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FOCUS ON TAX CONTROVERSY AND LITIGATION

Treasury and IRS Issue Proposed Regulations Imposing Documentation Requirements Under Section 385

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

In addition to the discussion of the recently proposed regulations which impose new documentation requirements under Section 385, this month's issue features articles regarding the Circuit Court decision in *Chemtech Royalty Associates v. United States* discussing the substantial authority defense to penalties, a survey of recent transferee liability cases involving Midco transactions, Revenue Procedure 2016-30 which provides new procedures to resolve issues through a pre-filing agreement, and Revenue Procedure 2016-19 which describes changes to the Service's Industry Issue Resolution ("IIR") Program.

Treasury and IRS Issue Documentation Requirements for Debt-Equity Regulations

On April 4, 2016, the Treasury Department and IRS issued proposed regulations under Section 385 which includes specific Documentation Requirements for certain related-party debt instruments under Prop. Reg. § 1.385-2 (the "Proposed Regulations"). The Documentation Requirements prescribe the nature of the documentation and information that must be prepared and maintained for a purported debt instrument issued by a corporation to another member of the expanded group to be treated as such. The Documentation Requirements are intended to provide the IRS with sufficient information in order to permit it to determine whether an instrument should be respected as debt for US tax purposes. The documentation must be provided within prescribed time limits in order to be considered for debt treatment.

Background

Section 385(a) authorizes the Treasury to prescribe necessary and appropriate regulations to "determine whether an interest in a corporation is to be treated" as equity or indebtedness.[1] Under the Proposed Regulations, in order for related parties to avoid equity characterization

[1] I.R.C. § 385(a).

"Satisfaction of the Documentation Requirements is a threshold matter that allows the instrument to be considered as indebtedness for US tax purposes," but document submission does not guarantee a debt classification.

on certain related-party debt instruments, documentation must be provided that demonstrates: (i) the issuer was under an unconditional and legally binding obligation to pay a sum certain on a fixed date or upon demand; (ii) the holder had legal rights as a creditor; (iii) as of the date the instrument was issued, there was a reasonable expectation of ability to repay the debt; and (iv) after the date of issuance of the debt instrument, the conduct of the holder and issuer was consistent with that of unrelated parties acting on arm's-length terms.[2] In addition, the parties must prepare documentation of (i) each payment of principal and interest under the debt instrument and (ii) evidence of the holder's reasonable efforts to enforce creditors' rights in the event of default under the debt instrument. While the Documentation Requirements must be met to prevent the instrument from being categorized as equity, timely submission does not guarantee a debt classification. Satisfaction of the Documentation Requirements is a threshold matter that allows the instrument to be considered as indebtedness for US tax purposes. Failure to provide documentation will result in the instrument being treated as equity for US tax purposes.

Applicability

The Proposed Regulations only apply to instruments that are cast in the form of debt, not those that do not purport to be indebtedness. Instruments subject to the Documentation Requirements are only those issued and held by members of an expanded group. An expanded group under the Proposed Regulations generally includes two or more corporations connected through direct or indirect stock ownership of at least 80 percent (by vote or value). The term "expanded group" includes non-US corporations, real estate investment trusts ("REITS"), regulated investment companies ("RICS") and corporations connected indirectly through partnerships. Moreover, the Proposed Regulations apply only to large taxpayer groups. Thus, compliance with the Proposed Regulations is only necessary where the stock of any member of the expanded group is publicly traded, total assets of the group exceed $100 million on any applicable financial statement on the instrument's issuance date, or annual total revenue exceeds $50 million on any applicable financial statement on the instrument's issuance date.[3]

Documentation Categories

The Proposed Regulations create four categories of documentation that attempt to distill case law principles for determining whether the debt instrument will be treated as indebtedness or stock. Failure to provide documentation for each of these categories will result in a classification of equity, even where the underlying instrument may otherwise qualify as indebtedness under general US tax principles.

2 Prop. Reg. § 1.385-2(b)(2).
3 Prop. Reg. § 1.385-2(a)(2)(i).

"The Proposed Regulations create four categories of documentation that attempts to distill case law principles for determining whether the debt instrument will be treated as indebtedness or stock."

1. **Unconditional Obligation to Repay**. The Proposed Regulations require evidence of an unconditional obligation on the part of the issuer to pay a sum certain. Such evidence should be offered in the form of written documentation executed by both parties that shows such obligation.
2. **Holder's Right to Enforce the Terms**. Second, and similarly, there must be written documentation that establishes that the holder of the instrument has the legal right to enforce the obligation according to its terms. Evidence of such rights may include the ability to trigger a default or accelerate payments, as well as a superior right to equity holders in the issuer's assets in the event of a dissolution or liquidation.
3. **Reasonable Expectation of Issuer's Ability to Repay**. Third, the Proposed Regulations require evidence showing there is a reasonable expectation that the issuer will be able to repay the amount of the debt. Evidence of the issuer's adequate financial position may be established through cash flow projections, financial statements, business forecasts, or other financial information showing that the obligation can be met pursuant to the instrument's terms. The documentation is to be evaluated by the IRS as of the time of the loan's issuance.
4. **Evidence of a Debtor-Creditor Relationship**. While the first three categories focus on the nature of the instrument and positions of the parties at the time the purported debt is issued, the fourth category requires evidence of actions that show an ongoing debtor-creditor relationship. Where the issuer of the loan has upheld its obligations according to its terms, the documentation should include evidence of timely payments of principal and interest. That evidence could be in the form of a wire transfer record, bank statement, or other document showing that the payment was made. However, where the issuer fails to comply with the terms of the loan, such as in the case of a default or other non-payment, the written documentation should include evidence of the holder's reasonable exercise of diligence and judgment as a creditor. This evidence may demonstrate the holder's attempts to enforce its rights under the instrument or any efforts it made to renegotiate the instrument's terms.

Timing

With respect to evidence of the binding obligation to repay, the holder's rights of enforcement and the reasonable expectation of repayment, documentation should be prepared no later than 30 calendar days after the relevant event. The date of the relevant event can either be the date that the instrument is issued to an expanded group member, or the date in which the instrument comes to be held by a member of the expanded group (where, for instance, the instrument holder was not part of the expanded group at the time of issuance). If the instrument is deemed to be stock under the Proposed Regulations, and thereafter ceases to be held by an expanded group member, the character of the instrument is thereafter determined under normal US tax principles. With respect to evidence of an ongoing debtor-creditor relationship, the Proposed Regulations allows the documentation to be prepared up to 120 calendar days from the date of the principal or interest payment or other relevant event (e.g., a default or non-payment).

"If the instrument is deemed to be stock under the Proposed Regulations, and thereafter ceases to be held by an expanded group member, the character of the instrument is thereafter determined under normal US tax principles."

