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Second Circuit Determines that Tax Memo Shared Between Taxpayers and Banks Is Protected Under the Common Interest Doctrine and Subject to Work-Product Protection

On Tuesday, December 8, 2015, Shearman & Sterling will host its Year-End Tax Conference and Celebration at our New York Office from 8:30 a.m. – 6:00 p.m. with a cocktail reception to follow. The client conference will include panels comprised of Shearman & Sterling partners and client speakers from AIG, Bank of America Merrill Lynch, Barclays, Citigroup, Deutsche Bank, Goldman Sachs, JPMorgan Chase, Morgan Stanley, UBS and others. Topics will include: tax litigation, corporate transactions, cross-border transactions, financial products, executive compensation and European tax. Ethics credits will be included. Please contact Lawrence.Hill@Shearman.com if you are interested in attending

In addition to the discussion of the Second Circuit's decision in *Schaeffler*, this month's issue features articles regarding the "new" IRS Notices covering "Basket Options" and "Basket Contracts," the Tax Court's recent transferee liability decision in *Tricarichi v. Commissioner*, two recent decisions from the United States District Court relating to the attorney-client privilege and the issuance of "John Doe" summonses for information related to offshore accounts in Belize, Notice 2015-22, which describes best practices to manage the flow of docketed cases between IRS Appeals and the Office of Chief Counsel, and an update on proposed changes to the US Tax Court rules of practice and procedure.

In this Issue (please click on any title to go directly to the corresponding discussion):

Second Circuit Determines that Tax Memo Shared Between Taxpayers and Banks Is Protected Under the Common Interest Doctrine and Subject to Work-Product Protection

This ruling is one of the most favorable privilege decisions in years as it clarifies and broadens common interest doctrine protection. "The decision supports application of the work product doctrine where the size and complexity and ambiguity of the tax treatment of the transaction in the transaction planning stage governs the likelihood of IRS scrutiny of the transaction."

On November 10, 2015, the US Court of Appeals for the Second Circuit unanimously held in a published opinion that (i) the attorney-client privilege was not waived by appellants-taxpayers who shared a group of documents, including a 58-page tax memorandum, with a consortium of banks having a common legal interest with the taxpayers in the tax treatment of a corporate refinancing and restructuring transaction; and (ii) the work-product doctrine protected documents analyzing the tax treatment of the transaction prepared in anticipation of litigation with the IRS.[1] This ruling, which vacated and remanded Magistrate Judge Gabriel Gorenstein's denial of taxpayers' petition to quash an IRS summons, is one of the most favorable privilege decisions in years as it clarifies and broadens common interest doctrine protection for communications among accountants, lawyers and bankers who have, or whose clients have, a common commercial and legal interest in the tax consequences of a transaction and for parties who are engaged in a "common legal enterprise" with the holder of the privilege. It also reaffirms Supreme Court and Second Circuit precedent concerning work-product protection for documents created in anticipation of litigation.

Background

In *Schaeffler*, the taxpayers petitioned to quash an IRS summons for a tax memorandum and related documents prepared by taxpayers' accounting firm in connection with a complex refinancing and corporate restructuring transaction in 2008 by the Schaeffler Group, an automotive and industrial parts supplier incorporated in Germany, in an attempt to acquire a minority interest in a target German company through a tender offer for its stock. To finance the tender offer, the Schaeffler Group executed an eleven-billion Euro loan agreement with a consortium of banks. With the announcement of Lehman Brothers' bankruptcy only two days before the end of the tender offer acceptance period, the stock price of the target company declined drastically, resulting in a significantly higher than expected number of shareholders who accepted the offer. Moreover, the Schaeffler Group was prohibited under German law from withdrawing its tender offer. These events threatened the Schaeffler Group's solvency and its ability to meet its payment obligations with its lenders under the loan

[1] *Schaeffler, et al., v. United States*, No. 14-1965-cv, 2015 US App. LEXIS 19617 (2d Cir. Nov. 10, 2015).

agreement. Accordingly, the Schaeffler Group and the bank consortium sought to refinance the acquisition debt and restructure the Schafeffler Group, which resulted in various potential tax consequences for the Schaeffler Group, including for the majority owner of the parent of the Schaeffler Group in his personal capacity (collectively, the "taxpayers").

The taxpayers believed an IRS audit and potential litigation as to at least some of the US tax consequences of the proposed refinancing and restructuring was likely, and therefore engaged outside tax and legal advisors to assist with the US tax implications of the transactions and possible future litigation with the IRS. As part of its engagement, Ernst & Young LLP ("E&Y") prepared a memorandum for the taxpayers that identified potential US tax consequences of the proposed transactions, identified and analyzed potential IRS challenges to the Schaeffler Group's treatment of the transactions and analyzed the relevant statutory provisions, US Treasury regulations, judicial decisions and IRS rulings (the "Tax Memo"). The Schaeffler Group also retained Dentons US LLP to advise it on the federal tax implications of the transactions and potential litigation with the IRS. The bank consortium and its outside counsel worked closely with the Schaeffler Group's outside tax advisors at E&Y in effectuating the transactions and analyzing the US tax consequences of the transactions. In this regard, the Schaeffler Group and the bank consortium signed an agreement whereby they agreed to share privileged, protected and confidential documents, including their analyses, in an effort to protect and not to waive those privileges, protections or the confidentiality of the information. After the execution of that agreement, the Schaeffler Group shared the Tax Memo and other documents with the bank consortium.

