Representing Clients in Audits and Controversies in Today's Tax Enforcement Environment

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I. INTRODUCTION

A. Trends and Developments

1. Coordinated Industry Case Program/Industry Specialization Program

a. These two initiatives focus on large cases and include an enhanced emphasis on international matters. The IRS recognized the need for more expertise and concentrated efforts on specialized industry segments and industry specific issues.

b. The IRS has instituted teams to assist Special Trial Attorneys in these programs that include legal, accounting, economic, and engineering specialists.

c. Application of the Large Business and International Division’s business-style exam process to IRS audits of high-net-worth individuals in a new “industry group” called the Global High Wealth Industry Group whereby the LB&I exam team uses a holistic approach that includes examining the full web of entities connected to a taxpayer, including international components.

2. Tax Shelter Litigation

a. Cases involving BOSS or SON of BOSS tax shelters have been heavily litigated in Tax Court in the last few years. The Service has aggressively pursued these marketed tax shelter cases. At times, the differentiation between a tax shelter and traditional tax planning transaction has been blurred. Many cases for which practitioners consider simple tax planning have been caught up in the IRS enhanced litigation pursuits.

3. Forum Selection

a. Traditionally, the majority of major tax controversies have been litigated in the United States Tax Court. In 2010, the Tax Court’s docket caseload exceeded 29,600 cases that aggregated over $26.6 billion of disputed tax liability. Many taxpayers seek review in Tax Court because of the less burdensome jurisdictional requirements. Many taxpayers are not able to pay the entire disputed tax amount prior to seeking judicial review, which is required for district court review.

b. Tax Court rules and procedures generally follow a more informal approach than other federal courts. In practice, the Tax Court prefers that counsel for taxpayers and the IRS engage in informal discovery and attempt to resolve factual issues without the use of formal discovery. Recently, the Tax Court changed its rules relating to discovery procedures. The changes have resulted in the
Tax Court moving toward a more traditional federal court model with increased use of formal discovery techniques including requests for admissions, interrogatories, and depositions.

c. Recent trends have shown that more major tax cases are being decided by the Court of Federal Claims. As of May 2011, the Court of Federal Claims had approximately 300 cases pending before the court. The average dollar amount involved in these cases was over $12 million. This forum has issued major opinions in recent years relating to economic substance and substance over form doctrines. (See Part VII.D for a more detailed discussion on the inconsistencies present in Court of Claim decisions.) Recent major decisions include:

(1) Coltec Industries, Inc. v. United States, 62 Fed. Cl. 716 (2004) (Company offset $240 million gain with contingent liabilities that had been transferred to a “litigation management activity fund.” Court found that principal purpose of the transaction was not tax avoidance.)

(a) The Federal Circuit (454 F. 3d 1340 (2006)) in reviewing the case stated five principles of economic substance:

(i) A lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance;

(ii) The taxpayer's bear the burden of proof;

(iii) The transaction must be analyzed objectively, therefore the taxpayer's subjective understanding of the deal was irrelevant;

(iv) The court should focus in on the transaction which actually gave rise to the deduction; and

(v) Transactions which have no economic impact on third parties bear especially close scrutiny.

(b) Federal Circuit reversed the lower court and found that the transaction lacked economic substance.

(2) Jade Trading, LLC v. United States, 80 Fed. Cl. 11 (2007) (involving foreign currency options. Court of Federal Claims applied the Coltec economic substance test and
found that transactions lacked economic substance and should be disregarded for tax purposes even though it met literal code requirements).

(3) **Stobie Creek Investments v. United States**, 82 Fed. Cl. 636 (2008) (involving Son of Boss with a twist. Court applied the Coltec economic substance test and found that transaction lacked economic substance.)

(4) **Consolidated Edison Co. v. United States**, 90 Fed. Cl. 228 (2009) (involving lease in-lease out transaction with a foreign utility. Court applied the Coltec economic substance test and found that the transaction had economic substance and a non-tax business purposes)

d. The United States District Courts saw a decrease in refund cases filed between March 2009 and March 2010 (1,233) from the prior period (1,420). Of the 1,349 cases for which the Courts terminated between March 2009 and March 2010 only 21 actually began trial proceedings.

II. INFORMATION GATHERING

A. **Introduction**

1. During the last few years, the IRS has made a concerted attempt to obtain as broad a swath of client documents as possible. The environment surrounding tax reporting and filing has changed. As a result, and in order to properly defend a tax controversy, it is imperative for taxpayers to understand the various information production privileges available to them. This risk is one which cannot be ignored; increasingly, it is clear that what you say and the thought processes and deliberations that went into that statement can and will be used against you in a court of law.

2. There are a number of privileges that may protect the deliberative process from inadvertent or involuntary disclosure to the IRS. The most significant privileges are the attorney-client privilege (both as to communications with lawyers and federally enrolled agents) and the work-product doctrine.

3. Recent practice has identified a number of situations where clients have been forced to disclose to the IRS and other tax authorities their candid, honest and internal discussions of tax risks related to business transactions. This forced disclosure not only provided tax auditors with a road map, but it also gave the government ammunition to use in challenging the company's tax position.

4. In most cases, what caused this forced disclosure of internal tax discussions was inadvertent – and fully avoidable. It resulted from the
failure of company personnel to preserve privilege and confidentiality during their early-stage discussions with third-parties. And, in several cases, it resulted in a waiver of attorney-client privilege and attorney work product confidentiality for the entire issue – meaning that the law department’s files became subject to discovery.

B. IRS Initiatives

1. In the past few years, the IRS has dramatically expanded its efforts to curb abusive tax transactions, including corporate tax shelters. The most notable IRS efforts include:
   a. New, expansive definitions of “tax shelters” and “reportable transactions.”
   b. New tax return disclosure requirements on taxpayers.
   c. New “reportable transaction” and list maintenance requirements on material advisors.
   d. New nationally coordinated tax shelter examination teams.
   e. New penalty provisions.

2. Other expansions of IRS review of taxpayers include increased attempts to access data and corporate records which, traditionally, the IRS has not sought, including:
   a. E-mails and other correspondence describing the tax benefits – and the tax risks – of specific transactions;
   b. Internal financial analysis of alternative tax strategies; and
   c. Management presentations regarding negotiation strategies.
   d. The IRS is also expanding efforts to access auditor workpapers, including the increasingly detailed FAS 5 tax accruals and valuation analysis.

C. Increased Use of Summons (including SB/SE cases)

1. IDR - The IRS gathers information using multiple techniques. The IRS will issue Information Document Request (“IDR”) to the taxpayer. Either the taxpayer or its representative routinely discuss any problems or issues relating to providing responses to these requests with the examining agent. If a taxpayer does not comply or cooperate with the agent, the agent has the power to issue summons for the information requested in the original IDR. See IRC §7602.

2. Section 7602 limits the ability of the IRS to request documents and
records to only items that are relevant or material to their inquiry. However, the standard for relevance in this regard is very low. As long as the items requested are helpful or shed light on the correctness of the inquiry, the request will be allowed.

3. The IRS also will attempt to gather documents from third parties in the course of the audit. The IRS will issue summons to third-party recordkeepers. These third parties may include banks, brokers, attorneys, and accountants. In most situations, the IRS will provide the taxpayer notice of the issuance of a third party summons to give the taxpayer the opportunity to challenge the summons. However, the IRS does not have to provide notice if it is issued in the aid of collection of an assessment or judgment. See IRC 7609(c)(2)(D).

D. Attorney Client Privilege

1. Under the most common formulation, determining if a communication deserves protection under the attorney-client privilege requires an analysis of six separate elements -- all of which must be satisfied for the privilege to apply. The attorney-client privilege protects:
   a. Communications from a client.
   b. To a lawyer.
   c. Related to the rendering of legal advice.
   d. Made with the expectation of confidentiality.
   e. Not in furtherance of a future crime or fraud.
   f. As long as the privilege has not been waived.

E. Work Product Doctrine

1. General Considerations
   a. Work product is NOT privilege.
   b. Work product is based on notions of fairness in litigation. Courts consider it unfair to require a party in litigation to disclose all their thinking and strategy on a case to the other side.
   c. Work product, unlike attorney-client privilege, does not require an attorney.
   d. In order to apply, the document or analysis at issue must be prepared “because of” litigation rather than in the ordinary course of business.
2. Objectively reasonable expectation of litigation
   a. Burden of proof is on the party claiming protection, and should be documented.
   b. In Federal Tax Court, an expectation of an audit by the IRS is not considered an objectively reasonable basis to expect litigation, and therefore, work product protection will not attach in Tax Court. However, in U.S. District Court (in which federal tax claims may also be brought), a more liberal rule is available. See U.S. v. Roxworthy, 457 F.3d 590 (6th Cir. 2006).

3. Subjective Expectation of Litigation
   a. Burden of proof is on the party claiming protection, and should be documented.

F. Differences Between the Work Product Doctrine and the Attorney-Client Privilege

1. Unlike the attorney-client privilege, the work product doctrine:
   a. Is relatively new.
   c. Is a creature of statute and rule.
   d. Applies to non-lawyers.
   e. Arises only at certain times.
   f. Only protects communications made "because of" litigation.
   g. May be asserted by the client or the lawyer.
   h. May not last forever.
   i. May be overcome if the adversary really needs the information.
   j. Is not easily waived.²

2. Unlike the attorney-client privilege, the work product doctrine:
   a. Does not rest on the *intimacy* of the attorney-client relationship -- a lawyer does not even have to be involved in its creation.
   b. Does not rest on the *confidentiality* within that intimate relationship -- it protects such materials as pictures of accident scenes, measurements of skid marks, interviews with strangers, etc.
   c. Does not rest on *communications* within that intimate relationship -- the work product doctrine can protect materials that have never been communicated to anyone.
   d. The work product doctrine is both narrower and broader than the attorney-client privilege.
   e. It is narrower because: the work product doctrine only applies at certain times (during or in anticipation of litigation); and is not actually a privilege, but rather a qualified immunity that can be overcome under certain circumstances.
   f. It is broader because: anyone can create work product (without a lawyer's involvement); and work product can be shared more easily with third parties without causing a waiver of its protection.

