

Tax Shelter ALERT

Vol. V, No. 8, August 2008

INSIDE

- ▼ IRS Scores Another Son of BOSS Victory 3
- ▼ Senior DOJ Tax Litigator Promotes Tax Shelter Penalties and More 5
- ▼ Witnesses Question Approach in Proposed CFC Regs 6
- ▼ IRS Rules Sale Is Not Lease-Stripping Transaction 7
- ▼ Reporting for Groupings of Activities Used to Determine Losses Proposed 8
- ▼ Court Enforces IRS Summons for Foreign Branch Transaction Tax Shelter 9
- ▼ Claims Court Grants Jurisdictional Leniency to Suspected Tax Shelter 11
- ▼ Court Refuses Taxpayer Disclosure Request 12

IRS Offers Limited-Time, Penalty-Free LILO/SILO Tax Shelter Settlements

The IRS has unveiled a much-anticipated settlement initiative for lease-in, lease-out (LILO) and sale-in, lease-out (SILO) tax shelters. Speaking by telephone with reporters on August 6, IRS Commissioner Douglas Shulman explained that the IRS will soon be sending out form settlement offer letters to approximately 45 of the nation's largest corporations across a broad spectrum of industries with identical settlement terms. In exchange for amnesty from the Code Sec. 6662 penalties, taxpayers must agree to terminate their LILO and SILO transactions or deem them as terminated and give up a significant amount of their purported tax benefits.

CCH Comment: Lawrence Hill, partner, Dewey & LeBoeuf, New York, told CCH: "The most attractive aspect of the settlement offer is the penalty waiver. However, given the significant tax exposure that these companies face and the fact that they received outside legal penalty opinions of a 'more likely than not' (MLTN) or 'should' level, these corporations will have a complicated settlement evaluation calculus to undertake. It is interesting to recall that despite the IRS's wins, drum beating and talk of these being abusive transactions—the IRS itself had evaluated its hazards of litigation at 50-50."

LILO/SILO Transactions

In Rev. Rul. 99-14 and Notice 2005-13, respectively, IRS determined that LILO and SILO transactions had tax-avoidance properties sufficient enough to warrant treatment as listed transactions. Under the auspices of a legitimate sale or lease of assets, both transactions have been used to artificially generate tax benefits, such as interest and rental deductions. This is accomplished by circular cash flows between the parties, where the taxpayer obtains a sham loan (often from an affiliate of the counterparty), uses those funds to make the lease/purchase payments normally required in legitimate transactions, and the counterparty enters into a purportedly separate lease transaction of the same asset with a similar payment structure—funneling those funds back to the original lender. An investment fund is typically involved that allows the taxpayer to also earn a profit on the loan proceeds during the transaction. Not only do these transactions often lack economic substance, but they are also designed to defer the tax benefits of a lease over the course of several decades.

The settlement offer

In return for “putting these cases behind them” and being excused of all underreporting penalties, each corporation would be required in effect to give up most of the deferral benefits of the shelter. The shelters targeted by the initiative represent “billions of dollars in lost tax revenues,” Shulman reported.

While hundreds of LILO and SILO transactions have taken place, many large corporations reportedly have participated in multiple shelter transactions. Shulman announced that some corporations will not be receiving settlement letters. Neither Shulman nor other IRS officials at the briefing, however, elaborated on how many taxpayers were being excluded from this initiative. Nor did anyone suggest that other taxpayers will be added to the offer-letter list over time. If a corporation that has participated in a LILO or SILO does not receive a letter, Shulman advised that the taxpayer might contact Paul DeNard, LMSB Deputy Commissioner, for the reason.

In its form letter to the selected taxpayers, the IRS will offer identical terms that must be accepted for all of a taxpayer’s LILO or SILO leases within 30 days or no agreement will be valid. Shulman explained, and the settlement documentation (letters and attachments) distributed with his announcement confirmed, that the settlement has five main features:

- (1) the taxpayer must agree to concede 80 percent of any claimed interest expense deduction, amortized transaction costs and head lease rent expense for each tax year through 2007;
- (2) the IRS agrees to disregard 80-percent of any reported taxable rental income with respect to SILO or LILO transactions for each tax year through 2007;
- (3) the taxpayer must agree to report in 2008, 80 percent of the original issue discount (OID) connected with the SILO or LILO for each tax year through 2007;
- (4) the taxpayer must exercise best efforts to terminate its SILO or LILO transactions on or before December 31, 2008; and
- (5) the taxpayer must agree to recognize as ordinary income any termination gain, whether realized under an actual or deemed termination.

In return, the taxpayer will not be liable for any penalties under Code Sections 6662 and 6662A.

Recent SILO, LILO victories

The settlement initiative comes after a recent string of major IRS court victories against these transactions earlier this year. In *AWG Leasing Trust*, DC-Ohio, 2008-1 USTC ¶150,370, a federal district court denied tax benefits to

EDITORIAL ADVISORY BOARD

Arthur L. Berkowitz, CPA

Owner
Arthur L. Berkowitz CPA
Aliso Viejo, Calif.