The IRS, in conjunction with an audit of the taxpayers' tax returns for 2009 and 2010, issued a number of document demands requesting all tax opinions and analyses that discussed the US tax consequences of the Schaeffler Group's restructuring, and, eventually, it issued an administrative summons to E&Y requiring it to provide all legal opinions that it provided to parties outside the Schaeffler Group. Although it produced several thousand documents, the taxpayers petitioned to quash the IRS summons on the grounds that it sought legal opinions and other confidential advice protected by both the work-product doctrine and the attorney-client privilege, as extended to E&Y by the federal tax practitioner privilege.

With respect to their privilege claim, the taxpayers argued that no privilege waiver of the Tax Memo and related documents occurred when they were provided to the bank consortium because the Schaeffler Group and the consortium had a common legal interest. The taxpayers also maintained that the Tax Memo and related documents were subject to work-product protection because they were prepared in anticipation of litigation. The District Court, however, disagreed, holding that attorney-client and tax practitioner privileges were waived when the Tax Memo was shared with the bank consortium. In particular, the District Court held that there was no "common legal interest" because the bank consortium's interest was commercial rather than legal.[2] The District Court also rejected the taxpayers' claim that the Tax Memo and related documents were protected under the work-product doctrine because, according to the District Court, the documents did not specifically refer to litigation, and the detailed analyses and advice provided to the taxpayers would have been provided even if they had not anticipated an audit or litigation with the IRS.[3]

The Court determined that because of the threat of insolvency and default, the taxpayers and the bank consortium "had a strong common interest" in obtaining particular tax treatment of the refinancing and restructuring.

Non-Waiver of Attorney-Client Privilege

On appeal, The Second Circuit noted that while the attorney-client privilege is generally waived by voluntary disclosure of the communication to another party, the privilege is not waived by disclosure of communications to a party that is engaged in a "common legal enterprise" with the holder of the privilege.[4] According to the Court, the dispositive issue was "whether the Consortium's common interest with [the taxpayers] was of a sufficient legal character to prevent a waiver by the sharing of those communications."[5] The Court held that it was.

At the outset, the Court made clear that parties may share a common legal interest even if there is no ongoing litigation at the time of the shared communications between the parties. Thus, the relevant issue for the Court was whether the communications were made in the course of an ongoing common enterprise and intended to further the enterprise. Analyzing the facts at issue, the Court determined that because of the threat of insolvency and default, the taxpayers and the bank consortium "had a strong common interest" in obtaining particular tax treatment of the refinancing and restructuring.[6] The Court determined that "[taxpayers] and the [bank consortium] could avoid this mutual financial disaster by cooperating in securing a particular tax treatment of a refinancing and restructuring. Securing that treatment would likely involve a legal encounter with the IRS."[7] Moreover, the Court found that the bank consortium "needed 'access to confidential tax information and analyses' to 'assess its credit exposure for potential tax liabilities'" of the Schaeffler Group's

[2] *Id.* at *6.
[3] *Id.* at *8-*9.
[4] *Id.* at *12.
[5] *Id.* at *13.
[6] *Id.* at *8-*9.
[7] *Id.* at *14.

majority shareholder.[8] Accordingly, both parties "had a strong common interest in the outcome of that legal encounter."[9]

The Court also observed that no case law in the Second or other circuits compelled it to hold that the bank consortium's interest in the taxpayers' obtaining favorable tax treatment for the refinancing and restructuring transactions was not a sufficient common legal interest.[10] Thus, "[a] financial interest of a party, no matter how large, does not preclude a court from finding a legal interest shared with another party where the legal aspects materially affect the financial interests."[11] In support of its reasoning, the Court noted that the bank consortium's legal interest was evidenced by how it "essentially insured" the taxpayers, including by extending credit and subordinating its debt, and retaining control over decisions by the Schaeffler Group's majority shareholder concerning the IRS, including whether to pay taxes, to sue for a refund or to settle. The Court then pointed to the fact that in an analogous context several courts outside of the Second Circuit have held that an insurer and an insured may maintain a common legal interest in the outcome of litigation even if their defenses are not aligned.[12]

Application of Work-Product Doctrine

The Second Circuit separately addressed the issue of whether the work-product doctrine applied to the Tax Memo and related documents, noting at the outset that the work-product immunity, if applicable, was not waived by sharing those documents with E&Y.[13] The Court concluded that the District Court had erred and that the Tax Memo and related documents were protected by the work-product doctrine because they contained "legal analysis that falls squarely within [*Hickman v. Taylor*, 329 US 495 (1947)]'s area of primary concern-analysis that candidly discusses the attorney's litigation strategies [and] appraisal of likelihood of success."[14]

Citing *United States v. Adlman*,[15] the Court determined that work-product doctrine protected the documents because they were specifically aimed at addressing tax issues

The Court found that the Tax Memo "was specifically aimed at addressing the urgent circumstances arising from the need for a refinancing and restructuring and was necessarily geared to an anticipated audit and subsequent litigation."