3. Lawyers and their clients considering both the attorney-client privilege and the work product doctrine should remember that both, either or none may apply in certain circumstances.
   a. For instance, communications between lawyers and their clients occurring when no one anticipates litigation can never be work product, but may deserve privilege protection.
   b. Materials reflecting lawyers' communications with those other than clients (or the lawyers' own agents) can rarely if ever be privileged, but may well be work product -- such as notes of a witness interview.

**G. Waiver of Work Product**

1. Whereas the attorney-client privilege is *always* waived by any disclosure outside the attorney-client relationship, disclosing work product to third parties does not automatically waive that protection. Viacom, Inc. v. Sumitomo Corp. (In re Copper Mkt. Antitrust Litig.), 200 F.R.D. 213, 221 n.6 (S.D.N.Y. 2001).

2. This difference in waiver principles between the attorney-client privilege and the work product doctrine sometimes means that sharing materials protected by both the attorney-client privilege and the work product
doctrine might waive the former but not the latter. 


3. Disclosure to third party other than an adversary generally causes a waiver only if the disclosure makes it likely that the work product will "fall into enemy hands" -- ending up with the adversary. **Bowman v. Brush Wellman, Inc.**, No. 00 C 50264, 2001 U.S. Dist. LEXIS 14088, at *7 (N.D. Ill. Sept. 13, 2001); **In re Doe**, 662 F.2d 1073, 1081, 1082 (4th Cir. 1981), *cert. denied*, 455 U.S. 1000 (1982). Sharing with friend or ally does not waive protection. **Sheets v. Ins. Co. of N. Am.**, No. 4:04CV00058, 2005 U.S. Dist. LEXIS 27060 (W.D. Va. Nov. 8, 2005) (holding that a personal injury plaintiff did not waive the work product protection by sharing work product with others involved in a boating accident; noting that those to whom the plaintiff disclosed the work product shared the plaintiff's interest in obtaining insurance coverage for the boating accident).

4. **PRACTICE NOTE**: Given this difference between the attorney-client privilege and work product doctrine, it makes sense to share work product only under a confidentiality agreement. A confidentiality agreement would not prevent waiver of the attorney-client privilege, but might demonstrate that the party disclosing work product did not increase the chance the adversary would obtain access to the work product. **Blanchard v. EdgeMark Fin. Corp.**, 192 F.R.D. 233, 237-38 (N.D. Ill. 2000).

5. Disclosure of Work Product to Outside Auditors


b. In case closely watched as one of the government's first efforts to get tax accrual workpapers through court proceedings from a financial services subsidiary of conglomerate Textron, Inc. **United States v Textron, Inc.**, No. 06-198T (D.R.I. August 29, 2007).

(1) District Court Phase: Textron Victory

(a) The U.S. District Court for the District of Rhode Island denied the government's petition to get the 2001 tax accrual workpapers from Textron, Inc.'s financial services subsidiary.

(b) Facts: Textron, Inc. (Textron), a publicly traded corporation with approximately 190 subsidiaries, had a subsidiary that provided commercial lending and financial services (Textron Financial Corp. or
TFC) relied on Textron attorneys, private law firms, and outside accounting firms for advice regarding tax matters. IRS learned that TFC had engaged in nine “sale-in, lease-out” (SILO) transactions involving telecommunications equipment and rail equipment. Because the transactions were considered to be of a type engaged in for the purpose of tax avoidance, IRS issued more than 500 IDRs to Textron. In June 2005, the IRS manager examining Textron’s return issued an administrative summons for all of the tax accrual work papers for Textron’s tax year ending Dec. 29, 2001. Textron refused to produce its tax accrual work papers asserting that they were privileged and that the summons was issued for an improper purpose. During the course of an audit conducted by Textron’s independent auditor, Textron permitted the auditor to examine the final tax accrual work papers at issue in the case with the understanding that the information was to be treated as confidential.

Reasoning: The District Court at trial said determination of any tax owed must be based on factual information, none of which is contained in the work papers and all of which is readily available to the IRS through the issuance of information document requests (IDRs) and by other means. The District Court said that, in its view, the papers sought by the IRS would have little bearing on calculating Textron’s tax liability. “The opinions of Textron’s counsel, either favorable or unfavorable, would have little to do with that determination, and forced disclosure of those opinions would put Textron at an unfair disadvantage in any dispute that might arise with the IRS,” the court found. The District court ruled the requested documents are protected by the work product privilege, supporting Textron’s claims. “The IRS has failed to carry the burden of demonstrating a ‘substantial need’ for ordinary work product, let alone the heightened burden applicable to Textron’s tax accrual work papers, which constitute opinion work product,” the court said in a 34-page opinion.

(2) 1st Circuit Phase - Government Victory (United States v. Textron, 577 F. 3d 21 (1st Cir. 2009) (en banc)).
(a) The 1st Circuit Court of Appeals held that Textron’s tax accrual workpapers were not protected from discovery by the IRS.

(b) Reasoning: The workpapers were independently required by statutory and audit requirements and, therefore, the work product privilege did not apply.

(c) The Court stated that unless the document was prepared for use in potential litigation, the Court did not believe the work product privilege applied. Tax accrual workpapers are prepared in support of financial statement certification by independent auditors, not potential litigation.

(d) The dissent in Textron argued that the test adopted by the majority is more narrow and restrictive than prior precedent. The dissenting opinion saw no reason to require a taxpayer to provide the IRS their assessment of the likely outcome of litigation simply because it was created for a business purpose.

(3) Supreme Court - In 2010, the Supreme Court denied Textron’s petition for certiorari. (Textron v. United States, 130 S. Ct. 3320 (2010)).

c. This new debate has caused great concern to in-house lawyers, who find themselves pressured by outside auditors to disclose litigation-related analyses, litigation outcome predictions, etc. -- yet justifiably worry about waiving the work product protection that would otherwise entitle the companies to withhold such documents from the private plaintiffs against whom they are litigating.

d. IRS releases internal memoranda on FIN 48. “FIN 48 Disclosures... should be considered by examiners and others when conducting risk assessments.” (Deborah Nolan, LMSB Commissioner). The battle wages on despite such court decisions like the Textron decision.

e. Since its release on July 13, 2006, FIN 48 has generated considerable interest and concern. Many taxpayers fear that the disclosures required by FIN 48 and the workpapers prepared in connection therewith will serve as a “roadmap” for IRS examinations. The IRS Office of Chief Counsel has determined that FIN 48 Workpapers are Tax Accrual Workpapers (TAW), and are therefore subject to the IRS' current policy of restraint as contained in IRM 4.10.20. IRS officials have stated, however, that
the current TAW Policy is being evaluated to ensure that it is still appropriate in today’s environment.

f. The memorandum captioned “FIN 48 Implications LMSB Field Examiner’s Guide,” lists ten common questions and answers related to the requirements of FIN 48. The first question, and the one most likely on taxpayers’ and IRS examiner’s minds is, “Are FIN 48 Disclosures a Roadmap for the IRS?” The memorandum does not answer this question with a simple “yes” or “no,” but it is clear from the answer that, at a minimum, IRS examiners should use the FIN 48 disclosures to point them in the right direction. The answer notes that FIN 48 disclosures may lack specificity, and therefore, it may be difficult, for example, to know whether the disclosure has a U.S. tax or foreign tax implication. Nevertheless, the answer goes on to state, “Even with the lack of specificity, tax footnotes included in financial statements, including FIN 48 Disclosures, should be carefully reviewed and analyzed as part of the audit planning process.

g. The second question and answer in the memorandum addresses the impact of FIN 48 on the IRS’ TAW Policy. While the answer states that FIN 48 Workpapers are TAWs, and therefore, subject to the policy of restraint, FIN 48 Disclosures are another matter. “On the other hand, FIN 48 Disclosures reported in quarterly and/or annual financial statements, and any other public documents, are not subject to the policy of restraint, and should be considered by examiners and others when conducting risk assessments.”

h. A number of the questions and answers address taxpayers’ concerns about obtaining certainty on tax issues more quickly through closing agreements, restricted consents to extend the statute of limitations, and the IRS’ pre-filing programs (Industry Issue Resolution, Pre-filing Agreements, Advance Pricing Agreements, and Compliance Audit Program) and post-filing programs (Joint Audit Plan, LIFE, Advance Issue Resolution, Appeals Fast Track Program, Accelerated Issue Resolution, and Early Referral to Appeals). In this regard, the memorandum notes, “We can remind taxpayers that candor, transparency and the right motivations, coupled with programs and processes we have in place today can quickly generate certainty on tax issues.”

i. Question and Answer #8 addresses the situation in which a transaction that has closed becomes a Listed Transaction. Under the Jobs Creation Act, the statute of limitations is extended until one calendar year after the IRS receives proper disclosure of Listed Transactions. In the case of a closed transaction that becomes a Listed Transaction, the answer states that, until one year after proper disclosure to the IRS, interest must be accrued in the P&L
on the unrecognized tax benefit (perhaps all of the benefit because the “more likely than not” threshold may not have been met) under the rules of FIN 48, and the tax benefit taken on the tax return will never be recognizable in the financial statements. As a result, each year the accrued interest increases and the P&L is negatively affected.

j. The memorandum states that LMSB has consulted FASB on this point and FASB agrees that this is the result. The memorandum advises that “it may be a good practice to remind taxpayers about this provision affecting Listed Transactions and the way they impact on the application of FIN 48 in their financial statements.”

k. It is clear from the memoranda that the IRS is preparing its LMSB examiners to focus carefully on FIN 48 Disclosures. The statement that LMSB is evaluating the policy of restraint with respect to FIN 48 Workpapers suggests that LMSB examiners may be increasing their requests for FIN 48 Workpapers. LMSB has created a “TAW Cadre whose members are available to assist with the review of documents received in response to TAW IDR[s] [information document requests]. The primary objective of the Cadre is to assist LMSB examiners in determining whether items received fulfill the IDR, whether additional documents should be requested, and in considering the risk assessment related to the review of those tax accrual workpapers.”