Other Special Arrangements

Where the loan is part of a revolving credit agreement rather than a separate note or writing, all documentation that relates to the purported indebtedness must be provided. Documentation may include board of directors' resolutions, credit agreements, or other agreements prepared in connection with legal documents governing the indebtedness. If the instrument is issued as part of a cash pooling arrangement or internal banking service, the Proposed Regulations are met only if all material documentation that governs the operations of the cash pool or internal banking service is provided.

Comment Period

The Proposed Regulations generally apply to debt instruments issued on or after April 4, 2016, but they are subject to comment. Written or electronic comments and requests for a public hearing must be received by July 7, 2016 for consideration.

Eric Grosshandler and Daniel Kachmar[4]

Chemtech Affirmed by Fifth Circuit

On May 17, 2016, the US Court of Appeals for the Fifth Circuit affirmed a decision by the district court for the Middle District of Louisiana in *Chemtech Royalty Associates v. United States* and upheld accuracy-related penalties imposed on Chemtech under Section 6662.[5] The district court held that the substantial-understatement and negligence penalties applied against Chemtech I for tax years 1997 through 1998, which subjected Chemtech I to a 20 percent penalty.

Background

Dow Chemical Company ("Dow") created Chemtech I ("Chemtech"), a limited partnership, and contributed 73 patents to the partnership, which Dow later leased back in return for royalty payments. Dow deducted its royalty payments to Chemtech. In 1998, Dow terminated Chemtech in response to a change in the US tax law. The Service conducted a partnership-level audit for Chemtech, disregarded the partnership form of Chemtech for tax purposes, reasoning that Chemtech was a sham transaction. The Service asserted adjustments, resulting in the disallowance of $1 billion of tax deductions to Dow, and asserted accuracy-related penalties pursuant to Section 6662. Dow contested the substantial-understatement and negligence penalty award as to Chemtech. Dow argued that it had reasonable cause and substantial authority for its position that Chemtech was a valid partnership. The district court held that the penalties properly applied to Chemtech. On appeal, the Circuit Court concluded that "[t]he district court did not err in failing to justify the negligence and substantial

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[5] *Chemtech Royalty Associates v. United States*, No. 15-30577 (5th Cir. May 17, 2016).

understatement penalties on the basis of our sham-partnership holding, but it could have done so."[6]

The Circuit Court held that the "district court did not err in failing to justify the negligence and substantial understatement penalties on the basis of our sham-partnership holding."

Analysis

On the merits, the Circuit Court recognized that in order for there to be substantial authority "the weight of the authorities supporting treatment of an item must be substantial in relation to the weight of those supporting contrary treatment."[7] Substantial authority is more stringent then the reasonable-basis standard but less stringent than the more-likely than-not standard.[8] Dow argued that it had substantial authority for its position that Chemtech was a valid partnership, relying on *Hunt v. Commissioner*[9] and *Morris v. Commissioner*.[10]

In *Hunt*, the Tax Court held that a partnership was not a sham when a partner was entitled to a cumulative return of 18 percent, followed by a return of its capital contribution, before any other partners received returns of capital. In *Morris* the Tax Court held that despite receiving only a fixed 6 percent return plus 2 percent of profits, the petitioner's wife was a true limited partner in her husband's brokerage partnership. Dow argued that both decisions treated an interest with minimal sharing of profits and losses as a partnership interest. But the Circuit Court distinguished both *Hunt* and *Morris* and rejected Dow's interpretation, which the court found would eliminate any intent element from the sham-partnership doctrine. The Circuit Court also cited the totality of circumstances test in *Culbertson*,[11] which holds that a partnership is a sham if the partners do not intend to share profits and losses. The court added that *Hunt* and *Morris* fail to constitute substantial authority when taking into account the court's prior decision in *Merryman v. Commissioner*.[12] That decision affirmed a finding that a partnership with similar features as Chemtech (partner control of property contributed, minority partners lack of risk, circular flow of funds), was a sham. The court held that "[b]ecause *Merryman* is more apposite than are *Morris* and *Hunt*, and because Merryman is published circuit authority, whereas *Morris* and *Hunt* are Tax Court cases, Dow lacked substantial authority for its position that [Chemtech] was a valid partnership."[13]

The court concluded that "Dow lacked substantial authority for its position that [Chemtech] was a valid partnership."

Richard A. Nessler

6 *Id.*
7 26 C.F.R § 1.6662-4(d)(3)(i).
8 *Id.* § 1.6662-4(d)(2).
9 T.C. Memo 1990-248, 59 T.C.M. (CCH) 635 (1990).
10 13 T.C. 1020 (1948).
11 *Commissioner v. Culbertson*, 337 US 733 (1949).
12 873 F.2d 879 (5th Cir. 1989).
13 *Chemtech Royalty Associates v. United States*, No. 15-30577 (5th Cir. May 17, 2016).

MIDCO Transactions and the Expanding Universe of Transferee Liability[14]

The Internal Revenue Service's determination of transferee liability, essentially secondary liability, resulting from transactions involving the taxable sale and disposition of corporate stock, is being litigated with increasing frequency in the federal courts. The outcome of these disputes varies as they are highly fact determinative. Thus, not surprisingly, Taxpayers have experienced mixed results in court. Although there are lower courts that have held in favor of the putative transferee, selling shareholders, three recent Tax Court decisions have been reversed on appeal.[15] In fact, to date only one taxpayer victory has been affirmed on appeal.[16] The IRS's recent successes have emboldened it to utilize transferee liability more frequently as a tax collection mechanism, most notably against corporate shareholders who engaged in so-called Midco or middle-company transactions,[17] primarily during the late 1990s to early 2000s. Generally, a Midco transaction is one in which the seller engages in a stock sale (thus avoiding the triggering of built-in gain in appreciated assets) while the buyer engages in an asset purchase (thus allowing a purchase price basis in the assets), through use of an intermediary company. Taxpayers involved in these Midco transactions, and taxpayers who may be contemplating transactions that could be construed as Midcos, should be cognizant of their potential exposure as transferees under Code section 6901. They could potentially be subject to liability for their counterparty's unpaid taxes, interest and potential penalties related to the disposition of the property. Generally, the salient issue in these Midco transferee cases is whether the selling shareholder knew or should have known that the Midco intermediary would incur a tax liability that it could not and would not pay and thus would not be collected.

"The IRS's recent successes have emboldened it to utilize transferee liability more frequently as a tax collection mechanism, most notably against corporate shareholders who engaged in so-called Midco or middle-company transactions."

Section 6901 - Transferee Liability Cases Involving Midcos

The leading transferee liability case in New York involving a Midco transaction is the Second Circuit's decision in *Diebold Foundation, Inc*.[18] Diebold involved Double D Inc. ("Double D"), a New York C corporation with two shareholders: the Dorothy R. Diebold Marital Trust and the Diebold Foundation, Inc. Double D was a holding company containing substantially appreciated assets of $319 million, which consisted of $291.4 million of publicly traded securities.[19] The shareholders agreed to sell all of the Double D stock to Shap Acquisition Corp. II ("Shap II"), a newly formed corporation created by Sentinel Advisors for $309 million, which was funded through a bank loan. Immediately afterwards, Shap II sold the securities to Morgan Stanley and repaid the Rabobank loan, netting a $10 million profit.[20]

[14] The following article is an excerpt from a paper presented to The Tax Club on April 20, 2016 by Lawrence. M. Hill.

