

## The Unprecedented Extraterritorialization of Tax Crimes



### In this issue:

The Unprecedented Extraterritorialization of Tax Crimes

Circuit Court Permits Managing Partner to Raise Penalty Defense

District Court Defines “Substantially Similar” under Section 6707A

Fifth Amendment Challenge Defeats IRS Summons

Rules for Electing Into the New Partnership Audit Regime

Federal Circuit Court Denies Deductions of Forfeiture Payment

IRS Announces Changes to CAP Program

IRS Will Issue Rulings on Spin-off-Related Issues

In addition to the discussion of the recently proposed UK criminal tax legislation, this month’s issue features articles regarding the Tenth Circuit Court decision in *McNeill v. United States* discussing a managing partner’s right to raise a partner-level good faith and reasonable cause defense to penalties, the District Court’s decision in *Interior Glass*, which upheld the constitutionality of section 6707A, the Second Circuit’s decision in *United States v. Greenfield*, concluding that an IRS summons violated taxpayer’s Fifth Amendment protections against self-incrimination, the Federal Circuit’s decision in *Nacchio v. United States* which held that a forfeiture payment could not be deducted under section 162, the IRS’ recent announcement to change the CAP Program and Revenue Procedure 2016-45 that announced that the IRS will issue letter rulings on two spinoff-related areas under section 355.

### The Unprecedented Extraterritorialization of Tax Crimes<sup>1</sup>

The United Kingdom has proposed broad sweeping criminal tax legislation that is unprecedented in its extraterritorial reach, scope and application. It will affect any financial institution, corporation or other entity or person with a UK nexus.

<sup>1</sup> This article was previously published by *Tax Notes International* on August 1, 2016 and is reprinted with the permission of *Tax Notes International*.

**“The UK’s efforts are representative of increased international pressure to develop a global strategy to crack down on tax offenders.”**

The proposed legislation has received virtually no fanfare in the United States, but has profound legal and risk management implications for US multinationals and any entity or person doing business in the UK. It is representative of a growing trend of nations policing the tax and criminal activities of their citizens globally, and goes a few steps further in policing activities of non-UK taxpayers and even their agents. The legislation is also consistent with the growing trend of international law enforcement cooperation, as well as, transparency in the areas of tax compliance, money laundering, bribery and other cross-border criminal activities.

The penalties for violation of the proposed legislation are draconian and include strict liability criminal responsibility and unlimited fines, regardless of whether the alleged offender benefited from the crime.

### **Proposal Background**

In its March 2015 budget, the UK government announced the introduction of a new corporate criminal offence of “failure to prevent the criminal facilitation of tax evasion.” A public consultation ran from July to October 2015, and in December 2015 a response containing draft legislation was published. On April 17 HM Revenue & Customs published a new consultation containing revised draft legislation. The closing date for comments was July 10, 2016.

The Panama Papers disclosure coupled with Prime Minister David Cameron’s announcement at the recent global money laundering conference in London that he wants to expand the legislation to apply to general fraud and money laundering provides momentum for enacting the new rules, which could be as early as the end of the year.<sup>2</sup>

The UK’s efforts are representative of increased international pressure to develop a global strategy to crack down on tax offenders. Early efforts include the 2013 G20/OECD action plan as base erosion and profit shifting, which sought to address multinational companies’ avoiding taxation in their home countries by taking advantage of foreign tax jurisdictions. The action plan identified 15 actions to curb international tax avoidance to address BEPS. Further, the Joint International Taskforce on Shared Intelligence and Collaboration (“JITSIC”), an initiative of the OECD’s

<sup>2</sup> The author anticipates that prime Minister Theresa May and the Conservative party will continue to support this legislation and that international cooperation efforts to thwart cross-border tax evasion and abuses will not be measurably affected by Brexit.

**“The proposed legislation is modeled after the Bribery Act. . . Under the Bribery Act, corporations face strict liability for bribes paid by associated persons (defined broadly to include employees, agents, representatives or other third parties) for the benefit of the corporation.”**

Forum on Tax Administration, has been influential in developing strategies for early identification and deterrence.

On April 13, 2016, following the publication of the Panama Papers, JITSIC convened a meeting of tax administrators from 28 countries to launch an unparalleled inquiry into corporate tax evasion.

The UK has also undertaken efforts similar to the US Foreign Account Tax Compliance Act to mandate greater disclosure of foreign account information to the IRS. Following the US model, the HMRC has adopted measures that include agreements for automatic exchange of information about UK residents with foreign accounts and a tax disclosure facility to enable those with irregularities in their tax affairs to correct matters with HMRC before the exchange of information.

In conjunction with these efforts, the OECD has implemented the Common Reporting Standard (“CRS”) to facilitate the automatic exchange of taxpayer information starting in 2017. Further, both the US and the UK have implemented beneficial ownership legislation that requires companies to know and report accurate beneficial ownership information.<sup>3</sup>

The international trend in aggressive tax enforcement has given birth to the UK’s unprecedented extraterritorial proposal to criminalize conduct involving the failure to prevent the facilitation of tax evasion. The key motivator for the new offense is the difficulty in attributing criminal liability to corporations whose agents commit criminal acts in the course of their business.

Fraudulent UK tax evasion is already a crime, as is facilitation of tax evasion (accessorial liability, although a fraud facilitator, is generally also subject to principal liability). However, to attribute criminal liability to a corporation, it is necessary to demonstrate the involvement of a directing mind of the corporation, which generally requires the involvement of senior management. This standard has been difficult to satisfy; consequently, UK law has shifted towards a more aggressive paradigm.

The proposed legislation is modeled after the Bribery Act and follows the UK’s first conviction and deferred prosecution agreement for the corporate offence of failure to prevent bribery under section 7 of the act. Under the Bribery Act, corporations face

<sup>3</sup> In May 2016, the US Treasury Department’s Financial Crimes Enforcement Network issued final rules regarding beneficial owner identification obligations for legal entity customers. The UK implemented a similar disclosure regime which requires disclosure of ultimate beneficial ownership through the Small Business, Enterprise and Employment Act 2015, which amends the Companies Act 2006.

**“The provision’s jurisdictional reach is massive . . . it is immaterial whether the relevant acts or omissions related to the offence occur in the UK or abroad, or whether the entity itself benefited from the facilitation of tax evasion.”**

strict liability for bribes paid by associated persons (defined broadly to include employees, agents, representatives or other third parties) for the benefit of the corporation. The bribery offence is paired with a compliance defense in which a corporation may claim adequate procedures to preclude a bribery conviction.

### **The April 17th Consultation**

The proposed offence would find corporations criminally responsible if they fail to implement reasonable procedures to prevent their agents from facilitating a third party’s criminal offence of tax evasion. The draft legislation broadly states that this offence may be committed by a relevant body, which would include any corporation or partnership incorporated in the UK or abroad. That would reach a broad range of organizations including banks, law firms, financial advisors and non-profits.

Further, the proposal broadly defines an associated person as any individual who performs services for the relevant body without regard to their official title or location. Accordingly, agents and vendors could constitute associated persons. Any employees of a relevant body are presumptively considered to be associated persons under the statute.

Liability under the proposed offence is based upon three stages: (1) criminal tax evasion by a taxpayer; (2) criminal facilitation of this offence by an associated person of a relevant body acting on behalf of the relevant body; and (3) the relevant body’s failure to take reasonable steps to prevent those who acted on its behalf from committing the criminal act in stage 2.

That new construction of corporate liability for facilitation of tax evasion will make the relevant body criminally responsible through vicarious liability for the actions of any associated person acting on its behalf.

The jurisdictional scope of the proposed offence includes foreign corporations that facilitate evasion of UK taxes as well as any corporation with a nexus to the UK that facilitates the evasion of foreign taxes, even if no UK taxes have been evaded. The facilitation of foreign taxes are covered if it is illegal in the foreign country where taxes are payable and if it would amount to a UK offence if those same taxes were due to be paid to the UK.

The provision’s jurisdictional reach is massive, applying to any entity incorporated or formed under the law of any part of the UK, those who carry on a business from an establishment in the UK or when any act or omission constituting part of the foreign tax evasion facilitation offence takes place in the UK. Further, it is immaterial whether the relevant acts or omissions related to the offence occur in the UK or abroad, or whether the entity itself benefited from the facilitation of tax evasion.

In the UK, fraudulent or criminal tax evasion consists of “cheating the public revenue,” which is any fraudulent conduct intended to divert money from HMRC, or

**“The proposed legislation is so broad. . . [it] would put the UK in a position of interpreting and applying both its and a foreign jurisdiction’s tax laws.”**

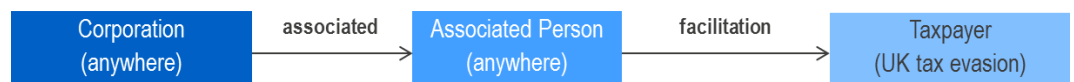
any fraudulent act in which an individual is knowingly concerned in, or takes steps with a view to, the fraudulent evasion of tax. The common element of the tax evasion offence is fraud, or dishonest conduct to evade a tax liability. Examples include the deliberate hiding of money from tax authorities so as to not pay tax due on it, deliberately submitting false tax returns and deliberately omitting to register for Value Added Tax (“VAT”) when required to do so. For purposes of the corporate failure to prevent offence, the element of the tax evasion offence must be proved to a criminal standard to have occurred, but it is not necessary that the taxpayer himself is prosecuted.

Evasion facilitations include the aiding, abetting, counseling or procuring the commission by another person to evade UK tax. As noted, this consists of accessory liability for the taxpayer’s offence, and the facilitator is also liable as a principal by virtue of being knowingly concerned in or taking steps with a view to the fraudulent tax evasion by another person. Examples of this offence include setting up hidden bank accounts and dealing in large cash payments to help hide money from tax authorities, creating false invoices to facilitate under-reporting and referring clients to service providers knowing this will help them evade tax. This element must also be proved to a criminal standard for purposes of the corporate offence.

Ultimately, for a corporation to be guilty of the criminal offence, the facilitator must be an associated person acting in that capacity. If facilitation of fraudulent tax evasion is proved to have been committed by an associate of a corporation acting as such (together with the underlying tax evasion offence), the corporation is guilty of the failure to prevent offence unless the corporation can prove it had reasonable procedures in place.

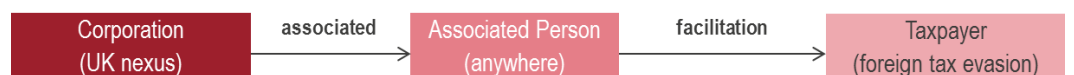
The UK tax evasion facilitation offence applies to all corporations, both foreign and UK incorporated, and the failure to prevent facilitation of an underlying UK tax evasion offence gives UK courts jurisdiction. (See Figure 1)

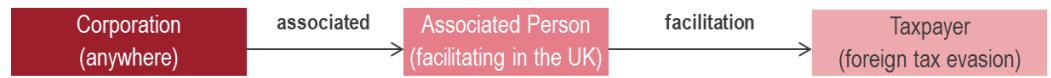
**Figure 1:**



The foreign tax evasion facilitation offence applies to corporations having a sufficient UK nexus (either U.K incorporated, carrying business in the UK or undertaking business through a UK establishment) or when part of the facilitation takes place within the UK. (See Figure 2)

**Figure 2:**





**“HMRC provides six principles to guide corporations in establishing such ‘reasonable measures’ for purposes of the new offence. These six principles should be kept in mind when designing and implementing appropriate compliance programs.”**

The proposed legislation is so broad that the UK could find itself prosecuting an alleged violation of, for example, Singapore tax law that would also constitute a violation of UK law, even if the Singapore authorities did not prosecute. That would put the UK in a position of interpreting and applying both its and a foreign jurisdiction’s tax laws. Such a prosecution would undoubtedly be challenged in court and would involve calling in legal experts to opine on the application of the foreign law to the particular facts at hand. Whether a fact-finder would deem that kind of prosecution overreaching remains to be seen.

The extensive ambit of the new offence could also mean that a corporation, even without the corporation’s knowledge of illegal activity, would be held strictly liable if individual’s associated with it were to knowingly facilitate tax evasion. There are several collateral issues that might emerge, such as whether a violation of the proposed UK law would expand the ability of jurisdictions to extradite individuals under existing extradition treaties.

**Implementation of Reasonable Procedures**

As noted, the new offence is paired with a due diligence defense similar to that in the Bribery Act. However, the new offence provides a defense for implementation of “reasonable measures” to prevent facilitation of tax evasion, compared to the seemingly stricter “adequate measures” required by the Bribery Act. HMRC provides six principles to guide corporations in establishing such “reasonable measures” for purposes of the new offence. These six principles should be kept in mind when designing and implementing appropriate compliance programs for the purpose of establishing a due diligence defense to the new offence.

The procedures corporations must establish include formal policies adopted to prevent criminal facilitation of tax evasion by its agents as well as practical steps taken by a corporation to implement these policies. They are similar to what US corporations include in their corporate compliance programs.

The first principle stresses that procedures taken to prevent facilitation of criminal tax evasion should be proportionate to a corporation’s risk profile. Those procedures must be reasonable, given those risks; burdensome procedures designed to address every conceivable risk are not required. The procedures put in place to establish a corporation’s due diligence defense should be designed to mitigate identified risks as well as prevent criminal conduct by associated persons working on behalf of the company.

The second principle emphasizes the need for top-level corporate management to be directly involved in preventing associated persons from engaging in criminal

facilitation of tax evasion. Under existing law, top-level management is considered to have incentives to turn a blind eye to that type of activity under the directing mind test.

The new guidance is intended to encourage the involvement of senior management in the decision-making process regarding risk assessment and creation of reasonable measures. This includes internal and external communication and endorsement of the corporation's position against the facilitation of tax evasion, which may take the form of a zero-tolerance policy or a specific articulation of the corporation's preventative procedures. The principle is in line with what US regulators consider the "culture" of an organization. Senior management should not only encourage good behavior, but they should also effectuate and monitor it.

The third principle requires a corporation to assess the nature and extent of its exposure to the risk that its associated persons will facilitate tax evasion. That assessment must be documented and reviewed. The guidance emphasizes that some corporations, such as those in the financial services, legal and accounting sectors, might be more affected. The measures must be updated to account for increased risk as a corporation's business and consumer base develops.

What constitutes reasonable measures may change depending on the continuously developing risk profile of a given corporation. HMRC asks that corporations closely monitor their risk, including commonly encountered risks such as Country risk, Sectorial risk, Transaction risk, Business opportunity risk and Business partnership risk.<sup>4</sup> A sufficient risk assessment under the third principle would also consider the extent of internal risk of a corporation, including weak internal structures or procedures such as deficiencies in employee training, lack of clear financial controls and lack of clear communication from top-level management.