H. Post Textron Decision Events on Tax Accrual Workpapers – Deloitte (United States v. Deloitte LLP, 610 F. 3d 129 (D.C. Cir. 2010))

1. Background:

a. To aid examining agents in the audit of taxpayers, the IRS has increased requests for a taxpayer’s tax accrual workpapers. These papers document the taxpayer’s decision-making process and rationale for creating tax reserves for financial accounting purposes. Taxpayers are concerned that providing these documents will provide the IRS with an audit roadmap. (Similar to the arguments against Uncertain Tax Position reporting).

b. A taxpayer generally prepares the workpapers in connection with assistance from inside and outside counsel. The workpapers include information relating to the making of legal judgments relating to certain positions taken on returns. The taxpayer usually needs the assistance of counsel to properly estimate the audit risk and, if necessary, litigation risks.

c. Taxpayers generally assert the Work Product Privilege in their attempts to defeat the IRS’s ability to obtain these workpapers. The Work Product Privilege prohibits discovery of “documents
and tangible things...prepared in anticipation of litigation or for trial” when discussed with a taxpayer’s representative (usually an attorney or accountant).

(1) This privilege finds its origin in the U.S. Supreme Court decision Hickman v. Taylor, 329 U.S. 495 (1947) (where the Court granted protection from disclosure materials prepared by a party “in anticipation of litigation.”) The disputed materials consisted of summaries of witness statements gathered by an attorney during trial preparation.

(2) In 1970, a rule was added to the Federal Rules of Civil Procedure to address the issue. FRCP 26(b)(3) provides that “a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial or for another party or its representative.”

(a) The rule is different from the holding in Hickman in two regards. The rule does not protect from disclosure:

(i) intangible work product; or

(ii) work product prepared by non-attorneys (this issue was not addressed in Hickman).

(b) Courts generally apply the “because of” test to determine if the material has been prepared in anticipation of litigation.

d. As of 2009, the IRS official policy is that tax accrual workpapers will not automatically be requested in every audit. Recent trends have shown that the IRS is requesting these workpapers more and more. In contrast, once a matter goes forward to the litigation phase, the IRS routinely asks for copies of tax accrual workpapers as part of their informal discovery.


a. Rationale: In contrast to Textron, the D.C. Circuit focused on the content of the materials at dispute. The D.C. Circuit determined that Deloitte’s tax accrual workpapers contained work product which includes the thoughts and opinions of counsel developed in anticipated of litigation.
b. The Court also stated that the disclosure of the work product to the taxpayer's independent auditor did not constitute a waiver of the privilege because Deloitte was not a potential adversary and a reasonable expectation of confidentiality was expected.

c. The IRS did not seek Supreme Court review in this case.

3. Wells Fargo – Dual Purpose Documents (District Court Minnesota)

a. On September 1, 2010, Wells Fargo & Co. asked the court to quash a subpoena issued to its independent auditor, KPMG LLP relating to requests for tax accrual workpapers.

(1) The summons asked for "any and all analyses, computations, opinions, notes, summaries, discussions, and other documents relating to such reserves and any footnotes."

(2) Wells Fargo & Co is attempting to protect from disclosure the following items from its files and from the files of its auditor:

(a) Company memoranda based on advice of in-house tax controversy attorneys identifying and evaluating the legal merits of its UTPs and selecting a reserve percentage based on the likelihood of settlement;

(b) Meeting agendas and emails identifying and/or evaluating litigation risks associated with its UTPs; and

(c) Spreadsheets, reports, and electronic data files identifying UTPs with potential analysis relating to evaluating appropriate legal tax reserve percentages and reserve amounts.

(3) The question for the Court is whether the work product doctrine applies to dual purpose documents prepared by taxpayers to support their FASB Interpretation No. 48 tax reserves. The tax reserves would not be necessary but for the anticipated litigation.

(4) Government's Position – the documents were prepared in the ordinary course of business as part of Wells Fargo’s obligations under regulatory requirements not for anticipated litigation. The government also asserts that any work product privilege was waived when Wells Fargo provided the documents to its auditors.
The District Court held a four-day evidentiary hearing beginning on July 25, 2011. The parties are awaiting a final decision.

4. Effect of UTP Reporting on the Tax Accrual Workpaper Issue

a. On September 24, 2010, the IRS released materials relating to the new reporting requirements for uncertain tax positions (UTPs) including the final form of Schedule UTP.

b. For 2010, private or public companies with total assets of $100 million or more that issue or are included in audited financial statements and that file a Form 1120, 1120-L, or 1120-PC must file a Schedule UTP. The schedule will be phased in for taxpayers with assets of less than $100 million.

c. Schedule UTP requires filers to rank UTPs by the amount of reserves.

d. Schedule UTP requires a concise description of relevant facts affecting the tax treatment of the position and information to apprise the IRS of the identity of the tax position and the nature of the issue. The statement does not have to include the rationale for the filing of the UTP.

e. The IRS plans to process Schedule UTP through an established centralized process under LB&I. This will enable LB&I to select issues and returns for audit.

f. It is to be seen whether the reporting requirements for Uncertain Tax Positions will moot future disputes over tax accrual workpapers.

III. IRS GUIDANCE -- WHAT DEGREE OF DEFERENCE AND WHEN CAN TAXPAYERS RELY UPON IT?

A. Six-Year Statute of Limitations – Beard; Home Concrete; Grapevine; etc.

1. Background:

a. Code Section 6501(a) generally provides that a valid assessment of income tax liability may not be made more than 3 years after the later of the date of the tax return was filed or the due date of the tax return.

b. Code Section 6501(e)(1)(A) allows a 6 year statute of limitations on assessment when a taxpayer “omits from gross income” an amount that is greater than 25% of the amount of gross income stated in the return.
6501(e)

Except as otherwise provided in subsection (c) —

(1) Income taxes. In the case of any tax imposed by subtitle A—

(A) General rule. If the taxpayer omits from gross income an amount properly includible therein and—

(i) such amount is in excess of 25 percent of the amount of gross income stated in the return, or

(ii) such amount—

(I) is attributable to one or more assets with respect to which information is required to be reported under section 6038D (or would be so required if such section were applied without regard to the dollar threshold specified in subsection (a) thereof and without regard to any exceptions provided pursuant to subsection (h)(1) thereof), and

(II) is in excess of $5,000,

the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.

(B) Determination of gross income. For purposes of subparagraph (A) —

(i) in the case of a trade or business, the term “gross income” means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and

(ii) in determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

(C) Constructive dividends. If the taxpayer omits from gross income an amount properly includible therein under section 951(a), the tax may be assessed, or a proceeding in court for the collection of such tax may be done without assessing, at any time within 6 years after the return was filed.
2. **Colony, Inc. v. Commissioner**, 357 U.S. 28 (1958)

   a. Background: Real estate developer that miscalculated profits from the sale of realty by erroneously including an excessive item of cost of the realty.

   b. Issue: Under the predecessor statute to 6501(e), did the taxpayer omit from gross income some taxable item?

   c. Holding: The extended period of limitations in applies to situations where specific income receipts have been "left out" in the computation of gross income, and not something put in and overstated.

   d. Rationale —

      (1) When a taxpayer omits an item, the IRS is at a disadvantage in detecting errors. In such cases the return on its face provides no clue to the existence of an omitted item. However, in an overstated basis issue the face of the return the Commissioner is not at a disadvantage because the basis is disclosed.

3. 1954 Code Changed/Clarified Code Section 275(c) (now 6501(e))

   a. Congress made modifications to the 3-year/6-year issue in response to court decisions. In each instance, Congress limited the 6-year statute to cases in which the taxpayer left out items of income.

      (1) New Heading on Code Subsection— "Substantial Omission of Items" replaced "Omission from Gross Income."

      (2) Exception from 6-year statute if adequate disclosure is provided.

      (3) Redefined gross profit as including only the revenue side.

4. IRS Litigation Position: Treasury Regulation 301.6501(c)-1(e) (T.D. 9511).

   a. Background: In December 2010, the IRS issued final regulations which held that an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis is an omission of gross income for purposes of the 6-year period for assessing tax.
IRS disagrees that the holding of Colony applies to Section 6501(e)(1)(A). The IRS takes the position that when Congress enacted the 1954 Code, it limited what became the holding of Colony under the 1934 Code.