[15] *See Diebold Foundation, Inc. v. Commissioner*, 736 F.3d 172 (2d Cir. 2013); *Frank Sawyer Trust v. Commissioner*, 712 F.3d 597 (1st Cir. 2013); *Slone v. Commissioner*, 778 F.3d 1049, *modified* 116 AFTR2d 2015-5962 (9th Cir. 2015).

[16] *See Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2013).

[17] *See* Notice 2001-16.

[18] *Diebold Foundation, Inc. v. Commissioner*, 736 F.3d 172 (2d Cir. 2013).

[19] *Id.* at 176.

[20] *Id.* at 181.

A "Midco transaction is one in which the seller engages in a stock sale (thus avoiding the triggering of built-in gain in appreciated assets) while the buyer engages in an asset purchase (thus allowing a purchase price basis in the assets), through use of an intermediary company."

Shap II reported all of the gain from the asset sales with Double D, but the gain was entirely offset by losses (from a Son-of-BOSS tax shelter), resulting in no net tax liability.[21]

The IRS issued a notice of deficiency against Double D for the $81 million tax on its built-in gain and also asserted an accuracy-related penalty based on a determination that the shareholders' sale of Double D stock was in substance an asset sale followed by a liquidating distribution.[22] But Double D had been dissolved and its assets were gone. Double D did not contest the tax liability, but the Service was unable to collect the tax. Deciding that any additional efforts to collect from Double D would be futile, the Commissioner then proceeded against the former shareholders as transferees under Section 6901. The IRS pursued the selling shareholders in Tax Court. The Tax Court held that one of the shareholders, a marital trust, was not a transferee of the Midco but that the other shareholder, a foundation and its successor foundations, was a transferee. However, the Tax Court concluded that the foundations were not liable for the unpaid tax liabilities under New York's fraudulent conveyance law because Double D Ranch representatives' level of awareness about Shap II's plan to engage in some sort of tax strategy did not require the representatives to make further inquiry into the circumstances of the transaction.[23] The Tax Court concluded that Diebold's facts closely resembled the facts in *Starnes*[24] and *Frank Sawyer Trust*[25]—both cases where the Tax Court decided not to collapse various transactions under the uniform fraudulent conveyance statute.[26]

On appeal, the IRS acknowledged that it may assess transferee liability under Section 6901 against a party only if two independent prongs are met: (1) the party must be a transferee under Section 6901, and (2) the party must be subject to liability at law or in equity.[27] As to the first prong of Section 6901, the court must look to federal tax law to determine whether the party in question is a transferee.[28] The Service argued that the two questions were not independent—that the court must first make a determination as to whether the party in question is a transferee, looking to the federal tax law doctrine of "substance over form" to re-characterize the transaction.[29]

The Second Circuit rejected the IRS's argument that transferee liability should be determined by applying the "substance over form" doctrine to re-characterize the transaction and then

21 *Id.*
22 *Id.*
23 *See Salus Mundi Foundation v. Commissioner*, T.C. Memo 2012-61, *17 (103 T.C.M. (CCH) 1289).
24 *See Starnes v. Commissioner*, T.C. Memo 2011-63 (101 T.C.M. (CCH) 1283).
25 *See Frank Sawyer Trust v. Commissioner*, T.C. Memo 2011-298.
26 *Salus Mundi Foundation v. Commissioner*, T.C. Memo 2012-61, *18, affd 776 F.3d 1010 (9th Cir. 2014).
27 *See Rowen v. Commissioner*, 215 F.2d 641, 643 (2d Cir. 1954).
28 *Id.* at 644.
29 *Diebold Foundation, Inc. v. Commissioner*, 736 F.3d 172, 184 (2d Cir. 2013).

assessing liability with respect to the re-characterized transaction.[30] Instead, the court adopted a two-prong framework followed by the First Circuit in *Frank Sawyer*[31] and the Fourth Circuit in *Starnes*[32] that determines: (1) whether the taxpayer is a transferee under Section 6901, and (2) whether the taxpayer is liable under state law due to a fraudulent transfer.[33]

In *Diebold*, the court concluded that "Double D's shareholders evinced 'constructive knowledge' because the facts plainly demonstrate that the parties 'should have known' that this was a fraudulent scheme."

The Second Circuit looked to the New York Uniform Fraudulent Conveyance Act (NYUFCA) to determine whether the shareholders knew or should have known of "the entire scheme" that rendered the sale transaction fraudulent—a conveyance without consideration that rendered the transferor insolvent.[34] The court held that the shareholders should have inquired further into the supposed tax attributes that allegedly would have allowed Shap II to absorb the tax liability on the appreciated assets.[35] Accordingly, the court concluded that Double D's shareholders evinced "constructive knowledge" because the facts "plainly demonstrate that the parties 'should have known' that this was a fraudulent scheme, designed to let both the buyer of the assets and the seller of the stock avoid the tax liability inherent in a C Corp holding appreciated assets and leave the former shell of the corporation, now held by a Midco, without assets to satisfy the liability."[36] The Diebold court relied primarily on the fact that "[t]he parties to this transaction were extremely sophisticated actors, deploying a stable of tax attorneys from two different firms in order to limit their tax liabilities."[37] The Second Circuit listed a number of other facts:

- The shareholders recognized a significant tax "problem" inherent in the appreciated assets;
- The shareholders actively sought a tax solution—seeking out parties that could avoid the inherent tax liability;
- The shareholders viewed presentations from three different firms that purported to deal with the tax liability problem;
- The shareholders' advisors knew that Shap II borrowed funds to purchase the stock and intended to sell its assets immediately after closing to repay the loan; and
- The shareholders knew that Shap II was a newly formed entity.

30 *Id*.

31 *See Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597 (1st Cir. 2013).

32 *See Stames v. Commissioner*, 680 F.3d 417 (4th Cir. 2012).

33 *See also*, *Salus Mundi Foundation v. Commissioner*, 776 F.3d. 1010 (9th Cir. 2014) The Ninth Circuit noted that although the IRS's argument was a plausible reading of Stern, three other circuits had rejected its position: *Diebold Foundation, Inc. v. Commissioner*, 736 F.3d 172 (2nd Cir. 2013), *Frank Sawyer Trust v. Commissioner*, 712 F. 3rd 597 (1st Cir. 2013) and *Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2012). The Ninth Circuit agreed with the 2nd, 1st and 4th Circuits that Stern is "best interpreted as establishing that the state law inquiry is independent of the federal law procedural inquiry."

34 *Diebold*, *supra*, at 187.

35 *Id*.

36 *Id*. at 189.

37 *Id*. at 188.

