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This month's newsletter also features articles about the agreement between Switzerland and the United States to permit some Swiss banks to participate in a settlement program and avoid criminal prosecution over accounts maintained by US taxpayers; the First Circuit's decision in *Sun Capital*, in which the First Circuit found that a private equity fund was engaged in a "trade or business" for ERISA purposes; and the Fifth Circuit's decision in *Nevada Partners*, affirming the trial court's decision that FOCus transactions lacked economic substance and application of the negligence penalty despite the taxpayers' reliance on outside attorneys and accountants.

Tax Court Holds Against Taxpayer in *John Hancock*

The Tax Court issued its first opinion on lease-in, lease-out ("LILO")/sale-in, lease-out ("SILO") leveraged lease transactions in *John Hancock Life Insurance Co v. Commissioner* on August 5.[1] The controversy concerned John Hancock's involvement in 27 LILO and SILO transactions between 1997 through 2001, but to resolve the matters "expeditiously,"[2] the parties agreed to try seven test transactions consisting of three LILOs and four SILOs. The court held in favor of the government and denied John Hancock the tax benefits of all the transactions. In its analysis, the court discussed the decisions of other federal courts that had decided cases involving LILOs

[1] *John Hancock Life Insurance Co. v. Commissioner*, 141 T.C. No. 1 at 126 (Aug. 5, 2013).
[2] *Id.* at 10.

In *John Hancock* the IRS asserted that the transactions were, in substance, loans made by the taxpayer rather than true leases or equity investments. The Tax Court found that the IRS had failed to show that the taxpayer had no realistic expectation of profit or business purpose for the relevant transactions, thus holding that the IRS failed to prove that the test transactions lacked economic substance.

and SILOs, including *Altria Grp., Inc. v. US*,[3] *BB&T Corp. v. US*,[4] and *Wells Fargo & Co. v. US*,[5] all of which were also decided against the taxpayers.

In *John Hancock* the IRS asserted that the transactions were, in substance, loans made by the taxpayer rather than true leases or equity investments. The Tax Court found that the IRS had failed to show that the taxpayer had no realistic expectation of profit or business purpose for the relevant transactions, thus holding that the IRS failed to prove that the test transactions lacked economic substance. Nevertheless, the court found that most of the test transactions failed a substance over form analysis and recharacterized those transactions as financing transactions. For the taxpayer, this resulted in additional original issue discount ("OID") income and the loss of various deductions, including interest on non-recourse debt incurred pursuant to the transactions.

Economic Substance Analysis

The Tax Court's 244-page decision begins its analysis of the subject transactions testing for economic substance. Economic substance analysis includes both an objective and subjective test. A transaction passes the objective test if there is economic substance separate from the tax benefits of the transaction. A transaction passes the subjective test if the taxpayer shows a legitimate non-tax business purpose for entering into the transactions. For the objective test, the taxpayer presented evidence of projected cash flow from the investments. The court stated that a net present value calculation for the investments could be useful in this analysis and found that the taxpayer's reports lacked a determination and were inconclusive with respect to the net present value calculation. Nevertheless, the court found that the IRS had not met its burden of proof because it failed to show that there was no reasonable expectation of profit for the taxpayer. With regard to the subjective test, the court noted that the taxpayer had a long history of making careful investment decisions based on its principal business purpose of fulfilling its obligations as an insurance company. For each transaction, the company performed due diligence and engaged advisers to determine that each transaction would "contribute towards diversifying its investments, provide a strong yield, and match its long-term obligations."[6] This convinced the Tax Court that there was a legitimate, non-tax business purpose for the SILO/LILO investments. Therefore, using the objective and subjective tests, the Tax Court was not convinced that the transactions failed the economic substance analysis.

[3] 658 F.3d 276 (2d. Cir. 2011).
[4] 523 F.3d 461 (4th Cir. 2008).
[5] 641 F.3d 1319 (Fed. Cir. 2011).
[6] *John Hancock Life Insurance Co. v. Commissioner*, 141 T.C. No. 1 at 144.

Substance over Form

After finding for the taxpayer on the economic substance issue, the Tax Court considered whether the substance of the transactions was consistent with their form.

After finding for the taxpayer on the economic substance issue, the Tax Court considered whether the substance of the transactions was consistent with their form. The court cited the Supreme Court's decision in *Frank Lyon* for the idea that a sale-leaseback will be respected for tax purposes if the "lessor retains significant and genuine attributes of a traditional lessor."[7] Accordingly, the court stated that in this case, the transactions could be respected if John Hancock could show that it had a true leasehold interest in the LILO properties and a true ownership interest in the SILO properties. In testing for substance over form, the Tax Court used an overall facts and circumstances analysis, while citing various factors that are relevant to the inquiry (but not requiring a strict factor test). Considering the LILO transactions, the court found that the true substance was a loan rather than a lease because, among other things, the terms and security provided in the deal created only a *de minimis* risk for the taxpayer, and the taxpayer was guaranteed a fixed return on its investments. Moreover, the purported lessees in the transactions had purchase options, and the court found that they were reasonably likely to exercise the options based on the financial realities of the deal. Therefore, the court held that the taxpayer had not shown that it acquired the benefits and burdens of a traditional lessor in the LILO transactions and recharacterized the transactions as loans.

Similarly, the court found that one SILO transaction should be recharacterized as a loan because John Hancock did not acquire the benefits or burdens of ownership. As was the case in the LILO transactions, the court noted that the counterparty in the SILO was likely to exercise a purchase option while the taxpayer was insulated from the risk of loss and received a guaranteed return on its investment. In each recharacterized transaction, the taxpayer received a predetermined return on its investment without any of the appreciable downside risk or upside potential that a true owner would have.

