SHEARMAN & STERLING LLP

FOCUS ON TAX CONTROVERSY AND LITIGATION

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Supreme Court Decides *Woods v. Commissioner*, Holds for IRS on Jurisdictional and Penalty Issues

In this issue:

In addition to a discussion of the Supreme Court's decision in *Woods v. Commissioner*, this month's issue features articles about a pair of recent decisions from the Southern District of New York regarding waiver of attorney-client communications by disclosure to the SEC, two directives recently issued by the Internal Revenue Service's Large Business & International Division regarding Information Document Requests, new John Doe summonses issued to US banks for the production of records about US taxpayers with offshore accounts, Notice 2013-69, which provides guidance on the implementation of FATCA for Foreign Financial Institutions, and an urge by Congress to seek extradition of Swiss residents charged with tax evasion offenses.

US Supreme Court Imposes Valuation-Misstatement Penalty in TEFRA Proceeding

On December 3, 2013, the United State Supreme Court, in a unanimous decision written by Justice Scalia, ruled that San Antonio entrepreneur and former owner of the Minnesota Vikings, Red McCombs, and his business partner, Gary Woods, were liable for the 40 percent gross valuation-misstatement penalty under IRC § 6662.[1] The Supreme Court granted certiorari to address the question whether the federal district courts have jurisdiction in a TEFRA partnership level proceeding to determine whether a partnership's lack of economic substance could justify imposing a

[1] *United States v. Gary Woods*, 571 US __ No. 12-562 (Dec. 3, 2013).

The District Court held that the partnerships were properly disregarded as shams, but that the valuation-misstatement penalty under section 6662 did not apply. . . .The Court of Appeals held that the valuation-misstatement penalty did not apply, citing to *Bemont Invs, LLC v. United States*, 679 F.3d 339 (5th Cir. 2012), when the relevant transaction is disregarded for lacking economic substance.

valuation-misstatement penalty on the partners. The Supreme Court reversed the Fifth Circuit, and found that the District Court had jurisdiction in the TEFRA proceeding to determine the applicability of the valuation-misstatement penalty.

The jurisdictional penalty issue arose in connection with an offsetting-option tax shelter known as COBRA. The taxpayers entered into the COBRA transaction to reduce their tax liability for 1999. To do so, the taxpayers created two general partnerships, one that would produce an ordinary loss, and the other, capital losses. They used wholly owned LLCs to execute a series of long and short currency option transactions, with a net cost of about $2.3 million. Woods and his employer later contributed the currency spreads to the partnerships along with about $900,000 of cash. The cash was used to purchase foreign currency and stock. The partnerships terminated the spreads in exchange for a lump sum payment from the bank. At the end of the tax year, they transferred their interests in these partnerships to two S corporations, leaving each partnership with a single partner (the relevant S corporation). The partnerships were then liquidated by operation of law and their assets, the currency and stock, were deemed distributed to the S corporations. Upon the sale of the currency and stock the S corporations reported a huge loss, which flowed to the taxpayers. The loss was reported because the taxpayers calculated the tax basis of their interests in the partnerships by disregarding the short option, on the theory that it was "too contingent" to count as a liability. As a result, the taxpayers claimed a total adjusted outside basis (the partner's tax basis as opposed to the "inside basis", which is the partnership's basis) of more than $48 million.

The Service did not agree with the taxpayers and issued a Final Partnership Administrative Adjustment ("FPAA") to deny the COBRA losses. The Service determined that the partnerships had been formed solely for purposes of tax avoidance by artificially overstating basis in the partnership interests. Woods sought judicial review of the FPAA under TEFRA's procedural rules (i.e., IRC Section 6226(a)). The District Court held that the partnerships were properly disregarded as shams, but that the valuation-misstatement penalty under section 6662 did not apply. The Government appealed the decision on the penalty only, to the Fifth Circuit Court of Appeal. The Court of Appeals held that the valuation-misstatement penalty did not apply, citing to *Bemont Invs, LLC v. United States*, 679 F.3d 339 (5th Cir. 2012), when the relevant transaction is disregarded for lacking economic substance. Two other courts, in the Federal Circuit and DC Circuit, held that the federal court lacked jurisdiction to impose the valuation-misstatement penalty under section 6662 in similar circumstances, which prompted the Supreme Court to take the issue.

The Supreme Court first reviewed the jurisdictional issue, finding that the Federal district court has jurisdiction under Section 6226(f), which provides that the court in a TEFRA partnership level proceeding has jurisdiction to determine "the applicability of any penalty . . . which relates to an adjustment to a partnership item"[2] even if the item (e.g., overstated outside basis) is an affected item, and not a partnership item. Simply stated, the issue considered by the Supreme Court was whether the valuation-misstatement penalty "relates to" the determination that the partnerships were shams. The Supreme Court held that the term "relates to" is "essentially indeterminate" and any attempt to narrow jurisdiction goes against the purposes of TEFRA. As the Court put it, "[b]arring partnership-level courts from considering the applicability of penalties that cannot be imposed without partner-level inquiries would render TEFRA's authorization to consider some penalties at the partnership level meaningless."[3] The Supreme Court rejected taxpayer's argument that the outside basis was not a partnership item, but an affected item because it required a partner-level determination, regardless of whether or not the penalty had a connection to a partnership item.