Under the fourth principle a corporation should apply sufficient due diligence procedures for those who will conduct business for and with them. The guidance stresses that a corporation's previous diligence procedures may be insufficient to identify the risk of tax evasion facilitation. Consistent with the first principle, the due diligence measures put in place should be proportionate to identified risks.

Accordingly, some corporations in high risk sectors may have to have a relatively high level of due diligence measures in place compared to those corporations operating in sectors with less risk.

<sup>4</sup> Those are commonly encountered risks articulated in the Bribery Act guidance.



The fifth principle asks that corporations ensure that any developed procedures are widely understood through extensive communication and training. A developed procedure might not be sufficiently reasonable if it is not embedded within the corporation. As such, corporations should take extensive measures to ensure that their associated persons are aware of any measures taken. Internal communications should clearly convey the corporation's zero tolerance policy for the facilitation of illegal tax evasion and the consequences for noncompliance.

The sixth principle focuses on the ongoing monitoring and review of a corporation's preventative procedures. That process includes progressive improvements of procedures if the corporation identifies increased risk or insufficient processes. The guidance suggests that corporations might seek internal feedback, have formalistic reviews or work with third parties to monitor the status of preventative procedures.

These principles are intended to be illustrative and do not spell out measures to be taken for every company; the guidance stresses the importance of tailoring the measures to the risk and needs of each company. The reasonable standard provides companies with more forgiveness than the Bribery Act's requirement of "adequate procedures" but it is important that companies implement thorough studies of their risk profiles in order to shield against liability.

#### **Extension to Other Crimes**

On May 12, the UK's Ministry of Justice announced its intent to extend the corporate offense to failure to prevent economic crimes such as fraud and money laundering, but it is unclear which offences would be considered economic crimes. The increasing trend of aggressive international enforcement of tax evasion following the leak of the Panama Papers makes it likely that the proposed offense will become law.

This extension of the new offense would further increase the compliance burden companies face to prevent the facilitation of tax evasion. While the precise terms of the new offence are unknown, it will likely be similar to the terms of the tax evasion offense. Therefore, companies should take into account the increased focus on compliance measures and take preventative measures to identify their risk profiles.

This will include:

- developing a global tax compliance policy and global tax principles consistent with consultation, FATCA and BEPS principles and designed to improve relations with regulators;
- applying policies and procedures regarding identified tax risks and extending them to employees, agents and outside service providers;
- identifying potential material tax risks both locally and globally and implementing mechanisms to mitigate customer, employee, agent and counterparty risks;



**“The proposed UK criminal offence of failure to prevent the facilitation of tax evasion may appear extreme . . . It does not appear to be aberrational, however, but instead seems to be the wave of the future.”**

- combining procedures to avoid the facilitation of tax evasion with those intended to counteract money laundering, bribery, and fraud; data privacy and protection; and other interrelated policies and procedures, including creating a cross-disciplinary team of in-house legal and compliance experts and outside counsel to orchestrate the implementation of, training on, and monitoring those procedures;
- creating, promulgating and enforcing a top-down culture designed to encourage compliance with policies and procedures; uncover wrongdoing; define acceptable business risks; identify and mitigate against material risks; and ensure employee the effectiveness, productivity and satisfaction—including a reward system for those who comply and sanctions for those who do not; and extending know-your-customer procedures to agents, professional advisors and counterparties.

### **Conclusion**

The proposed UK criminal offence of failure to prevent the facilitation of tax evasion may appear extreme and will likely be challenged should it be enacted. It does not appear to be aberrational, however, but instead seems to be the wave of the future. The globalization of business combined with the globalization of criminal activity has necessitated international coordination and cooperation among disparate nations and regulatory schemes. The UK and other nations clearly understand that financial crime in jurisdictions other than their own can affect their economies and enforcement efforts, resulting in unforeseen long-arm statutes and regulations. Other nations are monitoring the proposed UK legislation and are likely to enact similar measures.

Early efforts to implement appropriate mechanisms to mitigate tax, criminal, civil and reputational risks and to develop efficacious compliance programs to successfully assert a due diligence defense will not result in wasted resources. That has been demonstrated by the fallout resulting from the failure of numerous companies to comply with the Bribery Act years after its implementation. Proactive planning will significantly mitigate tax and criminal exposure and reputational risk in the burgeoning arena of extraterritorial tax enforcement.

*Lawrence M. Hill*

## Circuit Court Permits Managing Partner to Raise Penalty Defense

On September 6, 2016, the United States Court of Appeals for the Tenth Circuit reversed a district court and held that the managing partner of a partnership was not precluded from raising a partner-level good faith and reasonable cause defense to penalties resulting from a TEFRA partnership audit.<sup>5</sup> The district court had ruled that it was precluded from considering the manager partner's defense because the TEFRA statute precludes a managing partner from pursuing at the partner level a reasonable cause/good faith defense where the IRS has rejected the partnership's assertion of reasonable cause/good faith at the partnership level. Although the Tenth Circuit reversed the District Court, the decision was not unanimous.

### Background

Upon retirement as a utility company executive, taxpayer McNeill expected to receive an \$18 million payment. In an effort to reduce any tax on the payout, McNeill created a series of partnerships, based on advice of tax counsel, who purchased underwater debt instruments for little money. McNeill was the managing partner of the relevant partnership and owned over 90% of the partnership. McNeill later sold the debt instruments and claimed a \$20 million loss, which offset his \$18 million in income received upon retirement. McNeill obtained opinion letters from various accounting and law firms concluding that the transaction would withstand IRS scrutiny. The IRS conducted a TEFRA audit of the partnership, concluded that McNeill's true basis in the debt was the modest amount he contributed to the partnership and denied the loss. The IRS also imposed penalties and interest. Under TEFRA, McNeill as the tax matters partner sought judicial review of the IRS's partnership level determination, but the matter was dismissed by the district court and McNeill never sought to reinstate it.

The IRS thereafter issued a deficiency to McNeill and determined that McNeill's share of the partnership liability was \$7.75 million. McNeill paid the liability and sued for a partial refund, arguing that he should be excused from penalties and associated interest because he had "reasonable cause" and he filed his tax return in "good faith."<sup>6</sup> McNeill's bases for his defense were the opinions he received from his accountants and lawyers that the transaction was legitimate.<sup>7</sup>

**"The district court concluded that the TEFRA statute precluded it from reviewing McNeill's defense because McNeill was a managing partner and the IRS had rejected the partnership's assertion of reasonable cause at the partnership level."**

<sup>5</sup> See *McNeill v. United States*, 14 cv 00174 (10th Cir. [Sept. 6, 2016]).

<sup>6</sup> Slip Opn. at 5.

<sup>7</sup> *Id.*

**The Circuit Court applied a plain reading to the statute and said . . . “[n]othing in the last sentence of the statute carves out managing partners and prevents them alone from taking advantage of its terms.”**

### **District Court Ruling**

The district court declined to decide the merits of McNeill’s partner level defense. The district court concluded that the TEFRA statute precluded it from reviewing McNeill’s defense because McNeill was a managing partner and the IRS had rejected the partnership’s assertion of reasonable cause at the partnership level.

On appeal, the Tenth Circuit reversed and concluded that the district court had misread the TEFRA statute. The relevant portion of TEFRA states:

No review of substantive issues.--For purposes of any claim or suit under this subsection, the treatment of partnership items on the partnership return, under the settlement, under the final partnership administrative adjustment, or under the decision of the court (whichever is appropriate) shall be conclusive. In addition, the determination under the final partnership administrative adjustment or under the decision of the court (whichever is appropriate) concerning the applicability of any penalty . . . which relates to an adjustment to a partnership item shall also be conclusive. Notwithstanding the preceding sentence, the partner shall be allowed to assert any partner level defenses that may apply or to challenge the amount of the computational adjustment.<sup>8</sup>

### **Analysis of Section 6230**

The Circuit Court applied a plain reading to the statute and said that a partner, including “any” partner may raise a partner level defense to challenge the amount of the tax adjustment. According to the circuit court “Congress pretty clearly seemed to contemplate a regime in which any partner may assert any ‘partner level defenses’ that may apply.”<sup>9</sup> But the Government argued that it is inappropriate to allow the managing partner to pursue a good faith defense at the partner level when the partnership already raised a good faith defense because often it’s the managing partner’s good faith that is tested and evaluated at the partnership level. But the Circuit Court rejected the Government’s argument, stating that “[n]othing in the last sentence of the statute carves out managing partners and prevents them alone from taking advantage of its terms.”<sup>10</sup> The court noted that “if Congress had wished to single out managing partners for special treatment, it could have done so—as it has done for other types of partners in other settings. *See, e.g.,* section 6231(a) (defining tax matters partner, notice partner, pass-thru partner, etc.)”<sup>11</sup>

<sup>8</sup> IRC § 6230(c)(4).

<sup>9</sup> Slip Opn. at 7.

<sup>10</sup> Slip Opn. at 7.

<sup>11</sup> Slip Opn. at 8.

The Circuit Court’s conclusion that section 6230 does not carve out the managing partner was further supported by the government’s own implementing regulations. Treasury regulation 301.6221-1(c) expressly indicates that section 6664(c)(1)’s reasonable cause/good faith defense is not a “partnerships item” but something more appropriately determined at the partner level. The court also noted that while the government’s argument would yield a more efficient process, “any claim of efficiency” cannot substitute for “the statute’s text and structure.”<sup>12</sup>

The court also found that judicial precedent disfavored a reading of section 6230 that carved- out managing partners. In *Woods*, the Supreme Court suggested that under TEFRA a partner’s reasonable cause and good faith defenses cannot be “conclusively” determined at the partnership level.<sup>13</sup> And the lower court cases provided little support for the government. In *Stobie Creek Investments, LLC v. United States*,<sup>14</sup> the partnership argued that “the partnership-level trial should resolve conclusively the reasonable cause defenses of each of the individual partners.”<sup>15</sup> Meanwhile, in *Stobie Creek* the government (consistent with the regulations) argued that the reasonable cause/good faith defense is more properly adjudicated at the partner level—and the court agreed, for the court proceeded to hold that TEFRA “explicitly disallows adjudication of partner-level defenses” like reasonable cause/good faith “in a partnership-level proceeding.”<sup>16</sup> Much the same story played out in *Klamath Strategic Investment Fund ex rel. St. Croix Ventures v. United States*,<sup>17</sup> where the government again argued that the reasonable cause/good faith defense “is a partner-level defense that can only be asserted in separate refund proceedings.”<sup>18</sup> Accordingly, the circuit court reversed and remanded the matter to the district court to consider the merits of McNeill’s reasonable cause and good faith defense to penalties.

Judge Phillips dissented and voted to affirm the district court’s decision. The dissent rested on the fact that McNeill’s defense based on reasonable cause was already evaluated at the partnership level, because the partnership-level defense was based on McNeill’s conduct and state of mind. Judge Phillips said that he saw “nothing in 26

<sup>12</sup> Slip Opn. at 12.

<sup>13</sup> See *United States v. Woods*, 134 S. Ct. 557 at 564 (2013).

<sup>14</sup> 82 Fed. Cl. 636 (2008).

<sup>15</sup> *Id.* at 658.

<sup>16</sup> *Id.*

<sup>17</sup> 568 F.3d 537, 548 (5th Cir. 2009).

<sup>18</sup> *Id.* at 547.

**“Interior Glass argued that section 6707A is void as unconstitutionally vague because no reasonable person, including the IRS, could know the meaning of the phrase ‘substantially similar.’”**

U.S.C. § 6230(c)(4) announcing a rule that all partner-level defenses automatically fully escape the effects and underpinnings of FPAA’s partnership-level determinations of penalties and interest.”<sup>19</sup>

The importance of *McNeill* may be diminished in light of recent legislation regarding future partnership audits. Congress recently revised the program for auditing partnerships to permit the IRS to recoup taxes from the partnership itself rather through the individual partners.<sup>20</sup>

*Richard A. Nessler*

### **District Court Defines “Substantially Similar” under Section 6707A**

On August 12, 2016, the United States District Court for the Northern District of California held that the taxpayer who invested in a group life insurance plan was liable for penalties under section 6707A (listed transaction penalty) for failure to disclose its participation in a group term life insurance transaction for years 2009 through 2011.<sup>21</sup> The taxpayer, Interior Glass, filed a refund action seeking the recovery of the section 6707A penalty. Interior Glass argued, in part, that section 6707A is unconstitutionally vague, and therefore void. Taxpayer’s vagueness argument focused on the phrase “substantially similar,” as incorporated into section 6707A.

#### **Background**

In 2006, Interior Glass purchased an insurance product, known as the Insured Security Program (“ISP”), which claimed that the employer could deduct the insurance premium paid on behalf of an employee, while the employee would not have to report any compensation income from the premiums paid on his behalf.<sup>22</sup> The ISP was marketed by Lawrence Cronin.

In 2007, the IRS targeted programs similar to the ISP and identified them as “abusive trust arrangements.” To regulate the ISP, the IRS issued Notice 2007-83 providing that abusive trust arrangements are transactions identified as “listed transactions” under the Internal Revenue Code. In response to the notice, Cronin developed a new program that he believed would not be subjected to the disclosure requirements. He founded a

<sup>19</sup> Dissenting Opn., at 6.

<sup>20</sup> See Bipartisan Budget Act of 2015, Pub. L. No. 114-74.

<sup>21</sup> See *Interior Glass Systems, Inc. v. United States*, 13 cv 5563 (D.C. Cal. [August 29, 2016]).

<sup>22</sup> Slip Opn. at 1.