The Second Circuit also cited to the purchase agreement, where the buyer's plan to sell the target's assets was apparent to the sellers because it was mentioned in the draft purchase agreement.[38] The court concluded that "[c]onsidering their sophistication, their negotiations with multiple partners to structure the deal, their recognition of the fact that the amount of money they would ultimately receive for an asset or stock sale would be reduced based on the need to pay the C Corp. tax liability, and the huge amount of money involved, among other things, it is obvious that the parties knew, or at least should have known but for active avoidance that the entire scheme was fraudulent and would have left the target corporation unable to pay its tax liability."[39]

Upon determining that the shareholders had constructive knowledge, the court collapsed the sale and post-sale transactions, applying New York law, and concluded that Double D made a fraudulent conveyance. The case was remanded to the Tax Court to consider, among other questions, whether the foundation was a transferee under Section 6901. Briefs have been submitted to the Tax Court, but the matter remains undecided since remand from the Second Circuit.

The Fourth Circuit Rules for Taxpayer Starnes

In *Starnes v. Commissioner*[40] the Fourth Circuit, faced with facts similar to *Diebold*, applied North Carolina law and upheld the Tax Court's decision that the selling shareholders were not liable as transferees because they did not know, nor did they have reason to know, that the Midco would cause the target corporation to fail to pay its taxes.[41] The Starnes transaction was entered into after issuance of Notice 2001-16, but that fact did not appear to influence the court's decision.[42]

In *Starnes*, the shareholders had worked at the trucking company they owned (Tarcon, Inc.) for over forty years. In 2003, the shareholders decided to retire and liquidate their interests. At that point, Tarcon had ceased its business operations, and its sole remaining non-cash asset

38 *Id.* at 179.

39 *Id.* at 188. The same facts were raised in *Salus Mundi Foundation v. Commissioner*, 776 F.3d 1010 (9th Cir. 2014). The Ninth Circuit therefore looked to the Second Circuit's decision. The Second Circuit had concluded that under substantive state law, the Double D shareholders had constructive knowledge of the tax avoidance scheme since (1) they knew an asset sale by the corporation would create a large tax liability from the built-in gain, (2) they had a sophisticated understanding of the structure of the transaction, and (3) they knew that Shap was formed to facilitate the transaction and did not have assets to meet its obligation to purchase the stock to sell to Morgan Stanley or to compensate Morgan Stanley if it could not meet its obligations. Since "absent a strong reason" the Ninth Circuit will not create a direct conflict with another circuit, and the Second Circuit addressed the same facts, issues and applicable law, the Ninth Circuit adopted the Second Circuit's reasoning and held that the shareholders had constructive knowledge. As in *Diebold*, the Ninth Circuit remanded the case to the Tax Court to determine Salus Mundi's status as a transferee of a transferee under federal law and whether the IRS asserted transferee liability within the statutory period.

40 *Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2012).

41 *Id.* at 439.

42 *Id.* at 435.

was an industrial warehouse that it leased to others.[43] After considering various options and consulting with their real estate broker, accountant and attorneys, the shareholders sold Tarcon's only asset, a warehouse, to one company, ProLogis, Inc., which left Tarcon with only cash. The shareholders then sold their Tarcon stock to another company, MidCoast Investments. MidCoast was introduced to the shareholders through a commercial real estate broker. MidCoast represented that it was in the "asset recovery business." MidCoast met with the shareholders and contractually agreed to operate Tarcon as a going concern; MidCoast would not dissolve, liquidate or merge into another company; MidCoast would cause Tarcon to file all tax returns related to the federal and state income taxes owed by the company from selling the warehouse on a timely basis, and MidCoast represented that Tarcon's tax liabilities would be satisfied.[44] The shareholders made no inquiries and did not understand what was meant by the "asset recovery business," but they had no reason to believe MidCoast would not honor these commitments. The parties agreed that the price of the stock would be $2.6 million, equal to the amount of Tarcon's cash ($3.1 million) less 56.25 percent of Tarcon's $880,000 income tax liability.[45]

According to the stock purchase agreement, Tarcon's $3.1 million was supposed to be transferred into Tarcon's "post-closing" bank account, but that did not occur. A few days after the closing and without prior notice to the former shareholders, MidCoast sold its Tarcon stock to Sequoia Capital, a Bermuda company, for $2.9 million and transferred the cash to an account in the Cook Islands in the name of Delta Trading Partners.[46] Tarcon filed its 2003 federal tax return, but never paid its taxes, claiming large offsetting losses for certain transactions that occurred after MidCoast acquired Tarcon. The IRS audited Tarcon and disallowed and assessed Tarcon with a deficiency of $1.5 million including penalties and interest, which Tarcon did not pay. Looking for a pocket to pick, the IRS sent notices of transferee liability to Tarcon's former shareholders under the theory that the transaction was substantially similar to an intermediary transaction (a Midco tax shelter) and was, in substance, a sale of Tarcon assets followed by a distribution of the proceeds to its shareholders. The IRS asserted the former shareholders were liable as transferees under Section 6901. The former shareholders filed petitions in the Tax Court contesting the notices of transferee liability. The Tax Court ruled in favor of the former shareholders, finding that the IRS had failed to carry its burden of proof.[47] The IRS appealed that decision in the US Court of Appeals for the Fourth Circuit.

In *Starnes*, the court found that "the IRS failed to prove that the former shareholders had the requisite knowledge to impose transferee liability under North Carolina law."

The Fourth Circuit addressed and rejected the Service's various claims for transferee liability under state law, specifically under North Carolina's version of the Uniform Fraudulent

[43] *Id.* at 423.
[44] *Id.* at 421.
[45] *Id.* at 423.
[46] *Id.* at 424.
[47] *Id.* at 425.

Transfer Act (the "NCUFTA") and North Carolina common law. With respect to the arguments advanced by the IRS under the NCUFTA, the threshold question for the court was "what transfer or combination of transfers should be considered to determine whether Tarcon received reasonably equivalent value and/or was rendered insolvent?"[48] The IRS argued that the sale and post-sale transactions, which would include MidCoast's transfer of cash to the Cook Islands, should be "collapsed."[49] But the court refused to collapse the transactions because it found the IRS failed to prove that the former shareholders had the requisite knowledge to impose transferee liability under North Carolina law.[50] The test applied by the court was whether the former shareholders knew or should have known that Tarcon would fail to pay its taxes under its new owner.[51]

MidCoast represented to the shareholders that Tarcon would not be "dissolved or consolidated," but rather Tarcon would be "'reengineered into the asset recovery business' and become an 'income producer' for MidCoast going forward."