The Regulations provide that any overstatement of basis that results in an understatement of gross income under Code Section 61(a) is an omission from gross income under Code Section 6501(e)(1)(A).


(1) On January 11, 2011, the Supreme Court addressed the validity of Treasury regulations dealing with employment taxes for medical residents and other student-employees.

(2) Issue: Whether medical residents are exempt from FICA taxes based on the exception for service performed in the employ of a school, college, or university if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university.

(3) The Treasury regulations promulgated in 1951 provide that the exception only applies to students who work for their schools as incident to and for the purpose of pursuing a course of study. See Treas. Reg. §31.3121(b)(10)-2(d).

(4) In 2004, Treasury amended the regulations so that the exception only applies only when the educational aspect predominates over the service aspect. Specifically, student working a full-time schedule (scheduled more than 40 hours a week) are not within the exception.


(6) However, the 8th Circuit reversed the lower court ruling finding that the regulation was valid under the Chevron standard (Chevron U.S.A. Inc., v. Natural Resources Defense Council Inc., 467 U.S. 837 (1984)) (Mayo Found. For Med. Res. v. United States, 568 F. 3d 675 (8th Cir. 2009).
(7) The Supreme Court unanimously affirmed the circuit court opinion (131 S. Ct. 704 (2011)) and held:

(a) **Chevron**, not **National Muffler** controls;

(b) Section 3121(b)(10) is silent or ambiguous as to the definition of the student exception; and

(c) The amended regulations reasonably interpret section 3121(b)(10).

c. Application of **Mayo/Chevron**.

(1) Determination

(a) Step 1 – Did Congress have an intention on the precise question at issue? If so, that intent is controlling. If the regulation takes a different position, the regulation is invalid.

(i) Ask -- Is the statutory provision ambiguous?

(ii) Ask – Can the judge look to other guidance to determine Congressional intent such as legislative history or should the focus be solely on the text of the statute?

(b) Step 2 – If Congress did not have an intention on the precise question at issue, then a government agency can adopt any reasonable interpretation.

(i) Ask – Is the regulation reasonable interpretation of the statute?

(2) Generally, for a taxpayer to be successful in challenging the validity of a regulation, the taxpayer must win at Step 1. If the statutory provision is found to be ambiguous, the burden on the taxpayer to show that the interpretation is unreasonable is quite steep. However, it is not impossible to convince a court that the agency determination is unreasonable.

5. Supreme Court -- **Home Concrete & Supply, LLC v. United States** (Docket No. 11-139).

a. On September 27, 2011, the U.S. Supreme Court granted certiorari. Many people were surprised that the Supreme Court chose to select this case as opposed to the taxpayer’s petition in **Beard v. Commissioner**. **Beard** had been decided earlier and had the
b. Issue Before the Supreme Court:

(1) Whether an understatement of gross income attributable to an overstatement of basis in sold property is a gross omission that triggers the six-year assessment period.

(2) Whether final regulations promulgated by Treasury are subject to judicial deference.

c. Facts:

(1) Robert Pierce and Stephen Chandler owned Home Oil and Coal Company. They planned to sell the business. Prior to engaging in a sales transaction, the two owners participated in a variety of transactions including short sales of U.S. Treasury Bonds. These transactions were designed to increase their basis in certain assets and decrease their tax liability upon the actual sale of the business.

(2) When they initiated the sales of the U.S. Treasury bonds, they transferred the short sale proceeds and margin cash to Home Concrete & Supply, LLC (“LLC”) as capital contributions. The contributions created an outside basis in the LLC. When the LLC closed the short sale transactions by purchasing and returning almost identical U.S. Treasury bonds to the open market.

(3) Home Oil & Coal Company transferred all of its business assets to the LLC as a capital contribution.

(4) Pierce and Chandler transferred percentages of their respective partnership interest in the LLC to Home Oil as a capital contribution.

(5) LLC sold substantially all of its assets to a third-party purchaser.

(6) On its 1999 tax return, the LLC made a Section 754 election to adjust or step up its inside basis to equal the taxpayer’s outside basis in the LLC. The LLC then adjusted its inside basis and as a result reported a modest gain on the sale of its assets.
On September 7, 2006, the IRS issued a Final Partnership Administrative Adjustment ("FPAA"). In the FPAA, the IRS did not allow the basis step-up, which resulted in a substantial increase in the LLC’s gain on the sale of the assets.

The IRS rational for the adjustment was that the partnership was formed and availed of solely for purposes of tax avoidance by artificially overstating basis in the partnership interest.

Home Concrete paid the amount due and filed a refund suit in the U.S. District Court for the Eastern District of North Carolina.

The Taxpayers alleged that the FPAA was barred by the Code Section 6501(a) 3-year limitations period.

d. District Court’s Holding (Home Concrete & Supply, LLC v. U.S. (E.D. NC 2008) – Held in Favor of the IRS:

(a) Holding: Granted partial summary judgment in the IRS’s favor.

(b) Rationale: Held that where a taxpayer overstates basis, and as a result, leaves an amount out of gross income, the taxpayer omits an amount from gross income for purposes of Code Sec 6501(e)(1)(A).

(c) Therefore, the 6-year statute applied, not the 3-year.

e. Fourth Circuit’s Holding (Home Concrete & Supply, LLC v. United States, 634 F. 3d 249 (4th Cir. 2011) – Held in Favor of the Taxpayer:

(a) Holding: Overruled District Court and found that the 3-year statute of limitations not the 6-year statute applied, which meant that the FPAA was untimely.

(b) Rationale: Held that the Supreme Court holding in Colony continued to apply to Code Section 6501(e)(1)(A) and that an overstated basis in property is not an omission from gross income that extends the period of limitation.

(c) Home Concrete’s overstated basis in the short sale proceeds did not trigger the 6-year statute of limitations.
(d) The Colony decision construed the phrase “omits from gross income” separate from being dependent on the taxpayer’s identity as a trade or business selling goods or services. The language of the statute that was at issue in Colony is identical to the language at issue in Home Concrete.

(e) The 4th Circuit held that because the Treasury Regulation at issue was interpreting language that the Supreme Court held to be unambiguous when it decided Colony, the regulation was not entitled to controlling deference.

f. Supreme Court Review: Effect of Mayo

(1) In Mayo, the Supreme Court gave the government wide latitude when regulations are issued. There is confusion regarding how broad these powers extend. Can the IRS do whatever it wants when it issues regulations? Did Congress intend to permit the IRS to issue retroactive regulations with such a broad scope when used to bolster a litigation position?

(2) Does Colony still apply post Chevron/Mayo?

(3) Step 1 - Will the Supreme Court find the statute ambiguous?

(a) In aiding their determination, will the Supreme Court look past the statutory provision to legislative history and Congressional reports?

(4) Step 2 – If it is ambiguous, are the retroactive regulations reasonable?

(a) Do the regulations meet the Administrative Procedures Act standards – did Treasury provide adequate explanation for the regulations?

(g) Taxpayer’s Response to Government’s Certiorari Petition

(1) Argued that legislative changes to section 6501(e) have never overruled Colony, which remains good law because it is not limited to goods or services.

(2) Argued that the final regulations are not applicable even if the six-year statute applies because the retroactive nature of the regulations violates due process and does not deserve judicial deference.
6. Status of Other Cases –

a. Court of Appeals – Government Wins

(1) Seventh Circuit – Beard v. Commissioner, 633 F. 3d 616 (7th Cir. 2011).
   
   (a) Found Colony not to be controlling, did not reach issue of deference to the regulations.
   
   (b) No mention of Mayo, even though decided and opinion written after Mayo.

(2) Tenth Circuit – Salman Ranch Ltd. v. United States, 573 F. 3d 1362 (Fed. Cir. 2009).
   
   (a) Applied Mayo to permit deference for issued regulations notwithstanding pending litigation.
   
   (b) Note that litigation in the Federal Circuit relating to a prior tax year, Salman Ranch (573 F. 3d 1362
   
   (Fed. Cir. 2009) won on the same issue. The 10th Circuit said that the “rules” had changed in the interim and held that collateral estoppel did not apply.

   
   (a) Found statute to be ambiguous by exploring Colony decision and legislative history.
   
   (b) Applied Mayo to permit deference for issued regulations notwithstanding pending litigation.

   
   (a) Statutory language was ambiguous. Treasury regulations were reasonable interpretation of the statute.
   
   (b) Relied solely on Chevron and Brand X. Mayo not mentioned.

b. Court of Appeals – Taxpayer Victories

(1) Fourth Circuit – Home Concrete (See above).
(a) Found statute unambiguous.

(2) Fifth Circuit – Burks v. United States, 633 F. 3d 347 (5th Cir. 2011).

(a) Found statute unambiguous, Mayo not applicable. Assuming statute ambiguous, court expressed concern over the retroactive litigation position of the new regulations asserted by the IRS.

(3) Ninth Circuit – Bakersfield Energy Partners, LP v. Comm'r, 568 F. 3d 767 (9th Cir. 2009).

(a) Case decided prior to the issuance of the new Treasury regulation. Also, the case was decided before the Mayo decision.

(b) Held that Colony controlled the case and that overstated basis was not a gross omission.

(c) Stated that the IRS may issue regulations that run contrary to a Supreme Court holding provided that the statute is ambiguous and the regulations are reasonable (citing Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 545 U.S. 967(2005)). However, they were bound by the decision in Colony.