Based on the Supreme Court's analysis, federal courts may exercise jurisdiction to determine the applicability of the valuation-misstatement penalty under Section 6662 to determine whether the partnerships' lack of economic substance could justify imposing a valuation-misstatement penalty on the partners.

As to the application of the valuation-misstatement penalty, the Court found that the plain language under IRC Section 6662(a), (b)(3) required application of the penalty. The COBRA transactions generated losses by enabling the partners to claim a high outside basis in the partnerships. But if disregarded as shams the Supreme Court found that no partner could legitimately claim an outside partnership basis greater than zero. If a partner attempts to do so, to claim losses on his return, and the deduction of losses caused the partner to underpay his taxes, then the resulting underpayment of tax would be "attributable to" the partner having claimed an "adjusted basis" in the partnership that exceeded the correct amount of such adjusted basis. The Supreme Court noted that the statute refers to either "value" or "adjusted basis" and it is this latter term that requires the "application of a host of legal rule" and the statute "contains no indication that the misapplication of one of those legal rules cannot trigger the penalty."[4] The Court was not influenced by the fact that the term "adjusted basis" appears in a parentheses, finding that this does not justify "robbing the term of its independent and ordinary significance."[5]

The Supreme Court rejected Woods' other argument that the underpayment of tax would be attributable to the determination that the partnerships were shams, and not to

[2] Slip Op. at 7.

[3] Id. at 9.

[4] Id. at 13.

[5] Id. at 14, quoting *Reiter v. Sonotone Corp.*, 442 US 330, 339 (1979).

the misstatement of outside basis. This was the rationale used by the Fifth and Ninth Circuits who refused to permit application of the penalty. However, the Supreme Court had no difficulty concluding that the underpayment for the COBRA tax shelter was attributable to the partners' misrepresentation of outside bases. Based on the Supreme Court's analysis, federal courts may exercise jurisdiction to determine the applicability of the valuation-misstatement penalty under Section 6662 to determine whether the partnerships' lack of economic substance could justify imposing a valuation-misstatement penalty on the partners.

– Richard A. Nessler

Southern District of New York Holds Cooperation with Government Waives Attorney-Client Privilege

In July and again in November 2013, the Southern District of New York held that the voluntary disclosure of privileged communications to the government, even with a confidentiality agreement in place, can be treated as a waiver of attorney-client privilege with respect to the communications and the underlying source documents.[6]

The defendants and their principal owner operated several hedge funds that hired outside counsel in 2006 to conduct internal investigations regarding certain financial irregularities that had come to light. The plaintiff, CFO of one of the defendant entities at the time, was blamed for the irregularities and resigned. In 2007, defendants hired a second law firm to conduct a second internal investigation into the financial irregularities and to notify the SEC of the firm's findings. Defendants' disclosures to the SEC were entirely voluntary and were governed by a confidentiality agreement that stated the defendants did not intend to waive the protection of attorney-work product or attorney-client privilege and that the SEC would maintain the confidentiality of the protected materials and would not disclose them to any party, "except to the extent that the Staff determines that disclosure is required by law or would be in furtherance of the Commission's discharge of its duties and responsibilities."

The defendant later disclosed the financial irregularities and internal investigations to investors, blaming the plaintiff for the irregularities in this disclosure. The plaintiff sued the defendants, claiming the statements to investors were false and defamatory. The plaintiff sought production of attorney notes and summaries of witness interviews conducted by outside counsel, which defendants opposed, claiming the notes and summaries were protected by attorney-client privilege and the work-product doctrine.

[6] *Gruss v. Zwirn*, 2013 WL 3481350 (S.D.N.Y. July 10, 2013), *on motion for clarification*, 296 F.R.D. 224 (2013).

The ruling further limits the utility of the “selected waiver” under which a party may produce privileged materials but maintain privilege as to other parties.

The plaintiff argued that the defendants had waived attorney-client privilege and work product protection as to witness interview notes and summaries by making selective use of the same in their presentations to the SEC.

On July 14, 2011 a magistrate judge issued an order denying the plaintiff’s motion to compel production of these materials, finding that the defendants’ disclosure to the SEC did not constitute a waiver of the privilege in the undisclosed portions of the interview notes and summaries as to the plaintiff. The plaintiff objected to part of this holding, arguing that he was seeking only factual interview notes reflecting the statements made by witnesses, and not disclosure of the notes and summaries that disclosure counsel’s opinion or analytical process.