[8] *Id.* at *15.
[9] *Id.* at *14.
[10] *Id.* at *18.
[11] *Id.*
[12] *Id.* at *18-*19.
[13] *Id.* at *17.
[14] *Id.* at *25 (brackets in original).
[15] 134 F.3d 1194 (2d Cir. 1998).

that may arise in an anticipated audit and subsequent litigation, including the strengths, weaknesses and likely outcomes of potential legal arguments.[16] In analyzing *Adlman*, the Court drew a distinction between documents prepared or obtained "because of" the prospect of litigation, on the one hand, and documents created "irrespective of the litigation," on the other hand.[17] Addressing the facts at hand, the Court found that the Tax Memo "was specifically aimed at addressing the urgent circumstances arising from the need for a refinancing and restructuring and was necessarily geared to an anticipated audit and subsequent litigation," which was "highly likely."[18]

The Court further disagreed with the District Court's reasoning that E&Y would have been compelled by professional standards, tax laws and regulations to provide the same tax advice to the taxpayers even in the absence of anticipated litigation.[19] Noting the level of detail contained in the Tax Memo, the Court rejected the notion that the taxpayers would have sought the same level of detail as part of an "annual routine tax return with no particular prospect of litigation."[20]

Looking Forward

The *Schaeffler* decision is significant because it clarifies the scope of the common interest privilege for communications involving accountants, lawyers and bankers in situations where they and their clients have a common commercial and legal interest in the tax consequences of a transaction. It also is a strong reaffirmation of the *Hickman* and *Adlman* work-product decisions and supports a liberal interpretation of what constitutes "anticipation of litigation" in the work-product context. Although the Second Circuit's analysis pertained to the specific facts in the case, the decision supports application of the work-product doctrine where the size, complexity and ambiguity of the tax treatment of the transaction heightens the likelihood of IRS scrutiny of the transaction.

Lawrence M. Hill, Matthew Craner and Richard A. Nessler

[16] *Id.* at *20.

[17] *Id.* at *20-21 (internal citations omitted).

[18] *Id.* at *21.

[19] *Id.* at *22-*23.

[20] *Id.* at *23.

IRS Issues "New" Notices Covering "Basket Option" and "Basket Contract" Transactions

The new notices provide additional details on the type of transactions that are the same as or substantially similar to the transactions described in the notices.

As previously reported, on July 8, 2015, the IRS issued Notice 2015-47 and Notice 2015-48, which designated "basket option" transactions as listed transactions and "basket contract" transactions as transactions of interest.[21] However, on October 21, 2015, the IRS revoked Notice 2015-47 and Notice 2015-48 and issued Notice 2015-73 and Notice 2015-74 as replacements to cover basket options and basket contract transactions. The prior notices were replaced in response to concerns expressed by practitioners and taxpayers about the difficulty of identifying transactions that are the same as or substantially similar to the transactions described in Notice 2015-47 and Notice 2015-48. The new notices attempt to cure the uncertainty by providing additional details on the types of transactions that are the same as or substantially similar to the transactions described in the prior notices.

Notice 2015-73

Notice 2015-73, which replaced Notice 2015-47, identifies transactions that it references to as "basket option contracts" and any substantially similar transactions as "listed transactions." The general definition of a basket option contract has not changed and is still described as a contract denominated as an option between a taxpayer and its counter party (bank) with a stated term of more than one year. The option entitles the taxpayer to receive a return based on the performance of a notional basket of referenced, actively traded personal property, and the taxpayer or its designee changes the components of the referenced basket or is in control of a trading algorithm that changes those components. What's new in the notice is that it identifies additional features of the transaction that must be present in order for it to be substantially similar to a basket option contract and excludes certain transactions from being substantially similar to a basket option contract.

Under Section 2.01 of the notice, the transaction is the same as or substantially similar to the transaction identified in the notice only if: "(1) T [taxpayer] enters into a transaction with C [counterparty] that is denominated as an option contract;
(2) T receives a return based on the performance of the reference basket;
(3) substantially all of the assets in the reference basket primarily consist of actively traded personal property as defined under § 1.1092(d)-1(a); (4) the contract is not fully settled at intervals of one year or less; (5) T or t's designee has exercised discretion to

[21] *See* Shearman & Sterling, Focus on Tax Controversy and Litigation, September 2015 Newsletter, at 6-8.

To fall under the notices, the taxpayer must have claimed a tax benefit defined as the deferral of income of conversion of ordinary income or short-term capital gain or loss into long-term capital gain or loss.

change (either directly or through a request to C) the assets in the reference basket or the trading algorithm; and (6) T's tax return for a taxable year ending on or after January 1, 2011 reflects a tax benefit described in Section 2.04 of this notice." A "tax benefit" is defined as a "deferral of income" into a later taxable year or conversion of ordinary income or short-term capital gain or loss into long-term capital gain or loss. If for some reason the taxpayer's tax benefit is different, then the transaction is not the same or substantially similar to the basket option transaction.

Sections 2.02 and 2.03 of the notice provide additional guidance about who may be considered the taxpayer's designee and when the taxpayer or its designee will be considered to have discretion to change the referenced basket of assets or the trading algorithm that manages the basket. A designee must be either the taxpayer's agent or compensated or selected by the taxpayer to suggest, request or determine changes in the referenced basket or the trading algorithm. The taxpayer is not considered to compensate or select a person to suggest, request or determine changes in the referenced basket or trading algorithm, however, as a result of (1) the person's position as an investment advisor, officer or employee of an issuer of publicly offered securities included in the basket, (2) the person's use or licensing of an index that is widely used, publicly quoted and based on objective financial information or an index that tracks a broad market or market segment or (3) the person's authority to suggest, request or determine changes in such an index. A taxpayer or its designee are not considered to have discretion to change the basket or trading algorithm if changes are made according to rules that are disclosed at the inception of the transaction and the taxpayer or designee does not have the right to alter, amend or deviate from the rules. There is no alteration, amendment or deviation solely because the taxpayer or designee exercises routine judgment in administering the rules, corrects implementation or calculation errors or makes adjustments to respond to unanticipated, extraordinary events outside of the taxpayer's control.