B. Non-precedential guidance – e.g., Directives, FAQs:

1. Increasingly Utilized; Examples include:

a. Success-Based Fees – On July 26, 2011, LB&I issued a directive directing agents not to pursue a taxpayer’s treatment of success-based fees paid or incurred in a transaction described in § 1.263(a)-5(e)(3) of the Income Tax Regulations in taxable years ended before April 8, 2011, where the taxpayer’s original return position is to capitalize such fees to the transaction in an amount of at least 30 percent of the total success-based fees incurred by the taxpayer with the respect to the transaction.

b. Economic Substance Doctrine – On July 15, 2011 LB&I issued internal directive with guidelines related to when it is appropriate to apply the codified economic substance doctrine and penalties.

c. Gift Tax on 501(c)(4) Contributions – On July 7, 2011 LB&I issued an internal directive without guidance, directing agents not to pursue gift tax audits related to 501(c)(4) Contributions until further guidance is provided.
d. **Strict Liability Economic Substance Doctrine Penalty** - On September 14, 2010, LMSB issued a directive requiring that any assertion of the strict liability penalty be approved at the DFO level.

e. **Gain Recognition Agreements** – On July 26, 2010, LMSB issued a memorandum titled “Directive on Examination Action With Respect to Certain Gain Recognition Agreements” with a procedure for taxpayers that timely filed a document that "purports" to be a GRA regarding an initial transfer but does not satisfy the requirements of reg. section 1.367(a)-8(c)(2).

f. **Tiered Issue Industry Director Directives** – Provide guidance to agents on how to examine tiered issues.

2. **Must be Adhered to By IRS Personnel**

   a. IRS personnel are expected to follow these directives - “LMSB Examiners are expected to follow guidelines and instructions provided in LMSB Directives. If the Directive is jointly issued with another operating division, then examiners of both divisions must follow the Directive.” IRM 4.51.2.6(5).

3. **Taxpayers Cannot Rely On Them**

   a. Directives Constitute Informal Guidance

   b. Generally only administrative in nature; Does not address IRS legal position

   c. Not recognized as authoritative

      (1) For penalty purposes - Directives are not specifically identified in reg. section 1.6662-4(d)(3)(iii) as authority that constitute "substantial authority" for penalty purposes.

      (2) For Circular 230 purposes.

4. **Can Sometimes Mutate Into Proposed Regulations.**

IV. **TAX OPINIONS AND PENALTIES POST-CANAL**

   A. **Canal Corporation** (Canal Corp. v. Comm'r, 135 T.C. 199 (2010))

   1. **Issue** - Issue was whether anti-abuse regulations of Treas. Reg. §1.752-2(j) applied to a debt-financed distribution transaction.
2. Facts:

a. **Formation of Partnership** – Georgia Pacific (GP) and WISCO (a subsidiary of Chesapeake) formed Georgia-Pacific Tissue LLC (LLC) as the vehicle for a joint venture. GP and WISCO treated the LLC as a partnership for tax purposes. Both partners contributed the assets of their respective tissue businesses to the LLC. GP transferred to the LLC its tissue business assets with an agreed value of $376.4 million in exchange for a 95-percent interest in the LLC. WISCO contributed to the LLC all of the assets of its tissue business with an agreed value of $775 million in exchange for a 5-percent interest in the LLC.

b. **Debt-Financed Distribution** - The LLC borrowed $755.2 million from Bank of America (BOA) on the same day it received the contributions from GP and WISCO. The LLC immediately transferred the loan proceeds to Chesapeake's (WISCO’s parent) bank account as a special cash distribution.

c. **Guarantee and Indemnification** - GP guaranteed payment of the BOA loan, and WISCO agreed to indemnify GP for any principal payments GP might have to make under its guaranty.

d. **LLC’s Assets** - The LLC had approximately $400 million in net worth based on the parties' combined initial contribution of assets ($1.151 billion) less the BOA loan ($755.2 million), and it had a debt to equity ratio of around 2 to 1. The LLC assumed most of WISCO's liabilities. Chesapeake and WISCO both indemnified GP and held it harmless for any costs and claims that it might incur with respect to any retained liabilities of WISCO.

e. **WISCO’s Assets** - WISCO's assets following the transaction included an intercompany note with a face value of $151 million and a corporate jet worth approximately $6 million. WISCO had a net worth, excluding its LLC interest, of approximately $157 million. This represented 21 percent of its maximum exposure on the indemnity.

3. **Opinion** – The Court determined that the anti-abuse rules of Treas. Reg. §1.752-2(j) applied to the debt-financed distribution transaction.

   a. **Legal Background**

   (1) **Contributions and Distributions to Partnerships are Tax Free** - The Court first recognized that contributions to and distributions from partnerships are generally tax-free events. See generally IRC §§721, 731.
(2) **Disguised Sale Rule** - Section 707(a)(2)(B), however, provides the 'disguised sale rule’ exception to this general rule. There, when a partner contributes property to a partnership and soon thereafter receives a distribution of money or other consideration from the partnership, a disguised sale, as opposed to a tax-free distribution, may be deemed to have occurred.

(3) **Debt-Financed Distribution Exception to Disguised Sale Rule** - The taxpayer in Canal argued that the distribution to Chesapeake was not a disguised sale because it met one of the exceptions to the disguised sale rules – the Debt-Financed Distribution Exception. Under this exception, certain debt-financed distributions are excluded in determining whether a partner received “money or other consideration” for disguised sale purposes. This includes a partner's share of a partnership’s recourse liabilities, provided the partner bears the economic risk of loss associated with that liability.

(4) **Anti-Abuse Rule** – The anti-abuse rule provides that a partner's obligation to make a payment on a partnership’s recourse liabilities may be disregarded if (1) the facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's risk of loss or to create a facade of the partner's bearing the economic risk of loss with respect to the obligation, or (2) the facts and circumstances of the transaction evidence a plan to circumvent or avoid the obligation.

b. **Court’s Analysis**

(1) **Indemnity Limited Risk** – The Court first determined that the indemnification of the GP guarantee of the LLC debt limited the risk of loss to only WISCOs remaining assets – Chesapeake bore no risk of loss.

(2) **WISCO's Assets** – The Court determined that WISCO’s assets were minimal relative to the indemnified amount and as a result the “agreement to indemnify GP's guaranty lacked economic substance and afforded no real protection to GP.”

(3) **Conclusion** – The anti-abuse rules applied, effectively rejecting application of the debt-financed distribution to the disguised sale rule.
B. **Penalty** – Court also considered whether a section 6662 penalty applied to the transaction.

1. **Raised During Litigation** – Although the assertion of a penalty to the transaction was not unique, the manner in which it was first raised was. Rather than the penalty being asserted in the Notice, the penalty was first raised during the litigation.

   a. **Ability to Raise New Issues in Tax Court** – The IRS may raise new issues during litigation in Tax Court that are not present in the Notice.

   b. **Tax Court Chief Judge Colvin’s Remarks** – Commenting on the Canal case in oral remarks made at the 2011 ALI-ABA course entitled *How To Handle a Tax Controversy at the IRS & in Court: From Administrative Audit Through Litigation* on September 16, 2011 in Washington, DC, Chief Judge of the Tax Court, John O. Colvin acknowledged that the Government is not precluded from raising new issues during litigation that were not addressed in the Notice, including penalties.

   c. **Burden of Proof** – When the Government raises a new issue during litigation, the burden of proof generally falls to the Government with respect to those new issues.

2. **Reliance on Experts** – Court rejected reasonable reliance on accounting firm’s ‘should’ opinion.

   a. **Fee** – Court suggested that the $800,000 flat fee paid for the opinion indicated that the advice therein was unreasonable. In making this suggestion, the Court found that the draft of the opinion submitted at trial contained typographical errors, was disorganized and was incomplete, and that as a result it must have been hastily drafted. In describing why a should opinion was issued, the Court asserted that “The only explanation that makes sense to the Court is that no lesser level of comfort would have commanded the $800,000 fixed fee that Chesapeake paid for the opinion.”

   b. **Legal Reasoning** – Court determined that “the opinion was riddled with questionable conclusions and unreasonable assumptions.”

   c. **Court’s Conclusion** – Based on what it found to be questionable conclusions and unreasonable assumptions, the court concluded that “Chesapeake's tax position did not warrant a “should” opinion because of the numerous assumptions and dubious legal
conclusions in the haphazard draft opinion that has been admitted into the record. Further, we find it inherently unreasonable for Chesapeake to have relied on an analysis based on the specious legal assumptions.”

d. **Personal Identification of Opinion Drafter** – The Court singled out and identified by name and employer the drafter of the opinion issued to Chesapeake.

V. **APPEALS – CHANGES IN COORDINATION OF TECHNICAL ISSUES**

A. **Practitioners Concerns:** Practitioners continue to be concerned about Appeals’ coordination of tax issues along with other originating functions at IRS.

1. Although more subtle than a direct violation of ex parte prohibitions, coordination jeopardizes the appearance of Appeals independence given the level of interaction.

B. **IRS Response:** IRS appears to recognize these concerns and may be attempting to mollify practitioners concerns in several ways.

1. IRS has announced that Appeals will no longer formally sit on issue management teams.

2. Commenting on Appeals’ coordination of technical issues at the 2011 ALI-ABA course entitled *How To Handle a Tax Controversy at the IRS & in Court: From Administrative Audit Through Litigation* on September 15, 2011 in Washington, DC, National Director Of Appeals, Chris Wagner, stated that there had been no new issues identified for technical coordination during FY 2011 and that appeals had withdrawn 18 issues from the coordinated technical guidance list (which requires the concurrence of an Appeals Technical Guidance Coordinator to approve the terms of settlement).