The Court considered the Second Circuit case *In re Steinhardt Partners L.P.*, 9 F.3d 230 (2d Cir. 1993), where, in *dicta*, the Second Circuit suggested that a party’s voluntary submission to a governmental agency in an adversarial posture of a document containing attorney work product might not waive work product protection in that document where the disclosing party and the government shared a common interest, or where the government agency had explicitly agreed to maintain the disclosed materials as confidential. The Court noted that the confidentiality agreement the defendants signed with the SEC provided no meaningful protection to defendants because it essentially granted the SEC discretion to disclose the submitted materials whenever it chose. After surveying other circuit authority on the effect of confidentiality agreements with government agencies, the Court concluded that the magistrate judge was mistaken in finding there was no waiver of privilege. In addition, the Court held that when a party selectively discloses attorney-client communications to an adverse government entity, the privilege is waived not only as to the materials provided, but also as to the underlying source materials. The Court ordered that the defendants produce all notes and summaries for *in camera* inspection in order to determine what portion of the documents constituted opinion work product, with the intention of ordering production of the rest.

Subsequent to the Court’s July 10, 2013 decision, former outside counsel to the defendants moved for clarification of the Court’s order, objecting to producing hand-written interview notes taken by the firm’s lawyers during its representation of the defendants, on the grounds of work product privilege and public policy. The Court held that the law firm did not have a distinct privacy interest in the interview notes that would protect them from disclosure. However, the Court agreed to conduct an *in camera* review of the interview notes to protect disclosure of the notes that constituted opinion work product.

The IRS has introduced many of the new requirements with the goals of making the IDR process more efficient and encouraging communication between the IRS and the taxpayer.

IRS Issues Revised Information Document Request Procedures

On November 4, the IRS issued a second directive regarding the Large Business and International ("LB&I") Division's new Information Document Request ("IDR") process.[7] The new IDR process, which will be effective January 2, 2014, will all but eliminate an IRS Examiner's authority to extend deadlines for IDRs.[8] The November 4 directive describes the new process in greater detail than the first directive, issued June 18, which introduced the new IDR process and its requirement that LB&I examiners consult with taxpayers before issuing an IDR. Specifically, the new directive describes pre-determined deadlines and consequences that will follow should a taxpayer fail to provide a timely response to an IDR.

The New IDR Process

LB&I has introduced thirteen new requirements for IDRs. The IRS has introduced many of the new requirements with the goals of making the IDR process more efficient and encouraging communication between the IRS and the taxpayer. For example, under the new IDR guidelines, examiners are to discuss with the taxpayer the issue related to the IDR and how the requested information is related to the issue under consideration. After consulting the taxpayer, the examiner is to determine what information will ultimately be requested in the IDR and provide and discuss the draft IDR with the taxpayer.

The new process represents an effort by LB&I to respond to criticism that IDRs are too broad or often reflect a misunderstanding of the taxpayer's business. The directive requires examiners to ensure that the IDR is customized to the taxpayer or industry and that the IDR only requests information relevant to the stated issue. All IDRs will be negotiable, so there is an opportunity for taxpayers and the IRS to make the exam process more productive.

Although the new IDR process may prove more efficient, the directive's new IDR timing and enforcement procedures are troubling. The directive gives IRS examiners or specialists sole authority to set a reasonable response date for the IDR if the taxpayer and examiner cannot agree on a response date. The IRS directive apparently includes this provision to address IRS concerns that taxpayers are not providing timely responses to IDRs. If the information requested in the IDR is not received by the response date, the examiner or specialist must follow a mandatory IDR Enforcement Process.

[7] LB&I-04-1113-0009.

[8] LB&I-04-0613-004.

Enforcement Process

The IDR Enforcement Process has three sequential stages, consisting of (1) a Delinquency Notice; (2) a Pre-Summons Letter; and (3) a Summons.

Delinquency Notice (Letter 5077)

The first phase of the enforcement process begins if the taxpayer is unable to furnish the information requested in the IDR by the response date.

The first phase of the enforcement process begins if the taxpayer is unable to furnish the information requested in the IDR by the response date. Should that occur, the IRS will issue a Delinquency Notice within ten calendar days of the IDR Response date. The Delinquency Notice will set forth another response date. In this stage, the examiner or specialist must discuss the Delinquency Notice with the taxpayer and ensure that the taxpayer understands the next steps in the enforcement process, including the response date for the Delinquency Notice, which generally will be no more than fifteen calendar days from the date of the Delinquency Notice.

Pre-Summons Letter (Letter 5078)

If a taxpayer does not provide a complete response to an IDR by the response date in the Delinquency Notice, the Territory Manager will issue a Pre-Summons Letter. The Pre-Summons Letter will generally be issued within fourteen calendar days after the due date of the Delinquency Notice. The Territory Manager will discuss the Pre-Summons Letter with the taxpayer to make sure that the taxpayer understands the next steps in the enforcement process if the information requested in the IDR is not provided by the response date established in the Pre-Summons Letter, which will generally be ten calendar days from the date of the Pre-Summons Letter.

Summons

IRS Counsel will be involved early in the process to ensure counsel's preparedness for issuing a summons.