Although there were purchase options in the SILOs, the court assumed that they would not be exercised.

For the remaining SILOs among the tested transactions, the court found that John Hancock had an ownership interest in the relevant properties, albeit a future interest, and did not recharacterize the transactions as loans. Although there were purchase options in the SILOs, the court assumed that they would not be exercised. John Hancock was protected from risk before the purchase option, but after that period the company would acquire the risks and benefits of ownership if the option was not

[7] *Id.* at 145.

exercised during a period when a service contract (rather than the original lease) would control the transaction.

The court noted that the allowance of the taxpayer's claimed interest deductions for non-recourse debt incurred in the transactions depended on the taxpayer acquiring the benefits and burdens of the underlying properties. Thus, the recharacterization of the LILO transactions and one SILO transaction as loans eliminated the taxpayer's relevant claims for deductions. For the remaining SILO transactions which were not recharacterized, the court found that the taxpayer did not receive a present ownership interest in the SILO properties sufficient for it to claim interest deductions with respect to the relevant non-recourse indebtedness associated with the investments. Therefore, the taxpayer's interest deductions were denied.

The rejection of the LILO/SILO transactions in general is consistent with other courts' decisions, but the decision not to rely on the economic substance doctrine is a noteworthy departure from the analyses of the other federal courts that have addressed similar transactions.

Because most of the transactions failed the substance over form analysis and were recharacterized as financing transactions, the taxpayer had additional OID income and lost various deductions, including interest on non-recourse debt incurred pursuant to the transactions. The rejection of the LILO/SILO transactions in general is consistent with other courts' decisions, but the decision not to rely on the economic substance doctrine is a noteworthy departure from the analyses of the other federal courts that have addressed similar transactions.

–Dan Smith

Switzerland and United States Reach Agreement on Swiss Bank Cooperation

Switzerland and the United States have reached an agreement to permit some Swiss banks to disclose information and to participate in a settlement program with the US Department of Justice to avoid criminal prosecution in connection with Swiss accounts maintained by US taxpayers. Switzerland's Finance Minister and the Justice Department announced the agreement on August 29, 2013, which resolves the ongoing tax evasion investigation by the US within the scope of existing Swiss law. A previous attempt by the Swiss government to reach an agreement with the US failed in June of this year.

According to the Department of Justice, the settlement program will permit Swiss financial institutions to disclose financial information about US taxpayers with undeclared Swiss accounts and pay a penalty to the US to resolve criminal liability. Swiss financial institutions currently under formal investigation by the US are not eligible to participate in the settlement program. At present, 14 Swiss banks are under criminal investigation for allegedly helping US taxpayers evade taxes, including Credit Suisse and Julius Baer. In February 2012, the United States indicted Wegelin & Company, the oldest Swiss bank. Wegelin later pled guilty to one count of conspiracy to defraud the IRS and is no longer in business.

It is expected that the settlement may involve nearly 100 Swiss banks that held accounts for US clients. The settlement is expected to cost the Swiss banks hundreds of millions, and could exceed a billion dollars. Attorney General Eric Holder stated that "[t]his program will significantly enhance the Justice Department's efforts to aggressively pursue those who attempt to evade the law by hiding their assets outside of the United States" and "will improve our ability to bring tax dollars back to the US treasury from across the globe."[8]

Swiss banks must also make a complete disclosure of their cross-border activities, provide detailed information on an account-by-account basis for accounts in which US taxpayers have a direct or indirect interest, provide information as to other banks that transferred funds into secret accounts or that accepted funds when secret accounts were closed, agree to close accounts of account holders who fail to come into compliance with US reporting obligations, and cooperate with US treaty requests for account information.

The settlement program would require the Swiss banks to pay a 20 percent penalty to the US on all non-disclosed US accounts that were held by a Swiss bank on August 1, 2008. The penalty would increase to 30 percent if there is evidence that the accounts were opened after that date but before the end of February 2009, when UBS entered into a deferred prosecution agreement and agreed to pay a $780 million fine and turn over information on thousands of US accounts. The penalty would increase to 50 percent for accounts opened after February 2009. Swiss banks will also need to provide the Justice Department with a description of their banking activities, including providing the names of bank employees involved and third-party advisers or professionals.

Under the program, Swiss banks must also make a complete disclosure of their cross-border activities, provide detailed information on an account-by-account basis for accounts in which US taxpayers have a direct or indirect interest, provide information as to other banks that transferred funds into secret accounts or that accepted funds when secret accounts were closed, agree to close accounts of account holders who fail to come into compliance with US reporting obligations, and cooperate with US treaty requests for account information. Banks meeting these requirements, in addition to payment of an imposed penalty, will be eligible for non-prosecution agreements. Bank employees, financial advisors and other individuals are excluded from the program.

A key component of the program requires cooperating Swiss banks to provide information that will assist the United States to follow the money to other Swiss banks and to bank located in other countries. US officials also expect that this agreement will encourage US taxpayers with Swiss accounts to take advantage of the voluntary disclosure program conducted by the IRS. Under the voluntary disclosure program, the US has collected more than $5 billion.

–Richard A. Nessler

[8] *See* Press Release, US Department of Justice, August 29, 2013.