C. **Appeals - Ex Parte**

1. **Ex Parte Background**

   a. Section 1001(a) of RRA 1998 directs IRS commissioner to ensure: “an independent appeals function within the Internal Revenue Service, including the prohibition in the plan of ex parte communications between appeals officers and other Internal Revenue Service employees to the extent that such communications appear to compromise the independence of the appeals officers.”

   (1) **Comports with Appeals’ Mission** - This comports with Appeals’ fundamental mission “to resolve tax controversies, without litigation, on a basis which is fair.
and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service.” Internal Revenue Manual 8.1.1.1(2) (2003).


(1) **Purpose of Rev. Proc. 2000-43** - Approach taken therein is to “accommodate the overall interests of tax administration, while preserving operational features that are vital to Appeals case resolution processes within the structure of the IRS and ensuring more open lines of communication between Appeals and the taxpayer/representative.” Rev. Proc. 2000-43, §2.

(2) **Protect Appeals Independence** - Guidelines are intended to preclude written or oral ex parte communications between Appeals and originating functions that could jeopardize the appearance of Appeals’ independence.

(3) **Substantive Communications Only** - Communications that are ministerial, administrative, or procedural in nature are not precluded by the Guidelines.

(4) **Reasonable Opportunity to Participate** - Communications are not ex parte if the taxpayer is provided a “reasonable opportunity” to be present.


c. IRS’ misperception of, and internal procedures to handle, ex parte guidelines jeopardize Appeals’ independence.

(1) **Administrative/Ministerial** - IRS classifies ex parte communications as administrative or ministerial when in reality they may be at least partially substantive.

(2) **Harmless Error** - IRS asserts communications result in harmless error.

(3) **Good Faith** – IRS asserts communications are made in good faith (i.e., they are intended as factual development)

(4) **Lack of Procedures and Processes** – No procedure for disclosures to occur, and no process for when a disclosure does occur.

a. Convert the guidelines into narrative format from question-and-answer format.


c. Adopts a series of guiding principles that, in theory, are designed to help with the interpretation and understanding of the ex parte restrictions.

d. New and Continuing Causes for Concern:

(1) **Little Taxpayer-Favorable Change** – Little in the new guidance provides for new restrictions or rules that favor taxpayers. Old concerns remain, and additional new concerns have arisen.

(2) **Self-Enforcement** - No procedures have been established by which a taxpayer can inquire or test whether an improper ex parte communication has occurred, nor are any remedies established for violations. Taxpayers should continue to be vigilant in inquiring as to potential prohibited communications and in requesting to participate in all communications of which they are given advance notice.

(3) **Chief Counsel Field Attorney Communications** – Appeals’ communications with Chief Counsel field attorney advising the originating IRS function is an ex parte communication only if the field attorney “personally” advised or advocated on the issue. Whether this was the case now dependent on an internal assessment (one not likely to be shared with the taxpayer) of the “extent and nature of the field attorney’s involvement.” This is a change from the old rules of Rev. Proc. 2000-43 in which Appeals was not permitted to communicate “ex parte regarding an issue in a case pending before them with Counsel field attorneys who have previously provided advice on that issue in the case to the IRS employees who made the determination Appeals is reviewing.”

(4) **Chief Counsel Recommendations of Settlement Ranges** – New guidelines state that Appeals officers are responsible for independently evaluating the strengths and weaknesses of the specific issues in the case and need not follow Counsel’s advice. This is a departure from the stronger
language in prior guidelines which provided that “Counsel attorneys will not provide advice that includes recommendations of settlement ranges for an issue in a case pending before Appeals or for the case as a whole.”

VI. TEFRA LITIGATION


B. Issue in Bush – Whether Government was required to issue deficiency notices before making post-settlement partner assessments stemming from partnership losses and at-risk adjustments.

C. Facts – Two cases were consolidated for trial and considered in tandem on Appeal.

1. Taxpayers were part of a partnership for which the IRS had issued FPAAAs for the 1983-1986 years. While Tax Court proceedings related to those FPAAAs were ongoing, taxpayers settled with the IRS by entering into closing agreements.

2. The closing agreements expressly stated that they did not make any adjustments to partnership items. The agreements addressed the right to claim partnership losses on individual tax returns. The agreements provided that the settling partners were only entitled to claim partnership losses to the extent of their “at risk” amount. They also contained stipulations as to how to calculate the exact dollar amount for each settling partner that was “at risk” for the relevant tax years. Once these agreements were executed, the Tax Court dismissed the taxpayers from the partnership proceedings.

3. In 2000, the IRS issued Notices of Adjustment for the taxpayers’ 1985, 1986, and 1987 tax returns. The Notices disallowed a significant portion of the losses the Bushes had claimed connected to the two partnerships. Two weeks later, the IRS assessed the taxpayers for those amounts. The assessed amounts were based on the calculations contained in the closing agreements. At no point did the IRS issue a Notice of Deficiency related to the assessed amounts.

4. The taxpayers paid the assessed tax and interest and two years later initiated refund proceedings with the IRS seeking to recover that payment on grounds that the IRS failed to provide them deficiency notices. The IRS denied their claims, and the taxpayers filed suit in the Court of Federal Claims.

D. Procedural History

1. Court of Federal Claims – The Court of Federal Claims sided with the government. It held that the post-settlement adjustments were
“computational adjustments” as that term is defined in the Tax Code and that none of the Tax Code provisions requiring a Notice of Deficiency applied because of the computational nature of the adjustment.

2. First Federal Circuit Opinion — A divided panel affirmed the Court of Federal Claims, but on different grounds. The Federal Circuit reasoned that the adjustments were not “computational adjustments” but instead the failure to provide notice was harmless under the federal harmless error statute, 28 U.S.C. § 2111.

E. En Banc Federal Circuit Opinion

1. The Federal Circuit adopted the position of the Court of Federal Claims. The Court found that “[a]fter the settlement, there was nothing to do other than plug numbers into a formula to determine any change in tax liability.”

2. The Federal Circuit also addressed the Taxpayer’s argument that: (1) such a holding impermissibly widened the purview of computational adjustments, (2) such a holding would render the second sentence of I.R.C. § 6231(a)(6) (the definition of “computational adjustment”) superfluous, and (3) such a holding conflicted with regulations on computational adjustments were unpersuasive to the Court.

VII. TEFRA LITIGATION – PENALTIES / SALA V. U.S., 613 F. 3d 1249 (10TH CIR. 2010)

A. Issue in Sala – Whether Government was entitled to offset excess interest payments due to taxpayer with Section 6662 penalty owed but not assessed where overpayment did not exist and where, in any event, taxpayer had filed a qualified amended return.

B. Facts

1. In 2000, taxpayer realized more than $60 million in income related to the sale of stock options. Taxpayer invested all but $9 million of this income in fixed income assets. The remaining $9 million was invested in a foreign currency investment program.
2. The $9 million foreign currency investment resulted in the acquisition of 24 foreign currency options, consisting of both long and short positions. The net cost was approximately $725,000.

3. In November, 2000, taxpayer formed Solid Currencies, Inc. ("Solid" or "Solid Currencies")—a Delaware S Corporation in which taxpayer was the sole shareholder. Taxpayer then transferred the 24 options, plus approximately $8 million in cash, to Solid and then from Solid to Deerhurst Investors, GP, in exchange for a partnership interest. Deerhurst Investors, GP was liquidated prior to December 31, 2000.

4. Upon liquidation of Deerhurst GP, Solid received a share of the proceeds. Solid transferred its share of the Deerhurst GP proceeds to a different entity where the funds continued to be used for investment purposes through 2004.

5. Taxpayer's 2000 return reported an ordinary loss from a trade or business of $60,000,000. This loss was achieved by disregarding short options as liabilities for purposes of establishing partnership basis. Thus, upon transfer of the 24 foreign currency options from taxpayer to Solid and then to Deerhurst GP, Solid's basis in Deerhurst GP was increased by the value of the long options, but was not offset by the cost of the short options.

6. Upon liquidation of Deerhurst GP, Solid received a portion of Deerhurst GP's liquidated assets equal to the proportionate size of Solid's basis. Solid claimed to have received approximately $8 million in cash and two foreign currency contracts. Under the Tax Code, the foreign currency contracts were considered to be "property" at transfer. The value of the foreign exchange contracts distributed to Solid, therefore, was claimed to be approximately $61 million—$69 million (Solid's original basis in Deerhurst GP) less the $8 million in cash. When Solid sold the foreign currency contracts, its loss was equal to the $61 million dollar value of the contracts, offset by any profit received from their sale. According to Solid's 2000 tax return, the combined loss on the foreign currency contracts was approximately $60,000,000.

7. In November 2003, taxpayer filed a form 1040X amending his 2000 return. The amended return reported the same income amounts as the original return, but did not report the approximate $60,000,000 loss previously attributed to Solid Currencies. Taxpayer paid the resulting approximately $26 million in taxes, interest, and penalties. On or about June 18, 2004; the IRS issued a Notice of Deficiency to taxpayer, asserting he owed additional taxes in the amount of $22,204 due to the disallowance of $56,071 of losses taxpayer reported as attributable to Solid Currencies. The Notice of Deficiency also asserted an accuracy-related penalty in the amount of $4,400.80 for tax year 2000.
8. In September 2004, taxpayer filed another form 1040X for the 2000 tax year reclaiming the loss attributable to Solid Currencies and claiming a refund due of $23,727,630.


1. For a variety of reasons not particularly relevant to the penalty issues herein involved, the District Court ruled that the currency program giving rise to the tax losses that Petitioner had entered into was a valid transaction, thereby sustaining the tax losses.