If a taxpayer does not provide a complete response to an IDR by the response date in the Pre-Summons Letter, the examiner or specialist will complete the next phase of the enforcement process, the summons. IRS Counsel will be involved early in the process to ensure counsel's preparedness for issuing a summons. In the summons phase, the examiner or specialist will coordinate issuance of the summons with counsel.

Significantly, an IRS Examiner will have no discretion regarding deadlines for IDR responses under the new enforcement process. Taxpayers with outstanding IDRs that do not comply with the new directive on January 2, 2013 are to have their IDRs reissued, so any taxpayer with an outstanding IDR should coordinate with the IRS to prepare for the new procedures.

– Liz McGee

The Tax Division continues to aggressively pursue taxpayers who attempt to evade the law by hiding income and assets outside the United States. Within the past year, the Tax Division has obtained two convictions after trial and six guilty pleas of defendants who maintained, or assisted others in maintaining, undeclared bank accounts in foreign countries.

Several Swiss Banks Accept DOJ Settlement Program

On December 12, 2013, the Tax Division of the Department of Justice issued a press release strongly encouraging Swiss Banks that want to obtain non-prosecution agreements to resolve past cross-border criminal tax violations to submit letters of interest by the December 31, 2013 deadline required by the Program for Non-Prosecution Agreements or Non-Target Letters from Swiss Banks (the “Program”). The Program is open to about 300 Swiss banks that are not already part of the US tax probe. The Program was jointly announced on August 29, 2013 by the Department of Justice and Ambassador Manuel Sager of Switzerland.

Despite criticism of the Program from some Swiss banks as well as Swiss regulators, a dozen Swiss regional banks have announced that they would cooperate with US officials to avoid prosecution in a crackdown on Swiss lenders suspected of helping wealthy Americans evade taxes through offshore Swiss accounts. The banks include Banque Cantonale Vaudoise, Banque Cantonale de Geneve, St. Galler Kantonalbank, Zuger Kantonalbank, Luzerner Katonalbank, Aargauische Kantonalbank, Nidwaldner Kantonalbank, and Graudundner Kantonalbank; all announced that they would apply as Category 2 banks under the program. Piquet Galland, subsidiary of Banque Cantonale Vaudoise, and St Galler’s subsidiaries Hyposwiss Privatbank Zurich and Hyposwiss Private Bank Genève elected to join the Program. Two banks, Appenzeller Kantonalbank and Schwyzer Kantonalbank disclosed that they would apply as Category 4 banks. These banks heeded the DOJ warning and recognized that the Program, while not perfect, offers Swiss banks that engaged in wrongdoing their best opportunity to resolve outstanding criminal issues. Several larger banks, including Credit Suisse and Julius Baer currently under formal criminal investigation, are not eligible for the Program.

There are four categories under the program. Category 1 comprises Swiss banks that are already under criminal investigation, making the banks ineligible for the program. Category 2 banks are those that “have reason to believe” that they have violated US tax laws and want to apply for a non-prosecution agreement (“NPA”). Prior to the execution of an NPA, a Category 2 bank must disclose to the US (i) how the cross-border business for US related accounts was structured, operated and supervised; (ii) provide the name and function of employees involved in the cross-border business; (iii) explain how the bank attracted and serviced account holders; and (iv) provide the total number of US related accounts. Category 2 banks are required to pay a penalty of 20 to 50 percent of the maximum aggregate dollar value of the undeclared US accounts, which is dependent on when the accounts were opened. Category 3 applies to banks that believe they did not violate US tax law and have not assisted US taxpayers with undeclared accounts and wish to apply for a non-target letter. A Category 3 bank must retain an independent examiner to conduct an internal investigation and provide the Tax Division with a written report that includes (i) the

Category 3 and 4 banks have until October 31, 2014 to submit a letter to the Tax Division.

witnesses interviewed, (ii) a summary of the information provided by the witness, (iii) identification of the files reviewed by the examiner, (iv) the factual findings of the examiner and (v) the conclusions reached by the examiner. Category 4 are banks that are deemed-compliant financial institutions under the Switzerland-US intergovernmental agreement. Category 4 banks may apply for a non-target letter.

The Tax Division continues to aggressively pursue taxpayers who attempt to evade the law by hiding income and assets outside the United States. Within the past year, the Tax Division has obtained two convictions after trial and six guilty pleas of defendants who maintained, or assisted others in maintaining, undeclared bank accounts in foreign countries. In 2009, Switzerland's largest bank admitted to helping Americans evade taxes and paid a $780 million settlement. Last year, Wegelin & Co, the oldest Swiss private bank, was fined $57.6 million after it confessed to helping taxpayers living abroad avoid paying the US Government. Wegelin later announced that it will cease to operate as a bank. And Bank Frey & Co. AG, another Swiss institution, ceased its operations because of a tax dispute with the US. In its recent press release, the DOJ warned Swiss banks that they took the risk of being targeted and prosecuted if they did not join the Program. Category 3 and 4 banks have until October 31, 2014 to submit a letter to the Tax Division.