First Circuit Finds Private Equity Fund was Engaged in a "Trade or Business" for Purposes of ERISA Rules in *Sun Capital*

In a decision with significant potential tax implications, a three-judge panel for the US Court of Appeals for the First Circuit found that a private equity fund was engaged in a "trade or business" for purposes of the Employee Retirement Income Security Act ("ERISA").[9]

Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund involved a dispute regarding whether either of two private equity funds were responsible for the $4.5 million pension liability of a bankrupt company, Scott Brass Inc. ("SBI"), in which the funds were passive investors. The funds, which are under Sun Capital Advisors, Inc., have no offices or employees and report only investment income. Under the ERISA rules, a member of a controlled group is liable for an employer member's withdrawal liability if (1) the member is engaged in a trade or business and (2) the other member is in common control of the employer member.[10] For this purpose, common control is 80 percent ownership.[11]

The First Circuit disagreed with the district court on the "trade or business" issue. The court acknowledged that the term had no uniform definition provided by regulations or the Supreme Court, and applied the Seventh Circuit's "investment plus" standard.

The funds contended that they did not meet either of these requirements because they were not engaged in a trade or business and, individually, neither fund owned 80 percent of SBI. In 2012, a Massachusetts district court found that the funds were not engaged in a trade or business, relying on the fact that they did not have offices or employees, they did not make or sell goods and they reported only investment income on their tax returns.[12]

The First Circuit disagreed with the district court on the "trade or business" issue. The court acknowledged that the term had no uniform definition provided by regulations or the Supreme Court, and applied the Seventh Circuit's "investment plus" standard. The court found that the funds' investment in SBI, combined with the funds' intimate involvement with the management and operation of SBI, constituted a "trade or business." The panel remanded the case to the district court for additional fact finding relating to whether there was common control for purposes of the ERISA rules.[13] On

[9] *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund*, No. 12-2312 (1st Cir. 2013).
[10] 29 USC. § 1301(b)(1).
[11] *Id.*
[12] *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund*, 903 F. Supp. 2d 107 (D. Mass. 2012).
[13] *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund*, No. 12-2312 (1st Cir. 2013).

August 23, the First Circuit entered an order denying a petition for a rehearing *en banc* filed by private equity firms affiliated with Sun Capital.

The opinion in *Sun Capital* may have serious implications in the tax world—according to one expert, the case could "devastate the economics of private equity investment."[14] For tax purposes, private equity funds are generally treated as passive investors that are not engaged in a trade or business. Thus, the ruling in *Sun Capital* that a private equity firm was engaged in a trade or business creates concern that similar treatment could be applied for tax purposes, potentially leading to significant tax ramifications, including ordinary income for managers, effectively connected income for foreign investors and unrelated business taxable income for tax-exempt investors.[15]

Thus, the ruling in *Sun Capital* that a private equity firm was engaged in a trade or business creates concern that similar treatment could be applied for tax purposes, potentially leading to significant tax ramifications, including ordinary income for managers, effectively connected income for foreign investors and unrelated business taxable income for tax exempt investors.

The implications of *Sun Capital* on tax issues are not clear, as the case related to the meaning of "trade or business" for purposes of the ERISA rules. Some tax practitioners have drawn comfort from the fact that the First Circuit specifically created a holding which related to the ERISA rules and did not attempt to define trade or business for purposes outside this context.[16] Others have acknowledged that while the language of *Sun Capital* may be "troubling," they do not believe it should have significant tax effects on private equity funds.[17] It is unclear what the impact of the First Circuit's decision in *Sun Capital* will be, but it is certain that the eyes of many in the tax world will be on the rulings that come in the wake of this decision.

–Melissa Henkel

Seventh Circuit Affirms Tax Court in Distressed Asset/Debt Case *Superior Trading*, Upholds Valuation Misstatement Penalty

On August 26, the US Court of Appeals for the Seventh Circuit joined a majority of circuits in holding that a taxpayer who overstates basis and participates in a sham transaction can be held liable for the forty-percent valuation misstatement penalty under section 6662(h).[18] In *Superior Trading, LLC v. Commissioner*,[19] the Seventh Circuit affirmed the Tax Court's decision in favor of the government after it disallowed losses claimed by "partners" in a so-called distressed asset/debt transaction.

[14] Amy S. Elliot and Lee A. Sheppard, "Private Equity Fund Is in a Trade or Business, First Circuit Holds," *Tax Notes Today* (July 26, 2013).
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] All section references are to the Internal Revenue Code and all references to regulations are to the Treasury regulations issued thereunder, unless otherwise noted.
[19] Nos. 12-3367; 12-3368; 12-3369; 12-3370; and 12-3371 (7th Cir. Aug. 26, 2013).

John Rogers created a limited liability company known as Warwick LLC to transfer Brazilian company Arapuã's receivables with built in losses to US taxpayers who would then deduct the losses from their federal income tax. Arapuã and Rogers' company, Jetstream, joined to form Warwick. Jetstream was designated managing partner of Warwick. Arapuã contributed its receivables to Warwick, and Arapuã's partnership interest was sold to investors, who, as successors in the partnership, then claimed the partnership losses. To deduct the built-in losses, the investors had to contribute property. The investors contributed promissory notes made out to the partnership. The appellate court stated that the promissory notes had no value because Warwick would not collect on them—rather, they were promised only to give the appearance that the investors had enough basis to claim the built-in losses from Arapuã's receivables. The court stated that the partnership was "just a conduit from the original owner of the receivables (Arapuã) to the US taxpayers" and was a "sham." On that basis, the court affirmed the Tax Court's decision in favor of the government. It also upheld the valuation misstatement penalty, while acknowledging the circuit split on the issue and stating that the Supreme Court had granted *certiorari* in *United States v. Woods*[20] to resolve the issue.