The notice also excludes certain transactions from being substantially similar to a basket option contract in Section 2.05. A transaction is not treated as a listed transaction by the notice if: (1) the contract is traded on (a) a national securities exchange that is regulated by the Securities and Exchange Commission or a domestic board of trade regulated by the Commodity Futures Trading Commission, or (b) a foreign exchange or board of trade that is subject to regulation by a comparable regulator; or (2) the contract is treated as a contingent payment debt instrument under § 1.1275-4 (including a short-term contingent payment debt instrument) or a variable rate debt instrument under § 1.1275-5. With respect to T, a transaction is not the same as, or substantially similar to, the transaction described in this notice unless T's tax return for a taxable year ending on or after January 2, 2011 reflects a tax benefit of the transaction that is described in Section 2.04 of the notice. With respect to C (counterparty), a transaction is not the same as or substantially similar to the transaction described in this notice if: (1) T represents to C in writing under penalties of perjury that T's tax return will not reflect a tax benefit described in Section 2.04 of this notice in any taxable year ending after January 1, 2011, or (2) C has established that T is a non-resident alien or foreign corporation that is not engaged in a US trade or business by obtaining a valid withholding certificate from the beneficial owner of the payments made or to be made under the basket option contract (W-8BEN, W-8BEN-E OR W3-8EXP), or in the case of payments made outside of the US on offshore obligations, by obtaining documentary evidence as described in Treas. Reg. § 1.1441-1(c)(17).

Notice 2015-74

Notice 2015-74 identifies transactions that it referred to as "basket contracts" and any substantially similar transactions as "transactions of interest." As previously noted in Notice 2015-48, the basket contract transactions bear similarities to the basket options designated as listed transactions in Notice 2015-73, but need not be denominated as options (and instead may be denominated as any type of derivative contract), and may reference non-actively traded property. Notice 2015-74 updates Notice 2015-48 by defining when a transaction is considered the same as, or substantially similar to, a basket contract. A transaction will be a reportable transaction of interest under Notice 2015-74 only if: (1) T enters into a contract with C to receive a return based on the performance of the reference basket; (2) the basket contract has a stated term or more than one year or overlaps two of T's taxable years; (3) T or T's designee has exercised discretion to change (either directly or through a request to C) the assets in the reference basket or the trading algorithm; and (4) T's tax return for a taxable year ending on or after January 1, 2011 reflects a tax benefit of the same type described in Notice 2015-73—a "deferral of income into a later taxable year or conversion of ordinary income or short-term capital gain or loss into long-term capital gain or loss." Notice 2015-74 contains the same guidance for determining when a person is the taxpayer's designee and when the taxpayer or its designee has discretion over the basket that is included in Notice 2015-73.

In addition, transactions that are excluded from reportable transaction treatment under Notice 2015-73, Section 2.05, are excluded as transactions under Notice 2015-74.

Effective Date

Notice 2015-73 applies to transactions in effect on or after January 1, 2011. Notice 2015-74 applies to transactions entered into on or after November 2, 2006 that were in effect on or after January 1, 2011. Participants in the notice transaction include the purchaser of the contracts, any general partners or managing members of a contract purchaser that is a partnership or LLC and the counterparty to the contract.

Taxpayers involved in transactions that fall under either notice must disclose the transaction, under Section 6011, for each taxable year in which the taxpayer participated in the transaction for which the statute of limitations had not run on or before October 21, 2015. Material advisors who made a tax statement on or after January 1, 2011, with respect to transactions in effect on or after January 1, 2011, have disclosure and list maintenance obligations under Sections 6111 and 6112. The penalty under Section 6707A for failure to declare a reportable transaction under Section 6011, and penalties under Section 6707 for failure to register the transaction are both substantial. A reasonable cause defence is applicable to Section 6708, but it is not applicable to Section 6707.

Accounting Method Change

The notices also address a taxpayer's request to change a method of accounting.

Both notices contain instruction regarding a taxpayer's request to change a method of accounting under Section 446(e) and Treas. Reg. §1.446-1(e). The Service will permit a taxpayer to change the accounting method for a transaction described in the notice for a transaction in which the taxpayer's only tax benefit is a deferral of income into a later taxable year. The change may be made by either (1) filing amended returns in accordance with Section 3.06(3) of the notice, or (2) if eligible, requesting a change in method of accounting under the non-automatic change procedure of Rev. Proc. 2015 13, subject to the rules provided in the notice. However, the IRS will not permit a change in method of accounting filed under Rev. Proc. 2015-13 if the tax benefit involves the conversion of ordinary income or short-term capital gains or loss into long-term capital gains or loss. A taxpayer may, however, change its method of accounting for a conversion transaction within the scope of the notice by filing an amended return in accordance with Section 3.06(3) of the notice.

Nathan Tasso and Richard A. Nessler

Prior Corporate Shareholder Liable As Transferee

On October 14, 2005, the United States Tax Court in *Tricarichi v. Commissioner*[22] held that the sole shareholder of a corporation was liable as a transferee under Section 6901 and Ohio law for the corporation's unpaid tax liability after he sold his stock to an "intermediary company" involved in a "Midco" transaction. In addition to the underlying tax liabilities, the taxpayer was found liable for penalties under Section 6662(a) and (h) for $6,012,777. An appeal, if taken, will lie to the US Court of Appeals for the Ninth Circuit.

[22] T.C. Memo 2015-201, 2015 WL 5973214.

Taxpayer's accountant characterized the transaction as a "very aggressive, tax-motivated strategy" that will likely be challenged by the IRS.