–Richard A. Nessler

IRS Issues John Doe Summons for Hidden Accounts

The US Government's recent crackdown on offshore tax evasion shows no sign of slowing down and appears to be expanding to include new jurisdictions. On November 12, 2013, US District Judge Richard Berman of the Southern District of New York issued an order authorizing the IRS to issue "John Doe" summonses requiring the Bank of New York (Mellon), Citibank, JPMorgan Chase Bank NA, HSBC Bank USA NA and Bank of America to produce information about US taxpayers with undisclosed accounts at The Bank of N.T. Butterfield & Son Limited and its affiliates in the Bahamas, Barbados, Cayman Islands, Guernsey, Hong Kong, Malta, Switzerland and the United Kingdom. Previously, on November 7, 2013, US District Court Judge Kimba Wood of the Southern District of New York entered an order authorizing the IRS to issue John Doe summonses to the Bank of New York (Mellon) and Citibank to produce information about US taxpayers who may be evading federal taxes by holding interests in undisclosed accounts at Zurcher Kantonalbank ("ZKB") and its affiliates. Generally, the IRS will issue a John Doe summons to obtain information about possible tax fraud by individuals whose identities are unknown.

The IRS has successfully used the John Doe summons to obtain the identities of US taxpayers who maintained offshore bank accounts. In 2009, the IRS sent similar John Doe summonses seeking the identities of US taxpayers who tried to hide funds at UBS in Switzerland, and in 2011, the IRS received court approval to serve a John Doe summons seeking the identities of US taxpayers maintaining undisclosed bank accounts at HSBC in India. More recently, in April 2013, a federal judge in San Francisco authorized the IRS to serve a John Doe summons seeking the identities of US taxpayers who maintained bank accounts at the Canadian Imperial Bank of Commerce.

The issuance of the John Doe summonses demonstrates that foreign bank accounts used for tax evasion remain a significant priority of the IRS and the Tax Division of the Department of Justice.

The issuance of the John Doe summonses demonstrates that foreign bank accounts used for tax evasion remain a significant priority of the IRS and the Tax Division of the Department of Justice. It is reported that the IRS learned that US taxpayers may be hiding funds at these banks based on information submitted by taxpayers participating in the IRS offshore voluntary disclosure program ("OVDP"), where US taxpayers have disclosed dozens of accounts at Butterfield and hundreds of accounts at ZKB. The IRS is aggressively mining the data received in the tens of thousands of OVDP submissions made by taxpayers.

In December 2012, three employees of ZKB were indicted for conspiring with US taxpayers to hide income earned on ZKB accounts. Most recently the US has focused primarily on accounts held by Swiss banks, but the latest John Doe summonses demonstrate that the US is intent on aggressively pursuing undisclosed bank accounts in other foreign countries. In its press release announcing approval of the John Doe summonses, the Justice Department reminded taxpayers that the IRS continues to offer an offshore voluntary disclosure program for taxpayers with unreported foreign bank accounts and related unreported income. Kathryn Keneally, Assistant Attorney General for the Justice Department's Tax Division, stated that "[t]hese John Doe summonses will provide information about individuals using financial institutions from Switzerland to the Cayman Islands to Hong Kong to avoid their US tax obligations. US taxpayers still holding accounts who have not come clean should come forward and do the right thing before it is too late."

–Richard A. Nessler

Second Circuit Vacates and Remands Tax Court Decision in Midco Acquisitions Case

The Second Circuit found that shareholders in the transaction had constructive knowledge of the fraud, contrary to the previous Tax Court holding.

On November 14, the Second Circuit ruled that an intermediary or "midco" transaction was a fraudulent conveyance under New York state law and remanded the case back to the Tax Court to determine transferee liability.[9] The Second Circuit found that shareholders in the transaction had constructive knowledge of the fraud, contrary to the previous Tax Court holding.

Background

The case involves shareholders of a personal holding company taxed as a C corporation ("Double D") that held, among other things, $129 million in shares of appreciated stock that would have triggered a tax liability of approximately $81 million in a sale of the assets directly. Instead, the shareholders worked with an investment banking firm to set up a newly formed entity, Shap Acquisition Corporation II ("Shap II"), that purchased the shares of Double D with short-term financing, with a plan to immediately sell the securities portfolio portion of the assets to a third party.

The Second Circuit also avoided a circuit split with the First Circuit and Fourth Circuit, holding that the two prongs of the transferee liability test – transferee status and liability – are separate and independent inquiries, one procedural and governed by federal law, and the other substantive and governed by state law.

The IRS issued a notice of deficiency against Double D resulting from the IRS's determination that the sale by the shareholders of Double D was, in substance, an asset sale followed by a liquidating distribution to the shareholders. The IRS was unable to find any Double D assets from which to collect the liability, so the IRS issued a notice of transferee liability against three foundations that were transferees of Double D shareholders, and thus, transferees of a transferee.