Tom Durham

Partner
Mayer, Brown, Rowe & Maw LLP
Chicago

Mark H. Ely

National Partner in Charge
IRS Practice, Procedure and
Administration
KPMG
Washington

Lawrence M. Hill

Partner
Dewey Ballantine LLP
New York

Jeffrey H. Paravano

Firmwide Chair of Tax,
Personal Planning and
Employee Benefits
Baker & Hostetler LLP
Washington

Tax Shelter Alert (ISSN 1559-9906) is published monthly by CCH, a Wolters Kluwer business. Subscription inquiries should be directed to *Tax Shelter Alert*, 4025 W. Peterson, Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. E-mail: cust_serv@cch.com. ©2008 CCH. All Rights Reserved. *Tax Shelter Alert* also is available electronically on the Internet with a

searchable back-issue archive. Call customer service at (800) 449-8114 to get a trial electronic subscription. Photocopying or reproducing in any form in whole or in part is a violation of federal copyright law and is strictly prohibited without the publisher’s consent. *Tax Shelter Alert* is designed to provide general information on business taxes and not to offer legal or accounting advice on individual problems. Questions on specific issues should be addressed to the professional of your choice. No claim is made to original government works; however, within this product or publication, the following are subject to CCH’s copyright: (1) the gathering, compilation, and arrangement of such government materials; (2) the magnetic translation and digital conversion of data, if applicable; (3) the historical, statutory and other notes and references; and (4) the commentary and other materials.

Kurt Diefenbach, Managing Editor

Riverwoods, Ill.

kurt.diefenbach@wolterskluwer.com

George Jones, Managing Editor

Washington, D.C.

george.jones@wolterskluwer.com

Elice Webster, Executive Editor

Riverwoods, Ill.

Jim F. Walschlager, Coordinating Editor

Riverwoods, Ill.

jim.walschlager@wolterskluwer.com

**TO
SUBSCRIBE:
Please call
(800) 449-8114**

a U.S. partnership related to its alleged purchase of a German waste-to-energy facility as an abusive SILO transaction. In *BB&T Corp.* (CA-4, April 29, 2008), the Court of Appeals for the Fourth Circuit struck down the tax treatment of a financial services company's lease of a wood-pulp manufacturing equipment as a LILO tax shelter, finding a lack of a genuine lease or genuine indebtedness. In *Fifth Third Bancorp* (DC-Ohio, April 18, 2008), a federal district court jury, applying the economic substance doctrine, denied tax benefits related to a bank's leasing arrangement for passenger rail cars as an abusive LILO transaction.

Taxpayer equity/IRS pragmatism

Shulman was clear in representing the issue as one of fairness and equity among the taxpaying populace. "The public has a right to expect that large corporations be good corporate citizens and meet their legal and compliance obligations," he stated. "The nation's leading commercial enterprises have the legal and accounting resources to take full advantage of favorable provisions of the tax law," he continued, "but they are not entitled to use their extensive resources to twist provisions of the tax law to the point that they no longer reflect Congress's intent. As a basic matter of fairness to all taxpayers, the IRS cannot allow LILO and SILO deals to stand."

At the same time, however, Shulman reasoned that the settlement initiative also represented a pragmatic approach. Noting that "hundreds of these transactions" have not yet been examined and/or adjudicated, Shulman concluded that "the time has come to find the most effective way to resolve these existing disputes ... the settlement initiative achieves this." He added that pursuing this initiative against the most blatant offenders, instead of following the usual examination and litigation route, will allow the IRS to reclaim most of this revenue more quickly and free up its resources for other matters.

The agency hopes, Shulman concluded, that offenders will take advantage of the penalty-free settlement as an "opportunity to clean up liabilities and move on." ❖

■ ECONOMIC SUBSTANCE, STEP TRANSACTION DOCTRINES USED

IRS Scores Another Son of BOSS Tax Shelter Victory

The U.S. Court of Federal Claims has denied losses claimed under a Son of BOSS tax shelter in another in a recent string of victories for the IRS (*Stobie Creek Investments, LLC*, FedCl, 2008-2 USTC ¶150,471). In making this victory even more important for the government, the court used the IRS's weapons of choice, the economic substance and step transaction doctrines, to defeat a tax strategy that "crossed all the t's and dotted all the i's" in keeping within technical specifications. In underscoring its view that the IRS's position was sufficiently clear-cut and that the taxpayers should have known better than to think the shelter would work, the court not only stripped them of their tax benefits, but also imposed Code Sec. 6662 accuracy-related penalties.

CCH Comment: The battle of words both in and out of the courtroom on the validity of certain tax-sheltered arrangements will likely not cease as the result of this case. John DiCicco, Deputy Assistant Attorney General of the Department of Justice's Tax Division, stated immediately after this court opinion was released that, "We are pleased that yet another court has delved into the workings of this manufactured tax shelter and found it deficient...for our part, the Department of Justice will redouble its efforts to expose and defeat these blatant attempts to raid the Treasury." **Steven Toscher**, partner, **Hochman, Salkin, Rettig, Toscher & Perez, P.C.**, Beverly Hills, Calif., told CCH that "the conflicting decisions by the various courts reflect the difficulty of the issues and how courts can disagree. It is incumbent on both sides—taxpayers and the government—to recognize there can be differing viewpoints, and sound tax administration and good business sense suggest cases be resolved in appropriate circumstances and limited government resources be allocated to advance the mission of the IRS."