2. With respect to the accuracy-related penalty, the District Court determined that the penalty was inapplicable for two reasons:
   
   a. First, the court determined that because the transaction giving rise to the loss was valid, there was effectively no underpayment to which the penalty could have attached.

   b. More interestingly, the court went on to state that "Even if [taxpayer] did underpay his 2000 taxes, however, the Government is not entitled to a penalty if [taxpayer] filed a "qualified amended return." 26 C.F.R. § 1.6664-2(c)(2).” Such a filing would fail to meet the standards of a qualified amended return, however, if the Government had initiated an investigation of the taxpayer prior to the filing, or initiated an investigation of the shelter organizer. The Court determined that although an investigation of the shelter promoter had been initiated by the IRS, the investigation did not relate to the particular shelter at issue in the Sala case. As such, the qualified amended return filed by the taxpayer was valid, and even if a deficiency existed, an accuracy related penalty would be inappropriate.

3. **Circuit Court Opinion** - Sala v. U.S., 613 F.3d 1249 (10th Cir. 2010).

   a. On Appeal to the Tenth Circuit, the District Court was overturned on the grounds that the underlying transaction lacked economic substance and a business purpose.

   b. Despite being overturned, the Circuit Court included a footnote indicating that “the district court ruled Sala was entitled to a refund of more than $1.5 million in interest payments he made relating to his 2000 taxes and the Government represents to this court that it does not appeal this ruling. Neither does the Government seek to overturn the district court's ruling that it may not offset this refund with an accuracy related penalty. Accordingly, our decision has no affect on either of these aspects of the district court's judgment.”
Thus, despite the District Court's primary holding being overturned, it appears the penalty discussion related to the filing of a qualified amended return, and the existence of a non-transaction-specific investigation of the shelter promoter, remains valid.

(1) Note, however, that because District Court did not need to necessarily reach the qualified amended return issue (because it had determined a deficiency did not exist in the first place) one could argue the District Court's opinion related to the qualified amended return issue was merely dicta.

c. Supreme Court — On October 3, 2011, the Supreme Court declined to review the case rendering the 10th Circuit opinion to be final.

D. Jurisdictional Deposit / Prestop Holding LLC v. United States, 106 AFTR2d 2010-7246 (Fed. Cl. 2010)


2. Issue in Prestop – Whether the deposit requirement of IRC §6226(e)(1) included increases to the petitioning partner’s taxes, arising from adjustments made in an FPAA, but payable with respect to years subsequent to the year for which the FPAA was issued.

3. Facts –

a. Partnership made several tax-free distributions of property in 1997 to the taxpayer/partner. The taxpayer claimed a high basis in the distributed property.

b. The taxpayer sold the distributed property beginning in 1998 through 2001, claiming tax losses on the sale of the property due to the high basis.

c. In 2004, the IRS issued the partnership an FPAA for the 1997 taxable year, the effect of which was to reduce the taxpayer's basis in the distributed property.

d. In 2005, the taxpayer petitioned the Federal Claims Court, submitting as a jurisdictional deposit $100. The ultimate purported tax deficiency related to the distributed property was significantly higher than the $100 deposited.
E. Legal Background

1. IRC §6226(e)(1) provides that:

A readjustment petition under this section may be filed in a district court of the United States or the Claims Court [Court of Federal Claims, see §902(b), P.L. 102-572] only if the partner filing the petition deposits with the Secretary, on or before the day the petition is filed, the amount by which the tax liability of the partner would be increased if the treatment of partnership items on the partner's return were made consistent with the treatment of partnership items on the partnership return, as adjusted by the final partnership administrative adjustment. In the case of a petition filed by a 5-percent group, the requirement of the preceding sentence shall apply to each member of the group. The court may by order provide that the jurisdictional requirements of this paragraph are satisfied where there has been a good faith attempt to satisfy such requirements and any shortfall in the amount required to be deposited is timely corrected.

2. Unique Aspects of Partnership Adjustments

a. Adjustments to Income, not Tax - FPAs only propose adjustments to individual items of income or deduction of the partnership, but do not usually compute the taxpayer’s actual tax liability. Thus, an adjustment in an FPA with respect to a particular year may or may not correlate to the partner’s ultimate tax liability for the same year.

(1) Examples of situations in which an adjustment to a partnership in one year may have tax implications for the partner in different years include: 1) an adjustment that reduces losses or credits that the partner can carry to other years, or 2) an FPA that determines the tax consequences of a transaction in a way that does not have actual tax impacts until later years. See, e.g., Kligfeld Holdings (FPA issued in connection with 1999 contribution by partner to partnership, not with respect to 2000 distribution to partner that gave rise to tax).

b. One Party Files Petition for Readjustment – Section 6226 provides that one party will file a petition for readjustment of the partnership items, not necessarily all partners together.

3. Earlier Cases Opinions

a. Kislev – Held that the jurisdictional deposit relates to not only the year in question, but all tax effects of the adjusted items for all years at issue. Court relied upon the Dictionary Act (1 USC §1) to find that IRC §6226(e)(1)’s “tax liability” could be interpreted as “tax liabilities.” Court also determined that taking the position that
all tax effects were included in deposit was consistent with TEFRA's "computational adjustment" provisions, where amounts owed by a partner for all years at issue can be collected from the partner at the conclusion of the TEFRA proceeding without the need to issue new Notices. Finally, the Court believed that a taxpayer's voluntary deferral of taxes or losses into a later year should not affect the deposit amount.

b. **Russian Recovery Fund** – A year after Kislev, the Court in Russian Recovery Fund arrived at the same conclusions, based on reasoning very similar to that in Kislev. There, the Court stated that "we agree with Kislev and the defendant that the total tax liability depository requirement trumps the singular "return." Kislev, 84 Fed. Cl. at 388. Moreover, a voluntary election to defer losses to subsequent years should not control the deposit amount. Allowing an entity to do so would permit it to assure itself of a deposit-free chance to litigate by allocating the loss entirely to other years."

F. **Prestop Opinion**

1. Despite two recent cases in the Federal Claims Court to the contrary, J. Alegra determined that "With all due respect to the distinguished jurists who penned these opinions, both Kislev and Russian Recovery are mistaken in requiring a partner to pay the total, multi-year tax liability associated with the adjustment made in a FPAA as a precondition to challenging that adjustment."

2. J. Alegra rejected the reasoning of the Kislev and Russian Recovery opinions based on the following:

   a. **Rejection of Dictionary Act** – J. Alegra found that the Dictionary Act did not apply because that provision is inapplicable, by its own terms, where the context of the statute at issue indicates that singular terms should not be given plural effect. J. Alegra determined that a review of that context indicated that, under TEFRA, an FPAA will be issued with respect to a single partnership taxable year. Those same rules would not operate well in a multi-year context.

   b. **Rejection of Multi-Year Approach** – The Court rejected Kislev and Russian Recovery's adoption of a multi-year approach for calculating the jurisdictional deposit because it was contrary to precedent applying an annual accounting concept to federal tax matters.
c. Jurisdiction over Partnership Adjustments Where No Adjustment to Income Occurs – Finally, citing prior court precedents, J. Alegra determined that the court has jurisdiction over a partnership adjustment even where the FPAA does not result in an immediate adjustment to income or deduction.

G. Implications

1. Highlights how Federal Claims Court judges are not bound by opinions of other judges on the court – only Federal Circuit and Supreme Court opinions.

2. Highlights distinction between J. Alegra’s interpretation of TEFRA provision (that Congress could not have intended that the review of a single FPAA would encompass all the partners’ liabilities for all the taxable years affected by the partnership adjustment) and the IRS’ practice of issuing an FPAA that makes no adjustments to income in the partnership taxable year referenced. If such FPAA’s can be issued, as they are, what purpose does the jurisdictional deposit serve?

3. Taxpayer success in Prestop may be of limited benefit. IRC §6225(a) permits the assessment of a “deficiency attributable to any partnership item” and levy or proceeding in court to collect the deficiency at any time after the close of the 150th day on which the FPAA was mailed to the Tax Matters Partner, unless a petition is filed in the Tax Court. Nothing in IRC §6225(a) appears to restrict such assessments to adjustments to income related to only the FPAA’d year. Thus, it could be that paying a limited jurisdictional deposit will afford, at most, 150 days of relief before the IRS can proceed with a levy or action in court to collect the remaining deficiency for the remaining years at issue.

VIII. VALIDITY OF A PARTNERSHIP

A. Classification of the Investor as a Partner

1. Culbertson – In this landmark case, the Supreme Court held that the test to determine if a partner is treated as a partner of partnership is based on the conduct of parties showing that they in good faith and acting with a business purposes intended to join together in the present conduct of the enterprise. Comm’r v. Culbertson, 337 U.S. 733 (1949). The Supreme Court remanded the case to the Tax Court because it had not made any findings to determine if there was a bona fide intent on the part of the partners to be part of a partnership.

a. The Supreme Court disagreed with the 5th Circuit Court of Appeals, which had held that each partner must contribute either vital services or capital to the partnership. The 5th Circuit found
that the intent of the partners to contribute time and services in the future constituted sufficient grounds for recognizing a partnership for federal income tax purposes. (Culbertson v. Comm'r, 168 F. 2d 979 (5th Cir. 1948))

2. IRC Section 704(e)(1) states “A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

B. Virginia Historic Tax Credit Fund 2001 LP v. Commissioner

1. Facts: The syndicators established several partnerships (collectively, the “Virginia Fund”) to which they admitted nearly 300 investors. Although they originally intended to give the investors interests that were proportional to their investments, they ultimately gave all the investors .01% interests, regardless of the size of their investment. These upper tier partnerships then invested in operating partnerships (the “Developer Partnerships”), making capital contributions and being allocated the Developer Partnerships’ Virginia historic rehabilitation tax credits (the “Virginia HTC’s”). These credits were then allocated to the investors based on the cash they contributed to the upper-tier partnerships. Finally, between one to six months later, the syndicators bought out the investors for 1/1000 of their original capital contributions.