The Service argued that the Tax Court's findings were clearly erroneous and that the shareholders "knew or should have known" that MidCoast had tax avoidance intentions because "MidCoast's promotional materials stated that it targeted corporations that had only cash and offered shareholders a way to minimize their tax burden" and that the "negotiations revolved largely around the percentage of the amount of Tarcon's 2003 taxes that MidCoast would pay the Former Shareholders as a "premium."[52] In further support of its position, the Service argued that the shareholders' inquiry was not reasonably diligent based on the fact that one shareholder acknowledged that paying cash for a corporation that held only cash "did sound strange," and that another shareholder stated that he did not understand the deal and did not want to understand it.[53] Even the shareholders' accountant questioned whether the sale was "2001-16 reportable."[54] But the Circuit Court concluded that while this evidence supported the Service's position it did not persuade the court that the Tax Court's findings were clearly erroneous. The court noted the taxpayers' lack of sophistication and explained that although the selling shareholders had experience in the freight and warehousing business, none of the shareholders had ever sold a business before and "none had any education, training or experience in accounting, taxes or finance."[55] In addition, MidCoast represented to the shareholders that Tarcon would not be "dissolved or consolidated," but rather Tarcon would be "'reengineered into the asset recovery business' and become an 'income producer' for MidCoast going forward."[56] MidCoast "repeatedly represented that it would ensure that Tarcon would pay its . . . taxes,"[57] and MidCoast had been in business since 1958, and

48 *Id.* at 431.
49 *Id.* at 429, 432, 437.
50 *Id.* at 437.
51 *Id.* at 439.
52 *Id.* at 435.
53 *Id.* at 422.
54 *Id.*
55 *Id.* at 436.
56 *Id.*
57 *Id.* at 422.

represented that it had recently transitioned to asset recovery involving credit card debts. Notably, MidCoast's attorney testified that he had no reason to believe that MidCoast would not ensure that Tarcon's corporate taxes would be paid.[58]

Based on these facts, the court held that the Tax Court did not commit clear error in finding that the IRS was required but failed to prove that "no reasonably diligent person in the Former Shareholders' position would have failed to discover that MidCoast would cause Tarcon to fail to pay its 2003 taxes."[59] The court also rejected an argument that the former shareholders were liable under North Carolina's "trust fund doctrine" because the IRS was unable to demonstrate the transaction amounted to a winding up or dissolution of the company.[60]

The IRS is Victorious in Frank Sawyer

A year after the loss in Starnes, the Service notched a win in *Frank Sawyer*[61] where the First Circuit recognized that something suspicious occurred in a Midco transaction. The patriarch, Frank Sawyer, died in 1992 at age 97. His wife Mildred died in 2000. Included in her estate was the Frank Sawyer Trust of 1992 ("Trust"). The taxable estate was $138,480,721 and there were four C corporations (taxi companies) with highly appreciated assets. All four corporations sold their assets to unrelated third parties. Each of the corporations recognized gain on the sale and were left holding large amounts of cash. A representative of the Trust received an unsolicited promotional letter from MidCoast Credit Corp, which indicated that MidCoast was interested in purchasing the corporate stock. Because of the size of the stock sale, MidCoast brought in Fortrend, described as an investment bank, who had greater access to capital. Representatives of the trust met with Fortrend. Fortrend indicated that it would pay a purchase price for the stock equal to value of the cash and other assets less 50 percent of the amount of the income tax liability—the purchase price represented a significant premium above the amount that the Trust would have received if the companies paid the federal and state tax themselves and then distributed the remainder to the Trust. The offer was too good to pass, so the Trust decided to sell to Fortrend.

As we have seen in earlier Midco cases, Fortrend was not the purchaser. Instead, Fortrend formed a new Delaware LLC, Three Wood, which borrowed $30 million from Rabobank.[62] Following the sale, Three Wood used the loan to pay the former shareholders, and cash received from the corporation was used to repay the loan.[63] Three Wood then transferred the stock of the C corporations to two shell companies. What assets remained, Three Wood transferred to accounts held by other Fortrend entities year later, the Trust agreed to sell two

58 *Id.* at 421-422.
59 *Id.* at 434.
60 *Id.* at 438-439.
61 *Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597 (1st Cir. 2013).
62 *Id.* at 600-601.
63 *Id.* at 600-601.

other corporations to Fortrend. As before, Fortrend used controlled subsidiaries to consummate the deals, with Rabobank providing the financing.[64] With all deals, Fortrend had agreed to assume the tax liabilities, but Fortrend claimed unrelated stock losses to offset the gain recognized from the Trust corporations. The IRS subsequently examined all of the companies' tax returns and disallowed the deductions.[65]

In *Frank Sawyer*, the court applied its own theory—it called this theory a "transferee-of-transferee liability," where liability may be found regardless of whether the trust had constructive knowledge of Fortrend's intentions.

When the transaction proceeded apace and the attempted tax offset was unwound, the IRS started looking for other suspects from whom it could collect. The problem the IRS had was that the Trust did not receive corporate distributions. In fact, Fortrend had borrowed from a bank to pay the Trust. The loan was transitory, but the Trust appeared not to know. With arguments similar to those in *Diebold*, the IRS wanted to collapse everything together. Yet under the Uniform Fraudulent Transfer Act, the burden was on the IRS to prove that the Trust knew Fortrend's schemes were illegitimate. The court didn't find that the Trust had actual knowledge. In fact, the IRS had stipulated that at the time of the stock sales the Trust representatives didn't know about the post-closing merger or the contribution of inflated-basis stock contemplated by Fortrend.[66]

The Government argued that the combination of Section 6901 transferee liability (the procedural tool) and the Massachusetts Fraudulent Transfer Act (the remedial tool) permitted the IRS to assert transferee liability. The Tax Court rejected transferee liability because it read the Massachusetts Fraudulent Transfer Act requiring knowledge of the buyer's maneuvers to underpay the tax liability and strip the cash out of the corporation.[67] The Tax Court, concluding that the IRS had not shown enough to invoke the knowledge or constructive knowledge requirement, refused to collapse the transaction.[68]

The First Circuit approved the Tax Court's key fact findings and declined to apply a collapsing theory. But it came up with another theory—apparently not argued by the parties—that essentially amounts to the same thing. It called this theory a "transferee-of-transferee liability,"[69] where liability may be found regardless of whether the trust had constructive knowledge of Fortrend's intentions.

Essentially, the theory is that the IRS having rejected Fortrend's attempt to offset the taxi companies' tax liabilities—became a creditor of those companies, then it had a fraudulent transfer claim against Three Wood.[70] The court then recognized that "[i]f the IRS had a fraudulent transfer claim against Three Wood, then the IRS is also a creditor of Three Wood

64 *Id.* at 600-602.
65 *Id.* at 600-604.
66 *Id.* at 600-601.
67 *Id.* at 599.
68 *Id.* at 606.
69 *Id.* at 606.
70 *Id.* at 607.

under Massachusetts UFTA. And if the IRS is a creditor of Three Wood, the IRS can recover not only from Three Wood, but also from parties who received fraudulent transfers from Three Wood."[71] Three Wood made a transfer to the Trust: it paid the Trust $32.4 million in exchange for the taxi companies with a net book value of only $25.3 million. The First Circuit remanded the case to the Tax Court to "determine in the first instance whether the value of the companies transferred by the Trust to Three Wood was 'reasonably equivalent' to the value of the cash transferred by Three Wood to the Trust."[72] And if not, whether the Fortrend acquisition vehicle's inability to satisfy the tax liability was reasonably foreseeable.