Offsetting stock sale gain

In transferring their family business to a private equity firm, the taxpayers decided against a tax-free/carryover-basis reorganization, but instead to go the taxable sales route and shelter most of the resulting tax liability, on their attorney's advice, through "strategies that could reduce taxes in connection with the...transaction."

To launch the strategy, each family member formed a single-member limited liability company (LLC) that joined a partnership. Acting through their LLCs, the family members contributed their stock in the family corporation to the partnership. Then, they each purchased two pairs of opposing option contracts, a long option and short option based on the value of the U.S. dollar versus the Swiss franc and long and short options based on the value of the U.S. dollar versus the euro. These options were also contributed to the partnership.

As outlined in the tax shelter prospectus, the family members then contributed their partnership interests to a single-member S corp, causing the partnership to terminate. As a result, the taxpayers reported a stepped-up costs base in their corporate stock and the premiums on their contributed long options. When the company was later sold, they offset their gains from the stock sale against this new stepped-up basis.

Court's analysis

No economic substance. The Federal Circuit, to where an appeal in this case would lie, has adopted a disjunctive test for determining if a transaction should be disregarded as an economic sham, the Claims Court found. The doctrine should apply and a transaction should be disregarded either if the transaction lacks objective economic substance or if it is subjectively shaped solely by tax-avoidance motivations. The court ultimately found that the taxpayers did not satisfy the objective factors of economic substance. The transactions were structured according to a canned strategy and not with regard to a tax-independent profit or investment considerations.

CCH Comment: The court found that the taxpayers' subjective motivations for entering into the transactions were insufficient to "imbue the transactions with economic substance."

The court found that the transactions lacked a legitimate business purpose required for economic substance. Although the taxpayers' actions were consistent with high-risk investors, their actions were not genuine because they only considered the structure of the transactions, not their magnitude of risk relative to their cost and possibility of return. While none of the taxpayers' experts testified to the profitability of the transactions to the court's satisfaction, the government presented an expert who showed how a "reasonable investor" would judge a transaction's potential for profit. He found that the options themselves were over-priced in the transaction; the costs and fees were significant enough to interfere with the taxpayers' profit potential, and the overall probability of receiving a return on investment was minimal.

CCH Comment: The government expert in this case was the same expert in *Sala*, which was a loss for the IRS. The Claims Court distinguished *Sala* from the present case as having a greater probability of taxpayer profit from the transaction.

The court distinguished its application of the economic substance doctrine from that of the *Sala* court.

Step transaction. The court also found that the transactions met the interdependence and end result tests for the step transaction doctrine. Each of the steps involved produced tax effects the taxpayers claimed, but lacked any business purpose. All of the steps were "component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."

Penalties imposed

While the court acknowledged that the individual family member partners could assert their own defenses in their subsequent partner-level hearings, the court found that the partnership itself could not overcome liability for the 40-percent Code Sec. 6662 penalty on the underpayment of tax due to a gross valuation misstatement. The transactions qualified for the extraordinary penalty because the taxpayers reported an adjusted basis in their corporate stock exceeding the correct basis by more than 400 percent. The court also enforced the 20-percent penalty for underpayment of tax due to negligence.

FOLLOW-UP: MOTION FOR NEW TRIAL DENIED IN SALA TAX SHELTER CASE

The government was denied a new trial in a case involving a currency options investment transaction (*Sala*, DC-Colo., 2008-1 USTC ¶150,308). Evidence that the government claimed was new was merely cumulative or impeaching; furthermore, the one noncumulative and nonimpeaching statement presented would not have altered the outcome of the case. The court also questioned the government's diligence in attempting to discover this evidence, as the timing of the new evidence implied a deliberate attempt by the government to delay the case for tactical gain. The government's motion to alter or amend the judgment on the basis of the new statement was denied for the same reasons.

CCH Comment: The government's loss in *Sala*, which involved an alleged Son of BOSS tax shelter, was notable because, until then, the IRS had enjoyed a string of victories in similar cases. The IRS, however, was undeterred by this "bump in the road," and IRS Commissioner Douglas H. Shulman promised to continue its campaign against tax shelters. Insiders suspect that after having tried this motion for a new trial, the next step that the government will take in *Sala* will be an appeal.

The court also determined that the partnership could not assert the reasonable cause and good faith exception to these penalties allowed under Code Sec. 6664(c)(1). Although the opinion upon which the taxpayers relied referenced substantial authority of the law, the partnership could not claim reliance upon the opinion because it made certain assumptions and factual representations. The court found that, if the taxpayers had made a *bona fide* examination of the profit potential of their own transactions, they would have discovered that these assumptions and representations could not be supported. ❖

Senior DOJ Tax Litigator Promotes Tax Shelter Penalties and More

The "sea change" of tax shelter activity that took place since the 1990s created a current need for stringent tax shelter prosecution, according to Dennis Donohue, chief senior litigation counsel, Department of Justice Tax Division. Donohue stated that not only are tax shelter penalties appropriate, but that the

Department Justice may need even stronger tools in combating sophisticated tax shelter marketers, despite evidence in other areas that harsh government efforts may actually weaken tax enforcement.