–Liz McGee

Fifth Circuit Upholds Lower Court's Economic Substance and Negligence Penalty Holdings in FOCus Tax Shelter Case

The appellate court affirmed the district court's determinations that the transactions at issue, known as "Family Office Customized" or "FOCus" transactions, lacked economic substance.

The US Court of Appeals for the Fifth Circuit affirmed in part and vacated in part a decision by the US District Court for the Southern District of Mississippi in *Nevada Partners Fund v. United States*.[21] In an appeal arising from eleven notices of final partnership administrative adjustment (FPAAs) issued with respect to three limited liability companies treated as partnerships for tax purposes, the appellate court affirmed the district court's determinations that the transactions at issue, known as "Family Office Customized" or "FOCus" transactions, lacked economic substance and should be disregarded for tax purposes. The court also affirmed the negligence penalty and rejected the partnerships' reasonable cause defense, but did not apply the valuation misstatement penalty.

[20] 133 S.Ct. 1632 (2013).
[21] No. 10 60559 (5th Cir. June 24, 2013).

An accounting firm presented on the "FOCus" program, which was expected to yield a tax benefit with zero net capital gains and losses. According to the presentation, a second law firm would provide a "more likely than not" tax opinion with regard to the structure.

Background

James Kelley Williams expected to realize $18 million in capital gains in 2001. After conferring with his accountant and his attorney, an accounting firm gave a presentation to him and his attorneys on Bricolage Capital LLC's "FOCus" program, which was expected to yield a tax benefit with zero net capital gains and losses. According to the presentation, a second law firm would provide a "more likely than not" tax opinion with regard to the structure.

As part of the FOCus program, Bricolage set up three tiers of LLCs, with the first-tier LLC being 99 percent owned by a subchapter S corporation called Pensacola PFI Corp. ("Pensacola"). The third-tier LLC engaged in foreign currency straddle transactions that resulted in 80 closely offsetting loss and gain legs, resulting in $18 million in gains and $18 million in losses. Then Pensacola began the process of separating gains and losses through the partnership to two shareholders who were investors connected to Bricolage. More than 50 percent of the interest in one of the partnerships was sold or exchanged, resulting in the termination of the tax year, so one of the partnerships was required to declare certain gains and losses on the straddle trades, resulting in the gains flowing up the partnership to Pensacola. Because the parties were related parties, they could only claim the gains from the straddle trades, not the losses, so the gain legs were reported on the owners' tax returns and Bricolage "achieved its first goal of creating an embedded loss that one of its investor-clients could later claim for tax purposes".[22]

In December 2001, Williams purchased a 99 percent interest in the first-tier partnership for $883,000. Bricolage kept a one-percent interest. Williams' Trust, which held most of his wealth, purchased the first-tier partnerships' interest in the second-tier partnership for $523,000 and then increased its basis in one of the partnerships by transferring equity interests and cash into the partnership, giving Williams a tax basis in the partnership of approximately $9.7 million. Later that month, the third-tier partnership settled five remaining open loss legs, producing $1 million in ordinary losses, that flowed up the partnership chain to Williams, who reported them as ordinary losses. The second-tier partnership sold its interest in the third-tier partnership to another Bricolage corporation for $168,000, triggering a $17 million capital loss for the second-level partnership. Williams had a 99 percent share of that loss but could not yet take advantage of the losses because he did not have enough basis in the second-tier partnership. To increase his basis, Williams

[22] Slip. op. at 9.

signed a personal guarantee of a $9 million loan for the second level partnership to participate in a carry trade involving Japanese Yen. The second-level partnership and the lending institution limited their exposure to rate fluctuations with a narrow risk collar that set the partnership's maximum gain at $77,000 and maximum loss at $90,000. The partnership gained $51,000 on the transactions.

Williams paid Bricolage $845,000, or seven percent of the $18 million desired loss.

IRS Notice 2000-44

The IRS published Notice 2000-44 "Tax Avoidance Using Artificially High Basis" in September 2000 to combat abusive tax shelters known as Son of BOSS schemes. In April 2002, the IRS compelled the accounting firm that presented the FOCus transaction to Williams to disclose information about participants in the FOCus programs. The IRS issued Notice 2002-50, "Partnership Straddle Tax Shelter" on June 27, 2002, which designated partnership straddle tax shelters as "listed transactions."

Two months after straddle transactions became designated listed transactions, Williams received the "more likely than not" opinion from the law firm. The opinion stated that the FOCus transaction was, in the firm's opinion, "more likely than not" "the same as, or substantially similar to, the listed transaction described in Notice 2002-50." The tax opinion did not distinguish the FOCus transactions from those described in the notice but still recommended that the transactions more likely than not had economic substance.

Parties' Positions and Court's Analysis

The IRS issued FPAAs challenging the transactions and disallowing the losses claimed by the partnerships under the economic substance doctrine. The FPAAs also assessed three alternative penalties under section 6662: the substantial understatement penalty (twenty percent), the negligence penalty (twenty percent), and the gross valuation misstatement penalty (forty percent).

The IRS issued FPAAs challenging the transactions and disallowing the losses claimed by the partnerships under the economic substance doctrine. The FPAAs also assessed three alternative penalties under section 6662.