Facts

In September 2003, Petitioner sold his cellular telephone business, West Side, a C corporation incorporated in Ohio, to Nob Hill, Inc., a Cayman Islands company and affiliate of Fortrend, for $35 million dollars. At the time of the sale, West Side had a net asset value of only $23.7 million, which reflected an aggregate tax liability for 2003 of $16 million. In 2003, West Side obtained total settlement proceeds of $65 million from litigation against major cellular service providers. As part of the settlement, West Side agreed to end all service to its cell phone customers as of June 2003.

Before the sale, Petitioner met with PwC to investigate alternatives to maximize after tax proceeds from the anticipated settlement. Petitioner expressed desire to eliminate the two-level tax on the settlement proceeds. Petitioner ultimately met with representatives of Midcoast and Fortrend to discuss the sale of West Side. Midcoast's representatives explained to petitioner that it was in the "debt collection" business and that, as part of its business model, it purchased companies that "had large tax obligations."[23] Petitioner later met with Fortrend. Petitioner understood that Fortrend and Midcoast were both involved with "distressed debt receivables" and had basically the same business model. Fortrend told petitioner that it would purchase West Side and would offset the taxable gain with losses, thereby eliminating West Side's corporate income tax liability. Petitioner ultimately chose to sell West Side to Fortrend.

PwC reviewed the proposed transaction and characterized it as a "very aggressive, tax-motivated strategy" and indicated that the IRS would likely challenge the deductibility of the bad debt loss expected to be reported by West Side after the stock sale.[24] The memorandum noted that PwC had provided no formal written advice to petitioner, but had discussed its conclusions orally with him.

Fortrend agreed to pay a "premium" for West Side. Fortrend offered to pay petitioner the amount of cash remaining (after the sale of all operation assets) in West Side, less 31.875% of West Side's total Federal and State tax liability for 2003. This left petitioner with a premium, above and beyond West Side's closing net asset value, equal to 68.125% of its accrued 2003 tax liability. In preparation for the stock sale, Millennium Recovery Fund, LLC, a Fortrend affiliate, created Nob Hill, Inc., a shell company to be the "intermediary company" that would purchase the West Side stock.

[23] *Id.* at *3.
[24] *Id.* at *12.

The parties negotiated a statement that Nob Hill "has no intention" of causing West Side to engage in a listed transaction.

Petitioner's lawyers negotiated with Fortrend the technical details of the stock purchase agreement. Nob Hill provided covenants aimed at mitigating the risk that the transaction would be characterized as a "liquidation" of West Side. Nob Hill represented that West Side would remain in existence for at least five years after the closing, would "at all times be engaged in an active trade or business," and would "maintain a net worth of no less than $1 million" during this five-year period.[25] (None of these representations were substantially honored.)

Nob Hill also provided purported tax warranties. The agreement represented that Nob Hill would "cause * * * [West Side] to satisfy fully all United States * * * taxes, penalties and interest required to be paid by * * * [West Side] attributable to income earned during the [2003] tax year."[26] The agreement did not specify how Nob Hill would "cause" West Side to satisfy its 2003 tax liabilities or explain the strategy it would use to offset West Side's gain from the $65 million settlement. Nob Hill agreed to indemnify petitioner in the event of liability arising from breach of its representation to "satisfy fully" West Side's 2003 tax liability.[27]

Petitioner's lawyers attempted to include in the stock purchase agreement a provision prohibiting West Side from engaging in a "listed transaction" after Fortrend acquired West Side. Fortrend refused to agree to this provision. Instead, the parties negotiated a statement that Nob Hill "has no intention" of causing West Side to engage in a listed transaction.[28]

Petitioner agreed to sell West Side to Fortrend for $35 million, which represented a premium of $11.2 million above West Side's net asset value. In exchange, Petitioner agreed to pay Fortrend a fee in excess of $5 million. The stock purchase transaction was carefully structured to ensure that Fortrend made no real outlay of cash.

Following the closing, in November 2003, Millennium contributed to West Side a portion of a Japanese debt portfolio, consisting of defaulted loans that had a purported tax basis of $43 million, but a fair market value of less than $1 million. West Side wrote off the loans as worthless, and on its 2003 corporate income tax return, claimed a bad debt deduction of $42 million on account of that write-off. Following an audit, the IRS disallowed West Side's bad debt deduction. West Side did not challenge the deficiency notice, and in July 2009, the IRS assessed the tax deficiency of $15 million

[25] *Id.* at *17.
[26] *Id.*
[27] *Id.*
[28] *Id.* at *18.

and penalties of $6 million under Section 6662(a) and (h). In 2012, the IRS timely mailed to petitioner a notice of liability as a transferee.

Legal Analysis

To impose transferee liability, a Court must first determine whether "the party [is] substantively liable for the transferor's unpaid taxes under State law."[29] The Tax Court looked to Ohio law, the state of West Side incorporation and local for negotiating the sales contract. To determine petitioner's substantive liability under Ohio law, the Tax Court considered two questions: (1) did petitioner qualify as a transferee under Ohio law; and (2) was petitioner's transfer of West Side a fraudulent transfer under Ohio law.[30] As to the first issue, petitioner argued that he was not a transferee of West Side because the cash he received from Nob Hill and the sources of that cash were "loans" from Rabobank and Moffat. For this reason, petitioner argued that he received no West Side assets. The Tax Court rejected petitioner's claim finding that the "loans" from Rabobank and Moffat were shams, and West Side was the true source of the cash petitioner received.[31] Second, under Ohio law, the stock sale would be recharacterized as a defacto liquidation of West Side, with petitioner receiving in exchange for his stock a $35 million liquidating distribution.