Penalties justified

At a July 25 Tax Analysts round table conference at the National Press Club in Washington, D.C., Donohue addressed the tax shelter arena's transformation from a practice involving a few doctors and lawyers advised by shady preparers in the 1970s and 1980s to a mass-marketed phenomenon of the 1990s and early 2000s, conducted by highly reputable law firms and accountants. The majority of these latter shelters involved partnerships used to generate artificial paper losses to offset the income of wealthy individuals and large corporations. Donohue implied that, since these later tax shelters also involved a much higher ratio of tax benefits to taxpayer investment than their predecessors, draconian enforcement measures such as strict liability penalties are justified.

Problematic opinions

In this later era, Donohue continued, supporting legal opinions often assumed a profit motive on the part of the tax shelter participants, rather than considering the objective component of the economic substance test to the transaction. In some cases, he stated, there was even evidence that attorneys wrote their opinions with the mindset of an advocate, rather than with calculated legal analysis. Donohue questioned whether these firms, in writing their opinions, performed adequate due diligence regarding the transactions.

Penalty skeptics

Donohue defended his call for strong government action amidst comments that recent attempts to codify the economic substance doctrine with strict liability penalties may force judges to hesitate in applying the doctrine to middle-of-the-road cases of abusive tax avoidance. Additionally, N. Jerold Cohen, partner at Sutherland, Asbill, & Brennan LLP, asserted that the best kind of penalty is one that is never enforced because it deterred tax shelter activity.

Stronger tools needed

Donohue countered that penalties are indeed effective deterrents for taxpayers who are legitimately seeking compliance with the tax laws and visit the right tax practitioner. However, he acknowledged that the diehard tax shelter promoters will never simply give up their activities and move on. Instead, he explained, they will continue their attempts to distinguish their positions from those IRS has deemed abusive. No amount of current regulation, he stated, can deter this behavior.

When asked about which alternatives would succeed, Donohue responded, “raising the bar for those who promote these programs from civil to criminal, I think, is going to send alarm bells throughout our respective professions. What remains to be seen is what is going to happen when it does.” ❖

■ WITNESSES ATTEND HEARING ON FBSCI REGS

Witnesses Question Approach in Proposed CFC Regs

Witnesses at an IRS hearing on proposed regulations (NPRM REG-124590-07, I.R.B. 2008-16, 801) on foreign-base company sales income (FBSCI) of controlled foreign corporations (CFC) complimented Treasury and the IRS for recognizing the need to update the regulations to aid the competitiveness of U.S. corporations operating abroad. However, many witnesses questioned the approaches taken in the regulations to modify the tests for achieving deferral of FBSCI.

Subpart F currently taxes income from the purchase or sale of personal property involving a related party. The anti-deferral regime applies to sales income, not to property that is manufactured by the CFC. The proposed regulations put forth a “substantial contribution” test for the manufacturing exception to FBSCI to take account of contract manufacturing arrangements. The regulations would require that the facts and circumstances demonstrate that the CFC made a substantial contribution to the property’s manufacture through the activities of its employees. The regulations propose nine nonexclusive factors for this test.

Barbara Angus of Angus & Nickerson, testifying for a group of U.S. multinational companies, commended the substantial contribution test, the use of facts and circumstances and the nonexclusive list of factors. These would cover a wide range of real-world business patterns. She recommended that any vagueness in the test be addressed by applying the economic principles behind Code Sec. 482 and the transfer pricing rules. Timothy McDonald of Procter & Gamble, representing the National Foreign Trade Council, agreed that Code Sec. 482 should be used for the substantial contribution standard.

Margie Rollinson of Ernst & Young noted that “the government and taxpayers have been at odds over the correct interpretation of the existing regulations” and that revisions were needed. Nevertheless, she felt that the regulations would not lessen controversy. She proposed that “substantial” be deleted from the substantial contribution test because it is unclear and does not add to the requirement that there be manufacturing activity. Alternatively, the regulations could identify activities that are considered substantial. She rejected the notion of an industry-specific test. Rollinson also asked for a transition period of at least two years after final regulations are issued.

The current regulations contain a branch rule that treats income as FBSCI if a CFC manufactures property through a branch located in a different country, and apply a “manufacturing branch tax rate disparity test” as part of this rule. The proposed regulations apply the substantial contribution test as a backstop to the branch rule. If a branch manufactures the property and a CFC claims it made a substantial contribution, there would be a rebuttable presumption that the CFC did not make a substantial contribution to the property’s manufacture.

Rollinson criticized the rebuttable presumption as vague and unnecessary and asked that it be deleted. She also questioned the need for the branch rule, since many businesses choose manufacturing locations for reasons unconnected to minimizing taxes. She asked the IRS to define branch and proposed that a CFC not be considered to have a manufacturing branch in certain circumstances. The adoption of this rule would eliminate the need for the tax disparity test, Rollinson indicated.