The partnerships challenged the FPAAs in Mississippi district court, which held, *inter alia*, that the FOCus program lacked economic substance. The appellate court upheld the district court's holding that the transactions lacked economic substance under its test derived from *Frank Lyon*, which examines whether the transaction: (1) has economic substance compelled by business or regulatory realities, (2) is imbued with tax-independent considerations, and (3) is not shaped totally by tax-avoidance features. After reviewing the question of economic substance *de novo* and the facts for

clear error, the appellate court saw no clear error in the district court's decision regarding economic substance. The court stated: "In sum, the transactions that created [the] $18 million embedded loss had no economic substance and Williams obtained the benefit of an $18 million deduction on his 2001 personal income tax return without suffering any real economic loss."[23]

The court stated that the district court "was justified in concluding as a matter of fact that the partnerships were negligent and exposed themselves to liability for the section 6662 accuracy-related penalties because they did not meet their burden of proving due care and the absence of

The court affirmed the district court's imposition of a negligence penalty (and vacated its approval of the substantial understatement penalty because the two are alternatives). The court stated that the district court "was justified in concluding as a matter of fact that the partnerships were negligent and exposed themselves to liability for the section 6662 accuracy-related penalties because they did not meet their burden of proving due care and the absence of negligence."[24] The court further stated that the partnerships were negligent in participating in the FOCus program after the IRS issued Notice 2002-50. The court rejected the parties' reasonable cause and good faith defense. The parties stated that Williams had relied on the tax advice of two law firms and an accounting firm, but the court found this unpersuasive—Williams did not become a controlling member until late 2001, and the partnership's negligence related to the FOCus program began before that: "Williams' subsequent reliance on tax law advice by counsel cannot serve retroactively to shield the partnerships from liability for their prior negligence and disregard of rules and regulations in formulating, promoting, and beginning to carry out the unlawful FOCus tax avoidance scheme."[25] According to the court, the law firm's opinion "clearly reflect[ed]" that the partnership did not provide the facts and circumstances surrounding the transaction to the law firms and that Williams and the partnerships knew that the tax opinions did not contain key information. Accordingly, the court held that the tax opinions could not be relied upon in good faith. Because Williams' other counsel had relied upon these tax opinions, and the partnerships knew this, the partnerships also did not reasonably rely upon the advice of Williams' second law firm.

–Liz McGee

Eighth Circuit Affirms District Court, Transactions Lacked Economic Substance in *Wells Fargo*

On August 22, the Eighth Circuit affirmed a holding by the US District Court for the District of Minnesota that a transaction involving lease transfers lacked objective

[23] Slip op. at 26 27.
[24] *Id.* at 32.
[25] *Id.* at 36.

The court rejected taxpayer Wells Fargo's contention that it had engaged in the transaction to avoid bank regulations regarding the leases.

economic substance and a subjective business purpose.[26] The court rejected taxpayer Wells Fargo's contention that it had engaged in the transaction to avoid bank regulations regarding the leases.

Background

When Old Wells Fargo ("OLF") acquired First Interstate Bancorp ("First Interstate") in 1996, the two banks had a number of leased properties in similar locations. After OWF merged with Northwest Corporation to become Wells Fargo ("WFC") in 1998, WFC retained the lease obligations.

Tax-Reduction Strategy

The court found that before the merger, an accounting firm which marketed a contingent-liability tax-reduction strategy called an "economic liability transaction" advised OWF that OWF's leases could be used to reduce its federal tax liability by creating current losses to shield current income from tax. The accounting firm recommended a strategy that included OWF making a tax-free transfer of valuable assets and tax-deductible liabilities to a subsidiary in exchange for corporate stock. The value of the corporate stock would be reduced by the value of the liabilities, but the stock basis would remain equal to the tax basis of the assets transferred. OWF would then sell the stock to an outside third-party at the low market value, resulting in a large capital loss.

According to the court's findings, the accounting firm told OWF that the strategy needed a non-tax business purpose to succeed. Ultimately, WFC wrote a business-purpose document that explained the regulatory benefit of transferring the leases into a non-banking

Under section 351(a), a taxpayer recognizes no gain or loss from its property transfer into a corporation solely in exchange for stock, provided that it controls the corporation immediately after the transfer. Under section 358(a)(1)(A)(ii), a taxpayer's basis in the stock it receives in such a transfer must equal its tax basis in the property transferred, and the taxpayer must reduce its basis in the stock by the amount of any money it receives in addition to stock. Assumption of liabilities is treated as money received by the taxpayer under section 358(d), but if the corporation assumes liabilities, the payment of which would give rise to a deduction, its assumption of the liabilities will not reduce its tax basis in the stock.[27] According to the court's findings, the accounting firm told OWF that the strategy needed a non-tax business purpose to succeed. Ultimately, WFC wrote a business-purpose document that explained the regulatory benefit of transferring the leases into a non-banking subsidiary. If the leases were in a non-banking subsidiary, WFC would have more flexibility in managing them because they would fall under less rigid regulations. According to WFC, the transfer

[26] *WFC Holdings Corp. v. US*, No. 11-3616 (8th Cir. Aug. 22, 2013).
[27] Sections 358(d)(2) and 357(c)(3).

The IRS disallowed WFC's refund, and WFC filed suit in district court. The district court held in favor of the IRS and found that although the government had not proven that WFC violated its requirements, the transaction failed both the business purpose and economic substance parts of the economic substance doctrine.

would also strengthen the bank's negotiating position with bank customers and incentivize managers.