**The court noted that section 6707A must be read in conjunction with Notice 2007-83, because “it is there that the Secretary identified certain trust arrangements claiming to be welfare benefit funds and involving cash value life insurance policies” as “tax avoidance transactions.”**

tax-exempt business league called the Association for Small Closely-Held Business Enterprises, which offered a group term life insurance plan (“GTLP”) to its member-companies/employers.<sup>23</sup> In 2009, Interior Glass purchased the GTLP and was told that the GTLP was not a “listed transaction” subject to disclosure under Notice 2007-83.<sup>24</sup> Thus, Interior Glass did not disclose its participation in the GTLP for the 2009, 2010 and 2011 tax years. In 2012, the IRS imposed penalties under section 6707A because Interior Glass failed to disclose its participation in the GTLP, which the Service determined was a “listed transaction” subject to disclosure under Notice 2007-83. Interior Glass paid the penalty and sought a refund of the tax penalties assessed and collected under section 6707A.<sup>25</sup>

Interior Glass argued that section 6707A is void as unconstitutionally vague because no reasonable person, including the IRS, could know the meaning of the phrase “substantially similar.” Taxpayer argued that the statute’s vagueness allows “any low level” IRS employee to determine that different policy plans are “substantially similar,” therefore facilitating the imposition of penalties. Taxpayer’s argument was premised on the Fifth Amendment’s Due Process Clause which requires that a penal statute define the criminal offense with sufficient definiteness that ordinary people can understand what conduct is prohibited and in a manner that does not encourage arbitrary and discriminatory enforcement. The government argued that section 6707A is not unconstitutionally vague since Notice 2007-83 describes a “listed transaction” in detail, and explicitly provides for “substantially similar” transactions, incorporating the definition for that phrase in Treasury Reg. 1.6011-4(c)(4).<sup>26</sup>

#### **Section 6707A Is Not Unconstitutionally Vague**

The District Court first looked to the phrase “substantially similar” as it appears in section 6707A(c)(2), which section defines a “listed transaction” as “a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011.” By its definition, the court noted that section 6707A must be read in conjunction with Notice 2007-83, because “it is there that the Secretary identified certain trust arrangements claiming to be welfare benefit funds and involving cash value life insurance policies” as “tax avoidance transactions” and “listed transactions

<sup>23</sup> Slip Opn. at 2.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> Slip Opn. at 6 – 7.

for purposes of § 1.6011-4(b)(2) . . . and §§ 6111 and 6112.”<sup>27</sup> Notice 2007-83 defines a “listed transaction” with four specific elements, and provides that “[a]ny transaction that has all of the [] elements, and any transaction that is substantially similar to such a transaction, are identified as ‘listed transactions’ . . .” Notice 2007-83 applies to “listed transactions,” which are defined as:

Any transaction that has all of the following elements, and any transaction that is substantially similar to such a transaction, are identified as “listed transactions” for purposes of section 1.6011-4(b)(2) and sections 6111 and 6112, effective October 17, 2007, the date this notice is released to the public:

- 1.The transaction involves a trust or other fund described in section 419(e)(3) that is purportedly a welfare benefit fund.
- 2.For determining the portion of its contributions to the trust or other fund that are currently deductible the employer does not rely on the exception in section 419A(f)(5)(A) (regarding collectively bargained plans).
- 3.The trust or other fund pays premiums (or amounts that are purported to be premiums) on one or more life insurance policies and, with respect to at least one of the policies, value is accumulated:
- 4.The employer has taken a deduction for any taxable year for its contributions to the fund with respect to benefits provided under the plan (other than post-retirement medical benefits, post retirement life insurance benefits and child care facilities) that is greater than the sum of the following amounts.

According to the court, because Notice 2007-83 lists specific elements to which an arrangement can be compared to determine whether it is “substantially similar” to a “listed transaction,” section 6707A does not “effectively require[] the taxpayer [to] guess what arguments (and what revised facts) the IRS might come up with in the future to allege that two different items are ‘substantially similar.’”<sup>28</sup> Accordingly, the court concluded that the language of section 6707A was sufficient to withstand constitutional scrutiny.<sup>29</sup>

<sup>27</sup> *Id.* at 7.

<sup>28</sup> *Id.*

<sup>29</sup> See *Village of Hoffman Estates*, 455 U.S. 489 (1982).



Interior Glass also argued that even though section 6707A is silent, it is a penal statute which implies a requirement of mens rea. The Government argued that section 6707A allows for a strict liability penalty, and thus taxpayer's knowledge or advice provided is irrelevant. The court agreed with the government that section 6707A provided for a strict liability penalty, and distinguished the case law cited by the taxpayer.<sup>30</sup>

Accordingly, the court concluded that Interior Glass's state of mind or any advice it received was irrelevant to the imposition of the section 6707A penalty.

*Richard A. Nessler*

### **Fifth Amendment Challenge Defeats IRS Summons**

On August 4, 2016, the United States Court of Appeals for the Second Circuit reversed and vacated a District Court order compelling toy importer Steven Greenfield to produce documents of family offshore bank accounts to the IRS, concluding that the government failed to show how such a request didn't violate Fifth Amendment protections against self-incrimination.<sup>31</sup> The Circuit Court vacated an order by Manhattan US District Judge Alvin K. Hellerstein that required Greenfield to turn over records detailing what the IRS believed to be at least \$30 million in family money held in an offshore account in a Liechtenstein financial institution. The Circuit Court found that the IRS failed to satisfy the requirements of the "foregone conclusion" doctrine, which eliminates Fifth Amendment protections against document summonses when the government can safely assume the necessary existence, control and authenticity of the documents.

#### **Background**

In 2008, Heinrich Kieber, an employee of Liechtenstein Global Trust ("LGT"), leaked thousands of documents from foreign accounts held at LGT. Steven Greenfield, who owns a toy company with operations worldwide, was one of the individuals implicated by Kieber's disclosure of LGT documents. Only a few of the documents disclosed by Kieber addressed the Greenfield's connections to offshore banking directly. These included a March 27, 2001 memorandum from LGT personnel that detailed a meeting in Liechtenstein between the Greenfields and LGT employees and an end of 2001 account statement issued on January 1, 2002 for the Maverick Foundation ("Maverick"). The LGT Memo describes a March 23, 2001 meeting with the

**The Circuit Court found that the IRS failed to satisfy the requirements of the "foregone conclusion" doctrine.**

<sup>30</sup> *Id.* at 8-9.

<sup>31</sup> See *United States v. Greenfield*, 15-543 (2d Cir. [August 1, 2016]).

Greenfields. According to the LGT Memo, Maverick was established in January 1992 and, as of the meeting, held \$2.2 million in cash as well as all the stock of TSF Company Limited (“TSF”) and Chiu Fu, which had been formed to channel assets into Maverick. In the memo, Harvey Greenfield, father of appellant-taxpayer Steven Greenfield, is described as the “sole beneficiary of the Maverick Foundation,” with Steven Greenfield holding a “power of attorney to give instructions” over Maverick. It also states that each of the Greenfields held US passports and lived, part time, in New York City.<sup>32</sup>

Greenfield never reported income from or ownership of Maverick, Chiu Fu, TSF or the trust. The IRS selected Greenfield’s 2005 income tax return for civil audit and, on May 17, 2013, issued an IDR for a number of documents with the audit (which was later expanded to include the 2006 tax year). Thereafter, on June 17, 2013, the IRS issued a summons that required Greenfield to appear on July 26, 2013 to produce documents (“Summons”). The Summons called for Greenfield to produce documents, in part, “relating to both domestic and foreign bank accounts” over which “Steven Greenfield exercised control during the years 2001 through 2011.” This request required Greenfield to produce “all documents” in his possession for the LGT account. Greenfield objected to the breadth of the Summons; the IRS later agreed to limit the Summons to documents for the 2001 through 2006 tax years. Greenfield continued to refuse to comply with the Summons. The government then brought this enforcement action in October 2014. Greenfield responded with a motion to quash, arguing, in relevant part, that the compelled production of the documents sought would violate his Fifth Amendment right against self-incrimination.

The Government asserted that under *Fisher v. United States*<sup>33</sup> “the act of producing these documents did not violate the Fifth Amendment because it was a foregone conclusion that the documents existed, that Greenfield had control over the documents and that the documents were authentic.”<sup>34</sup> The District Court granted the enforcement of the Summons and denied Greenfield’s motion to quash. The District Court relied in part on *United States v. Gendreau*,<sup>35</sup> where another district court had granted enforcement of a summons based on the LGT disclosure because “the Government

<sup>32</sup> Slip Opn. at 5-6.

<sup>33</sup> 425 U.S. 391 (1976).

<sup>34</sup> Slip Opn. at 9.

<sup>35</sup> No. 12 Misc. 303, 2014 WL 464754 (S.D.N.Y. Jan. 22, 2014).

**“In framing the issue, the Circuit Court said . . . we must examine whether the LGT Documents independently establish the communicative elements inherent in Greenfield’s production of the sought records or whether Greenfield’s production of the documents is a necessary part of the chain of potentially incriminatory evidence.”**

had specific knowledge of the accounts and the individual who controlled the accounts.” Greenfield appealed the decision to the Circuit Court.

### **Circuit Court Applies US Constitution**

While noting that the annual loss of tax revenue at the hands of offshore accounting at \$35 billion, US Circuit Judge Guido Calabresi wrote that curtailing tax evasion “nevertheless cannot warrant the erosion of protections that the Constitution gives to all individuals, including those suspected of hiding assets offshore.”<sup>36</sup> In framing the issue, the Circuit Court said that the “question before us . . . is whether the instant case is more like *Fisher* or *Hubbell*.<sup>37</sup> That is, we must examine whether the LGT Documents independently establish the communicative elements inherent in Greenfield’s production of the sought records or whether Greenfield’s production of the documents is a necessary part of the chain of potentially incriminatory evidence.”<sup>38</sup> Greenfield argued both that (1) the Government has not established with reasonable particularity the existence, control and authenticity of the sought documents as of the documents’ creation beginning in 2001, and (2) assuming arguendo that the Government could demonstrate this as of 2001, it cannot point to any evidence that the documents remained in Greenfield’s control through to 2013, when the Summons was issued.<sup>39</sup>

The Circuit Court found that the Government had in fact established the existence and Greenfield’s control over certain documents relating to offshore accounts, but decided it had not done the same to prove authenticity. Citing the government’s intent to call current or former bank employees of LGT or Kieber for such purposes, the court said it had not proffered evidence that those individuals would be willing to testify, nor was it a foregone conclusion “that foreign financial institutions and jurisdictions will cooperate with authentication requests.”<sup>40</sup> The court held that the Government “must provide more than speculation as to how authentication would occur.”<sup>41</sup>

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<sup>36</sup> Slip Opn. at 2.

<sup>37</sup> *Fisher v. United States*, 425 U.S. 391 (1976); *States v. Hubbell*, 530 U.S. 27 (2000).

<sup>38</sup> Slip Opn. at 13.

<sup>39</sup> Slip Opn. at 17.

<sup>40</sup> Slip Opn. at 22.

<sup>41</sup> *Id.*

**“The regulations are applicable to any partnership that desires to elect to have the new partnership audit regime apply to its returns filed for taxable years beginning after November 2, 2015 and before January 1, 2018.”**

### **Rules for Electing Into the New Partnership Audit Regime**

On August 4, 2016, the Internal Revenue Service issued temporary regulations regarding the time, place and manner for a partnership to elect to apply the new partnership audit regime established by the Bipartisan Budget Act of 2015. The regulations are applicable to any partnership that desires to elect to have the new partnership audit regime apply to its returns filed for taxable years beginning after November 2, 2015 and before January 1, 2018. The regulations took effect on August 5, 2016.

#### **The Bipartisan Budget Act of 2015**

The Bipartisan Budget Act of 2015 (the “BBA”), which was signed into law in November 2015, includes sweeping changes to the rules governing federal tax audits of entities treated as partnerships for US federal income tax purposes. The new rules replace the long-standing regimes for auditing partnerships under the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”) and the Electing Large Partnership (“ELP”) rules. The new rules allow the Internal Revenue Service (the “IRS”) to deal with only a single “partnership representative,” similar to the tax matters partner under TEFRA, during an audit and any related court cases. Unless a partnership elects out, the new rules impose an entity-level tax on the partnership at the highest rate of tax in effect for the reviewed year (subject to potential reduction) for any understatements of partnership income. The purpose of the new rules is to streamline partnership audits under a single set of rules and to make it easier for the IRS to assess and collect tax after a partnership audit. Importantly, the new audit regime will apply only to partnership tax returns filed for taxable years beginning after December 31, 2017 unless a partnership elects to apply them to an earlier taxable year. The temporary regulations issued on August 4, 2016 provide guidance on how a partnership can elect to have the new partnership audit regime apply to returns filed after November 2, 2015 (the date of the enactment of the BBA), and before January 1, 2018. During this interim period, an election by a partnership is only valid if made in accordance with the requirements of the temporary regulations set forth in section 301.9100-22T, and an election, once made, may only be revoked with consent of the IRS. A partnership may not request an extension of time for making an election described in section 301.9100-22T.

**“Temporary regulations set forth in section 301.9100-22T provide the time, form and manner for a partnership to make an election pursuant to the BBA.”**

### **Temporary Regulations**

Temporary regulations set forth in section 301.9100-22T provide the time, form and manner for a partnership to make an election pursuant to the BBA. An election under section 301.9100-22T must be made within 30 days of the date of notification to a partnership, in writing, that a return of the partnership for an eligible taxable year has been selected for audit.<sup>42</sup> The notice of selection for examination referred to in section 301.9100-22T(b) is a notice that precedes the notice of an administrative proceeding required under section 6231(a) as amended by the BBA. A written statement with the words “Election under Section 1101(g)(4)” written at the top of the statement will satisfy the notice requirements.<sup>43</sup> The statement must be provided to the individual identified in the notice of selection for examination as the IRS contact for the examination. The written statement must be dated and signed by the tax matter partner, as defined under section 6231(a)(7), and the applicable regulations, or signed by a person who has the authority to sign the partnership return for the taxable year under examination.<sup>44</sup> The fact that an individual dates and signs the written statement is deemed to be prima facie evidence that the individual is authorized to make the election on behalf of the partnership.<sup>45</sup>

The written statement must include the following:

- (i) The partnership’s name, taxpayer identification number and the partnership taxable year for which the election is made;
- (ii) The name, taxpayer identification number, address and daytime telephone number of the individual who signs the statement;
- (iii) Language indicating that the partnership is electing application of section 1101(c) of the BBA for the partnership return for the eligible taxable year identified in the notice of examination;
- (iv) Information necessary to properly designate the partnership representative, including the name, taxpayer identification number, address and daytime telephone number of the representative as well as any additional information required by applicable regulation and other guidance issued by the IRS.

<sup>42</sup> See 301.9100-22T(b).

<sup>43</sup> See 301.9100-22T(b)(2).

<sup>44</sup> See 301.9100-22T(b)(2)(ii).

<sup>45</sup> *Id.*

The statement must also include the following representations:

- (i) The partnership is not insolvent and does not reasonably anticipate becoming insolvent before resolution of any adjustment with respect to the partnership taxable year for which the election is being made;
- (ii) The partnership has not filed, and does not reasonably anticipate filing, voluntarily a petition for relief under title 11 of the United States Code;
- (iii) The partnership is not subject to, and does not reasonably anticipate becoming subject to, an involuntary petition for relief under title 11 of the United States code; and
- (iv) The partnership has sufficient assets, and reasonably anticipates having sufficient assets, to pay a potential imputed underpayment with respect to the partnership taxable year at issue.

The person who signs the statement must sign under the penalties of perjury and represent that the individual is duly authorized to make the election and that, to the best of the individual's knowledge and belief, all of the information contained in the statement is true, correct and complete. Upon receipt of the written election, the IRS will promptly mail a notice of administrative proceeding to the partnership and the partnership representative, as required under Section 6231(a)(1).

