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United States Tax Court Invalidated Treasury Regulation § 1.482-7(d)(2)

In addition to the discussion of the Tax Court's decision in *Altera*, this month's issue features articles regarding Notice 2015-47 "Basket Options" and Notice 2015-48 "Basket Contracts," the Federal Circuit Court of Appeals decision is *BASR Partnership v. United States* that Section 6501(C)(1)'s suspension of the three-year limitation applies only when the taxpayer acts with the requisite intent to evade tax, a recent Circuit Court ruling that upheld the application of the attorney-client privilege and work product protection, analysis of the Court of Federal Claims disallowance of losses from the DAD transaction and an update on Microsoft's request for an evidentiary hearing challenging an IRS summons.

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

Tax Court Rules Against IRS and Invalidates Treasury Regulation § 1.482-7(d)(2)

On July 17, 2015, the US Tax Court (en banc) ruled in favor of the taxpayer in *Altera Corporation v. Commissioner*,[1] holding that Treas. Reg. 1.482-7(d)(2), which was issued in 2003 requiring participants in qualified cost-sharing arrangements ("QCSAs") to share stock-based compensation costs to achieve an arm's-length result, was arbitrary and capricious and therefore invalid.

Altera US, the parent company of an affiliated group of corporations, developed, manufactured and sold programmable logic devices ("PLDs") and related hardware and software for use in programming the PLDs ("programming tools"). Altera US entered into a technology license agreement with its subsidiary, Altera International, granting Altera International the right to use and exploit, everywhere except the United States and Canada, all of Altera US's intangible property relating to PLDs and programming tools. In exchange for the right granted, Altera International paid royalties to Altera US each year through 2003. Under an existing R&D cost-sharing agreement, Altera US and Altera International agreed to pool their resources to conduct research and development relating to the PLDs and programming tools. Under the R&D cost-sharing agreement, Altera US and Altera International agreed to share the risks and costs of research and development activities they performed between May 23, 1997 through 2007.

The purpose of Section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions.

During each of taxable years ending December 31, 2004, December 30, 2005, December 29, 2006 and December 28, 2007, Altera US granted stock options and other stock-based compensation to certain of its employees. Certain of these employees who received stock options and other stock-based compensation performed R&D activities subject to the R&D cost-sharing agreement. The stock-based compensation was $24,549,315 (2004); $23,015,453 (2005); $11,365,388 (2006) and $15,463,565 (2007). The stock-based compensation was not included in the cost pool under the R&D cost-sharing agreement. The IRS audited petitioner and issued Notices of Deficiency with respect to the 2004-2007 taxable years. The Notices of Deficiency allocated, pursuant to Section 482, income from Altera International to Altera US by increasing Altera International's cost-sharing payments for 2004-2007.

Section 482 – Arm's-Length Standard

Section 482 authorizes the Commissioner to allocate income and expenses among related entities. The first sentence of Section 482 provides, in relevant part, as follows:

> In any case of two or more organizations, trades or businesses * * * owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to

[1] 145 T.C. No. 3 at 51 (2015).

> prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. * * *

The purpose of Section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions.[2] In 1986, Congress amended Section 482 by adding the following: "In the case of any transfer (or license) of intangible property * * *, the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."[3] This commensurate-with-income approach was adopted because of the recognition that there may be extreme difficulties in determining whether the arm's-length transfer between unrelated parties are comparable.

A later study by Treasury and the IRS explained that the commensurate-with-income standard is consistent with the arm's-length standard because:

> [l]ooking at the income related to the intangible and splitting it according to relative economic contributions is consistent with what unrelated parties do. The general goal of the commensurate-with-income standard is, therefore, to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm's-length transfer of the intangible.[4]

In *Xilinx Inc. v. Commissioner*,[5] the Tax Court addressed the treatment of stock-based compensation between controlled entities that entered into a qualified cost-sharing agreement. The Tax Court held that the Commissioner's allocation of stock-based compensation failed to satisfy the arm's-length standard of Section 1.482-1(b)(1).