Once it had established its business purpose, WFC transferred government securities with a tax basis of $426 million and leasehold interest to a holding corporation that issued 4,000 shares of its stock to the bank and assumed the lease obligations. An unrelated third party purchased the stock from WFC for $3.7 million. WFC claimed a deduction for a $423 million capital loss on its 1999 return and filed a refund claim in 2003 claiming a capital loss carryback from its 1999 tax return that resulted in part from the 1999 capital loss. WFC claimed an $82 million refund for 1996.

The IRS disallowed WFC's refund, and WFC filed suit in district court. The district court held in favor of the IRS and found that although the government had not proven that WFC violated its requirements, the transaction failed both the business purpose and economic substance parts of the economic substance doctrine.

Appellate Court Analysis

Relying on *Frank Lyon*,[28] the court analyzed the transaction under the economic substance doctrine. Under the economic substance doctrine, a court must disregard a transaction that a taxpayer enters into without a valid business purpose for the purpose of claiming tax benefits. In the Eighth Circuit, courts examine a transaction's economic substance under a two-part test that looks at (1) whether there is any economic purpose outside of tax considerations (the "business purpose test") and (2) whether a real potential for profit exists (the "economic substance test").[29] The court concluded that the transaction at issue lacked both an economic purpose and economic substance.

WFC argued that the district court's findings showed that the transaction had economic substance. The appellate court rejected this: "WFC has misconstrued the district court's findings. WFC's transfer of the Garland lease to Charter—one economically beneficial component of a much larger, complex transaction—does not impart substance to the larger LRT/stock transaction. We agree with the district court...."

The appellate court also agreed with the district court's business purpose analysis. The appellate court reiterated its conclusion that the transaction had no real potential for profit but still evaluated the district court's discussion of WFC's three bases for business purpose—the favorable bank regulations applicable after the transaction,

[28] *Frank Lyon Co. v. United States*, 435 US 561 (1978).

Notably, the Eighth Circuit highlighted the circuit court split over the application of the economic substance doctrine. The court declined to decide whether a transaction could fail either the economic substance and business purpose tests to fail the economic substance doctrine test because this transaction failed both tests.

strengthening its position with customers, and incentivizing managers. The district court had stated that WFC could have achieved the same regulatory result without creating a new class of stock and selling it simply by transferring the leases to a non-banking subsidiary. The appellate court did not find that the district court's analysis employed an improper approach and held that the district court made no error in finding that WFC had failed to meet its burden of proof that it engaged in the transaction for regulatory reasons. The court likewise held that the district court did not err in holding that the transfer was not motivated by improving its relationship with customers or incentivizing managers.

Notably, the Eighth Circuit highlighted the circuit court split over the application of the economic substance doctrine. The court declined to decide whether a transaction could fail only the economic substance or the business purpose tests and still fail the economic substance doctrine test because this transaction failed both tests.

–Liz McGee

Second Circuit Disallows Deductions Under "All Events Test" in *New York Life Insurance Co. v. US*

On August 1, the US Court of Appeals for the Second Circuit affirmed a district court's dismissal of New York Life Insurance Company's refund suit, concluding that the deductions did not meet the requirements of Treas. Reg. sec. 1.1461-1(a)(2)(i). The case centered around calendar-year, accrual-basis taxpayer New York Life's treatment of termination dividends and annual dividends on policies with a January anniversary date. Between 1990 and 1995, for policies eligible for a termination dividend and an annual dividend, New York Life deducted the lesser of the two dividends that it expected to pay the next year on its current income tax return because it either would pay the annual dividend or the termination dividend the next year. A dividend with a January anniversary date was credited to the policy holder's account no more than 30 days before the January anniversary (i.e. the year before), and the insurance company claimed a deduction in the credit year instead of the payment year.

The IRS disallowed the deductions because they were not made in the year of actual payment, and New York Life sued in district court. The district court agreed with the IRS and granted its motion to dismiss. New York Life appealed to the Second Circuit.

[29] *WFC Holdings Corp. v. US* (citing *Shriver v. Commissioner*, 899 F.2d 724, 725-26 (8th Cir. 1990).

The Second Circuit stated that New York Life took a deduction before the fact of the liability was established. Under the "all events" test, a liability is incurred and taken into account in the taxable year in which "all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability."[30] Because New York Life failed to allege that its obligations were fixed—i.e. not subject to any condition regardless of statistical probability—the appellate court affirmed the district court opinion.

The Second Circuit's opinion in *New York Life* is inconsistent with the Court of Federal Claims ruling last year in *Massachusetts Mutual Life Insurance Co. v. US*, 103 Fed. Cl. 111 (2012).

–Liz McGee

Court Approves "John Doe" Summons Authority for IRS to Provide Treaty Partner with Information on US Bank Accountholders

The Justice Department has announced that it initiated ten petitions to allow "John Doe" summonses to be served on US financial institutions at the request of the Norwegian government.[31] The John Doe summonses seek information from the banks about accountholders who have used certain credit or debit cards in Norway. Norway requested the information from the IRS pursuant to the tax treaty in effect between Norway and the US, which provides for cooperative exchanges of information relevant to enforcement of either country's tax laws. The Norwegian authorities have reason to believe that the use of US bank payment cards in Norway by cardholders who do not identify themselves may allow the cardholders to avoid income tax by failing to report the US account information or income on tax returns. In its press release, the Justice Department affirmed its commitment to international cooperation as part of its ongoing efforts to curb tax evasion. By cooperating with other nations, the US may have more success in the future with its own tax compliance initiatives, such as the Foreign Account Tax Compliance Act.

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Several courts have already entered orders authorizing the John Doe summonses.[32] For example, on July 24, the United States District Court for the Western District of

[30] Treas. Reg. § 1.461-1(a)(2).