To impose transference liability, a court must first determine whether "that party [is] substantively liable for the transferor's unpaid taxes under state law."

Fraudulent Transfer

The Tax Court looked to Ohio law, which provides that a transfer is fraudulent with respect to a creditor where: (1) the creditor's claim arose before the transfer; (2) the transferor did not receive "a reasonably equivalent value in exchange for the transfer;" and (3) the transferor became insolvent as a result of the transfer.[32] The Tax Court found that all three of these elements were satisfied.

In *Tricarichi*, there was no legitimate dispute that the IRS had a "claim" against West Side before the stock sale. West Side's federal tax liability had accrued in May 2003, four months before the transfer of assets. In addition, petitioner did not seriously dispute that West Side received "a reasonably equivalent value in exchange for the transfer."[33] The Tax Court found that West Side consisted of nothing but cash and tax liabilities. The value of petitioner's stock thus equalled West Side's net asset value,

[29] *Sloan v. Commissioner*, __ F3d __, 2015 WL 5061315 (9th Cir. 2015).
[30] *Id.* at *31.
[31] *Id.* at *44.
[32] *Id.* at *58-60.
[33] *Id.*

which was approximately $23.7 million (cash equivalents of $40.6 million minus accrued tax liabilities of $16.9 million). West Side transferred $35.2 million to petitioner in exchange for his shares. Since his shares were worth only $23.7 million, West Side did not receive "a reasonably equivalent value in exchange for the transfer."[34]

As to the last element, the debtor making the transfer must have been "insolvent at that time or . . . become insolvent as a result of the transfer."[35] Under Ohio law, solvency is measured at the time of the transfer. Here, West Side became insolvent as a result of the transfer. Following the transfer of $35.2 million to petitioner, West Side was left with tax liabilities of $16.9 million and assets of $5.1 million. Accordingly, the Tax Court found that West Side became insolvent as a result of the transfer and a fraudulent transfer had taken place.

Penalties

Petitioner argued that he should not be liable for any penalties because the distressed debt transaction claimed by West Side, giving rise to those penalties, was not entered into until after petitioner sold his stock and petitioner had nothing to do with the distressed debt transaction. The Tax Court rejected petitioner's argument and refused to follow *Stanko v. Commissioner*[36] because, according to the Tax Court, that case related to Nebraska law in effect before 1989, which was different than Ohio law. Ohio law defined "claim" expansively to include any "right to payment" even if it is "unliquidated" and "unmatured." Thus, the Court found that the IRS may have a claim for the penalties whether or not they are thought to have been "existing at the time of the transfer." [37]

Richard A. Nessler

Court Upholds GE's Attorney-Client Privilege Amidst Government Challenge

On September 15, 2015, the United States District Court, District of Connecticut rejected most of the Government's challenges to privilege claims asserted by General

[34] *Id.*

[35] *Id.*

[36] 209 F.3d 1082 (8th Cir. 2000).

[37] *Id.* at *62.

Electric Company ("GE").[38] The challenges related to nearly 9,000 documents on GE's privilege logs pertaining to GE's tax refund suit for approximately $660 million. While rejecting most of the Government's claims, the Court ordered the appointment of a special master to review nearly 1,000 documents that lacked identification on GE's privilege log of an author and recipient.

The Government argued that privilege does not relate to attachments of otherwise privileged email communications.

Background

The privilege dispute stemmed from GE's suit against the Government for a tax refund of approximately $660 million including interest relating to a series of complex corporate restructuring/sale transactions that occurred more than 10 years prior. The Government challenged GE's privilege logs, of which the Government sought discovery in opposition of GE's refund suit. The Government raised three challenges to GE's privilege claims: (i) privilege does not relate to attachments of otherwise privileged email communications; (ii) privilege does not attach when the predominant purpose of the communication is for business advice, not legal or tax advice purposes, and (iii) privilege does not attach to documents where the privilege log lacks indication of the author or recipient of the correspondence in violation of Local Rule 26.[39] The Court rejected the Government's first two challenges, but ordered the appointment of a special master to determine the privileged nature of documents that failed to identify an author and recipient.

Discussion

GE's privilege claims involved the attorney-client privilege and related tax practitioner privilege found in Section 7525 of the Internal Revenue Code. The basic elements of attorney-client privilege are as follows: "A party invoking the privilege must show (1) a communication between client and counsel that (2) was intended to be and was in fact kept confidential and (3) was made for the purpose of obtaining or providing legal advice."[40] Section 7525 recognizes a privilege with respect to tax advice, "the same common law protections of confidentiality which may apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney."[41]

[38] *General Electric Co. v. United States*, __F.Supp.3d __(D. Conn 2015), 2015 WL 5443479.
[39] *Id.* at *2.
[40] *In re County of Erie*, 473 F.3d 413, 419 (2d Cir. 2007).
[41] IRC Section 7525(a)(1).

The fact that the communicated information may be public in nature does not destroy the privileged nature of the attorney-client communication.