Section 301.9100-22T(c) provides an exception to the general rule regarding the election only after first receiving a notice of selection for examination. A partnership that has not been issued a notice of selection for examination may still make the election with respect to a partnership return for an eligible taxable year for the purpose of filing an administrative adjustment request ("AAR") under section 6227, as amended by the BBA. However, an election under 301.9100-22T(c) by a partnership that has not been issued a notice of selection for examination may not make the election before January 1, 2018. The Treasury Department and the IRS intend to issue guidance regarding AARs under section 6227 as amended by the BBA before January 1, 2018.

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### **Federal Circuit Court Denies Deductions of Forfeiture Payment**

On June 10, 2016, the United States Court of Appeals for the Federal Circuit held that Joseph Nacchio ("Nacchio") could not claim a tax deduction based on a prior court-

**“Nacchio argued that his loss was deductible under both section 165 and section 162.”**

ordered forfeiture payment of \$44 million following a jury verdict that found him guilty on nineteen counts of insider trading.<sup>46</sup> Nacchio, the former CEO of Quest Communications, was convicted in April 2007 of insider trading-related counts based on the federal prosecutor’s allegations that he sold \$52 million in Quest stock in 2001 when he knew, but did not disclose publicly, that Quest was unlikely to continue to meet its earnings targets. In addition to the forfeiture payment, Nacchio was ordered to pay a criminal fine of \$19 million and serve a 70-month criminal sentence.<sup>47</sup>

### **Background**

In 2009, following his conviction and forfeiture payment, Nacchio filed an amended federal tax return for 2007, claiming a nearly \$18 million tax credit under IRC section 1341 based on the forfeiture payment. In January 2011, Nacchio entered into a settlement in connection with a concurrent action brought by the SEC. The SEC settlement required Nacchio to disgorge his \$44 million trading profit in Quest stock, but gave him credit for his forfeiture payment to the United States, which satisfied Nacchio’s disgorgement obligation to the SEC. Thereafter, the Department of Justice notified prior participants in private securities class action litigation or SEC civil litigation concerning Quest stock that they were eligible to receive a remission from Nacchio’s forfeiture. In 2012, the chief of the Asset Forfeiture and Money Laundering authorized payment of the forfeited funds to eligible victims of Nacchio’s fraud.

In 2012, Nacchio commenced this action before the Court of Federal Claims seeking a tax credit for his forfeiture payment. The parties agreed to litigate cross-motions for summary judgment prior to discovery. The government argued that: (1) IRC section 162(f) barred any deduction under either section 165 or section 162, and (2) even if the loss caused by the forfeiture was a deductible loss under section 165 or section 162, Nacchio was estopped from seeking the special tax relief authorized by section 1341 because his criminal conviction was conclusive with respect to his state of mind. Nacchio argued that his loss was deductible under both section 165 and section 162 and that the question of whether it appeared that he had an unrestricted right to his trading profits in 2001 was not actually litigated in his criminal trial.

### **Court of Federal Claims rules for Taxpayer**

The Court of Federal Claims denied the government’s motion for summary judgment and granted-in-part Nacchio’s motion for partial summary judgment. The court held

<sup>46</sup> *Nacchio v. United States*, 824 F.3d 1370 (Fed. Cir. 2016)

<sup>47</sup> *Id.* at 1373.



**The trial court found that “Nacchio’s forfeiture was used for a compensatory purpose” because, even if not characterized as restitution, the amounts paid ultimately were returned to victims of Nacchio’s crimes through remission.**

that Nacchio’s forfeiture payment was deductible under section 165. The court expressly rejected the government’s argument that deduction of the forfeiture was barred by section 162(f). The court reasoned that, unlike the \$19 million criminal fine, which was clearly punitive and was paid from assets unrelated to insider trading, the forfeiture “exclusively represented the disgorgement of Mr. Nacchio’s illicit net gain from insider trading.”<sup>48</sup> In addition, the court found that “Nacchio’s forfeiture was used for a compensatory purpose” because, even if not characterized as restitution, the amounts paid ultimately were returned to victims of Nacchio’s crimes through remission.<sup>49</sup> In a footnote, the court rejected Nacchio’s attempt to deduct his forfeiture under section 162 as an “ordinary and necessary business expense.”<sup>50</sup> The court then rejected the government’s argument that Nacchio was collaterally estopped from pursuing special relief under section 1341. The government appealed and Nacchio cross-appealed.

On appeal, the circuit court viewed the relevant question regarding deductibility to be whether Nacchio’s criminal forfeiture was a “fine or penalty” under section 162(f). Following a *de novo* review, the circuit court held that Nacchio’s forfeiture payment was not deductible because it constituted a fine or penalty under section 162(f).

#### **Forfeiture is Ruled a “Penalty”**

First, the circuit court looked to the Tenth Circuit’s holding (Nacchio’s criminal appeal), that Nacchio’s forfeiture should be calculated in accordance with section 981(a)(2)(B),<sup>51</sup> not section 981(a)(2)(A).<sup>52</sup> Section 981(a)(2)(B) states that: “[T]he term ‘proceeds’ means the amount of money acquired through the illegal transactions resulting in the forfeiture, less the direct costs incurred in providing the goods or services. . . . The direct costs shall not include . . . any part of the income taxes paid by the entity.”<sup>53</sup> According to the language of the statute, the circuit court concluded that the forfeiture amount does not account for taxes paid on the amount of money acquired through the illegal transactions.

<sup>48</sup> *Id.* at 1376.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> 28 U.S.C. § 981(a)(2)(B).

<sup>52</sup> 28 U.S.C. § 981(a)(2)(A).

<sup>53</sup> 28 U.S.C. § 981(a)(2)(B).

Next, the circuit court looked to Treasury Regulation § 1.162-21(b)(1) which defines “fine or similar penalty” for the purposes of section 162(f) as including, *inter alia*, “an amount—(i) Paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding.”<sup>54</sup> Citing *Colt Industries, Inc. v. United States*,<sup>55</sup> courts have looked to the Treasury Regulation’s definition of a “fine or similar penalty” in denying deductions a taxpayer sought under section 162(a) for civil penalties paid to a state for violations of the Clean Water Act and the Clean Air Act. In *Nacchio*, the circuit court concluded that Nacchio’s criminal forfeiture met the definition of a “fine or similar penalty” under Treasury Regulation § 1.162-21(b)(1). Nacchio’s criminal forfeiture was imposed pursuant to 18 U.S.C. § 981(a)(1)(C) and 28 U.S.C. § 2461(c), as part of his sentence in a criminal case. Section 981(a)(1)(C), as amended by the Civil Asset Forfeiture Reform Act of 2000,<sup>56</sup> authorizes the forfeiture of “proceeds” traceable to numerous felony offenses, including any offense constituting “specified unlawful activity” as defined by 18 U.S.C. § 1956(c)(7)(A). Section 1956(c)(7)(A), in turn, defines “specified unlawful activity” as any act or activity constituting an offense under 18 U.S.C. § 1961(1)(D), which includes “any offense involving . . . fraud in the sale of securities.”<sup>57</sup>

The circuit court further noted that other appellate courts have concluded that forfeitures of property to the government similar to the one at issue are not deductible by the taxpayer because they are punitive.<sup>58</sup> For example, in *Wood v. United States*, the Fifth Circuit denied a loss deduction under section 165 for the civil forfeiture of

<sup>54</sup> 26 C.F.R. § 1.162-21.

<sup>55</sup> 880 F.2d 1311, 1313 (Fed. Cir. 1989) (“If there were any doubt about the meaning of the phrase ‘fine or similar penalty’, it is readily removed by reference to Treasury regulations promulgated in interpretation of the provision.”).

<sup>56</sup> Pub. L. No. 106-185, § 20, 114 Stat. 202, 224

<sup>57</sup> 824 F.3d at 1378.

<sup>58</sup> See *King v. United States*, 152 F.3d 1200, 1202 (9th Cir. 1998) (“on this matter of national tax policy there is something to be said for uniformity among the circuits.”)

proceeds from the taxpayer's drug trafficking activities.<sup>59</sup> In non-tax cases, other circuit courts have confirmed that, while restitution is compensatory, criminal forfeiture under section 2461(c) serves a distinct, punitive purpose. The Eleventh Circuit held in *United States v. Joseph* that a convicted criminal could not offset his restitution by the amount he forfeited under 18 U.S.C. § 981 and 28 U.S.C. § 2461.<sup>60</sup>

Nacchio argued that his right to deduct his forfeiture payment should follow the *Stephens* decision.<sup>61</sup> The taxpayer in *Stephens*, like Nacchio, was convicted of white-collar crimes. At sentencing, the prosecutor recommended that *Stephens* pay restitution to the company whose funds he had embezzled.<sup>62</sup> *Stephens* was then sentenced to several years in prison and fined, but part of the prison term was suspended “on the condition that he make restitution to Raytheon”<sup>63</sup> in the amount he embezzled plus interest. The Second Circuit held that the restitution was “a remedial measure” to compensate another party, not a “fine or similar penalty.”<sup>64</sup> It thus found the restitution deductible under section 165.

But the circuit court held that *Stephens* was distinguishable. Unlike Nacchio's case, the *Stephens* case “involved court-ordered restitution—imposed as a condition of his partially suspended sentence—which was clearly remedial, as it restored the embezzled funds to the injured party.”<sup>65</sup> The court noted that the payment was so “Raytheon [would] get its money back” and that “*Stephens*' payment was made to

<sup>59</sup> 863 F.2d 417, 418 (5th Cir. 1989). In *Wood*, the appellant pled guilty to a criminal offense, conspiracy to import marijuana and importation of marijuana and was sentenced to serve four years in prison and pay a \$30,000 fine. The appellant argued, inter alia, that, because he already paid his criminal debt by means of imprisonment and the \$30,000 fine, he should not have to pay taxes on proceeds he forfeited to the government. The court, nevertheless, found that his drug proceeds were taxable income and that “[f]orfeiture cannot seriously be considered anything other than an economic penalty for drug trafficking.” See also *Fuller v. Commissioner*, 213 F.2d 102, 105-06 (10th Cir. 1954) (disallowing business loss deduction under the precursor of § 165 for the cost of whiskey confiscated by law enforcement agencies of a “dry” state); *King*, 152 F.3d at 1201-02 (no loss deduction under section 165(a) for voluntary disclosure and forfeiture of hidden drug trafficking profits).

<sup>60</sup> 743 F.3d 1350, 1354 (11th Cir. 2014).

<sup>61</sup> *Stephens v. Commissioner*, 905 F.2d 667 (2d Cir. 1990).

<sup>62</sup> *Id.* at 668.

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* at 672-73.

<sup>65</sup> 824 F.3d at 1380.

**The circuit court found that the Attorney General’s “post-hoc decision to use the forfeited funds for remission did not transform the character of the forfeiture so that it was no longer a ‘fine or similar penalty’ under section 162(f).”**

Raytheon and not ‘to a government.’”<sup>66</sup> “Thus, allowing the restitution to be deducted comported with those cases explaining the difference between restitution orders and forfeiture orders.”<sup>67</sup> In Nacchio’s case, by contrast, forfeiture, not restitution, was at issue. The court’s amended judgment specifically provided that the amount of restitution owed was “\$0.00” and that restitution was “not applicable.”<sup>68</sup> At the resentencing hearing, the district court judge described Nacchio’s sentence of imprisonment, fine and disgorgement as “three forms of penalty.”<sup>69</sup> The judge further found that “the goal of restitution, sadly [ ] is not applicable here” because “there is no provision in the law for restitution.”<sup>70</sup> Instead, the district court directed that the fine of \$19 million “be deposited to the Crime Victims’ Fund” to “help fund state and local victims’ assistance programs[,] . . . And the forfeiture money can be used to assist victims within limitations under the law.”<sup>71</sup>

Finally, the circuit court found that the Attorney General’s “post-hoc decision to use the forfeited funds for remission did not transform the character of the forfeiture so that it was no longer a ‘fine or similar penalty’ under section 162(f).”<sup>72</sup> The decision to compensate victims was discretionary, and the forfeited amount was unrelated to the amount of losses suffered by the victims. Accordingly, the circuit court held that the trial court erred in relying that Nacchio may deduct his forfeiture under section 165.

Nacchio recently asked the circuit court to rehear *en banc* its ruling, arguing that the three-judge panel erred in finding that the forfeiture constituted a penalty or fine. In his petition, Nacchio argues that the panel’s decision erroneously placed form over substance—as it turns merely on the procedural mechanism that prosecutors choose to employ when routing the proceeds of a crime back to victims. The government has opposed the motion.

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<sup>66</sup> 905 F.2d at 673.

<sup>67</sup> 824 F.3d at 1380.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

## IRS Announces Changes to CAP Program

On August 26, 2016, the Internal Revenue Service announced that its Compliance Assurance Process (CAP) program is no longer accepting applications, which could mark the end of the CAP program as well as the end of the continuous audit program. According to the IRS release:

- (i) No new taxpayers will be accepted into the CAP program for the 2017 application season that begins in September 2016.
- (ii) Only taxpayers currently in the CAP and Compliance Maintenance phases may submit applications to participate in the CAP program.
- (iii) Taxpayers currently in the pre-CAP phase will not be accepted into the CAP phase.
- (iv) New Pre-CAP applications will not be accepted.
- (v) Current Pre-CAP taxpayers may remain in the Pre-CAP phase.
- (vi) Taxpayers currently in the CAP phase may be moved into the Compliance Maintenance phase, as appropriate.

CAP began as a pilot program in 2005 with 17 taxpayers and has grown to include 181 taxpayers today. Under CAP, participating taxpayers work collaboratively with an IRS team to identify and resolve potential tax issues before the tax return is filed each year. By eliminating major potential tax issues before filing, taxpayers are generally subject to shorter and narrower post-filing examinations. In 2011, the CAP program became permanent and added the Pre-CAP and Compliance Maintenance phases. The rest of the program has remained relatively unchanged since its inception. The IRS said that CAP assessment was necessary given today's challenging environment of limited resources and budget constraints as well as the need to evaluate existing programs to ensure they are aligned with LB&I's strategic vision.

Although the CAP program was a success by any measure, the recent announcement is not a complete shock as senior IRS officials over the past few months have publicly questioned CAP in light of recent shift of LB&I to identify and focus on specific areas of risk.

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## IRS Will Issue Rulings on Spin-off-Related Issues

On August 26, 2016, the Internal Revenue Service issued Rev. Proc. 2016-45, which modified the IRS's annual list of issues that the IRS will not issue letter rulings or determination letters.<sup>73</sup> According to the announcement, the IRS has removed two of the first three spin-off-related no-rules, which were put in place in 2003 by Rev. Proc. 2003-48. The two areas that are no longer no-rule areas are significant issues relating to:

- (i) The requirement under § 1.355-2(b) of the Income Tax Regulations that a distribution be carried out for a corporate business purpose (the corporate business purpose requirement), and
- (ii) The requirement under § 355(a)(1)(B) and § 1.355-2(d) that a transaction not be used principally as a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation or both (a device).