On remand, the Tax Court concluded that Three Wood overpaid for the taxi corporations because it believed it could avoid the corporations' tax liability—it did not receive equivalent value when it transferred cash to the Trust to pay the purchase price.[73] As to the second prong of the analysis, the Tax Court found that Three Wood should have known that its tax avoidance strategy would fail.[74] Consequently, Three Wood engaged in a fraudulent transfer to the Trust because Three Wood should have known that purchasing the taxi companies would cause it to incur debts beyond its ability to pay.[75] Accordingly, the Trust was liable as a transferee.

Taxpayer Slone is Victorious following Remand

In *Slone v. Commissioner*,[76] the Tax Court initially ruled in favor of the taxpayer and determined that a stock sale was a legitimate transaction and that the form of the transaction must be respected such that petitioners were not transferees under Section 6901 for Federal tax purposes. On Appeal, the Ninth Circuit Court of Appeals, vacated and remanded the case back to the Tax Court to make a necessary finding under the test set forth in *Commissioner v. Stern*.[77] On remand, the Tax Court concluded that the government failed to show that shareholders of a media company were liable as transferees of their media company. Therefore, the media company's stock sale was respected and not recast as a liquidating distribution.

In 2001, Slone Broadcasting, a C Corporation which operated several radio stations in Arizona, sold its assets to Citadel Broadcasting, which resulted in an estimated Federal and State income tax liability of $15 million. After the sale, Slone did not conduct any business and had no plans to liquidate. Indeed, a few months after the sale, Slone made its first estimated Federal income tax payment of $3.1 million to the Internal Revenue Service related

71 *Id.* at 607-608.
72 *Id.* at 609.
73 *Frank Sawyer Trust of May 1992 v. Commissioner*, T.C. Memo. 2014-59, *5 (107 T.C.M. (CCH) 1316).
74 T.C. Memo. 2014-59, *4.
75 T.C. Memo. 2014-59, *5.
76 T.C. Memo. 2016-115
77 357 U.S. 39 (1958).

to the gain from the sale. An outside entity, Fortrend International sent an unsolicited letter to Slone's accountant, expressing an interest to purchase Slone's stock. Fortrend described itself as a "private investment/merchant-banking group."[78] Fortrend also referenced MidCoast Credit Corp., which it described as a corporation engaged in the business of collecting delinquent credit card debt acquired from banks. Slone's accountant and outside tax lawyer investigated MidCoast and were told that MidCoast was a legitimate business. The advisors also reviewed the projections in the Fortrend/MidCoast business plan and concluded that they were reasonable. Thereafter, Slone agreed to the stock sale with Fortrend and MidCoast. After the stock sale was closed petitioners had no knowledge or say in the operation of Slone Broadcasting. Following the sale, Slone Broadcasting changed its name to Arizona Media. Arizona Media failed to pay tax, penalty and interest assessed by the IRS. Subsequently, the IRS issued transferee notices to the former shareholders of Slone Broadcasting.

The Court of Appeals remanded the case to the Tax Court in order for the court to make necessary findings to apply the test set forth in *Commissioner v. Stern*. Stern requires the satisfaction of a two pronged test in order for a tax liability to be imposed on a transferee pursuant to Section 6901. The first prong is satisfied if the party is a "transferee" under Section 6901 and Federal tax law. The second prong is satisfied if the party is "substantively liable for the transferor's unpaid taxed under state law."[79] Both prongs must be satisfied in order for liability to be imposed on a transferee. The Service has the burden of proof. The Tax Court chose to focus on the second prong to determine whether petitioners are "substantively liable for the transferor's unpaid taxes under state law." [80]

The law that applied was Arizona law because that is the State where the transfer occurred. Arizona follows the Uniform Fraudulent Transfer Act ("UFTA"). The Service argued that the form of the stock sale should be disregarded and treated as a liquidating distribution for purposes of applying the UFTA. The Tax Court said that in order for the stock sale to be recast as a liquidating distribution, the Service must prove that petitioners had actual or constructive knowledge of the entire scheme. The Tax Court concluded that the Service did not sustain its burden of proof as to either actual or constructive knowledge.[81]

Concluding that the individual shareholders did not have actual or constructive knowledge that the transaction was a tax avoidance scheme, the Tax Court found that the wife was not involved in the business, but was simply a signatory on the sale documents and the husband relied on his advisors' expertise and had no involvement in investigating the legitimacy of the transaction or negotiating its terms. In addition, the Tax Court concluded that the company's

[78] Slip. Opn. at 4.

[79] Slip. Opn. at 9-10.

[80] Slip. Opn. at 11.

[81] Slip. Opn. at 13.

advisors did not have actual or constructive knowledge either. They lacked actual knowledge because the advisors were stonewalled when they asked about the purchaser's strategy for reducing the media company's tax liability. Moreover, the information that the purchaser planned to offset gain from the asset sale by contributing high basis/low value debt to the company in a Code Section 351 transaction and then selling the assets at a loss was insufficient to give the advisors' constructive knowledge of the scheme. In addition, the court found that the shareholders and their advisors had no reason to believe that the purchase's strategies were not legitimate tax planning methods.

Further, the stock sale was not fraudulent under Arizona law. The Tax Court determined that when the shareholders sold their shares, they received consideration from the purchaser, not the media company that owed the taxes. Because no transfer was made by the media company to the shareholders as a result of the stock sale, there was no constructive fraud under state law. In addition, an analysis of the factors contained in the UFTA found there was no actual fraud.

Taxpayer is defeated in Estate of Marshall

On June 20, 2016, the Tax Court, in *Estate of Marshall v. Commissioner*[82], described the requirements for finding transferee liability under Section 6901, here specifically under Oregon law, as state law determines whether a person will be liable for federal taxes as a transferee. This case involved another Midco transaction, whereby the goal was to avoid the corporate level taxes on the disposition of the assets of a C corporation. The Tax Court held that the sale by the shareholders of their C corporation stock should be recharacterized as a sale by the C corporation of its assets and then a liquidating distribution of the sale proceeds to the shareholders of the C corporation. This recharacterization allowed the Tax Court to hold that the shareholders had transferee liability under Oregon law with respect to the tax liability recognized by the C corporation on the sale of its assets.

Taxpayers were shareholders of Marshall Associated Contractors, Inc. ("MAC"), a C corporation that operated as a construction contractor specializing in heavy construction. In 2002, MAC received a litigation award of over $40 million. Following receipt of the award, the taxpayers considered a liquidation of MAC, but decided not to pursue liquidation for tax reasons. One of the taxpayers was introduced to Fortrend International, Inc. ("Fortrend"), which represented itself as specializing in structuring transactions to solve specific corporate tax problems. Fortrend submitted a letter of intent to purchase the MAC stock. As proposed, "the stock purchase would be determined by taking the net value of the company after taxes and adding 50 percent of MAC's tax liability,"[83] which resulted in an amount greater than the

[82] T.C. Memo. 2016-199.