In reaching this holding the Tax Court concluded that, consistent with the 1995 cost-sharing regulations: (1) in determining the true taxable income of a controlled taxpayer, the arm's-length standard applies in all cases; (2) the arm's-length standard requires an analysis of what unrelated entities would do; (3) the commensurate-with-income standard was never intended to supplant the arm's-length standard; and (4) unrelated parties would not share the exercise spread or grant date value of stock-based compensation.[6] In so holding, the Tax Court observed, in part, that the IRS's expert agreed that unrelated parties would not share the stock-based compensation costs, and found that the taxpayer proved that companies do not take into account either the exercise spread or grant date value of stock-based compensation for producing pricing purposes. The Ninth Circuit initially reversed the Tax Court, but subsequently withdrew its opinion in *Xilinx* and issued a new opinion affirming the Court.[7]

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2 *See* Treas. Reg. 1.482-1(a)(1)

3 Tax Reform Act of 1986, Pub. L. No. 99-514, Sec. 1231(e)(1), 100 Stat. at 2562.

4 Notice 88-123, 1988-2 C.B. at 472.

5 125 T.C. 37 (2005), *affd* 598 F.3d 1191 (9th Cir. 2010).

6 145 T.C. No. 3 at 70-75.

7 *See Xilinx Inc. v. Commissioner*, 598 F.3d at 1191.

The Circuit Court affirmed the finding that all costs requirement should be construed as not applying to stock-based compensation because the regulations should be interpreted in the light of the dominant purpose of the statute—parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions.

Treasury desired that all stock-based compensation must be included in determining operating expenses under section 482.

2003 Cost-Sharing Regulations

The *Xilinx* opinion did not sit well with the IRS. In 2002 Treasury issued a notice of proposed rulemaking and notice of a public hearing with respect to proposed amendments to the cost-sharing regulations. The purpose of the proposed amendments to the cost-sharing regulations was to clarify "that stock-based compensation must be taken into account in determining operating expenses under § 1.482-7(d)(1), and to provide rules for measuring stock-based compensation costs."[8] A public hearing on the proposed amendments was held on November 20, 2002.

In response to the Notice, several commentators informed Treasury that they knew of no transactions between unrelated parties, including any cost-sharing arrangement, service agreement or other contract, that required one party to pay or reimburse the other party for amounts attributable to stock-based compensation. Indeed, several commentators identified arm's-length agreements in which stock-based compensation was not shared or reimbursed, and several commentators cited the practice of the Federal Government and cited Federal regulations which prohibit reimbursement of amounts attributable to stock-based compensation.[9]

In August 2003, Treasury issued the final rule. The final rule explicitly required parties to QCSAs to share stock-based compensation costs.[10] The final rule also added sections 1.482-1(b)(2)(i) through 1.482-7(a)(3), Income Tax Regs., to provide that a QCSA produces an arm's-length result only if the parties' costs are determined in accordance with the final rule.[11]

The final rule provides two methods for measuring the value of stock-based compensation: a default method and an elective method. Under the default method, "the costs attributable to stock based compensation generally are included as intangible development costs upon the exercise of the option and measured by the spread between the option strike price and the price of the underlying stock."[12] Under the elective method, "the costs attributable to stock options are taken into account in certain cases in accordance with the 'fair value' of the option, as reported for financial accounting purposes either as a charge against income or in footnoted disclosures."[13]

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8 *See* 67 Fed, Reg. 48997, 48998 (July 29, 2002).

9 145 T.C. No. 3 at 72-73.

10 *See* Treas. Reg. § 1.482-7(d)(2).

11 *See* T.D. 9088, 2003-2 C.B. 841, 847-848.

12 *Id.*, 2003-2 C.B. at 844.

13 *Id.*

When it issued the final rule, the files maintained by Treasury relating to the final rule did not contain any expert opinions, empirical data or published or unpublished articles, papers, surveys or reports supporting a determination that the amounts attributable to stock-based compensation must be included in the cost pool of QCSAs to achieve an arm's-length result. Those files also did not contain any record that Treasury searched any database that could have contained agreements between unrelated parties relating to joint undertakings or the provision of services.

The Tax Court found that the final rule lacked a basis in fact because Treasury failed to provide a reasoned basis for its conclusions from any evidence in the administrative record.