The reason for the change is that the Service has determined there are a number of unresolved legal issues under § 1.355-2(b) pertaining to the corporate business purpose requirement and under § 355(a)(1)(B) and § 1.355-2(d) pertaining to device that can be germane to determining the tax consequences of a distribution. The Service has also determined that it is appropriate and in the interest of sound tax administration to provide guidance to taxpayers on significant issues in these two areas. Accordingly, the Service will now issue a letter ruling with respect to a significant issue under § 1.355-2(b) pertaining to the corporate business purpose requirement, and a significant issue under § 355(a)(1)(B) and § 1.355-2(d) pertaining to device, provided that the issue is a legal issue and is not inherently factual in nature. Notwithstanding the announcement in Rev. Proc. 2016-45, the Service may decline to issue a letter ruling when appropriate in the interest of sound tax administration or on other grounds when warranted by the facts or circumstances of a particular case. The remaining spin-off issue that remains on the no-rule list relates to whether an acquisition subsequent to a spin-off is part of a plan under section 355(e).

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<sup>73</sup> See Rev. Proc. 2016-3.

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## **Tax Controversy and Litigation at Shearman & Sterling**

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**“The UK’s efforts are representative of increased international pressure to develop a global strategy to crack down on tax offenders.”**

policing the tax and criminal activities of their citizens globally, and goes a few steps further in policing activities of non-UK taxpayers and even their agents. The legislation is also consistent with the growing trend of international law enforcement cooperation, as well as, transparency in the areas of tax compliance, money laundering, bribery and other cross-border criminal activities.

The penalties for violation of the proposed legislation are draconian and include strict liability criminal responsibility and unlimited fines, regardless of whether the alleged offender benefited from the crime.

### **Proposal Background**

In its March 2015 budget, the UK government announced the introduction of a new corporate criminal offence of “failure to prevent the criminal facilitation of tax evasion.” A public consultation ran from July to October 2015, and in December 2015 a response containing draft legislation was published. On April 17 HM Revenue & Customs published a new consultation containing revised draft legislation. The closing date for comments was July 10, 2016.

The Panama Papers disclosure coupled with Prime Minister David Cameron’s announcement at the recent global money laundering conference in London that he wants to expand the legislation to apply to general fraud and money laundering provides momentum for enacting the new rules, which could be as early as the end of the year.<sup>2</sup>

The UK’s efforts are representative of increased international pressure to develop a global strategy to crack down on tax offenders. Early efforts include the 2013 G20/OECD action plan as base erosion and profit shifting, which sought to address multinational companies’ avoiding taxation in their home countries by taking advantage of foreign tax jurisdictions. The action plan identified 15 actions to curb international tax avoidance to address BEPS. Further, the Joint International Taskforce on Shared Intelligence and Collaboration (“JITSIC”), an initiative of the OECD’s Forum on Tax Administration, has been influential in developing strategies for early identification and deterrence.

<sup>2</sup> The author anticipates that prime Minister Theresa May and the Conservative party will continue to support this legislation and that international cooperation efforts to thwart cross-border tax evasion and abuses will not be measurably affected by Brexit.

**“The proposed legislation is modeled after the Bribery Act. . . Under the Bribery Act, corporations face strict liability for bribes paid by associated persons (defined broadly to include employees, agents, representatives or other third parties) for the benefit of the corporation.”**

On April 13, 2016, following the publication of the Panama Papers, JITSIC convened a meeting of tax administrators from 28 countries to launch an unparalleled inquiry into corporate tax evasion.

The UK has also undertaken efforts similar to the US Foreign Account Tax Compliance Act to mandate greater disclosure of foreign account information to the IRS. Following the US model, the HMRC has adopted measures that include agreements for automatic exchange of information about UK residents with foreign accounts and a tax disclosure facility to enable those with irregularities in their tax affairs to correct matters with HMRC before the exchange of information.

In conjunction with these efforts, the OECD has implemented the Common Reporting Standard (“CRS”) to facilitate the automatic exchange of taxpayer information starting in 2017. Further, both the US and the UK have implemented beneficial ownership legislation that requires companies to know and report accurate beneficial ownership information.<sup>3</sup>

The international trend in aggressive tax enforcement has given birth to the UK’s unprecedented extraterritorial proposal to criminalize conduct involving the failure to prevent the facilitation of tax evasion. The key motivator for the new offense is the difficulty in attributing criminal liability to corporations whose agents commit criminal acts in the course of their business.

Fraudulent UK tax evasion is already a crime, as is facilitation of tax evasion (accessorial liability, although a fraud facilitator, is generally also subject to principal liability). However, to attribute criminal liability to a corporation, it is necessary to demonstrate the involvement of a directing mind of the corporation, which generally requires the involvement of senior management. This standard has been difficult to satisfy; consequently, UK law has shifted towards a more aggressive paradigm.

The proposed legislation is modeled after the Bribery Act and follows the UK’s first conviction and deferred prosecution agreement for the corporate offence of failure to prevent bribery under section 7 of the act. Under the Bribery Act, corporations face strict liability for bribes paid by associated persons (defined broadly to include employees, agents, representatives or other third parties) for the benefit of the

<sup>3</sup> In May 2016, the US Treasury Department’s Financial Crimes Enforcement Network issued final rules regarding beneficial owner identification obligations for legal entity customers. The UK implemented a similar disclosure regime which requires disclosure of ultimate beneficial ownership through the Small Business, Enterprise and Employment Act 2015, which amends the Companies Act 2006.

**“The provision’s jurisdictional reach is massive . . . it is immaterial whether the relevant acts or omissions related to the offence occur in the UK or abroad, or whether the entity itself benefited from the facilitation of tax evasion.”**

corporation. The bribery offence is paired with a compliance defense in which a corporation may claim adequate procedures to preclude a bribery conviction.

### **The April 17th Consultation**

The proposed offence would find corporations criminally responsible if they fail to implement reasonable procedures to prevent their agents from facilitating a third party’s criminal offence of tax evasion. The draft legislation broadly states that this offence may be committed by a relevant body, which would include any corporation or partnership incorporated in the UK or abroad. That would reach a broad range of organizations including banks, law firms, financial advisors and non-profits.

Further, the proposal broadly defines an associated person as any individual who performs services for the relevant body without regard to their official title or location. Accordingly, agents and vendors could constitute associated persons. Any employees of a relevant body are presumptively considered to be associated persons under the statute.

Liability under the proposed offence is based upon three stages: (1) criminal tax evasion by a taxpayer; (2) criminal facilitation of this offence by an associated person of a relevant body acting on behalf of the relevant body; and (3) the relevant body’s failure to take reasonable steps to prevent those who acted on its behalf from committing the criminal act in stage 2.

That new construction of corporate liability for facilitation of tax evasion will make the relevant body criminally responsible through vicarious liability for the actions of any associated person acting on its behalf.

The jurisdictional scope of the proposed offense includes foreign corporations that facilitate evasion of UK taxes as well as any corporation with a nexus to the UK that facilitates the evasion of foreign taxes, even if no UK taxes have been evaded. The facilitation of foreign taxes are covered if it is illegal in the foreign country where taxes are payable and if it would amount to a UK offence if those same taxes were due to be paid to the UK.

The provision’s jurisdictional reach is massive, applying to any entity incorporated or formed under the law of any part of the UK, those who carry on a business from an establishment in the UK or when any act or omission constituting part of the foreign tax evasion facilitation offence takes place in the UK. Further, it is immaterial whether the relevant acts or omissions related to the offence occur in the UK or abroad, or whether the entity itself benefited from the facilitation of tax evasion.

In the UK, fraudulent or criminal tax evasion consists of “cheating the public revenue,” which is any fraudulent conduct intended to divert money from HMRC, or any fraudulent act in which an individual is knowingly concerned in, or takes steps with a view to, the fraudulent evasion of tax. The common element of the tax evasion

**“The proposed legislation is so broad. . . [it] would put the UK in a position of interpreting and applying both its and a foreign jurisdiction’s tax laws.”**

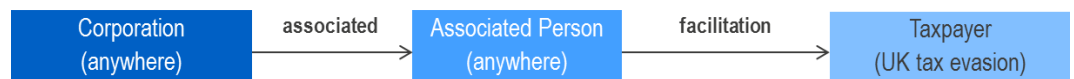
offence is fraud, or dishonest conduct to evade a tax liability. Examples include the deliberate hiding of money from tax authorities so as to not pay tax due on it, deliberately submitting false tax returns and deliberately omitting to register for Value Added Tax (“VAT”) when required to do so. For purposes of the corporate failure to prevent offence, the element of the tax evasion offence must be proved to a criminal standard to have occurred, but it is not necessary that the taxpayer himself is prosecuted.

Evasion facilitations include the aiding, abetting, counseling or procuring the commission by another person to evade UK tax. As noted, this consists of accessorial liability for the taxpayer’s offence, and the facilitator is also liable as a principal by virtue of being knowingly concerned in or taking steps with a view to the fraudulent tax evasion by another person. Examples of this offence include setting up hidden bank accounts and dealing in large cash payments to help hide money from tax authorities, creating false invoices to facilitate under-reporting and referring clients to service providers knowing this will help them evade tax. This element must also be proved to a criminal standard for purposes of the corporate offence.

Ultimately, for a corporation to be guilty of the criminal offence, the facilitator must be an associated person acting in that capacity. If facilitation of fraudulent tax evasion is proved to have been committed by an associate of a corporation acting as such (together with the underlying tax evasion offence), the corporation is guilty of the failure to prevent offence unless the corporation can prove it had reasonable procedures in place.

The UK tax evasion facilitation offence applies to all corporations, both foreign and UK incorporated, and the failure to prevent facilitation of an underlying UK tax evasion offence gives UK courts jurisdiction. (See Figure 1)

**Figure 1:**



The foreign tax evasion facilitation offence applies to corporations having a sufficient UK nexus (either U.K incorporated, carrying business in the UK or undertaking business through a UK establishment) or when part of the facilitation takes place within the UK. (See Figure 2)

**Figure 2:**



**“HMRC provides six principles to guide corporations in establishing such ‘reasonable measures’ for purposes of the new offence. These six principles should be kept in mind when designing and implementing appropriate compliance programs.”**

The proposed legislation is so broad that the UK could find itself prosecuting an alleged violation of, for example, Singapore tax law that would also constitute a violation of UK law, even if the Singapore authorities did not prosecute. That would put the UK in a position of interpreting and applying both its and a foreign jurisdiction’s tax laws. Such a prosecution would undoubtedly be challenged in court and would involve calling in legal experts to opine on the application of the foreign law to the particular facts at hand. Whether a fact-finder would deem that kind of prosecution overreaching remains to be seen.

The extensive ambit of the new offence could also mean that a corporation, even without the corporation’s knowledge of illegal activity, would be held strictly liable if individual’s associated with it were to knowingly facilitate tax evasion. There are several collateral issues that might emerge, such as whether a violation of the proposed UK law would expand the ability of jurisdictions to extradite individuals under existing extradition treaties.

#### **Implementation of Reasonable Procedures**

As noted, the new offence is paired with a due diligence defense similar to that in the Bribery Act. However, the new offence provides a defense for implementation of “reasonable measures” to prevent facilitation of tax evasion, compared to the seemingly stricter “adequate measures” required by the Bribery Act. HMRC provides six principles to guide corporations in establishing such “reasonable measures” for purposes of the new offence. These six principles should be kept in mind when designing and implementing appropriate compliance programs for the purpose of establishing a due diligence defense to the new offence.

The procedures corporations must establish include formal policies adopted to prevent criminal facilitation of tax evasion by its agents as well as practical steps taken by a corporation to implement these policies. They are similar to what US corporations include in their corporate compliance programs.

The first principle stresses that procedures taken to prevent facilitation of criminal tax evasion should be proportionate to a corporation’s risk profile. Those procedures must be reasonable, given those risks; burdensome procedures designed to address every conceivable risk are not required. The procedures put in place to establish a corporation’s due diligence defense should be designed to mitigate identified risks as well as prevent criminal conduct by associated persons working on behalf of the company.

The second principle emphasizes the need for top-level corporate management to be directly involved in preventing associated persons from engaging in criminal facilitation of tax evasion. Under existing law, top-level management is considered to have incentives to turn a blind eye to that type of activity under the directing mind test.

The new guidance is intended to encourage the involvement of senior management in the decision-making process regarding risk assessment and creation of reasonable measures. This includes internal and external communication and endorsement of the corporation's position against the facilitation of tax evasion, which may take the form of a zero-tolerance policy or a specific articulation of the corporation's preventative procedures. The principle is in line with what US regulators consider the "culture" of an organization. Senior management should not only encourage good behavior, but they should also effectuate and monitor it.

The third principle requires a corporation to assess the nature and extent of its exposure to the risk that its associated persons will facilitate tax evasion. That assessment must be documented and reviewed. The guidance emphasizes that some corporations, such as those in the financial services, legal and accounting sectors, might be more affected. The measures must be updated to account for increased risk as a corporation's business and consumer base develops.

What constitutes reasonable measures may change depending on the continuously developing risk profile of a given corporation. HMRC asks that corporations closely monitor their risk, including commonly encountered risks such as Country risk, Sectorial risk, Transaction risk, Business opportunity risk and Business partnership risk.<sup>4</sup> A sufficient risk assessment under the third principle would also consider the extent of internal risk of a corporation, including weak internal structures or procedures such as deficiencies in employee training, lack of clear financial controls and lack of clear communication from top-level management.

Under the fourth principle a corporation should apply sufficient due diligence procedures for those who will conduct business for and with them. The guidance stresses that a corporation's previous diligence procedures may be insufficient to identify the risk of tax evasion facilitation. Consistent with the first principle, the due diligence measures put in place should be proportionate to identified risks. Accordingly, some corporations in high risk sectors may have to have a relatively high level of due diligence measures in place compared to those corporations operating in sectors with less risk.

The fifth principle asks that corporations ensure that any developed procedures are widely understood through extensive communication and training. A developed procedure might not be sufficiently reasonable if it is not embedded within the corporation. As such, corporations should take extensive measures to ensure that their



associated persons are aware of any measures taken. Internal communications should clearly convey the corporation's zero tolerance policy for the facilitation of illegal tax evasion and the consequences for noncompliance.

The sixth principle focuses on the ongoing monitoring and review of a corporation's preventative procedures. That process includes progressive improvements of procedures if the corporation identifies increased risk or insufficient processes. The guidance suggests that corporations might seek internal feedback, have formalistic reviews or work with third parties to monitor the status of preventative procedures.

These principles are intended to be illustrative and do not spell out measures to be taken for every company; the guidance stresses the importance of tailoring the measures to the risk and needs of each company. The reasonable standard provides companies with more forgiveness than the Bribery Act's requirement of "adequate procedures" but it is important that companies implement thorough studies of their risk profiles in order to shield against liability.