Daniel Goff of Xilinx, Inc., representing the Tax Executives Institute, said the regulations would

cause more U.S. taxpayers to be taxed under Subpart F. The broader manufacturing test could cause a branch to be treated as a manufacturer, resulting in more FBCSI under the manufacturing branch rule. Goff recommended that the substantial contribution test apply only at the taxpayer's election, or that they not apply at all in certain circumstances. McDonald agreed that the substantial contribution test should not apply to the branch rule.

Angus approved of the predominant contribution standard but questioned the need for a "significantly greater" test in the proposed regulations. She testified that the manufacturing branch rules create significant complexity and must not be allowed to negate the substantial contribution test.

The nine-factor test is flawed, Goff testified, because the threshold for meeting the substantial contribution test is not defined. Furthermore, he criticized the examples for overemphasizing "oversight and direction" of the manufacturing activities, including management of the risk of loss, which he called a "super factor." Goff asked that ownership of intangibles be added to the list of factors, similarly to ownership of raw materials.

Robert Johnson of Cisco said that Cisco uses contract manufacturers for substantially all of its products, both in the U.S. and abroad. He criticized the nine factors' focus on employee activity. Excluding the use of technology is inconsistent with the statute and would impermissibly deny attribution of manufacturing to a company like Cisco that uses technology to monitor the contract manufacturer. In fact, human oversight would be inadequate; software is critical. He also questioned the treatment of employee oversight as a super factor.

Angus proposed that the factors include management of enterprise risk and financial management of the enterprise. She also proposed that, where an activity has multiple contributors, more than one entity or branch could make a substantial contribution.

Goff also testified that the five-percentage-point rate disparity test is too narrow, and that it would reach operations in far more countries than tax shelter jurisdictions because of significantly lower corporate tax rates. He proposed that the test be expanded to at least 15 percentage points. McDonald proposed a 10-15-percent differential test. ❖

INCOME PASSED THROUGH FROM S CORPORATION WAS WAGES SUBJECT TO EMPLOYMENT TAXES

A married couple and their adult son were subject to self-employment taxes because the father had earned income as a tax return preparer, and the son had earned income as a cabinet installer (*R. Jarrett*, TC Summary Opinion 2008-94). Although the father formed an S corporation to provide a corporate form for his tax return preparation business, his clients continued to make checks out to him personally or to his sole proprietorship. Both father and son claimed business expense deductions for amounts allegedly paid to the S corporation for professional services and then reported the same amounts deducted as passthrough income from the S corporation. The court found that the transactions between the taxpayers and the S corporation lacked economic substance, and, therefore, the IRS properly disallowed the deductions and increased their self-employment tax liabilities.

Both taxpayers were also subject to the 20-percent penalty for negligence or intentional disregard of income tax rules because they could not show that they had reasonable cause for, and in good faith took, the position that created the underpayment. In addition, the taxpayer son had to pay an additional tax for failure to timely file his tax return because he admitted that his return was filed late. Although the son argued that the amount due was *de minimis* and he should, therefore, not have to pay the addition to tax, the court noted that there is no *de minimis* statutory or regulatory exception to the penalty for failure to timely file.

■ IRS EXAMINES SALE OF ROYALTY INCOME SHARE

IRS Rules Sale Is Not Lease-Stripping Transaction

The IRS has ruled that a taxpayer, a consolidated group of corporations, was not engaging in a listed transaction when one of its subsidiaries licensed intellectual property to another group member, and that member sold shares in the royalty revenue stream to third parties (LTR 200829011, March 28, 2008). While the transactions were accelerations of future income streams, requiring immediate inclusion into gross income, the IRS held that they were not the same as or similar to the lease stripping transaction described in Notice 2003-55.

CCH Comment: While most suspected cases of lease stripping involve leasing of tangible property, the IRS noted in Notice 2003-55 that the same rules

could potentially apply to revenue streams flowing from intangible property. Reg. §1.61-8(b), the provision originally exploited by lease-stripping transactions, requires both prepaid rent and royalties to be currently included in gross income.

Background

Of all the members of the taxpayer's consolidated group, one subsidiary (technology subsidiary) owned the company's intellectual property. The technology subsidiary licensed patents out to the taxpayer, its affiliated companies, and third parties, charging royalties based upon the number of products sold. Because of this pricing model, the technology subsidiary's income varied greatly. To secure a steadier stream of income, the technology subsidiary entered into a swap transaction with one of the taxpayer's affiliated companies (affiliated subsidiary).

Both subsidiaries agreed to exchange the estimated amount of royalties the technology subsidiary was to receive from its licenses. However, the affiliated subsidiary would be responsible for additionally paying any estimated royalties the technology subsidiary did not receive. To even out the agreement, the affiliated subsidiary would also receive any excess royalties. After entering into this swap transaction, the affiliated subsidiary subsequently entered into a separate agreement with two third parties to sell portions of the stream of payments it expected to receive from the technology subsidiary.