[83] T.C. Memo. 2016-199., at *8.

net assets of the company. Taxpayers engaged PwC and outside counsel to review Fortrend's proposal. Fortrend special purpose vehicle, Essex, would buy the MAC stock. Essex proposed to use the cash in MAC's bank account to pay the purchase price for the MAC stock. Taxpayer's advisors had concern that Essex's proposal would pull MAC into bankruptcy, and that the sale would be considered a fraudulent transaction under Bankruptcy Code Section 548. Taxpayer's outside tax counsel also researched transferee liability and communicated to the taxpayers that if Essex took steps to render MAC unable to pay its tax liability, the IRS could pursue transferee liability against the taxpayers. Accordingly, taxpayer's counsel had concerns regarding whether Essex was going to defraud creditors and carefully structured the transaction to try to avoid any potential tax problems. The taxpayers decided to sell their MAC stock to Essex under the negotiated terms despite being advised of the tax risks of the transaction.

Taxpayers had also engaged PwC to review the Essex transaction. PwC's national office reviewed the transaction and concluded that the stock sale proposed by Essex was similar to a listed transaction and that it could not consult or advise on the proposed stock sale any further. PwC tried to discourage the taxpayers from entering into the proposed stock sale. Despite PwC's concerns, taxpayer proceeded with the stock sale.

Following the stock sale, MAC filed its Form 1120 and claimed a bad debt deduction of $39 million to offset its taxable income from MAC's litigation award. Upon audit, the IRS disallowed MAC's claimed bad debt deduction and made an assessment against MAC for income tax of $15.4 million, accuracy-related penalties of $6 million, and interest of $9.5 million. After determining that MAC had no assets from which the IRS could collect, the Service issued a notice of transferee liability to taxpayers for the unpaid tax imposed on MAC. The taxpayers filed a petition in Tax Court to challenge transferee liability.

Section 6901 provides with respect to a "transferee" that taxes may "be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred" and allows for the collection of "[t]he liability, at law or in equity, of a transferee of property…of a taxpayer."[84] Section 6901 does not create the substantive tax liability but provides a procedure by which the federal government may collect taxes. The substantive liability must be found under applicable state law. The IRS may assess transferee liability under Section 6901 only if the two prongs of the section are met: (1) the party must be a transferee under federal law, and (2) the party must be subject to liability under applicable state law, either at law or in equity.

The Court looked to Oregon's Uniform Fraudulent Transfer Act since the transactions occurred in Oregon. Oregon law broadly defines "transfer" as "every mode, direct or indirect,

[84] T.C. Memo. 2016-199., at *30-31.

absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset, and includes a payment of money, a release, a lease and the creation of a lien or other encumbrance."[85] Where a debtor transfers property to a transferee and thereby avoids creditor claims, the Oregon law provides creditors with certain remedies against the transferee. Under Oregon common law, the creditor must prove a fraudulent transfer by preponderance of the evidence. The Service argued that the series of transfers among MAC, Essex, and Fortrend should be collapsed and treated as if MAC had sold its assets and then made liquidating distributions to the shareholders. Since MAC did not actually convey anything to the shareholders due to the Midco form of the transaction, the Tax Court addressed the circumstances under which the transactions could be collapsed. The Tax Court noted that Oregon courts have not addressed this type of transaction; however, the Tax Court looked to courts in jurisdictions with fraudulent transfer provisions similar to Oregon's that have collapsed transactions if the ultimate transferee had constructive knowledge that the debtor's debts would not be paid.[86] The court also noted that constructive knowledge includes "inquiry knowledge", where the initial transferee became aware of circumstances that should have led to further inquiry into the circumstances of the transaction.

In reviewing the facts, the Tax Court concluded that taxpayers and their advisors had constructive knowledge of the entire scheme: they knew that "Essex was interested in buying MAC only for its tax liability"; "that Essex intended to use high-basis low-value assets to offset MAC's income"; "that Essex intended to obtain a refund of MAC's prepaid taxes" and "Essex was splitting MAC's avoided taxes" with the taxpayers.[87] The court also commended on taxpayer's advisors, who "had a sophisticated understanding of the entire scheme – having warned the taxpayers of the risks of transferee liability and that the stock sale "was similar to a listed transaction". [88] Further, Fortrend's promotional materials referenced Notice 2001-16. Based on these facts, the Tax Court found that the taxpayers and their advisors are analogous to the advisers in Diebold, where the Second Circuit found that if the advisers knew or should have known then the transferee is deemed to have had the same knowledge and had a duty to inquire. Accordingly, the court concluded that the taxpayers were transferees of MAC.

Under Oregon law, the Tax Court concluded that the Service had a claim against MAC before the transfer occurred, that MAC did not receive reasonably equivalent value in exchange for the proceeds from the sale of its assets, and that MAC became insolvent as a result of the MAC transaction Accordingly, the Tax Court concluded that the taxpayers are liable under

85 T.C. Memo. 2016-199., at * 30.

86 *See Salus Mundi Found. V. Commissioner*, 776 F.3d 1010; *Diebold Found. V. Commissioner*, 736 F.3d 172; *Starnes v. Commissioner*, 680 F.3d 417.

87 T.C. Memo. 2016-199, at *34-35.

88 T.C. Memo. 2016-199, at 35.

Oregon law for the full amount of MAC's tax deficiency and penalty, and (2) the IRS may collect the liability from the taxpayers as transferees pursuant to Section 6901.

Conclusion

The cases discussed herein raise a fundamental question: Must a selling shareholder concern himself with a buyer's intentions to pay or avoid paying corporate taxes following the stock sale? Regardless of how we answer this question, the court in *Diebold* has expanded the concept of transferee liability, and has imposed on the selling shareholders a duty to inquire and charged them with constructive knowledge when they have been deemed not to have conducted sufficient due diligence. Additionally, even if there is an absence of constructive notice, the shareholder may be held liable as a transferee of a transferee, as in *Frank Sawyer*. Thus, at a minimum, to protect oneself, it would be prudent for the selling shareholders to obtain written representations and effective indemnification for post-closing transactions over which the selling shareholders have no control.

Lawrence M. Hill and Richard A. Nessler

New Procedures and Increased Fees for Pre-Filing Agreements

The pre-filing program "permits eligible taxpayers to request that the Service examine specific issues relating to tax returns before those returns are filed with the Service."

On May 5, 2016, the Internal Revenue Service issued Revenue Procedure 2016-30 to announce the expansion of the existing pre-filing agreement program and changing procedures for resolving issues with corporate taxpayers through pre-filing agreements. The IRS also announced a significant increase in the user fee to participate in the program.