#### **Extension to Other Crimes**

On May 12, the UK's Ministry of Justice announced its intent to extend the corporate offense to failure to prevent economic crimes such as fraud and money laundering, but it is unclear which offences would be considered economic crimes. The increasing trend of aggressive international enforcement of tax evasion following the leak of the Panama Papers makes it likely that the proposed offense will become law.

This extension of the new offense would further increase the compliance burden companies face to prevent the facilitation of tax evasion. While the precise terms of the new offence are unknown, it will likely be similar to the terms of the tax evasion offense. Therefore, companies should take into account the increased focus on compliance measures and take preventative measures to identify their risk profiles.

This will include:

- developing a global tax compliance policy and global tax principles consistent with consultation, FATCA and BEPS principles and designed to improve relations with regulators;

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<sup>4</sup> Those are commonly encountered risks articulated in the Bribery Act guidance.

- applying policies and procedures regarding identified tax risks and extending them to employees, agents and outside service providers;
- identifying potential material tax risks both locally and globally and implementing mechanisms to mitigate customer, employee, agent and counterparty risks;
- combining procedures to avoid the facilitation of tax evasion with those intended to counteract money laundering, bribery, and fraud; data privacy and protection; and other interrelated policies and procedures, including creating a cross-disciplinary team of in-house legal and compliance experts and outside counsel to orchestrate the implementation of, training on, and monitoring those procedures;
- creating, promulgating and enforcing a top-down culture designed to encourage compliance with policies and procedures; uncover wrongdoing; define acceptable business risks; identify and mitigate against material risks; and ensure employee the effectiveness, productivity and satisfaction—including a reward system for those who comply and sanctions for those who do not; and extending know-your-customer procedures to agents, professional advisors and counterparties.

**“The proposed UK criminal offence of failure to prevent the facilitation of tax evasion may appear extreme . . . It does not appear to be aberrational, however, but instead seems to be the wave of the future.”**

### **Conclusion**

The proposed UK criminal offence of failure to prevent the facilitation of tax evasion may appear extreme and will likely be challenged should it be enacted. It does not appear to be aberrational, however, but instead seems to be the wave of the future. The globalization of business combined with the globalization of criminal activity has necessitated international coordination and cooperation among disparate nations and regulatory schemes. The UK and other nations clearly understand that financial crime in jurisdictions other than their own can affect their economies and enforcement efforts, resulting in unforeseen long-arm statutes and regulations. Other nations are monitoring the proposed UK legislation and are likely to enact similar measures.

Early efforts to implement appropriate mechanisms to mitigate tax, criminal, civil and reputational risks and to develop efficacious compliance programs to successfully assert a due diligence defense will not result in wasted resources. That has been demonstrated by the fallout resulting from the failure of numerous companies to comply with the Bribery Act years after its implementation. Proactive planning will significantly mitigate tax and criminal exposure and reputational risk in the burgeoning arena of extraterritorial tax enforcement.

*Lawrence M. Hill*

## Circuit Court Permits Managing Partner to Raise Penalty Defense

On September 6, 2016, the United States Court of Appeals for the Tenth Circuit reversed a district court and held that the managing partner of a partnership was not precluded from raising a partner-level good faith and reasonable cause defense to penalties resulting from a TEFRA partnership audit.<sup>5</sup> The district court had ruled that it was precluded from considering the manager partner's defense because the TEFRA statute precludes a managing partner from pursuing at the partner level a reasonable cause/good faith defense where the IRS has rejected the partnership's assertion of reasonable cause/good faith at the partnership level. Although the Tenth Circuit reversed the District Court, the decision was not unanimous.

### Background

Upon retirement as a utility company executive, taxpayer McNeill expected to receive an \$18 million payment. In an effort to reduce any tax on the payout, McNeill created a series of partnerships, based on advice of tax counsel, who purchased underwater debt instruments for little money. McNeill was the managing partner of the relevant partnership and owned over 90% of the partnership. McNeill later sold the debt instruments and claimed a \$20 million loss, which offset his \$18 million in income received upon retirement. McNeill obtained opinion letters from various accounting and law firms concluding that the transaction would withstand IRS scrutiny. The IRS conducted a TEFRA audit of the partnership, concluded that McNeill's true basis in the debt was the modest amount he contributed to the partnership and denied the loss. The IRS also imposed penalties and interest. Under TEFRA, McNeill as the tax matters partner sought judicial review of the IRS's partnership level determination, but the matter was dismissed by the district court and McNeill never sought to reinstate it.

The IRS thereafter issued a deficiency to McNeill and determined that McNeill's share of the partnership liability was \$7.75 million. McNeill paid the liability and sued for a partial refund, arguing that he should be excused from penalties and associated interest because he had "reasonable cause" and he filed his tax return in "good faith."<sup>6</sup> McNeill's bases for his defense were the opinions he received from his accountants and lawyers that the transaction was legitimate.<sup>7</sup>

**"The district court concluded that the TEFRA statute precluded it from reviewing McNeill's defense because McNeill was a managing partner and the IRS had rejected the partnership's assertion of reasonable cause at the partnership level."**

<sup>5</sup> See *McNeill v. United States*, 14 cv 00174 (10th Cir. [Sept. 6, 2016]).

<sup>6</sup> Slip Opn. at 5.

<sup>7</sup> *Id.*

**The Circuit Court applied a plain reading to the statute and said . . . “[n]othing in the last sentence of the statute carves out managing partners and prevents them alone from taking advantage of its terms.”**

### **District Court Ruling**

The district court declined to decide the merits of McNeill’s partner level defense. The district court concluded that the TEFRA statute precluded it from reviewing McNeill’s defense because McNeill was a managing partner and the IRS had rejected the partnership’s assertion of reasonable cause at the partnership level.

On appeal, the Tenth Circuit reversed and concluded that the district court had misread the TEFRA statute. The relevant portion of TEFRA states:

No review of substantive issues.--For purposes of any claim or suit under this subsection, the treatment of partnership items on the partnership return, under the settlement, under the final partnership administrative adjustment, or under the decision of the court (whichever is appropriate) shall be conclusive. In addition, the determination under the final partnership administrative adjustment or under the decision of the court (whichever is appropriate) concerning the applicability of any penalty . . . which relates to an adjustment to a partnership item shall also be conclusive. Notwithstanding the preceding sentence, the partner shall be allowed to assert any partner level defenses that may apply or to challenge the amount of the computational adjustment.<sup>8</sup>

### **Analysis of Section 6230**

The Circuit Court applied a plain reading to the statute and said that a partner, including “any” partner may raise a partner level defense to challenge the amount of the tax adjustment. According to the circuit court “Congress pretty clearly seemed to contemplate a regime in which any partner may assert any ‘partner level defenses’ that may apply.”<sup>9</sup> But the Government argued that it is inappropriate to allow the managing partner to pursue a good faith defense at the partner level when the partnership already raised a good faith defense because often it’s the managing partner’s good faith that is tested and evaluated at the partnership level. But the Circuit Court rejected the Government’s argument, stating that “[n]othing in the last sentence of the statute carves out managing partners and prevents them alone from taking advantage of its terms.”<sup>10</sup> The court noted that “if Congress had wished to single out managing partners for special treatment, it could have done so—as it has done for other types of partners in other settings. *See, e.g.,* section 6231(a) (defining tax matters partner, notice partner, pass-thru partner, etc.)”<sup>11</sup>

<sup>8</sup> IRC § 6230(c)(4).

<sup>9</sup> Slip Opn. at 7.

<sup>10</sup> Slip Opn. at 7.

<sup>11</sup> Slip Opn. at 8.

The Circuit Court's conclusion that section 6230 does not carve out the managing partner was further supported by the government's own implementing regulations. Treasury regulation 301.6221-1(c) expressly indicates that section 6664(c)(1)'s reasonable cause/good faith defense is not a "partnerships item" but something more appropriately determined at the partner level. The court also noted that while the government's argument would yield a more efficient process, "any claim of efficiency" cannot substitute for "the statute's text and structure."<sup>12</sup>

The court also found that judicial precedent disfavored a reading of section 6230 that carved- out managing partners. In *Woods*, the Supreme Court suggested that under TEFRA a partner's reasonable cause and good faith defenses cannot be "conclusively" determined at the partnership level.<sup>13</sup> And the lower court cases provided little support for the government. In *Stobie Creek Investments, LLC v. United States*,<sup>14</sup> the partnership argued that "the partnership-level trial should resolve conclusively the reasonable cause defenses of each of the individual partners."<sup>15</sup> Meanwhile, in *Stobie Creek* the government (consistent with the regulations) argued that the reasonable cause/good faith defense is more properly adjudicated at the partner level—and the court agreed, for the court proceeded to hold that TEFRA "explicitly disallows adjudication of partner-level defenses" like reasonable cause/good faith "in a partnership-level proceeding."<sup>16</sup> Much the same story played out in *Klamath Strategic Investment Fund ex rel. St. Croix Ventures v. United States*,<sup>17</sup> where the government again argued that the reasonable cause/good faith defense "is a partner-level defense that can only be asserted in separate refund proceedings."<sup>18</sup> Accordingly, the circuit court reversed and remanded the matter to the district court to consider the merits of McNeill's reasonable cause and good faith defense to penalties.

Judge Phillips dissented and voted to affirm the district court's decision. The dissent rested on the fact that McNeill's defense based on reasonable cause was already evaluated at the partnership level, because the partnership-level defense was based on McNeill's conduct and state of mind. Judge Phillips said that he saw "nothing in 26

<sup>12</sup> Slip Opn. at 12.

<sup>13</sup> See *United States v. Woods*, 134 S. Ct. 557 at 564 (2013).

<sup>14</sup> 82 Fed. Cl. 636 (2008).

<sup>15</sup> *Id.* at 658.

<sup>16</sup> *Id.*

<sup>17</sup> 568 F.3d 537, 548 (5th Cir. 2009).

<sup>18</sup> *Id.* at 547

**“Interior Glass argued that section 6707A is void as unconstitutionally vague because no reasonable person, including the IRS, could know the meaning of the phrase ‘substantially similar.’”**

U.S.C. § 6230(c)(4) announcing a rule that all partner-level defenses automatically fully escape the effects and underpinnings of FPAAs’ partnership-level determinations of penalties and interest.”<sup>19</sup>

The importance of *McNeill* may be diminished in light of recent legislation regarding future partnership audits. Congress recently revised the program for auditing partnerships to permit the IRS to recoup taxes from the partnership itself rather through the individual partners.<sup>20</sup>

*Richard A. Nessler*

### **District Court Defines “Substantially Similar” under Section 6707A**

On August 12, 2016, the United States District Court for the Northern District of California held that the taxpayer who invested in a group life insurance plan was liable for penalties under section 6707A (listed transaction penalty) for failure to disclose its participation in a group term life insurance transaction for years 2009 through 2011.<sup>21</sup> The taxpayer, Interior Glass, filed a refund action seeking the recovery of the section 6707A penalty. Interior Glass argued, in part, that section 6707A is unconstitutionally vague, and therefore void. Taxpayer’s vagueness argument focused on the phrase “substantially similar,” as incorporated into section 6707A.

#### **Background**

In 2006, Interior Glass purchased an insurance product, known as the Insured Security Program (“ISP”), which claimed that the employer could deduct the insurance premium paid on behalf of an employee, while the employee would not have to report any compensation income from the premiums paid on his behalf.<sup>22</sup> The ISP was marketed by Lawrence Cronin.

In 2007, the IRS targeted programs similar to the ISP and identified them as “abusive trust arrangements.” To regulate the ISP, the IRS issued Notice 2007-83 providing that abusive trust arrangements are transactions identified as “listed transactions” under the Internal Revenue Code. In response to the notice, Cronin developed a new program

<sup>19</sup> Dissenting Opn., at 6.

<sup>20</sup> See Bipartisan Budget Act of 2015, Pub. L. No. 114-74.

<sup>21</sup> See *Interior Glass Systems, Inc. v. United States*, 13 cv 5563 (D.C. Cal. [August 29, 2016]).

<sup>22</sup> Slip Opn. at 1.

**The court noted that section 6707A must be read in conjunction with Notice 2007-83, because “it is there that the Secretary identified certain trust arrangements claiming to be welfare benefit funds and involving cash value life insurance policies” as “tax avoidance transactions.”**

that he believed would not be subjected to the disclosure requirements. He founded a tax-exempt business league called the Association for Small Closely-Held Business Enterprises, which offered a group term life insurance plan (“GTLP”) to its member-companies/employers.<sup>23</sup> In 2009, Interior Glass purchased the GTLP and was told that the GTLP was not a “listed transaction” subject to disclosure under Notice 2007-83.<sup>24</sup> Thus, Interior Glass did not disclose its participation in the GTLP for the 2009, 2010 and 2011 tax years. In 2012, the IRS imposed penalties under section 6707A because Interior Glass failed to disclose its participation in the GTLP, which the Service determined was a “listed transaction” subject to disclosure under Notice 2007-83. Interior Glass paid the penalty and sought a refund of the tax penalties assessed and collected under section 6707A.<sup>25</sup>

Interior Glass argued that section 6707A is void as unconstitutionally vague because no reasonable person, including the IRS, could know the meaning of the phrase “substantially similar.” Taxpayer argued that the statute’s vagueness allows “any low level” IRS employee to determine that different policy plans are “substantially similar,” therefore facilitating the imposition of penalties. Taxpayer’s argument was premised on the Fifth Amendment’s Due Process Clause which requires that a penal statute define the criminal offense with sufficient definiteness that ordinary people can understand what conduct is prohibited and in a manner that does not encourage arbitrary and discriminatory enforcement. The government argued that section 6707A is not unconstitutionally vague since Notice 2007-83 describes a “listed transaction” in detail, and explicitly provides for “substantially similar” transactions, incorporating the definition for that phrase in Treasury Reg. 1.6011-4(c)(4).<sup>26</sup>

#### **Section 6707A Is Not Unconstitutionally Vague**

The District Court first looked to the phrase “substantially similar” as it appears in section 6707A(c)(2), which section defines a “listed transaction” as “a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011.” By its definition, the court noted that section 6707A must be read in conjunction with Notice 2007-83, because “it is there that the Secretary identified certain trust arrangements claiming to be welfare benefit funds and involving cash

<sup>23</sup> Slip Opn. at 2.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> Slip Opn. at 6 – 7.

value life insurance policies” as “tax avoidance transactions” and “listed transactions for purposes of § 1.6011-4(b)(2) . . . and §§ 6111 and 6112.”<sup>27</sup> Notice 2007-83 defines a “listed transaction” with four specific elements, and provides that “[a]ny transaction that has all of the [] elements, and any transaction that is substantially similar to such a transaction, are identified as ‘listed transactions’ . . .” Notice 2007-83 applies to “listed transactions,” which are defined as:

Any transaction that has all of the following elements, and any transaction that is substantially similar to such a transaction, are identified as “listed transactions” for purposes of section 1.6011-4(b)(2) and sections 6111 and 6112, effective October 17, 2007, the date this notice is released to the public:

1. The transaction involves a trust or other fund described in section 419(c)(3) that is purportedly a welfare benefit fund.
2. For determining the portion of its contributions to the trust or other fund that are currently deductible the employer does not rely on the exception in section 419A(f)(5)(A) (regarding collectively bargained plans).
3. The trust or other fund pays premiums (or amounts that are purported to be premiums) on one or more life insurance policies and, with respect to at least one of the policies, value is accumulated:
4. The employer has taken a deduction for any taxable year for its contributions to the fund with respect to benefits provided under the plan (other than post-retirement medical benefits, post retirement life insurance benefits and child care facilities) that is greater than the sum of the following amounts:

According to the court, because Notice 2007-83 lists specific elements to which an arrangement can be compared to determine whether it is “substantially similar” to a “listed transaction,” section 6707A does not “effectively require[] the taxpayer [to] guess what arguments (and what revised facts) the IRS might come up with in the future to allege that two different items are ‘substantially similar.’”<sup>28</sup> Accordingly, the court concluded that the language of section 6707A was sufficient to withstand constitutional scrutiny.<sup>29</sup>

<sup>27</sup> *Id.* at 7.