IRS determinations

The agency determined that the affiliated subsidiary's transactions with third parties to sell shares of the technology subsidiary's royalty income stream was an acceleration of future income, causing the affiliated subsidiary to recognize ordinary income it received from the third parties. The IRS found that the swap agreement between the technology subsidiary and affiliated subsidiary was not intended to be an actual sale of the underlying intellectual property, only an exchange of a series of fixed cash flows for a series of variable cash flows. As proof, the agency pointed to the fact that, in the event the technology subsidiary were to declare bankruptcy, the swap agreement provided that the royalties would become assets in the technology subsidiary's bankruptcy

estate; the affiliated subsidiary would become a creditor of the technology subsidiary, and the affiliated subsidiary would not have any claims to any cash flows under the licensing agreements. As a result, the third-party acquisitions of shares in the technology subsidiary's royalty income stream also failed to qualify as sales of the underlying intellectual property. They were, instead, exchanges of cash flows.

Additionally, the IRS ruled that the affiliated subsidiary's transactions with the third parties were not the same as, or substantially similar to, the lease-stripping listed transaction described in Notice 2003-55. These transactions typically involve one participant claiming to realize income from property, while another claims the tax deductions associated with that income. Yet, IRS found that the affiliated subsidiary's transactions were different because they were not expected to obtain similar, or similar types of, tax consequences, and they were not factually similar to the lease stripping transaction. While the Notice 2003-55 transaction involved a taxpayer claiming deductions without accounting for the corresponding income, the affiliated corporation's sale of the royalty income shares resulted in the reporting of both the income and related deductions on the taxpayer's consolidated income tax return.

Finally, the IRS stated that the affiliated subsidiary's transactions with the third parties were not intercompany transactions within the meaning of Reg. §1.1502-13. ❖

■ PASSIVE ACTIVITY LOSS GROUPINGS PROPOSED

Reporting for Groupings of Activities Used to Determine Losses Proposed

The IRS has proposed to require reporting of groupings of trade or business activities and rental activities for reporting of passive activity losses (PALs) under Code Sec. 469 (Notice 2008-64; FED ¶46,530). The reporting would make it easier for the IRS to verify taxpayers' grouping of activities. Activities that are grouped are treated as a single activity when applying the PAL limitations.

CCH Comment: Losses from passive activities cannot be deducted against other, nonpassive income. To avoid these limitations, taxpayers may attempt to group active and passive business activities as a single activity and treat any losses as coming from the active business. The IRS has not previously required reporting of taxpayer groupings (except for certain real estate professionals) and has had difficulty determining taxpayers' historical groupings.

CCH Comment: Passive activities generally include trade or business activities in which the taxpayer did not materially participate for the year and rental activities regardless of the level of participation.

Grouping of activities

One or more trade or business activities or rental activities may be treated as a single activity if the activities make up an appropriate economic unit for measuring gain or loss under Code Sec. 469. This determination depends on the facts and circumstances. Important factors are:

- similarities in types of trades or businesses,
- common control and common ownership,
- geographic location, and
- interdependence between activities.

Taxpayers generally cannot change their groupings, but the IRS may require that activities be regrouped.

Reporting of grouping

The IRS would require taxpayers to report changes to their groupings on their regular annual return. Taxpayers would not have to report groupings that existed on the effective date of final guidance.

CCH Comment: The IRS requested comments on its proposal, including the burden on taxpayers and on alternatives.

Taxpayers would be required to file a written statement about a grouping for the first year in which one or more trades or businesses or rental activities are originally grouped as single or separate activities. The statement would include the name, address and employer identification number of the activity. If the taxpayer fails to report whether the activities have been grouped, they would be treated as separate activities. Once activities have been grouped, they would not be able to be regrouped in a subsequent year unless

the original grouping was clearly inappropriate or there has been a material change in the facts and circumstances of the original grouping. A statement should be filed with the return for the year the activities are regrouped that explains why the original grouping is being changed.

CCH Comment: The proposal would not be effective until the date on which final guidance is published by the IRS. The deadline for the submission of comments is November 4, 2008. ♦

Court Enforces IRS Summons for Foreign Branch Transaction Tax Shelter

A federal court decision recently threw support behind the IRS's ongoing efforts to thwart manipulation of foreign currency discrepancies in the high-stakes international tax shelter arena. The court ruled that a taxpayer was not protected by the Code Sec. 7525 tax practitioner privilege in light of an IRS administrative summons for materials related to a suspected "circular exchange of cash flows" regarding its Canadian foreign branches. While the attorney-client privilege excepted some of the documents from disclosure, the court applied a step transaction analysis to those asserted to be protected by the tax practitioner privilege, finding that the Code Sec. 7525(b) tax shelter exception applied.

Post-merger transactions

The taxpayer underwent a merger, after which, it was the lone surviving entity. Subsequently, it engaged in several transactions with its Canadian subsidiaries resulting in almost \$100 million of foreign currency losses and leading to approximately \$46 million in federal income tax savings. Suspecting that the transactions were some sort of organized effort at tax avoidance, the IRS attempted to issue an administrative summons for related material. This summons was originally dismissed as overly broad and protected by the tax practitioner privilege.