[31] Department of Justice, Federal Courts Authorize Service of *John Dow Summonses Seeking Identities of Persons Using Payment Cards in Norway* (July 29, 2013).

[32] Department of Justice, Federal Courts Authorize Service of *John Dow Summonses Seeking Identities of Persons Using Payment Cards in Norway* (July 29, 2013).

Pennsylvania approved the IRS petition to serve summonses.[33] The court approved the petition without significant discussion of the issues, thereby implicitly approving the government's conclusions in its memorandum in support of the petition.

The government's memorandum to the court in support of the petition focused on the requirements for a John Doe summons in Section 7609(f).[34] Generally, courts may grant leave to serve such a summons when the government shows three factors: (1) the summons relates to a particular person or group of individuals, (2) there is a reasonable basis to believe that a person or group may not have complied with internal revenue laws, and (3) the information sought is not readily available from another source. In its memorandum and related declarations, the government argued that it had established these three factors. The government stated that the summonses relate to investigations of particular individual (or joint) accountholders who may be easily identified by the banks using the relevant account numbers in the summonses. The government argued that there was a reasonable basis to believe that these particular people violated internal revenue laws. The memorandum asserted that the requirement of a failure to comply with internal revenue laws should include Norwegian laws because the relevant tax treaty requires the US government to collect information requested by Norway under the treaty using the enforcement mechanisms under the Internal Revenue Code, such as a summons, as if the Norwegian tax were a tax of the US. Moreover, the government cited authority approving the use of a summons under section 7602 to acquire records for a treaty partner. Based on the records already in the possession of the Norwegian authorities, the government argued that there was reasonable basis to believe the particular cardholders may have violated tax laws because of the high level of activity and significant dollar amounts of transactions made by the cardholders without personally identifying themselves. As additional evidence, the government cited evidence of the successes of other payment card investigations, which have uncovered tax fraud in the past. Finally, the government argued that the information requested about the accountholders who used payment cards was not readily available from other sources apart from the banks which are the recipients of the summonses. According to the Norwegian authorities, cardholder identities cannot be ascertained for certain transactions, such as ATM and debit card transactions without the help of the banks to match an account number with an

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[33] *In Re Tax Liabilities of John Does*, No. 2:13 cv 01066 NBF (W.D. Pa. 2013), Order (07/24/13), Tax Analysts Document Service Doc. 2013 18393.

[34] *In Re Tax Liabilities of John Does*, No. 2:13 cv 01066 NBF (W.D. Pa. 2013), Memorandum in Support of Ex Parte Petition for Leave to Serve "John Doe" Summons (07/22/13), Tax Analysts Document Service Doc. 2013 18392.

accountholder's identity. In support of its argument, the government cited other cases where John Doe summonses were issued to identify US taxpayers when the IRS suspected that such taxpayers were using payment cards to avoid US taxes.

–Dan Smith

District Court Imposes Spoilation Sanctions on Plaintiff that Failed To Institute Litigation Hold

On August 15, the US District Court for the Southern District of New York imposed spoilation sanctions on Sekisui America Corporation ("Sekisui") and Sekisui Medical Co. Ltd for breaching the duty to preserve electronically stored information ("ESI"). In *Sekisui American Co. v. Hart*,[35] Sekisui brought action for breach of contract against Richard Hart, the president of a company that Sekisui had acquired, and Hart's wife. Sekisui did not put a litigation hold on the destruction of electronic information until over 15 months after it sent a Notice of Claims to the Harts, and during that time, ESI belonging to certain employees of the acquired company had been deleted or was missing. After learning that the information was missing, the Harts requested (1) an adverse inference jury instruction for destruction of ESI and (2) sanctions for spoliation based on the alleged or actual loss of the employee email folders. The matter was initially referred to a Magistrate Judge who declined to issue sanctions, but the court reversed the Magistrate Judge's decision to the extent that it denied the Harts' request for a sanction based on the destruction of ESI.

The court addressed two issues: "the appropriate penalty for a party that—with full knowledge of the likelihood of litigation—intentionally and permanently destroyed the emails of several key players" and "how to determine an appropriate remedy for the injured party when it remains unclear whether the destroyed evidence would, in fact, be favorable to that party."[36]

The court addressed two issues: "the appropriate penalty for a party that—with full knowledge of the likelihood of litigation—intentionally and permanently destroyed the emails of several key players" and "how to determine an appropriate remedy for the injured party when it remains unclear whether the destroyed evidence would, in fact, is favorable to that party."

To obtain adverse inference instructions for the destruction of evidence, a party "must establish (1) that the party having control over the evidence had an obligation to preserve it at the time it was destroyed; (2) that the records were destroyed with a culpable state of mind; and (3) that the destroyed evidence was relevant to the party's claim or defense such that a reasonable trier of fact could find that it would support that claim or defense."[37] A party must show that evidence was destroyed knowingly or

[35] *Sekisui American Co. v. Hart*, No. 1:12-cv-03479, slip. op. (SDNY filed Aug. 15, 2013).
[36] *Id.* at 2.
[37] *Id.* at 13 (citing *Residential Funding Corp. v. DeGeorge Financial Corp.*, 39 F.3d 99 (2d Cir. 2002).

The court's decision is the latest reminder of the importance of instituting and enforcing litigation holds as soon as a reasonable probability of litigation arises.

negligently to satisfy the requirement of a culpable state of mind but does not need to show intent to breach a duty and sufficient evidence that the destroyed evidence would have been helpful to the party seeking sanctions.[38] Prejudice is presumed when evidence is destroyed willfully or through gross negligence, but the burden of proving prejudice falls on the party seeking sanctions when the destruction of evidence is simply negligent.