Revenue Procedure 2016-30 revises Revenue Procedure 2009-14,[89] which outlines the procedures to resolve issues through a pre-filing agreement ("PFA"). The program permits eligible taxpayers[90] to request that the Service examine specific issues relating to tax returns before those returns are filed with the Service. The desired effect is that the Service and the taxpayer will memorialize their agreement by executing a PFA with LB&I. The PFA procedure often resolves issues more effectively and efficiently with the Service through a pre-filing examination rather than a post-filing examination, because the taxpayer and the IRS have more timely access to the records and personnel that are relevant to the issues. A pre-filing examination also provides the taxpayer with certainty regarding the examined issue at an earlier point than a post-filing examination. The procedures benefit both taxpayers and the IRS by improving the quality of tax compliance while reducing costs, burdens and delays.

The Revenue Procedure now permits an eligible taxpayer to request a PFA for the current taxable year, any prior taxable year for which the original tax return is not yet due, and for

89 2009-3 I.R.B. 324.

90 Eligible taxpayers are taxpayers under the jurisdiction of LB&I (or any successor operating division).

The user fee for the PFA is currently $50,000, but will increase to $134,300 for PFA requests submitted on or after June 3, 2016, and to $218,600 for PFA requests submitted on or after January 1, 2017.

future taxable years (limited to four taxable years beyond the current taxable year).[91] The Service will consider entering into a PFA on any issue that requires either a determination of facts or the application of well-established legal principles to known facts. The Service also will generally consider entering into a PFA regarding an accounting methodology used by a taxpayer to determine the appropriate amount of an item of income, allowance, deduction or credit. However, a PFA may not be used to obtain consent to change a taxpayer's method of accounting, except when the Service has first issued a letter ruling granting consent to make an accounting method change under Revenue Procedure 2015-13.

There is no list of eligible domestic and international issues. Any domestic or international issue that requires either a determination of facts or application of well-established legal principles to known facts is permissible. However, the Revenue Procedure identified a list of issues that a taxpayer may not request a PFA, which includes: (i) transfer pricing; (ii) reasonable cause, due diligence, good faith, clear and convincing evidence or any other similar standard under Subtitle F; (iii) issues involving the applicability of any penalty or criminal sanction, or (iv) issues that are the subject of pending litigation or issues designated for litigation. Additionally, the Service may, in its sole discretion, refuse to address an issue in a PFA based on consideration of sound tax administration.

Rev. Proc 2016-30 provides the framework within which a taxpayer and the IRS can work together in a cooperative environment to resolve, after examination, the issues accepted into the program. Unlike letter rulings and other forms of written advice provided by the Offices of the Associate Chief Counsels, however, the PFA does not determine the tax treatment of prospective or future transactions or events, but only of completed transactions or events whose tax treatment has not yet been reported on a return.

Finally, the user fee for the PFA program is currently $50,000, but will increase to $134,300 for PFA requests submitted on or after June 3, 2016, and to $218,600 for PFA requests submitted on or after January 1, 2017. A fee will be assessed for each separate and distinct issue. The user fee is required to be paid before the orientation meeting or the first substantive meeting with the taxpayer to discuss the PFA issues. Payment of the user fee must be made within 15 business days of notification that the issues have been selected for the PFA program.

Richard A. Nessler

New Procedures for Industry Issue Resolution Program

On March 26, 2016, the IRS issued Revenue Procedure 2016-19 to describe new procedures for taxpayers and other entities under the jurisdiction of the Large Business and International

91 Future taxable years will only be considered as part of a request for a PFA for the current taxable year or a prior taxable year for which the original return is not yet due and is not yet filed.

"The objective of the IIR Program is to identify and resolve through pre-filing guidance frequently disputed or burdensome tax issues that are common to a significant number of taxpayers."

(LB&I), Small Business and Self Employed (SB/SE) and Tax Exempt and Government Entities (TE/GE) Operating Divisions to submit issues for consideration under the Service's Industry Issue Resolution ("IIR") Program. The objective of the IIR Program is to identify and resolve through pre-filing guidance frequently disputed or burdensome tax issues that are common to a significant number of taxpayers. This Revenue Procedure supersedes Revenue Procedure 2003-36,[92] and updates, revises and clarifies the procedures.

The IRS announced the Industry Issue Resolution Pilot Program in 2000 to establish a procedure to address through pre-filing guidance rather than costly post-filing examination of frequently disputed tax issues. In 2002, the program was made permanent.[93]

The types of issues most appropriate for consideration under the IIR Program must have two or more of the following characteristics:

(1) The proper tax treatment of a common factual situation is uncertain;

(2) The uncertainty results in frequent, and often repetitive, examinations of the same issue;

(3) Frequent, and often repetitive, examinations require significant resources from both the IRS and impacted entities;

(4) The issue is significant and impacts a large number of entities;

(5) The issue requires extensive factual development; and

(6) Collaboration would facilitate proper resolution of the tax issue by promoting an understanding of entities' views and business practices.

The Revenue Procedure has identified the following types of issues that generally are not appropriate for consideration under the Program: (i) issues unique to one or a small number of entities; (ii) issues not under the jurisdiction of LB&I, SB/SE or TE/GE Operating Divisions; (iii) issues involving transactions that lack a bona fide business purpose, or transactions with a significant purpose of improperly reducing or avoiding federal taxes, and (iv) issues involving transfer pricing or international tax treaties. If the issue submitted is accepted, the IRS establishes an IIR team, drawn from the LB&I, SB/SE or TE/GE Operating Divisions, as well as IRS Appeals, the Office of Chief Counsel and the Treasury Department, to analyze the issue(s) and develop the appropriate guidance. The determination of the issue may result in published guidance, such as a regulation, revenue ruling, revenue procedure or notice. The request to the IIR Program is not required to be submitted in a particular format, but should include an issue statement, description of why the issue is appropriate for the IIR Program, an explanation of the need for guidance, an estimate of the number of entities affected by the issue, a description of how the requestor relates to those entities and how the issue may be

92 2003-1 C.B. 859.

93 *See* Notice 2002-20, 2002-1 C.B. 732.

resolved. The IIR Program request may be submitted at any time during the calendar year, and should be submitted by e-mail to IIR@IRS.Gov.

Richard A. Nessler

UBS Complies with IRS Summons regarding Singapore Documents

On June 22, 2016, UBS complied with a summons issued by the IRS and produced bank records regarding an account held by or on behalf of Ching-Ye Hsiaw. Account holder Hsiaw is under investigation by the IRS for failing to disclose foreign bank accounts. The IRS alleged that Hsiaw had transferred funds from a foreign account at UBS in Switzerland to UBS's Singapore branch in 2002. The IRS sought the records to determine Hsiaw's federal income tax liabilities for tax years 2006 through 2011.

UBS initially refused to turn over the account records. This led the Department of Justice to file a petition in federal district court to enforce the IRS administrative summons. The federal court had issued an order to show cause to UBS to explain why UBS should not be compelled to obey the summons. By producing the Singapore-based records responsive to the IRS's request, the Justice Department voluntarily dismissed its summons enforcement action against the bank.

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Tax Controversy and Litigation at Shearman & Sterling

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