CCH Comment: The court did, however, reject the taxpayer's claims that the information was created in anticipation of litigation and protected by the work-product privilege

Several months later, the taxpayer discovered new material that was potentially relevant to the agency's charges, redacted some of the material with the assumption it was covered by the tax practitioner privilege and produced it to the court.

Privilege analysis

The court found that redactions of certain billing sheets produced by the taxpayer were not protected by the tax practitioner privilege. These documents were produced internally by the taxpayer's accountant and never communicated between the accountant and the taxpayer. Also, the taxpayer redacted nonprivileged information, such as the name of the accountant's personnel and advice on Canadian income tax law. The court also found that certain fax cover sheets and engagement letters were not protected by the tax practitioner privilege. Yet, the court also ruled that certain internal documents were covered by the privilege, as well as communication among the taxpayer, its accountant and the counterparty to the merger.

CCH Comment: The court also found that communications between the taxpayer and its counsel were protected by the attorney-client privilege.

Tax shelter exception

However, the court determined that the Code Sec. 7525(b) tax shelter exception to the tax practitioner privilege also applied. The government successfully showed that the taxpayer had a tax-avoidance purpose.

CCH Comment: Although the first decision dismissing the administrative summons determined that there was no "foundation in fact for the tax shelter exception," the court revisited the issue. It decided that the tax practitioner privilege and tax shelter exception both applied on a document-by-document basis. The documents at issue were different from those contested in the first summons decision.

CCH Comment: In Notice 2000-20, the IRS described its concern for potential abuse of the foreign branch rule of Code Sec. 987 that seems to be this taxpayer's *modus operandi* of tax avoidance. Under the Code Sec. 987 proposed regs, U.S. taxpayers transferring property to a foreign branch and receiving property in turn on the same day are allowed to net these amounts in

order to determine the total amount received from the foreign branch. In calculating the gain or loss on this transfer, where the foreign branch operates in a different functional currency than the U.S. parent, this amount is converted into U.S. dollars at the spot exchange rate. It is compared against the U.S. parent's equity interest in the foreign branch's assets, converted to U.S. dollars at the historical exchange rate.

CCH Comment: Taxpayers with tax-avoidance intentions may seek to accelerate and expand tax losses from such a transaction by borrowing funds, contributing them to the foreign branch at a time when the spot exchange rate is lower than the historical exchange rate, and then, receiving an equal distribution back from the foreign branch on the same day. As a result of the equal fund transfers between the parent and the foreign branch, the economic result is a wash for the U.S. parent, but a Code Sec. 988 foreign currency loss remains due to the difference between the spot and historical exchange rates.

The court held that the totality of the circumstances proved the taxpayer was engaging in a "circular, intracompany step plan" to generate foreign exchange losses. The taxpayer made numerous wire transfers between bank accounts that were only opened for one day. First, funds flowed from the Canadian branches to the taxpayer, and then, back to the branches with the same account. Because the spot exchange rate was lower than the historical exchange rate, the taxpayer recognized huge losses. The court refused to consider the transfers as "fortuitous timing of a distribution while the Canadian dollar was weak." Through its *in camera* review of the disputed material, the court determined that the taxpayer had a tax-avoidance objective for a "step plan."

No traditional shelter doctrines required

The court ruled that the government was not required to show a lack of economic substance or that the transaction was driven solely or primarily by tax-avoidance concerns as with a traditional tax shelter case. To enforce the summons, the government was only required to show that the communication "relates to a plan of arrangement "a significant purpose of which" was the avoidance or evasion of federal income tax." The court distinguished this case from the *Jade Trading* case (*Jade Trading, LLC, FedCl, 2008-1*

USTC ¶50,112), emphasizing that this was not a tax refund case based on a specific transaction.

The court also determined that the government was not required to prove that the taxpayer's accountant was a tax shelter "promoter" in the traditional sense in order to apply Code Sec. 7525(b) tax shelter exception. The government was not required to show that the accountant sold or marketed a pre-packaged product, but rather was only required to show that it organized or assisted in organizing the shelter. Unlike the *Textron* case (*Textron*, DC-RI., 2007-2 USTC ¶50,605), the accountant was advising the taxpayer on a future transaction, rather than reviewing a previous transaction.

Claims Court Grants Jurisdictional Leniency to Suspected Tax Shelter

Proving that ignorance of the law can actually be a successful defense, the U.S. Court of Federal Claims recently gifted jurisdiction to a partnership suspected of engaging in a tax shelter for which the IRS has recently assumed an aggressive stance. The partnership was accused of engaging a distressed asset/debt transaction and attempted to fight the IRS in court. But, the partner disputing the charge deposited the incorrect amount of tax liability required under Code Sec. 6226(e)(1) for jurisdiction in the court. In an act of generosity, the court found a reasonable attempt by the partner to comply with the law and granted the partnership 60 days to remedy the error.

CCH Comment: In Notice 2008-34, the IRS listed distressed asset/debt transactions as listed transactions. The transaction involves manipulation of the rules for beneficial interests in trusts and ends with a transfer of built-in loss assets from a tax-indifferent party to a U.S. taxpayer with a carry-over basis.