At the outset, the parties disagreed whether the final rule was a legislative rule or an interpretative rule. If interpretative, as alleged by the Service, the requirements of APA Section 553 did not apply; thus there was no need to publish a notice of proposed rulemaking, provide interested persons an opportunity to participate in the rulemaking and incorporate a concise general statement of the rule's basis and purpose. The Tax Court concluded that the final rule was a legislative rule subject to the APA Section 553 because Treasury intended that the final rule to have the force of law. The court further concluded that the final rule must satisfy the "reasoned decision-making standard" followed in *State Farm*[14], because the "validity of the final rule turns on whether Treasury reasonably concluded that it is consistent with the arm's-length standard."[15]

Under the rubric of *State Farm*, the taxpayer argued that the final rule was invalid because (1) it lacked a basis in fact, (2) Treasury failed to rationally connect the choices it made with the facts if found, (3) Treasury failed to respond to significant comments, and (4) the final rule was contrary to the evidence presented to Treasury. The Tax Court agreed with the taxpayers.

The Tax Court found that the final rule lacked a basis in fact because Treasury failed to provide a reasoned basis for its conclusions from any evidence in the administrative record. According to the court, there was no evidence in the record that supported Treasury's belief that unrelated parties would share stock-based compensation costs. Moreover, the Tax Court refused to defer to Treasury's expertise because the court found that commentators introduced significant evidence showing that parties operating at arm's-length would not share stock-based compensation. The Tax Court also found that Treasury failed to respond directly to any of the evidence that unrelated parties would not share stock-based compensation costs. Specifically, the court held that "[m]eaningful judicial review and fair treatment of affected persons require 'an exchange of views, information and criticism between interested persons and the agency.' Treasury's failure to adequately respond to commentators frustrates our review of the final rule and was prejudicial to affected entities."[16]

The Tax Court noted that the significant evidence submitted by commentators demonstrated that unrelated parties to QCSAs would not share stock-based compensation costs.

Lastly, the Tax Court concluded that the final rule was contrary to the evidence before Treasury when it issued the final rule. The court noted that the significant evidence

[14] *United States v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983)

[15] 145 T.C. No. 3 at 68.

[16] 145 T.C. No. 3 at 74.

submitted by commentators demonstrated that unrelated parties to QCSAs would not share stock-based compensation costs; Treasury never found the submitted evidence incredible, and accepted the commentators' economic analysis. Accordingly, Treasury's explanation for its decision ran counter to the evidence. Because the court found that the final rule lacked a basis in fact, and was contrary to the evidence presented, the court held that the final rule failed to satisfy *State Farm's* reasoned decision making standard ad was therefore invalid. Finally, the Tax Court held that the harmless error rule of APA Section 706 was not applicable because it was not clear that Treasury would have adopted the final rule if it had been determined to be inconsistent with the arm's-length standard.

The *Altera* decision is significant for taxpayers with cost-sharing agreements. The decision may also have a broad impact on future regulatory rulemaking and challenges to existing IRS regulations.

–Richard A. Nessler

IRS Issues Notices Covering "Basket Option" and "Basket Contract" Transactions

On July 8, 2015, the IRS issued Notice 2015-47 and Notice 2015-48, which designated "basket option" transactions as listed transactions and "basket contract" transactions as transactions of interest. The Notices state that the Service is concerned that taxpayers may be using basket options and basket contracts to defer income recognition and convert ordinary income and short-term capital gain into long-term capital gain, among other potential abuses.

A basket option contract is described as a contract denominated as an option between a taxpayer and its counterparty (a bank) with a stated term of more than one year.

Notice 2015-47

Notice 2015-47 identified transactions that it referenced to as "basket option contracts" and any substantially similar transactions as "listed transactions."[17] A basket option contract is described as a contract denominated as an option between a taxpayer and its counterparty (a bank) with a stated term of more than one year. Under the contract, the taxpayer pays an amount to the bank upfront, and the bank promises to pay the taxpayer a return based on the performance of a notional basket of actively traded property, reduced by a fee to compensate bank for entering into the contract. The contract typically terminates automatically if the reference basket value decreases by an amount that approaches the amount of the upfront payment. In addition, either party may terminate the contract at any time with proper notice.

