregate value of the payments.

[46] *See* Kristen A. Parillo, "Switzerland, US Sign FATCA Agreement," *Tax Notes Today*, February 15, 2013.

Although the Swiss government may hope that the Swiss IGA will lead to a global agreement with the US government with respect to Swiss banks under US investigation or indictment, practitioners are skeptical of such an agreement.

—*Mary Jo Lang*

IRS Disqualifying Certain Taxpayers After Acceptance into Voluntary Offshore Disclosure Program; GAO Reports that IRS May Be Missing Continued Evasion

The IRS Criminal Investigation division is sending letters to certain participants in the Voluntary Offshore Disclosure Program ("OVDP") notifying them that they have been found ineligible for the program.[47] The IRS previously accepted these participants into the OVDP, many of whom had already disclosed information in the program before being notified of their ineligibility.

According to the OVDP Frequently Asked Questions posted on the IRS website, taxpayers may become ineligible for OVDP once the government obtains information from a summons or treaty request that demonstrates a taxpayer's non-compliance with tax and reporting laws.[48] The late disqualifications create problems both for the government and the taxpayer.[49] For OVDP participants, the ineligibility letters produce uncertainty and frustration with the program – taxpayers who thought that they were accepted into the program have learned that they cannot expect the resolution of their offshore tax compliance issues that they had anticipated. The recent publicity could also discourage future participation in the OVDP and thereby frustrate the government's efforts to encourage participation. Moreover, practitioners note that the government may have difficulty relying on the disqualifying evidence in prosecutions because it would need to prove that the evidence was not tainted by a connection to a taxpayer's OVDP disclosure.[50]

Regardless of the practical effects on future prosecutions of disqualified participants, the IRS letters have led some practitioners to question both the benefit of the OVDP acceptance process to potential participants as well as the government's motivation for

[47] *See* Amy S. Elliott and Jaime Arora, "OVDP Disqualifying Previously Cleared Offshore Account Holders," *Tax Notes Today*, March 11, 2013.

[48] *See* Internal Revenue Service, "Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers," June 26, 2012, available at http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers.

[49] Elliott and Arora, *supra* note 1.

[50] *Id.*

threatening prosecution of OVDP participants who were taking steps toward disclosure and fulfilling their tax compliance obligations.[51]

GAO Report[52]

The GAO recently reported that the IRS may be missing attempts by taxpayers to disclose offshore accounts. Based on GAO reviews of IRS data, including tax returns filed between 2003 and 2008, the IRS may be missing taxpayers' quiet disclosures. According to the report, the IRS is losing revenue because taxpayers are silently disclosing their offshore accounts rather than participating in OVDP. There have been significant increases in the number of taxpayers reporting offshore accounts – the IRS has estimated that nearly twice as many taxpayers reported foreign accounts in 2010 as reported them in 2007.

—Daniel B. Smith

Former Tax Attorney Sentenced for Promoting Illegal Tax Shelters

On March 1, 2013, the US Attorney for the Southern District of New York announced that Donna Guerin, a tax lawyer formerly with Jenkens & Gilchrist, was sentenced to eight years in prison following her guilty plea on conspiracy and tax evasion charges relating to her work designing, marketing, and implementing tax shelters.[53] According to Guerin's plea, she was involved in the design, marketing, and implementation of a variety of tax shelters including "Short Sales," "Short Options Strategy" ("SOS"), "Swaps," and "HOMER." These shelters generated billions of dollars in false tax losses.

In May 2011, after an eleven-week jury trial, Guerin, with Paul Daugerdas and two others, was convicted of various charges relating to her work at Jenkens & Gilchrist. Guerin, Daugerdas, and one of the others originally convicted of tax crimes were granted a new trial on June 4, 2012, as a result of certain juror misconduct. The fourth defendant, whose conviction was upheld, is awaiting sentencing.

—Liz McGee

[51] *Id.*

[52] US Gov't Accountability Office, GAO-13-318, Offshore Tax Evasion: IRS Has Collected Billions of Dollars, but May be Missing Continued Evasion (2013).

[53] Former Jenkens & Gilchrist Attorney Sentenced In Manhattan Federal Court To Eight Years In Prison For Promoting Illegal Tax Shelters That Generated Billions Of Dollars In Fraudulent Tax Losses," DOJ Press release, Mar. 1, 2013, available at http://www.justice.gov/usao/nys/pressreleases/March13/DonnaGuerinSentencingPR.php.

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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. Our tax controversy lawyers frequently participate in panels at tax law conferences and publish articles regarding significant tax controversy and litigation developments, and one partner recently ended his term as Chair of the ABA Tax Section's Court Practice and Procedure Committee.
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.

This memorandum 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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