Built-in loss euros

A limited partnership was acquired by three limited liability companies (LLCs). At the time of the acquisition, the partnership had 1.3 million euros, with a purported loss of approximately \$140 million in U.S. dollars. The euros came from the partnership's previous investment in a foreign

entity that operated duty-free stores and other airport businesses. Claiming their loss in value resulted from the creation of the European Union, the partnership converted the euros to U.S. dollars and reported a basis of over \$142 million. As a result, the LLCs received enormous losses from their investments. In fact, this loss was so large the partnership deferred most of it and reported the loss over the course of four tax years.

Disallowed losses

By way of a final partnership administrative adjustment (FPAA), the IRS disallowed the loss reported by the partnership during the first year and the subsequent deferred losses. The agency challenged the underlying transaction as a distressed asset/debt transaction. The agency claimed that both the transaction and the partnership were shams, lacked economic substance and undertaken for the purpose of tax avoidance. In response, the partnership brought suit challenging these findings.

Jurisdiction challenged

However, the government responded with a motion to dismiss the partnership's suit for lack of jurisdiction. Under Code Sec. 6226(e)(1), a partnership disputing an FPAA may only receive jurisdiction in the Claims Court if it deposits the amount with the IRS by which its tax liability would increase if the terms of the FPAA were accepted by the court. The partner petitioning the Claims Court on behalf of the partnership made a deposit, but its amount was only for his increased tax liability during the first year of claimed losses. The IRS argued that the partner's deposit duty should have been based on the entire tax liability over the course of the four tax years.

Siding with the IRS, the court analyzed the statutory language of Code Sec. 6226(e)(1). The court noted that the statute required a deposit in "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." However, the singular use of the word *return*, the court concluded, did not preclude interpretation of the statute as requiring the partner to deposit all of its tax liability before

bringing suit. To rule otherwise, the court stated “would stand the statute on its head.” The partner could have deferred all of his losses affiliated with the transaction to future years, and therefore, reduced his deposit requirement to zero.

Leniency granted

The Claims Court did, however, allow the taxpayer 60 days to make a correct deposit, in lieu of dismissing the case with prejudice. It found that the partner had made a good faith effort to comply with the requirements of Code Sec. 6226(e)(1). It accepted his misinterpretation of the statute as a reasonable explanation for his failure to do so. ❖

■ BENEFITS PLAN TAX SHELTER SUSPECTED

Court Refuses Taxpayer Disclosure Request

A federal court recently denied the majority of a multi-employer welfare benefits plan sponsor’s motion to compel disclosure of information related to the audit of its plan participants (*Millennium Marketing Group, LLC*, DC-Texas, 2008-2 USTC ¶50,478). The court refused to exercise its authority under Code Sec. 6103 to override the confidentiality of income tax returns applicable to parties of a judicial or administrative tax proceeding. The court acknowledged that the taxpayer merely wanted to gain insight into the deliberations of the IRS in determining how to treat deductions claimed by its plan participants.

Comment: In a 2006 decision (*Millennium Marketing Group, LLC*, DC-Texas, 2007-1 USTC ¶50,306), the same federal court denied a government motion for a protective order against discovery of documents related to examinations of participants in the taxpayer’s plan. The taxpayer made the request under the Freedom of Information Act. However, the court only granted the taxpayer’s motion to compel production in part because the documents were relevant to an unlawful disclosure claim. The court denied the motion to the extent that requested documents involved the IRS’s deliberative process and might have included privileged information.

Background

The taxpayer sponsored a multi-employer welfare benefit plan and requested a private letter ruling from IRS on whether its participants were entitled to deductions for their contributions to the plan. However, after some discussion, the IRS stopped communicating with the taxpayer and began auditing plan participants. It went on to begin an initiative of offering settlement of their participants’ disputed positions. In response, the taxpayer began requesting information about these examinations from the IRS, claiming the agency told the participants that the plan was an abusive tax shelter without officially making such a determination.

Comment: In Notice 95-34, IRS delineated certain trust arrangements under an alleged multi-employer welfare benefit plan as abusive tax shelters. These arrangements prevented plan participants from meeting the requirements for claiming deductions related to their contributions to the plan under Code Sec. 419A(f)(6). Instead, the arrangement was treated a deferred compensation to the participants.

Protected material

In this most recent decision, the court determined that many of the taxpayer-requested documents were nondisclosable. Some documents were IRS investigation files not directly related to the taxpayer’s issue, and therefore not subject to the Code Sec. 6103(h)(4)(C) exception for disclosure in judicial and administrative tax proceedings. While others were found not to be protected by the investigative privilege, they were still examinations of third parties and not subject to disclosure under the exception. Other documents were protected by the attorney-client, pre-decisional/deliberative and attorney work product privileges.

Protected information

The court also protected 11 out of 14 categories of information from the taxpayer’s request for production of documents and testimony by IRS employees. The court found them irrelevant to the issue of whether the multi-employer welfare benefit plan was similar to that described in Notice 95-34, whether it satisfied the requirements for contribution deductions under Code Sec. 419A(f)(6), or the accuracy of the IRS’s private letter ruling. ❖