The components of the basket are determined by the taxpayer (or its designee) or by an algorithm selected by the taxpayer or designee. During the contract term, the taxpayer

[17] The basket option contracts identified as listed transactions in the Notice are similar in many respects to the basket contract options addressed in GLAM 2010-005, which was issued by the IRS in 2010. The GLAM concluded that a basket option contract was not an option and that the hedge fund that purchased the "option" instead owned the reference basket of assets.

may request changes to the basket components or the algorithm, subject to the bank's right to reject certain requested changes. In practice, the bank generally accepts the taxpayer's requests. The bank typically acquires the basket components as a hedge of its risk under the contract and acquires and disposes of the basket components as changes to the reference basket are made.

The taxpayer takes the position that short-term gains and ordinary income with respect to the referenced property are not includible in income by the taxpayer; rather, the taxpayer reports long-term capital gain with respect to the termination of the option contract. The Notice states concern that such treatment is inappropriate and identifies basket option contracts and substantially similar transactions as listed transactions. For this purpose, the Notice states that a transaction is considered substantially similar to a basket option contract if: (i) the transaction is denominated as an option contract; (ii) substantially all of the assets in the referenced basket primarily consist of actively traded personal property as defined under Section 1.1092(d)-1(a); (iii) the purchaser of the option or the purchaser's designee has the right to: (1) determine the assets in the reference basket both at inception and periodically over the term of the transaction, or (2) select or use a specific trading algorithm under its control to determine the assets in the reference basket and (iv) the purchaser of the option, the purchaser's designee or the specified trading algorithm actually changes one or more of the assets in the reference basket during the term of the basket option contract.

Notice 2015-48

The basket contract transactions bear some similarities to the basket options designated as listed transactions in Notice 2015-47, but need not be denominated as options (and instead may be denominated as any type of derivative contract), and may reference non-actively traded property.

Notice 2015-48 identified transactions that it referred to as "basket contracts" and any substantially similar transactions as "transactions of interest." The basket contract transactions bear some similarities to the basket options designated as listed transactions in Notice 2015-47, but need not be denominated as options (and instead may be denominated as any type of derivative contract), and may reference non-actively traded property. Pursuant to the Notice, the basket contracts identified as transactions of interest entitle a taxpayer to receive payments based on the return of a referenced basket of assets, which may include hedge fund interests, securities, commodities, foreign currency or similar property, that is determined by the taxpayer, its designee or a trading algorithm selected by the taxpayer or its designee. During the term of the contract, the taxpayer or its designee has the right to request changes in this reference basket assets or the specified algorithm, which the counterparty generally accepts. To manage its risk under the basket contract, the counterparty typically acquires all or substantially all of the reference basket of assets. Notice 2015-48 does not specifically define when a transaction is substantially similar to the transaction of interest described in the Notice. However, Treas. Reg. § 1.6011-4(c)(4) states that a transaction is substantially similar if it: (i) is expected to obtain the same or similar types of tax consequences as the transaction of interest, and is either (A) factually similar, or (B) based on the same or similar tax strategy. Generally, the term "substantially similar" must be broadly construed in favor of disclosure.

Notice 2015-47 applies to transactions in effect on or after January 1, 2011. Notice 2015-48 applies to transactions entered into on or after November 2, 2006 and in effect on or after January 1, 2011. Participants in the Notice transaction include the purchaser of the contract, any general partners or managing members of a contract purchaser that is a partnership or LLC and the counterparty to the contract.

Taxpayers involved in transactions that fall under either Notice must disclose the transaction, under Section 6011, for each taxable year in which the taxpayer participated in the transaction for which the statute of limitations had not run on or before July 8, 2015. Disclosure is required within 120 days of the issuance of the Notices (*i.e.*, by November 5, 2015). Material advisors (as defined under the Code) who made a tax statement on or after January 1, 2011 with respect to such transactions have a duty to register under Section 6111 and a duty to maintain an investor list under Section 6112.