2. The IRS took the position that the investors should not be considered partners, or if they were partners, that the transaction should nonetheless be considered a taxable sale (disguised sale under Section 707).

3. Tax Court (T.C. Memo 2009-295):
   a. Holding: The Tax Court concluded that the investors should be respected as partners making a non-taxable capital contribution, and then getting the benefit of a loss when they sold their interests for a tenth-of-a-penny on the dollar. It ruled that an investor could make a tax-free capital contribution to become a partner of a partnership, be allocated state credits in return, and then soon thereafter, sell its partnership interest for a nominal amount, allowing the partnership to receive the funds without current tax liability while the investor could use the state credits to pay its state taxes, and then take a tax loss on the sale of its partnership interest.
   b. Rationale:
      (1) The Tax Court invoked the Culbertson standards to make its determination of whether the investors were to be considered partners.
(2) Factors:

(a) Agreement between the parties

(i) Found that the investors executed multiple documents that reflected their intent to become partners (subscription agreement and partnership agreement).

(b) Conduct of the parties in executing its provisions

(i) Investors contributed capital to the partnership upon execution of the partnership documents.

(ii) Investors received K-1s allocating their respective shares of credits from the partnership pool in addition to other partnership items.

(iii) The investors had certain rights pursuant to the partnership agreements, subscription agreements, and option agreements under Virginia law.

(c) Parties’ statements

(i) Multiple investors testified at trial that they understood themselves to be partners.

(d) Testimony of disinterested persons

(i) At trial, the Court heard testimony from representatives of accounting and investment firms regarding the Virginia Program. The investors’ testimony was consistent with the professionals’ testimony regarding the details of the programs.

(e) Relationship of the parties

(i) The Court found that the parties intended to pool their resources and share the results of the investment.

(f) Partners’ respective abilities and capital contributions
(i) Each party contributed something of value. The investors contributed capital, while the principals contributed both capital and services.

(g) Control of the income and the purposes for which the income is used

(i) The Court found this factor to be neutral because the only partnership income at issue is based on the respondent’s credit-sale theory.

4. 4th Circuit (639 F. 3d 129 (4th Cir. 2011): The 4th Circuit reversed the Tax Court in March 2011. The Appellate Court ruled that an allocation of state tax credits is subject to tax at the time of allocation.

a. The Fourth Circuit determined that the transaction should be recharacterized as a sale of tax credits, so that the other partners of the partnership have taxable income instead of receiving a nontaxable capital contribution.

b. The Fourth Circuit assumed, without deciding, that the investors were partners, and it also concluded that the state credits were “property.”

c. The Appellate Court reasoned that because the investor-partners got this “property” within two years of their investment, the court concluded that the regulations under section 707 required a presumption that the transaction was a sale, unless the investors could prove otherwise, something the court called a “high burden.” In a step-by-step consideration of two basic tests, and five factors all of which are found in the regulations, the court concluded that the transaction should be treated as a sale. In concluding that (A) the investment would not have been made if there were no transfer of the state credits, and (B) there was no “entrepreneurial risk to the investors,” the court made the following five findings

(1) Timing and amount of the transfers were “determinable with reasonable certainty” at the time the investors made their capital contributions;

(2) The transferor had an enforceable right to get the credits once it made its investment;

(3) The investor’s right to get the credits was “secured,”;
(4) The transfer of money was “disproportionately large” when compared to the partners’ “continuing interests in partnerships profits”; and

(5) The partners had no obligation to return or repay the state credits to the partnership.

5. **Castle Harbour**\(^3\) – The set of cases known as Castle Harbour addressed the relationship between the Culbertson facts and circumstances analysis of the purported partnership relationships and the “capital interest” approach of Section 704(e).

a. **Facts:**

(1) The Castle Harbour transaction involved an agreement between General Electric Capital Corporation (“GECC”) and two Dutch banks to engage in the aircraft leasing business. GECC contributed cash, accounts receivable, and sixty-three airplanes. The two Dutch banks together contributed cash to the partnership. Under the terms of the partnership agreement, 98 percent of the partnership’s operating income was allocated to the Dutch banks and 2 percent was allocated to GECC. Although the contributed aircraft had a tax basis of zero, their book value in the hands of the partnership was equal to their fair market value. As a result, the aircraft generated large annual depreciation deductions for book purposes but no corresponding tax deductions. Thus, the taxable income of the partnership generally exceeded its book or economic income by an amount equal to the book depreciation deductions. The allocation of 98 percent of the partnership’s operating income to the Dutch banks significantly reduced the tax liability of GECC while shifting very little economic income to the Dutch banks. As a result of the application of the so-called “ceiling rule” under section 704(c) of the Code (and the Treasury Regulations thereunder), the partnership could not allocate tax depreciation to the Dutch banks to match the book income in question. This resulted in an overstatement of the taxable income of the Dutch banks which essentially allowed GECC to “re-depreciate” the contributed airplanes.

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(2) Under the terms of the partnership agreement, the interests of the Dutch banks were to be purchased over an 8-year period through a self-liquidating mechanism based on the income of the partnership. As the interests of the Dutch banks were bought out, the interest of GECC would correspondingly increase. The partnership agreement provided for the payment of annual distributions to the Dutch banks calculated to produce an internal rate of return of approximately 9% over the 8-year period. Although payments of these amounts by the partnership were at the discretion of the partnership's general manager, as a practical matter they were mandated since nonpayment would give the Dutch banks the right to demand liquidation of the partnership.

(3) The partnership agreement also called for the creation of investment accounts for the Dutch banks. Although no cash was actually contributed to these accounts, they were initially credited with an amount equal to the investment by the banks and the partnership. They were then adjusted on a hypothetical basis for distributions actually made to the banks. When the banks exited from the partnership, the balance in the investment accounts was to be predetermined as if such accounts had been increased each year by an "applicable rate" and reduced by the 9 percent priority distributions referred to above. Upon exit, the Dutch banks were to receive a guaranteed payment if the hypothetical amount contained in their investment accounts exceeded the sum of operating income and disposition gain, minus operating losses (which were capped at approximately $4,000,000) and disposition losses (which were capped at approximately $3,000,000) previously allocated to them. This guaranteed payment was payable only if the banks had not previously received net allocations of operating income and gain sufficient to provide the specified minimum yield on their investments. In effect, the banks were entitled to the guaranteed payment if the balance in their investment accounts exceeded their book capital accounts as finally determined.

(4) The operating cash flow generated by the partnership generally was applied to fund distributions, to service debt, and to pay expenses. The partnership agreement provided that GECC was entitled to guaranteed payments (the so-called "class B guaranteed payments") that were treated as operating expenses at the partnership and did not reduce GECC's capital account. Any cash not needed to pay partnership distributions and expenses was transferred to a
U.S. corporation that was a wholly-owned subsidiary of the partnership. Under the terms of the partnership agreement, this subsidiary was obligated to maintain "core financial assets," consisting of cash and high-grade securities (including GECC's commercial paper) equal to 110 percent of the current value of the investment accounts of the Dutch banks.

b. Holdings: Castle Harbor I originally was tried in 2004. The District Court held in favor of the taxpayer. The IRS then appealed the case to the Second Circuit, which reversed the decision of the District Court in part and held in favor of the government ("Castle Harbor II"), but also remanded the case to the District Court to address the applicability of Section 704(e) of the Code. On remand, the District Court once again held in favor of the taxpayer, concluding that Section 704(e) of the Code compels the conclusion that the foreign banks involved in the transaction should be treated as partners for Federal income tax purposes ("Castle Harbor III").

c. Castle Harbour I Analysis: Held that the creation of an LLC was not a sham designed solely to avoid taxes. While the transaction sheltered a great deal of income from taxes, it was permissible.

d. Castle Harbour II Analysis: The Second Circuit held that the Dutch banks were promised a return of their investment and had no practical risks of loss. Also, the banks potential gain was capped. The Dutch banks were secured in such a manner that they would be repaid in full with interest from a source to which the general creditors had no access. According to the Appellate Court, the apparent subordination found by the District Court was a fiction overridden by GECC's guaranty. Castle Harbour II at p. 237. Therefore, the Second Circuit overturned the District Court opinion and remanded it back to the District Court to determine if the partnership was a family partnership under Section 704(e).

e. Castle Harbour III Analysis: Although the Second Circuit held that the Bank's interest was "debt-like," the District Court said that did not mean it could not be treated as an equity interest.

(1) The analysis considered whether the Bank was like a real owner.

(a) GECC did not control the Banks' capital, because the Banks could force a liquidation of the partnership.

(b) The Banks participated in management.
On certain transactions their consent was required.

The partnership treated the Banks as partners for all purposes.

The Banks received distributions for the "sole use and benefit" of their distributed shares of income.

The Banks were not guaranteed a return.

Held: It is unimportant whether a particular partners' capital was employed, as long as overall, the partnership used its capital to produce income. The District Court's ultimate finding was that the Banks were partners in Castle Harbour.