Section 6901 of the Code allows for the collection of a tax liability of a transferee of property of a taxpayer, and the IRS may assess transferee liability under section 6901 against a party if two prongs are met: (1) the party is a transferee under section 6901 and (2) the party must be subject to liability under the applicable state law. The applicable law in New York establishes liability for a transferee if the transferor makes a conveyance without fair consideration that renders the transferor insolvent.

The Tax Court found that the IRS failed to establish that a fraudulent conveyance occurred under New York state law and held that the three foundations were not liable as subsequent transferees under section 6901.

[9] *Diebold Foundation, Inc. v. Commissioner*, No. 12-3225 (2d Cir. Nov. 14, 2013).

Second Circuit Decision

The Second Circuit held that because the sophistication of the parties' representatives and the details of the case pointed to an "active avoidance of the truth," the shareholders should have known the conveyance from Double D was fraudulent, even though Double D did not actually make the conveyance to the shareholders itself as a result of the midco transactions. Accordingly, the Court held it was proper to collapse the multilateral midco transactions into a single transaction whereby liability could be established under state law.

The Second Circuit also avoided a circuit split with the First Circuit and Fourth Circuit, holding that the two prongs of the transferee liability test – transferee status and liability – are separate and independent inquiries, one procedural and governed by federal law, and the other substantive and governed by state law.

The Second Circuit also held, as a preliminary matter, that the standard of review for Tax Court decisions involving mixed questions of law and fact is de novo to the extent the alleged error is in the misunderstanding of a legal standard and clear error to the extent the alleged error is in a factual determination.

–Judy Fisher

IRS Notice 2013-69 Provides Guidance to FFIs and Draft FFI Agreement

In Notice 2013-69 (the "Notice"), the IRS has again provided additional guidance on the implementation of FATCA by discussing foreign financial institution ("FFI") obligations, the intention to issue additional, future regulations and by including a draft of the FFI agreement.

The IRS recently issued Notice 2013-69 (the "Notice"), providing additional guidance on the implementation of FATCA. The Notice addresses foreign financial institutions ("FFI") entering into an FFI agreement with the IRS to be treated as participating FFIs under section 1471(b) and Treasury regulation § 1.1471-4. The Notice contains guidance on complying with FFI agreements to FFIs and FFI branches treated as reporting financial institutions under a Model 2 intergovernmental agreement ("IGA"). Finally, the Notice contains information on the requirements for FFIs to be exempt from withholding, general responsibilities of participating FFIs and reporting Model 2 FFIs, intended updates to regulations and forms, and procedures for FFIs to register for participating FFI or reporting Model 2 FFI status.[10]

The FFI agreement will generally be used for FFIs under the Model 2 IGA. The Model 2 IGA provides for FFI reporting directly to the IRS. This is in contrast with the Model 1 IGA that relies on local tax authorities for reporting purposes. Compliance with the reporting rules is important because an FFI that enters into an FFI agreement with the IRS and complies with its terms will generally be treated as a participating FFI that is not subject to FATCA withholding on withholdable payments it receives.

[10] Notice 2013-69.

Requirements for FFI compliance are described in Treasury Regulation § 1.1471-4, and are incorporated into the draft FFI agreement included with the Notice. These FFI requirements include due diligence and documentation of US accountholders and payees, withholding obligations and information reporting to the IRS. The draft agreement also describes procedural matters for compliance with these requirements, such as refund requests. The IRS intends to finalize the agreement by the end of 2013.

The Notice confirms that any branch of an FFI that is eligible to comply with the terms can enter into an FFI agreement, and branches that cannot do so will be treated as non-participating and subject to FATCA withholding. FFIs that register at the FATCA registration website will receive a global intermediary identification number ("GIIN") to identify themselves to withholding agents. As necessary, relevant IRS forms will be updated to address the guidance in the Notice.

The Treasury Department also intends to issue regulations in the future with respect to FATCA and FFIs in particular. These regulations will provide that FATCA reporting under an FFI agreement will generally satisfy chapter 61 (Form 1099) reporting for US payees (or presumed US payees), except when backup withholding applies. Therefore, in many cases the participating FFI will not be required to file duplicate reports for the same payee. Moreover, the regulations will provide that backup withholding will not apply to a reportable payment if a participating FFI has already withheld under FATCA. In the case of recalcitrant accountholders who are known US persons, the participating FFI would be able to elect to satisfy its FATCA obligation by withholding under the backup withholding rules.

The intended future regulations would also modify transitional reporting requirements for 2015 and 2016 for payments to non-participating FFIs. While the current rules require reporting of the aggregate amount of foreign reportable amounts paid to non-participating FFIs (even if the payments are not associated with a financial account), the relaxed transitional rules will require reporting only for amounts paid with respect to a financial account of the non-participating FFI. Additionally, FFIs will not have to report accounts held by passive nonfinancial foreign entities ("NFFEs") if the NFFEs elect to directly report to the IRS regarding their US ownership instead of providing this information to the FFI (or withholding agent). These "direct reporting" NFFEs will be required to register with the IRS, agree to comply with information reporting obligations and obtain a GIIN to identify themselves. Under the intended regulations, NFFEs can be sponsored by another entity that will report to the IRS for the sponsored NFFE. In the case of NFFEs that are qualified intermediaries, the qualified intermediary agreements will be updated to include information reporting to the IRS regarding US owners in addition to the entity's other obligations as a withholding agent.