<sup>28</sup> *Id.*

<sup>29</sup> See *Village of Hoffman Estates*, 455 U.S. 489 (1982).



**The Circuit Court found that the IRS failed to satisfy the requirements of the “foregone conclusion” doctrine.**

Interior Glass also argued that even though section 6707A is silent, it is a penal statute which implies a requirement of mens rea. The Government argued that section 6707A allows for a strict liability penalty, and thus taxpayer’s knowledge or advice provided is irrelevant. The court agreed with the government that section 6707A provided for a strict liability penalty, and distinguished the case law cited by the taxpayer.<sup>30</sup>

Accordingly, the court concluded that Interior Glass’s state of mind or any advice it received was irrelevant to the imposition of the section 6707A penalty.

*Richard A. Nessler*

### **Fifth Amendment Challenge Defeats IRS Summons**

On August 4, 2016, the United States Court of Appeals for the Second Circuit reversed and vacated a District Court order compelling toy importer Steven Greenfield to produce documents of family offshore bank accounts to the IRS, concluding that the government failed to show how such a request didn’t violate Fifth Amendment protections against self-incrimination.<sup>31</sup> The Circuit Court vacated an order by Manhattan US District Judge Alvin K. Hellerstein that required Greenfield to turn over records detailing what the IRS believed to be at least \$30 million in family money held in an offshore account in a Liechtenstein financial institution. The Circuit Court found that the IRS failed to satisfy the requirements of the “foregone conclusion” doctrine, which eliminates Fifth Amendment protections against document summonses when the government can safely assume the necessary existence, control and authenticity of the documents.

#### **Background**

In 2008, Heinrich Kieber, an employee of Liechtenstein Global Trust (“LGT”), leaked thousands of documents from foreign accounts held at LGT. Steven Greenfield, who owns a toy company with operations worldwide, was one of the individuals implicated by Kieber’s disclosure of LGT documents. Only a few of the documents disclosed by Kieber addressed the Greenfield’s connections to offshore banking directly. These included a March 27, 2001 memorandum from LGT personnel that detailed a meeting in Liechtenstein between the Greenfields and LGT employees and an end of 2001 account statement issued on January 1, 2002 for the Maverick Foundation (“Maverick”). The LGT Memo describes a March 23, 2001 meeting with the

<sup>30</sup> *Id.* at 8-9.

<sup>31</sup> See *United States v. Greenfield*, 15-543 (2d Cir. [August 1, 2016]).

Greenfields. According to the LGT Memo, Maverick was established in January 1992 and, as of the meeting, held \$2.2 million in cash as well as all the stock of TSF Company Limited (“TSF”) and Chiu Fu, which had been formed to channel assets into Maverick. In the memo, Harvey Greenfield, father of appellant-taxpayer Steven Greenfield, is described as the “sole beneficiary of the Maverick Foundation,” with Steven Greenfield holding a “power of attorney to give instructions” over Maverick. It also states that each of the Greenfields held US passports and lived, part time, in New York City.<sup>32</sup>

Greenfield never reported income from or ownership of Maverick, Chiu Fu, TSF or the trust. The IRS selected Greenfield’s 2005 income tax return for civil audit and, on May 17, 2013, issued an IDR for a number of documents with the audit (which was later expanded to include the 2006 tax year). Thereafter, on June 17, 2013, the IRS issued a summons that required Greenfield to appear on July 26, 2013 to produce documents (“Summons”). The Summons called for Greenfield to produce documents, in part, “relating to both domestic and foreign bank accounts” over which “Steven Greenfield exercised control during the years 2001 through 2011.” This request required Greenfield to produce “all documents” in his possession for the LGT account. Greenfield objected to the breadth of the Summons; the IRS later agreed to limit the Summons to documents for the 2001 through 2006 tax years. Greenfield continued to refuse to comply with the Summons. The government then brought this enforcement action in October 2014. Greenfield responded with a motion to quash, arguing, in relevant part, that the compelled production of the documents sought would violate his Fifth Amendment right against self-incrimination.

The Government asserted that under *Fisher v. United States*<sup>33</sup> “the act of producing these documents did not violate the Fifth Amendment because it was a foregone conclusion that the documents existed, that Greenfield had control over the documents and that the documents were authentic.”<sup>34</sup> The District Court granted the enforcement of the Summons and denied Greenfield’s motion to quash. The District Court relied in part on *United States v. Gendreau*,<sup>35</sup> where another district court had granted enforcement of a summons based on the LGT disclosure because “the Government

<sup>32</sup> Slip Opn. at 5-6.

<sup>33</sup> 425 U.S. 391 (1976).

<sup>34</sup> Slip Opn. at 9.

<sup>35</sup> No. 12 Misc. 303, 2014 WL 464754 (S.D.N.Y. Jan. 22, 2014).

**“In framing the issue, the Circuit Court said . . . we must examine whether the LGT Documents independently establish the communicative elements inherent in Greenfield’s production of the sought records or whether Greenfield’s production of the documents is necessary part of the chain of potentially incriminatory evidence.”**

had specific knowledge of the accounts and the individual who controlled the accounts.” Greenfield appealed the decision to the Circuit Court.

### **Circuit Court Applies US Constitution**

While noting that the annual loss of tax revenue at the hands of offshore accounting at \$35 billion, US Circuit Judge Guido Calabresi wrote that curtailing tax evasion “nevertheless cannot warrant the erosion of protections that the Constitution gives to all individuals, including those suspected of hiding assets offshore.”<sup>36</sup> In framing the issue, the Circuit Court said that the “question before us . . . is whether the instant case is more like *Fisher* or *Hubbell*.<sup>37</sup> That is, we must examine whether the LGT Documents independently establish the communicative elements inherent in Greenfield’s production of the sought records or whether Greenfield’s production of the documents is necessary part of the chain of potentially incriminatory evidence.”<sup>38</sup> Greenfield argued both that (1) the Government has not established with reasonable particularity the existence, control and authenticity of the sought documents as of the documents’ creation beginning in 2001, and (2) assuming arguendo that the Government could demonstrate this as of 2001, it cannot point to any evidence that the documents remained in Greenfield’s control through to 2013, when the Summons was issued.<sup>39</sup>

The Circuit Court found that the Government had in fact established the existence and Greenfield’s control over certain documents relating to offshore accounts, but decided it had not done the same to prove authenticity. Citing the government’s intent to call current or former bank employees of LGT or Kieber for such purposes, the court said it had not proffered evidence that those individuals would be willing to testify, nor was it a foregone conclusion “that foreign financial institutions and jurisdictions will cooperate with authentication requests.”<sup>40</sup> The court held that the Government “must provide more than speculation as to how authentication would occur.”<sup>41</sup>

*Richard A. Nessler*

<sup>36</sup> Slip Opn. at 2.

<sup>37</sup> *Fisher v. United States*, 425 U.S. 391 (1976); *States v. Hubbell*, 530 U.S. 27 (2000).

<sup>38</sup> Slip Opn. at 13.

<sup>39</sup> Slip Opn at 17.

<sup>40</sup> Slip Opn at 22.

<sup>41</sup> *Id.*

**“The regulations are applicable to any partnership that desires to elect to have the new partnership audit regime apply to its returns filed for taxable years beginning after November 2, 2015 and before January 1, 2018.”**

### **Rules for Electing Into the New Partnership Audit Regime**

On August 4, 2016, the Internal Revenue Service issued temporary regulations regarding the time, place and manner for a partnership to elect to apply the new partnership audit regime established by the Bipartisan Budget Act of 2015. The regulations are applicable to any partnership that desires to elect to have the new partnership audit regime apply to its returns filed for taxable years beginning after November 2, 2015 and before January 1, 2018. The regulations took effect on August 5, 2016.

#### **The Bipartisan Budget Act of 2015**

The Bipartisan Budget Act of 2015 (the “BBA”), which was signed into law in November 2015, includes sweeping changes to the rules governing federal tax audits of entities treated as partnerships for US federal income tax purposes. The new rules replace the long-standing regimes for auditing partnerships under the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”) and the Electing Large Partnership (“ELP”) rules. The new rules allow the Internal Revenue Service (the “IRS”) to deal with only a single “partnership representative,” similar to the tax matters partner under TEFRA, during an audit and any related court cases. Unless a partnership elects out, the new rules impose an entity-level tax on the partnership at the highest rate of tax in effect for the reviewed year (subject to potential reduction) for any understatements of partnership income. The purpose of the new rules is to streamline partnership audits under a single set of rules and to make it easier for the IRS to assess and collect tax after a partnership audit. Importantly, the new audit regime will apply only to partnership tax returns filed for taxable years beginning after December 31, 2017 unless a partnership elects to apply them to an earlier taxable year. The temporary regulations issued on August 4, 2016 provide guidance on how a partnership can elect to have the new partnership audit regime apply to returns filed after November 2, 2015 (the date of the enactment of the BBA), and before January 1, 2018. During this interim period, an election by a partnership is only valid if made in accordance with the requirements of the temporary regulations set forth in section 301.9100-22T, and an election, once made, may only be revoked with consent of the IRS. A partnership may not request an extension of time for making an election described in section 301.9100-22T.

**“Temporary regulations set forth in section 301.9100-22T provide the time, form and manner for a partnership to make an election pursuant to the BBA.”**

### **Temporary Regulations**

Temporary regulations set forth in section 301.9100-22T provide the time, form and manner for a partnership to make an election pursuant to the BBA. An election under section 301.9100-22T must be made within 30 days of the date of notification to a partnership, in writing, that a return of the partnership for an eligible taxable year has been selected for audit.<sup>42</sup> The notice of selection for examination referred to in section 301.9100-22T(b) is a notice that precedes the notice of an administrative proceeding required under section 6231(a) as amended by the BBA. A written statement with the words “Election under Section 1101(g)(4)” written at the top of the statement will satisfy the notice requirements.<sup>43</sup> The statement must be provided to the individual identified in the notice of selection for examination as the IRS contact for the examination. The written statement must be dated and signed by the tax matter partner, as defined under section 6231(a)(7), and the applicable regulations, or signed by a person who has the authority to sign the partnership return for the taxable year under examination.<sup>44</sup> The fact that an individual dates and signs the written statement is deemed to be prima facie evidence that the individual is authorized to make the election on behalf of the partnership.<sup>45</sup>

The written statement must include the following:

- (i) The partnership’s name, taxpayer identification number and the partnership taxable year for which the election is made;
- (ii) The name, taxpayer identification number, address and daytime telephone number of the individual who signs the statement;
- (iii) Language indicating that the partnership is electing application of section 1101(c) of the BBA for the partnership return for the eligible taxable year identified in the notice of examination;
- (iv) Information necessary to properly designate the partnership representative, including the name, taxpayer identification number, address and daytime telephone number of the representative as well as any additional information required by applicable regulation and other guidance issued by the IRS.

<sup>42</sup> See 301.9100-22T(b).

<sup>43</sup> See 301.9100-22T(b)(2).

<sup>44</sup> See 301.9100-22T(b)(2)(ii).

<sup>45</sup> Id.

The statement must also include the following representations:

- (i) The partnership is not insolvent and does not reasonably anticipate becoming insolvent before resolution of any adjustment with respect to the partnership taxable year for which the election is being made;
- (ii) The partnership has not filed, and does not reasonably anticipate filing, voluntarily a petition for relief under title 11 of the United States Code;
- (iii) The partnership is not subject to, and does not reasonably anticipate becoming subject to, an involuntary petition for relief under title 11 of the United States code; and
- (iv) The partnership has sufficient assets, and reasonably anticipates having sufficient assets, to pay a potential imputed underpayment with respect to the partnership taxable year at issue.

The person who signs the statement must sign under the penalties of perjury and represent that the individual is duly authorized to make the election and that, to the best of the individual's knowledge and belief, all of the information contained in the statement is true, correct and complete. Upon receipt of the written election, the IRS will promptly mail a notice of administrative proceeding to the partnership and the partnership representative, as required under Section 6231(a)(1).

Section 301.9100-22T(c) provides an exception to the general rule regarding the election only after first receiving a notice of selection for examination. A partnership that has not been issued a notice of selection for examination may still make the election with respect to a partnership return for an eligible taxable year for the purpose of filing an administrative adjustment request ("AAR") under section 6227, as amended by the BBA. However, an election under 301.9100-22T(c) by a partnership that has not been issued a notice of selection for examination may not make the election before January 1, 2018. The Treasury Department and the IRS intend to issue guidance regarding AARs under section 6227 as amended by the BBA before January 1, 2018.

*Richard A. Nessler*

### **Federal Circuit Court Denies Deductions of Forfeiture Payment**

On June 10, 2016, the United States Court of Appeals for the Federal Circuit held that Joseph Nacchio ("Nacchio") could not claim a tax deduction based on a prior court-

**“Nacchio argued that his loss was deductible under both section 165 and section 162.”**

ordered forfeiture payment of \$44 million following a jury verdict that found him guilty on nineteen counts of insider trading.<sup>46</sup> Nacchio, the former CEO of Quest Communications, was convicted in April 2007 of insider trading-related counts based on the federal prosecutor’s allegations that he sold \$52 million in Quest stock in 2001 when he knew, but did not disclose publicly, that Quest was unlikely to continue to meet its earnings targets. In addition to the forfeiture payment, Nacchio was ordered to pay a criminal fine of \$19 million and serve a 70-month criminal sentence.<sup>47</sup>

### **Background**

In 2009, following his conviction and forfeiture payment, Nacchio filed an amended federal tax return for 2007, claiming a nearly \$18 million tax credit under IRC section 1341 based on the forfeiture payment. In January 2011, Nacchio entered into a settlement in connection with a concurrent action brought by the SEC. The SEC settlement required Nacchio to disgorge his \$44 million trading profit in Quest stock, but gave him credit for his forfeiture payment to the United States, which satisfied Nacchio’s disgorgement obligation to the SEC. Thereafter, the Department of Justice notified prior participants in private securities class action litigation or SEC civil litigation concerning Quest stock that they were eligible to receive a remission from Nacchio’s forfeiture. In 2012, the chief of the Asset Forfeiture and Money Laundering authorized payment of the forfeited funds to eligible victims of Nacchio’s fraud.