The Government claimed that GE improperly asserted privilege with respect to documents attached to email communications between GE and its counsel. According to the Government, "only confidential or secret facts . . . may be subject to the claim of privilege."[42] The Court rejected the Government's challenge, noting that the Government's assertion mistakenly adds the requirement that the underlying information of a confidential attorney-client communication be non-public or confidential itself. The Court reiterated that the privilege is not forfeited due to the fact that the communicated information may be public in nature. This is because the privilege attaches to the communication itself, not its underlying information.[43] In rejecting the Government's argument, the Court explained that the attachments within the GE email communications (e.g., board meeting minutes, presentations, spread sheet, etc.), although may be generally available to third parties not included in the privileged communication, does not render the documents "un-privileged" in the context of their inclusion of otherwise privileged communication.[44]

The Government further argued that certain privileged documents were predominantly for business purposes, rather than legal or tax advice purposes. GE explicitly describes the communications in its privilege logs as either "reflecting legal advice" or "reflecting tax advice."[45] Despite this, the Government introduced a few examples to the Court where some communications in GE's production appeared in other parts of GE's production as unprivileged communications. However, referencing the isolated nature of these instances introduced by the Government and in light of the several thousands of documents subject to production and GE's privilege review quality-assurance process, the Court determined it would not conclude that there was systemic failure with GE's privilege designations. In addition, the Court noted the large number of privileged documents was not surprising given the complicated nature of the transactions and their substantial legal and regulatory overtones.

Lastly, the Government challenged GE's privilege assertion on approximately 1,000 "standalone" documents appearing on the privilege log without identifying an author or recipient. The Government asserted that this omission by GE violated Local Rule 26, requiring the identity of the author and recipient on a privilege log.[46] The Court agreed and recognized the importance of Local Rule 26, which "preserves the

42 2015 WL 5443479 at *2.

43 See, *United States v. Cunningham*, 672 F.2d 1064 (2d. Cir. 1982).

44 *Id.*

45 *Id.*

46 D. Conn. L. Civ. R. 26(c)(4).

integrity of the privilege in the ordinary course to a requisite and specific attorney-client communication."[47] However, the Court explained that the absence of the author or recipient's name from the privilege log does not in all cases indicate that the document may never be subject to a proper claim of privilege. For example, the privilege claim may apply to client's notes of a prior conversation with counsel. GE asserted that while it was not always possible to determine the author and recipient, it is still possible to ascertain the "legal" or "tax" advice based on the content of the communication. In light of these two views, the Court ordered that the parties agree on a special master to review the category of documents missing an author and recipient to determine whether the privilege claim by GE was appropriate. While the Court ordered a special master, the Court made clear that the usual remedy for failure to designate author and recipient in accordance with Local Rule 26 should not be the appointment of a special master. Rather, the Court stated that in situations where a taxpayer may not have the author or recipient information available, that it provide reasonable explanation in advance of such a challenge on a document-by-document basis. Here, the Court ordered a special master "in light of the context, complexity and circumstances of this particular case."[48]

Eric Grosshandler

US District Court Grants "John Doe" Summonses for Information Related to Off-Shore Accounts in Belize

The "John Doe" summonses include US taxpayers who had an interest in any financial accounts maintained at, monitored by, or managed through the Belize Entities.

On September 16, 2015, the United States District Court for the Southern District of Florida entered an order allowing the IRS to proceed with "John Doe" Summonses seeking information regarding US persons who hold offshore accounts at Belize Bank International Limited and Belize Bank Limited (the "Belize Banks").[49] These summonses permit the IRS to seek records of the Belize Banks' correspondent accounts at Bank of America, N.A. and Citibank, N.A.

According to relevant court documents, the Belize Banks are known to "market their ability to provide secret banking services to foreign residents."[50] The US petition also discusses Belize Corporate Services ("Corporate Services," and together with the Belize Banks, the "Belize Entities"), which has the same parent company as the Belize

[47] 2015 WL 5443479 *2.

[48] *Id.*

[49] *In the Matter of the Tax Liability of John Doe* (Index No. 1:15-mc-23475)(Sept. 16, 2015).

[50] *See*, United States' Memorandum in Support of its Ex Parte Petition.

Banks and advertises its ability to create corporate entities, organized in Belize, that are used to hide the identity of account holders.[51]

A correspondent account is a bank account that one bank maintains for another bank. Typically, a foreign bank that does business in US dollars but does not have a US office will obtain a correspondent account in order to provide services to its US customers. Foreign correspondent banks, in this case the Belize Banks, and users of the correspondent accounts, such as Corporate Services, can potentially wire funds from the Belize Banks to their correspondent accounts at Bank of America and Citibank; or alternatively from the correspondent accounts at Citibank and Bank of America to the Belize Banks. The IRS believes that these John Doe Summonses will enable it to ascertain the identity of US taxpayers that it believes are using the Belize Entities and correspondent accounts to avoid their obligation to report and remit associated taxable income to the United States.

Pursuant to the Summonses, Bank of America and Citibank have been directed to produce records that identify US taxpayers with accounts at the Belize Banks. The Court also granted permission to the IRS to seek records of Corporate Service's correspondent accounts at Bank of America and Citibank, as well as information related to Corporate Service's deposit account at Bank of America. The "John Doe" class includes US taxpayers, who at any time from 2006 through 2014 had interests in, or authority with respect to, any financial accounts maintained at, monitored by or managed through the Belize Entities.

Adam Sternberg

IRS Proposes Changes to US Tax Court Rules of Practice and Procedure

The IRS has proposed that the Tax Court rules allow non-consensual depositions of party witnesses upon notice to the party without requiring a motion to the Tax Court.

On September 11, 2015, the IRS, responding to the Tax Court's request for suggested revisions to the Tax Court's Rules of Practice and Procedure, proposed changes to help improve tax court procedures and enhance efficiencies for both the Tax Court and litigants. The Tax Court has posted the proposals to its website and has requested comments be sent to Chief Judge Michael B. Thornton. The proposals cover a wide variety of procedural rules, including recommendations related to trial subpoenas, depositions and inadvertent disclosure of privileged material.