–Daniel B. Smith

On October 28, the IRS revised the Internal Revenue Manual 8.11.6 regarding penalties applicable for failure to file a Report of Foreign Bank and Financial Accounts ("FBAR").

IRS Introduces Revised IRM 8.11.6 Relating to FBAR Penalties

On October 28, the IRS revised Internal Revenue Manual 8.11.6 regarding penalties applicable for failure to file a Report of Foreign Bank and Financial Accounts ("FBAR").[11] The new provisions address electronic FBAR filing, which became mandatory on July 1, 2013, and explain when Fast Track Settlement and Fast Track Mediation are available. Under the new provisions, pre-assessed FBAR penalties are eligible for Fast Track Settlement only if the FBAR 30-day letter, Letter 3709, has not been issued to the taxpayer. The revised manual also provides that pre-assessed FBAR penalties are eligible for Fast Track Mediation. The new provisions clarify when Alternative Dispute Resolution ("ADR") rights are not available for FBAR cases: post-assessed FBAR penalties do not have ADR rights. In addition to referencing interest accrual on, and joint and several liability for, FBAR penalties, the new provisions change the time for completing post assessed FBAR cases from 60 days to 120 days.

–Liz McGee

Court of Federal Claims Refuses to Amend the Judgment in *Salem Financial*

The Court of Federal Claims refused to reconsider its decision in *Salem Financial* that BB&T was not entitled to claim $74,551,947.40 in deductions for interest expenses on its STARS loan.[12] In September, the Tax Court granted a similar motion in the *Bank of New York* case and subsequently issued an opinion permitting Bank of New York to deduct interest on its STARS loan. *Bank of New York Mellon Corp. v. Commissioner*, T.C. Memo. 2013-225 (Sep. 23, 2013). On the basis of its holding that the STARS loan was separate from the STARS trust, the Tax Court analyzed the loan separately from the trust and determined that Bank of New York was entitled to interest deductions because the loan was a bona fide loan. The Court of Federal Claims rejected the other argument that BB&T raised in the motion for reconsideration: the Loan was commercially viable on its own because it did not play a role as a technical matter in the claim for foreign tax credits. The court dismissed this argument because it was not raised earlier.

-Liz McGee

[11] I.R.M. 8.11.6.

[12] *Salem Financial Inc. v. United States*, No. 1:10-cv-00192 (Fed. Cl. Jan. 6, 2014).

Subcommittee Urges Action Against Tax Evaders

Nearly 90 percent of the Swiss bankers and financial advisers who have been charged with criminal misconduct have not been brought to stand trial in the United States.

On March 18, 2014, John McCain and Carl Levin, leaders of the Permanent Subcommittee on Investigations, urged the Department of Justice ("DOJ") to seek extradition of Swiss residents charged with tax evasion offenses by the DOJ.[13] The letter was written in response to Deputy Attorney General James Cole's testimony before the Subcommittee in a hearing relating to Swiss bank involvement in tax evasion in the United States. The letter stated that while 35 bankers and 25 financial advisers have been charged with misconduct relating to the Swiss bank scandal, only 6 have been convicted or pled guilty and the majority of the others currently live openly in Switzerland. McCain and Levin noted that Deputy Attorney General Cole testified that DOJ has not asked Switzerland to extradite any of the defendants, because DOJ believes that Switzerland will not extradite its own citizens.[14]

McCain and Levin encourage DOJ to seek Switzerland's cooperation in extradition of the individuals charged in the Swiss bank scandal. They note that the extradition treaty between the United States and Switzerland does not bar the extradition of Swiss nationals that have assisted US nationals in criminal tax evasion, although it does provide some discretion to Switzerland in extradition requests.[15] The treaty does not, however, permit Switzerland to "shield from extradition underlying criminal conduct, such as fraud…or falsification of public documents."[16] McCain and Levin argue that at least some of the charges against the Swiss bankers and advisers relate to such activities.[17] Moreover, while the extradition treaty provides an exception to extradition requests for a treaty partner's nationals, such exception is limited to circumstances where the treaty partner has "jurisdiction to prosecute that person for the acts for which extradition is sought."[18] Because Switzerland does not consider tax evasion a crime, McCain and Levin argue that Switzerland cannot prosecute the Swiss bankers and advisers for tax evasion, and thus the extradition exception should not apply.[19]

[13] Letter from John McCain and Carl Levin, Permanent Subcommittee on Investigations, to James M. Cole, Deputy Attorney General (Mar. 18, 2014), *available at* http://www.levin.senate.gov/newsroom/press/release/levin-mccain-urge-justice-department-to-seek-extradition-in-tax-evasion-cases.

[14] Id.

[15] Id.