In 2012, Nacchio commenced this action before the Court of Federal Claims seeking a tax credit for his forfeiture payment. The parties agreed to litigate cross-motions for summary judgment prior to discovery. The government argued that: (1) IRC section 162(f) barred any deduction under either section 165 or section 162, and (2) even if the loss caused by the forfeiture was a deductible loss under section 165 or section 162, Nacchio was estopped from seeking the special tax relief authorized by section 1341 because his criminal conviction was conclusive with respect to his state of mind. Nacchio argued that his loss was deductible under both section 165 and section 162 and that the question of whether it appeared that he had an unrestricted right to his trading profits in 2001 was not actually litigated in his criminal trial.

### **Court of Federal Claims rules for Taxpayer**

The Court of Federal Claims denied the government’s motion for summary judgment and granted-in-part Nacchio’s motion for partial summary judgment. The court held

<sup>46</sup> *Nacchio v. United States*, 824 F.3d 1370 (Fed. Cir. 2016)

<sup>47</sup> *Id.* at 1373.

**The trial court found that “Nacchio’s forfeiture was used for a compensatory purpose” because, even if not characterized as restitution, the amounts paid ultimately were returned to victims of Nacchio’s crimes through remission.**

that Nacchio’s forfeiture payment was deductible under section 165. The court expressly rejected the government’s argument that deduction of the forfeiture was barred by section 162(f). The court reasoned that, unlike the \$19 million criminal fine, which was clearly punitive and was paid from assets unrelated to insider trading, the forfeiture “exclusively represented the disgorgement of Mr. Nacchio’s illicit net gain from insider trading.”<sup>48</sup> In addition, the court found that “Nacchio’s forfeiture was used for a compensatory purpose” because, even if not characterized as restitution, the amounts paid ultimately were returned to victims of Nacchio’s crimes through remission.<sup>49</sup> In a footnote, the court rejected Nacchio’s attempt to deduct his forfeiture under section 162 as an “ordinary and necessary business expense.”<sup>50</sup> The court then rejected the government’s argument that Nacchio was collaterally estopped from pursuing special relief under section 1341. The government appealed and Nacchio cross-appealed.

On appeal, the circuit court viewed the relevant question regarding deductibility to be whether Nacchio’s criminal forfeiture was a “fine or penalty” under section 162(f). Following a *de novo* review, the circuit court held that Nacchio’s forfeiture payment was not deductible because it constituted a fine or penalty under section 162(f).

#### **Forfeiture is Ruled a “Penalty”**

First, the circuit court looked to the Tenth Circuit’s holding (Nacchio’s criminal appeal), that Nacchio’s forfeiture should be calculated in accordance with section 981(a)(2)(B),<sup>51</sup> not section 981(a)(2)(A).<sup>52</sup> Section 981(a)(2)(B) states that: “[T]he term ‘proceeds’ means the amount of money acquired through the illegal transactions resulting in the forfeiture, less the direct costs incurred in providing the goods or services. . . . The direct costs shall not include . . . any part of the income taxes paid by the entity.”<sup>53</sup> According to the language of the statute, the circuit court concluded that the forfeiture amount does not account for taxes paid on the amount of money acquired through the illegal transactions.

<sup>48</sup> *Id.* at 1376.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> 28 U.S.C. § 981(a)(2)(B).

<sup>52</sup> 28 U.S.C. § 981(a)(2)(A).

<sup>53</sup> 28 U.S.C. § 981(a)(2)(B).



Next, the circuit court looked to Treasury Regulation § 1.162-21(b)(1) which defines “fine or similar penalty” for the purposes of section 162(f) as including, inter alia, “an amount—(i) Paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding.”<sup>54</sup> Citing *Colt Industries, Inc. v. United States*,<sup>55</sup> courts have looked to the Treasury Regulation’s definition of a “fine or similar penalty” in denying deductions a taxpayer sought under section 162(a) for civil penalties paid to a state for violations of the Clean Water Act and the Clean Air Act. In *Nacchio*, the circuit court concluded that Nacchio’s criminal forfeiture met the definition of a “fine or similar penalty” under Treasury Regulation § 1.162-21(b)(1). Nacchio’s criminal forfeiture was imposed pursuant to 18 U.S.C. § 981(a)(1)(C) and 28 U.S.C. § 2461(c), as part of his sentence in a criminal case. Section 981(a)(1)(C), as amended by the Civil Asset Forfeiture Reform Act of 2000,<sup>56</sup> authorizes the forfeiture of “proceeds” traceable to numerous felony offenses, including any offense constituting “specified unlawful activity” as defined by 18 U.S.C. § 1956(c)(7)(A). Section 1956(c)(7)(A), in turn, defines “specified unlawful activity” as any act or activity constituting an offense under 18 U.S.C. § 1961(1)(D), which includes “any offense involving . . . fraud in the sale of securities.”<sup>57</sup>

The circuit court further noted that other appellate courts have concluded that forfeitures of property to the government similar to the one at issue are not deductible by the taxpayer because they are punitive.<sup>58</sup> For example, in *Wood v. United States*, the Fifth Circuit denied a loss deduction under section 165 for the civil forfeiture of

<sup>54</sup> 26 C.F.R. § 1.162-21.

<sup>55</sup> 880 F.2d 1311, 1313 (Fed. Cir. 1989) (“If there were any doubt about the meaning of the phrase ‘fine or similar penalty’, it is readily removed by reference to Treasury regulations promulgated in interpretation of the provision.”).

<sup>56</sup> Pub. L. No. 106-185, § 20, 114 Stat. 202, 224

<sup>57</sup> 824 F.3d at 1378.

<sup>58</sup> See *King v. United States*, 152 F.3d 1200, 1202 (9th Cir. 1998) (“on this matter of national tax policy there is something to be said for uniformity among the circuits.”)

proceeds from the taxpayer's drug trafficking activities.<sup>59</sup> In non-tax cases, other circuit courts have confirmed that, while restitution is compensatory, criminal forfeiture under section 2461(c) serves a distinct, punitive purpose. The Eleventh Circuit held in *United States v. Joseph* that a convicted criminal could not offset his restitution by the amount he forfeited under 18 U.S.C. § 981 and 28 U.S.C. § 2461.<sup>60</sup>

Nacchio argued that his right to deduct his forfeiture payment should follow the *Stephens* decision.<sup>61</sup> The taxpayer in *Stephens*, like Nacchio, was convicted of white-collar crimes. At sentencing, the prosecutor recommended that Stephens pay restitution to the company whose funds he had embezzled.<sup>62</sup> Stephens was then sentenced to several years in prison and fined, but part of the prison term was suspended “on the condition that he make restitution to Raytheon”<sup>63</sup> in the amount he embezzled plus interest. The Second Circuit held that the restitution was “a remedial measure” to compensate another party, not a “fine or similar penalty.”<sup>64</sup> It thus found the restitution deductible under section 165.

But the circuit court held that *Stephens* was distinguishable. Unlike Nacchio's case, the *Stephens* case “involved court-ordered restitution—imposed as a condition of his partially suspended sentence—which was clearly remedial, as it restored the embezzled funds to the injured party.”<sup>65</sup> The court noted that the payment was so “Raytheon [would] get its money back” and that “Stephens' payment was made to

<sup>59</sup> 863 F.2d 417, 418 (5th Cir. 1989). In *Wood*, the appellant pled guilty to a criminal offense, conspiracy to import marijuana and importation of marijuana and was sentenced to serve four years in prison and pay a \$30,000 fine. The appellant argued, inter alia, that, because he already paid his criminal debt by means of imprisonment and the \$30,000 fine, he should not have to pay taxes on proceeds he forfeited to the government. The court, nevertheless, found that his drug proceeds were taxable income and that “[f]orfeiture cannot seriously be considered anything other than an economic penalty for drug trafficking.” See also *Fuller v. Commissioner*, 213 F.2d 102, 105-06 (10th Cir. 1954) (disallowing business loss deduction under the precursor of § 165 for the cost of whiskey confiscated by law enforcement agencies of a “dry” state); *King*, 152 F.3d at 1201-02 (no loss deduction under section 165(a) for voluntary disclosure and forfeiture of hidden drug trafficking profits).

<sup>60</sup> 743 F.3d 1350, 1354 (11th Cir. 2014).

<sup>61</sup> *Stephens v. Commissioner*, 905 F.2d 667 (2d Cir. 1990).

<sup>62</sup> *Id.* at 668.

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* at 672-73.

<sup>65</sup> 824 F.3d at 1380.

**The circuit court found that the Attorney General’s “post-hoc decision to use the forfeited funds for remission did not transform the character of the forfeiture so that it was no longer a ‘fine or similar penalty’ under section 162(f).”**

Raytheon and not ‘to a government.’”<sup>66</sup> “Thus, allowing the restitution to be deducted comported with those cases explaining the difference between restitution orders and forfeiture orders.”<sup>67</sup> In Nacchio’s case, by contrast, forfeiture, not restitution, was at issue. The court’s amended judgment specifically provided that the amount of restitution owed was “\$0.00” and that restitution was “not applicable.”<sup>68</sup> At the resentencing hearing, the district court judge described Nacchio’s sentence of imprisonment, fine and disgorgement as “three forms of penalty.”<sup>69</sup> The judge further found that “the goal of restitution, sadly [ ] is not applicable here” because “there is no provision in the law for restitution.”<sup>70</sup> Instead, the district court directed that the fine of \$19 million “be deposited to the Crime Victims’ Fund” to “help fund state and local victims’ assistance programs[,] . . . And the forfeiture money can be used to assist victims within limitations under the law.”<sup>71</sup>

Finally, the circuit court found that the Attorney General’s “post-hoc decision to use the forfeited funds for remission did not transform the character of the forfeiture so that it was no longer a ‘fine or similar penalty’ under section 162(f).”<sup>72</sup> The decision to compensate victims was discretionary, and the forfeited amount was unrelated to the amount of losses suffered by the victims. Accordingly, the circuit court held that the trial court erred in relying that Nacchio may deduct his forfeiture under section 165.

Nacchio recently asked the circuit court to rehear *en banc* its ruling, arguing that the three-judge panel erred in finding that the forfeiture constituted a penalty or fine. In his petition, Nacchio argues that the panel’s decision erroneously placed form over substance—as it turns merely on the procedural mechanism that prosecutors choose to employ when routing the proceeds of a crime back to victims. The government has opposed the motion.

*Richard A. Nessler*

<sup>66</sup> 905 F.2d at 673.

<sup>67</sup> 824 F.3d at 1380.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

## IRS Announces Changes to CAP Program

On August 26, 2016, the Internal Revenue Service announced that its Compliance Assurance Process (CAP) program is no longer accepting applications, which could mark the end of the CAP program as well as the end of the continuous audit program. According to the IRS release:

- (i) No new taxpayers will be accepted into the CAP program for the 2017 application season that begins in September 2016.
- (ii) Only taxpayers currently in the CAP and Compliance Maintenance phases may submit applications to participate in the CAP program.
- (iii) Taxpayers currently in the pre-CAP phase will not be accepted into the CAP phase.
- (iv) New Pre-CAP applications will not be accepted.
- (v) Current Pre-CAP taxpayers may remain in the Pre-CAP phase.
- (vi) Taxpayers currently in the CAP phase may be moved into the Compliance Maintenance phase, as appropriate.

CAP began as a pilot program in 2005 with 17 taxpayers and has grown to include 181 taxpayers today. Under CAP, participating taxpayers work collaboratively with an IRS team to identify and resolve potential tax issues before the tax return is filed each year. By eliminating major potential tax issues before filing, taxpayers are generally subject to shorter and narrower post-filing examinations. In 2011, the CAP program became permanent and added the Pre-CAP and Compliance Maintenance phases. The rest of the program has remained relatively unchanged since its inception. The IRS said that CAP assessment was necessary given today's challenging environment of limited resources and budget constraints as well as the need to evaluate existing programs to ensure they are aligned with LB&I's strategic vision.

Although the CAP program was a success by any measure, the recent announcement is not a complete shock as senior IRS officials over the past few months have publicly questioned CAP in light of recent shift of LB&I to identify and focus on specific areas of risk.

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### IRS Will Issue Rulings on Spin-off-Related Issues

On August 26, 2016, the Internal Revenue Service issued Rev. Proc. 2016-45, which modified the IRS's annual list of issues that the IRS will not issue letter rulings or determination letters.<sup>73</sup> According to the announcement, the IRS has removed two of the first three spin-off-related no-rules, which were put in place in 2003 by Rev. Proc. 2003-48. The two areas that are no longer no-rule areas are significant issues relating to:

- (i) The requirement under § 1.355-2(b) of the Income Tax Regulations that a distribution be carried out for a corporate business purpose (the corporate business purpose requirement), and
- (ii) The requirement under § 355(a)(1)(B) and § 1.355-2(d) that a transaction not be used principally as a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation or both (a device).

The reason for the change is that the Service has determined there are a number of unresolved legal issues under § 1.355-2(b) pertaining to the corporate business purpose requirement and under § 355(a)(1)(B) and § 1.355-2(d) pertaining to device that can be germane to determining the tax consequences of a distribution. The Service has also determined that it is appropriate and in the interest of sound tax administration to provide guidance to taxpayers on significant issues in these two areas. Accordingly, the Service will now issue a letter ruling with respect to a significant issue under § 1.355-2(b) pertaining to the corporate business purpose requirement, and a significant issue under § 355(a)(1)(B) and § 1.355-2(d) pertaining to device, provided that the issue is a legal issue and is not inherently factual in nature. Notwithstanding the announcement in Rev. Proc. 2016-45, the Service may decline to issue a letter ruling when appropriate in the interest of sound tax administration or on other grounds when warranted by the facts or circumstances of a particular case. The remaining spin-off issue that remains on the no-rule list relates to whether an acquisition subsequent to a spin-off is part of a plan under section 355(e).

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<sup>73</sup> See Rev. Proc. 2016-3.

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## **Tax Controversy and Litigation at Shearman & Sterling**

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