[51] *Id.*

Trial Subpoenas

Under the current Tax Court rules, trial subpoenas are made returnable at the call of the calendar for the trial session on which a case has been calendared. This can be problematic if a subpoenaed party does not produce documents in response to the subpoena duces tecum until the first day of trial, which limits the party's ability to examine the documents and prepare for trial. To prevent this from occurring, the IRS has proposed that the Tax Court modify Tax Court Rule 147 to allow for the return of a subpoena duces tecum directed to third party custodian of records in advance of the trial calendar. The IRS has suggested the subpoena be returnable at least 30 days prior to trial to permit review of the documents, and, if objections raised, the Court time to consider scheduling a hearing.

Disclosure of Privileged Material

The IRS has proposed that the Tax Court adopt Fed. R. Civ. P. 26(b)(5)(B) followed by federal district courts, which covers the inadvertent disclosure of privileged material. Rule 26 provides that if information mistakenly produced in discovery is subject to a claim of privilege or of protection as trial preparation material, the party making the claim may notify any party that received the information of the privilege claim and the basis for it. After being notified, the receiving party is obligated to promptly return, sequester or destroy the specified information and any copies it has; must not use or disclose the information until the claim is resolved; must take reasonable steps to retrieve the information if the party disclosed it before being notified; and may promptly present the information to the court under seal for a determination of the privilege claim. The producing party must preserve the information until the claim is resolved. As an alternative to requiring that the subject documents be filed under seal, the Court may allow the parties to petition the Court for a determination of the privilege or work-product claim.

Deposition of Party Witness

Currently, Tax Court Rule 74 imposes restrictions and requirements for deposing party witnesses. In Tax Court litigation, deposing a party witness is considered an extraordinary method of discovery only available when other means of gathering information fail, and either consent of the parties or leave of the Court is required. The IRS explained that this may be a result of the Court's desire and objective to have the parties informally exchange information, as well as a recognition of the extensive fact gathering available during the examination stage. The concern is that in large, complex cases that are extremely factual and where a party may restrict even informal access to significant fact witnesses, the restrictions/limitations imposed by this rule may hinder the preparation of a case for trial. Accordingly, the IRS has recommended that the Court allow non-consensual depositions of party witnesses upon notice to the party without requiring leave of the Court by motion.

Richard A. Nessler

IRS Issues Proposed Revenue Procedure for Docketing Cases

On October 15, 2015, the IRS issued a proposed revenue procedure (Notice 2015-22)[52] that would update Rev. Proc. 87-84, which describes the practices used to manage the flow of docketed cases between the Office of Appeals and the Office of Chief Counsel. The proposed update to Rev. Proc. 87-24[53] is not intended to materially modify the current practice of referring docketed cases to Appeals for settlement, but was issued to reflect procedures utilized by the Tax Court in managing the flow of docketed cases between the Office of Appeals ("Appeals") and Office of Chief Counsel, and to ensure that docketed cases are handled consistently nationwide.

The proposed procedures make clear that except for specifically identified exceptions, IRS Counsel will refer all docketed cases to Appeals for settlement consideration.

The proposed procedures make clear that except for specifically identified exceptions, IRS Counsel will refer all docketed cases to Appeals for settlement consideration. The referral will not be made if Appeals issued the Notice of Deficiency or made the determination that is the basis of the Tax Court's jurisdiction, or if the taxpayer foregoes settlement consideration by Appeals. In addition, IRS Counsel will not need to refer to Appeals any docketed case or issue that has been designated for litigation by IRS Counsel, or if Division Counsel or a higher level of Counsel determines that referral is not in the interest of sound tax administration.

Certain types of cases docketed in the Tax Court are excluded from the proposed revision. This includes cases docketed under Section 6015(e)(1)(A)(i)(11), Section 6110, Sections 6320 and 6330, Section 6402, Section 7428, Section 7476, Section 7477, Section 7478 and Section 7479.

For cases not covered by the exception or exclusions, IRS Counsel is directed to refer the docketed case to Appeals within 30 days of the case becoming "at issue in the Tax Court"—as defined by Tax Court Rule 38, which provides that a case shall be deemed at issue upon the filing of the answer. But the 30 days can be extended an additional 90 days if IRS Counsel identifies a need for additional time. A delay longer than 120 days requires approval by an IRS Counsel executive. Such a delay may arise in cases when IRS Counsel has to do early trial preparation or when new facts, issues or items are raised in the pleadings.

52 2015-44 IRB 1.

53 1987 -1 C.B. 720.

The proposed revenue procedure also seeks to promote greater interaction between IRS Counsel and Appeals without impinging on Appeals' independence. For example, Counsel and Appeals are encouraged to transfer cases from Counsel to Appeals or from Appeals to Counsel, to promote a more efficient disposition of the case, notwithstanding the fact that the case was previously considered by the receiving entity. Appeals is further directed to make the administrative case file available to Counsel when needed, which will not end Appeals' settlement authority. Moreover, Appeals may exclude Counsel from a settlement conference if Appeals determines that Counsel's participation in the settlement conference will not further settlement of the case. However, Appeals is directed to provide Counsel with access to any documents received by Appeals in a settlement conference, and Appeals may obtain advice from Counsel and consider it in conjunction with other factors to reach a basis for settlement.

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Tax Controversy and Litigation at Shearman & Sterling

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