[16] Extradition Treaty With Switzerland, US-Swiss. (June 12, 1995).

[17] Letter from John McCain and Carl Levin, Permanent Subcommittee on Investigations, to James M. Cole, Deputy Attorney General (Mar. 18, 2014).

[18] Id. at Art. 8.

[19] Letter from John McCain and Carl Levin, Permanent Subcommittee on Investigations, to James M. Cole, Deputy Attorney General (Mar. 18, 2014).

Previously, on February 26, 2014, the Subcommittee released a lengthy bipartisan report describing how Swiss banks assisted their US customers in tax evasion.[20] The report looked to Credit Suisse, Switzerland's second largest bank after UBS, as a case study. According to the report, as of 2006, Credit Suisse had over 22,000 US customers with Swiss accounts. At their peak, the assets in these accounts totaled more than 12 billion Swiss francs. Credit Suisse had not determined how many of these accounts were concealed from US authorities, but the Subcommittee's report suggests that the vast majority were. The Subcommittee found that from at least 2001 through 2008, Credit Suisse encouraged US clients to open accounts in Switzerland and then employed practices to help its US customers to conceal such accounts from the United States. The Subcommittee further found that Credit Suisse exercised only limited oversight of its US-based accounts, which led to wrongdoing in violation of both US laws and Credit Suisse policies.[21]

According to the report, following the UBS scandal, Credit Suisse took steps to identify accounts that were opened for US customers and then requested that holders either close the accounts or disclose the accounts to the United States. At the close of 2013, Credit Suisse had closed approximately 18,500 accounts held by US customers, which represents an 85 percent decrease in Credit Suisse's US customer base in Switzerland. Credit Suisse estimated that only one-quarter of the US customer funds that were removed from Credit Suisse were returned to the United States and further estimated that one-half of the US customer funds that were removed from Credit Suisse remain in Switzerland.[22]

The report criticizes DOJ's failure to more aggressively pursue Swiss banks that facilitated tax evasion. At the time of the report, DOJ had initiated criminal investigations into 14 Swiss banks and had sought the names of their US customers. However, only one of the Swiss banks investigated has thus far been indicted, and when that bank pled guilty, DOJ accepted the guilty plea without obtaining US client names that could potentially have been used to seek unpaid taxes from customers that used the bank to avoid US tax liability. The report concludes by encouraging DOJ to more aggressively pursue Swiss banks and their US customers through the use of, among other tools, grand jury subpoenas, John Doe summonses, and the United States – Switzerland extradition treaty.[23]

[20] US Senate Permanent Subcommittee on Investigations, *Offshore Tax Evasion: The Effort to Collect Unpaid Taxes on Billions in Hidden Offshore Accounts* (February 26, 2014).

[21] Id.

[22] Id.

[23] Id.

District Court Denies Bankers Associations' Challenge to Bank Reporting Regulations

On January 13, 2014, the US District Court for the District of Columbia issued a decision denying a motion for summary judgment filed by the Florida Bankers Association and the Texas Bankers Association challenging new regulations requiring banks to report interest paid to certain nonresident aliens to the IRS.[24] The regulations, which were issued in 2012, require that US banks report information about accounts earning more than $10 of interest that are held by non-resident aliens.[25] The reporting requirement only applies to non-resident aliens that are from countries with which the United States has a tax treaty or an agreement to exchange tax information. The bankers associations asserted that the regulations violate the Administrative Procedure Act (the "APA") and the Regulatory Flexibility Act (the "RFA") because they will be more harmful to banks than the IRS realized when it originally estimated the economic effect of the regulations.

The court rejected the bankers associations' APA challenge because the IRS met the requirement under the APA that an agency examine the relevant data and demonstrate a connection between the facts and the choice made by the agency. The court noted that, although exact data regarding the amount of money non-resident aliens have deposited in US banks was not available, the IRS was able to estimate the amount using a "mountain of existing information."[26] Furthermore, the court found it was "hardly arbitrary or capricious" for the IRS to extend the reporting requirements, which were already applicable with respect to Canadians, to residents of the other countries with which the IRS has a tax treaty.[27] The court determined that the IRS was reasonable in its analysis of privacy concerns with respect to the disclosure of the bank account information, and the IRS properly weighed the costs and benefits of the risk of capital flight as a result of tax evaders withdrawing funds from the banks.

With respect to the RFA challenge, the court found that the IRS reasonably concluded that the regulations would not have a significant economic impact on small businesses because US financial institutions already have systems in place to withhold and report with respect to US customers. Thus, the regulations did not violate the RFA.

The bankers associations announced on February 4, 2014 that they are appealing the court's dismissal of their motion for summary judgment.

[24] *Florida Bankers Assoc. v. Treasury,* No. 1:13-cv-00529 (D.D.C. 2014) (slip op.).

[25] T.D. 9584.

[26] *Florida Bankers Assoc.,* No. 1:13-cv-00529.

[27] Id.

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Tax Controversy and Litigation at Shearman & Sterling

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