The court found that Hart's ESI was willfully destroyed because the head of human resources demanded that Hart's ESI be destroyed. The court stated "a good faith explanation for the willful destruction of ESI when the duty to preserve has attached does not alter the finding of willfulness."[39] The court found that Sekisui's failure to implement an appropriate document retention policy rose to the level of gross negligence given Sekisui's knowledge of the possibility of future litigation and the fact that it took Sekisui six months to notify the company responsible for preserving its documents of the litigation hold once it had put one in place.[40] After finding that the evidence lost was relevant, the court found that Sekisui had been unable to rebut the presumption of prejudice because "an unknowable amount of ESI . . . was permanently destroyed and remains irretrievable."[41] Accordingly, the court granted the Hart's request for an adverse jury instruction. The court's decision is the latest reminder of the importance of instituting and enforcing litigation holds as soon as a reasonable probability of litigation arises.

–Liz McGee

Liechtenstein Bank Enters into Non-Prosecution Agreement to Settle US Tax Dispute

The NPA is expected to pressure Swiss banks that are under investigation to settle with the DOJ because, as a result of the NPA, LLB will likely provide information about the Swiss banks to the DOJ.

On July 24, 2013, Liechtensteinische Landesbank AG ("LLB") and the Department of Justice (the "DOJ") entered into a non-prosecution agreement ("NPA") with respect to LLB's US tax issues.[42] The NPA provides that LLB will pay $23.8 million to US authorities, and LLB must cooperate with the DOJ over the next three years. The NPA is expected to pressure Swiss banks that are under investigation to settle with the DOJ because, as a result of the NPA, LLB will likely provide information about the Swiss banks to the DOJ.

38 *Id.* at 14, 16.
39 *Id.* at 23.
40 *Id.*
41 *Id.* at 27-28.

LLB is the first bank to enter into an NPA with the DOJ after admitting to conduct that involved the facilitation of tax evasion by US taxpayers. When entering into the NPA, the DOJ took into consideration LLB's cooperation with the DOJ and the IRS. The fact that LLB is majority owned by the Principality of Liechtenstein may also have influenced the DOJ's decision to entered into an NPA with LLB rather than a deferred prosecution agreement.

Of the $23.8 million settlement, $16.3 million represents forfeited proceeds from the maintenance of undeclared US accounts and $7.5 million represents restitution. LLB previously announced on July 18, 2013 that it set aside a CHF 31 million ($33 million) reserve in anticipation of resolving its US tax issues.[43] LLB had earlier set aside CHF 16 million on December 31, 2012.

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The DOJ has recently targeted foreign banks and fiduciaries (such as lawyers, accountants and investment advisers) who are suspected of assisting customers in hiding assets abroad to evade US taxes. The DOJ requested that the Liechtenstein Tax Administration provide administrative assistance in May 2012 and asked for information that would aid the DOJ's investigation of LLB's US customers that were suspected of holding undisclosed assets at the bank. The request was made shortly after Liechtenstein amended its Law on Administrative Assistance in Tax Matters to allow information exchange requests when a taxpayer's identity is unknown. The DOJ also made an informal document request to Liechtenstein in March asking for statistical information on fiduciaries that assisted US taxpayers in forming foundations or establishments in an effort to evade US taxation.[44]

–Mary Jo Lang

Former Swiss Attorney Pleads Guilty to Conspiracy

On August 16, 2013, the US Attorney for the Southern District of New York announced that Edgar Paltzer, a former partner at a Swiss law firm, pled guilty to conspiring with US taxpayers and others to help US taxpayers hide millions of dollars from the IRS in offshore accounts, and to evade US taxes on the income earned in those accounts. He faces a maximum sentence of five years in prison, and is scheduled

[42] *See* Kristen A. Parillo and Stephanie Soong Johnston, "Liechtenstein Bank Settles US Tax Dispute for $24 Million," *Tax Notes Today*, July 31, 2013.
[43] *See* Stephanie Soong Johnston, "Liechtenstein Bank Reserves Extra $33 Million to Resolve US Tax Dispute," *Tax Notes Today*, July 19, 2013.
[44] *See* Jaime Arora, "Seeking Tax Evaders, US Requests Liechtenstein Data," *Tax Notes Today*, March 26, 2013.

According to the Superseding Information and Indictment, Paltzer conspired with US taxpayers and others to ensure that their clients could hide their Swiss bank accounts and the income generated there from the IRS.

to be sentenced on February 21, 2014. According to the Superseding Information and Indictment, Paltzer conspired with US taxpayers and others to ensure that their clients could hide their Swiss bank accounts and the income generated there from the IRS. Paltzer, acting as a financial intermediary, helped US taxpayers maintain undeclared assets in Swiss banks by, among other things, working with US taxpayers to create and maintain sham foundations and other entities to nominally hold the US taxpayers' accounts in Swiss banks. After certain Swiss banks required that these US taxpayers close their accounts, Paltzer assisted these US taxpayers and others to move their accounts to other Swiss banks that were willing to maintain accounts for US taxpayers. It was further reported that Paltzer helped repatriate funds to the US taxpayers from their undeclared accounts in Switzerland designed to avoid detection from US authorities. Co-defendant, Stefan Buck, a Swiss citizen and former head of private banking at Zurich-based Bank Frey, has not yet been arrested.

–Richard A. Nessler

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