Potential Penalties

The penalties for failure to disclose, register and maintain a list can be substantial. The penalty under Section 6707A for failure to disclose a reportable transaction under Section 6011 is 75 percent of the decrease in tax as a result of the transaction, subject to a maximum cap of $200,000 in the case of a listed transaction for an entity, or $100,000 for an individual. The basket option contracts are considered to be listed transactions. The penalty under Section 6707 for failure to register the transaction is the greater of $200,000 or 50 percent of the gross income derived by such person. The penalty under Section 6708 related to maintaining an investor list is $10,000 for each day a material advisor fails to furnish a reportable transaction advisee list to the Service starting the day after the 20th day from which such list was requested in writing from the Service. A reasonable cause defense is applicable to Section 6708, but is not applicable to Section 6707.

-*Nathan Tasso*

Fraud of Third-Party Does Not Extend the Statue of Limitations Under Section 6501

The Claims Court held that Section 6501(c)(1)'s suspension of the three-year limitation applies only when the taxpayer—and not a third party—acts with the requisite "intent to evade tax."

On July 29, 2015, the United States Court of Appeals for the Federal Circuit in *BASR Partnership v. U.S.*[18] affirmed a decision by the US Court of Federal Claims which determined that Section 6501(a)'s three-year statute of limitations barred the Internal Revenue Service ("IRS") from administratively adjusting, in 2010, the 1999 US Partnership Tax Return filed by BASR Partnership ("BASR"). The Claims Court held that

[18] *BASR Partnership v. U.S.*, No. 2014-5037 (Fed. Cir., July 29, 2015)

Section 6501(c)(1)'s suspension of the three-year limitation applies only when the taxpayer—and not a third party—acts with the requisite "intent to evade tax."

Background

The facts were undisputed. In 1999, the Pettinati family intended to sell their printing business, which would realize a large capital gain. Before the sale, Erwin Mayer, a lawyer from the now-defunct law firm of Jenkins & Gilchrist, contacted the Pettinati family and prepared a "tax advantaged investment opportunity," which involved establishing the BASR Partnership. The Pettinati family hired Jenkins & Gilchrist, which recommended the transaction that could reduce the amount of capital gain reported. Jenkins & Gilchrist also provided a signed tax opinion, which attested to the legitimacy of the transaction. The Pettinatis retained Malone & Bailey, who had no connection to Jenkins & Gilchrist, to prepare their tax returns. Ultimately, by creating the BASR Partnership, the Pettinatis greatly reduced the tax liability arising from the sale of their printing business.

The Circuit Court rejected the IRS's argument and held that Section 6501 was limited to the fraud by the taxpayer.

In 2004, the IRS received a list of Jenkins & Gilchrist's clients, including the Pettinatis, who had employed this type of tax-advantaged investment structure. In 2010, the IRS issued a FPAA to BASR, which concluded that the transaction lacked economic substance and accordingly, significantly increased the Pettinatis' tax liability for the 1999 tax returns.

The taxpayers paid the tax and sued for a refund in the Claims Court. BASR sought summary judgment, arguing that the adjustments and increased tax liability were untimely under the three-year statute of limitations.[19] The IRS asserted that the three-year period remained open under IRC § 6501(c)(1) because the case involved "a fraud or fraudulent return with the intent to evade tax." The IRS conceded that the Pettinatis and their tax preparers, Malone & Bailey, lacked the intent to evade tax. The IRS asserted only that Erwin Mayer acted with intent to evade taxes when he conceived and marketed the tax-advantaged investment structure.[20] In reply, BASR argued that the three-year statute of limitations is suspended only when the taxpayer intended to evade tax.

Statutory Analysis

Section 6501(c)(1) provides that "[i]n the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed ... at any time." The IRS argued that the unlimited limitations period is triggered whenever any individual acts with intent to evade tax and the tax return ultimately filed contains a falsity, without regard to how remotely related that individual is to the actual tax return or to whether the taxpayer appreciates that individual's intentions. In essence, the IRS argued that the court should focus exclusively on the fraudulent nature of the tax return.

[19] *See*, IRC §§ 6229(a) and 6501(a).

[20] Slip Opn. at 7.

The Circuit Court did not find persuasive the Tax Court's analysis in *Allen v. Commissione*¸ where the Tax Court concluded that a tax preparer could supply the necessary fraudulent intent to evade tax.

The Circuit Court rejected the IRS's argument and determined that Section 6501(c)(1) was limited to the fraud of the taxpayer. The Circuit Court noted that Section 6501 is silent as to which party or parties must have the requisite fraudulent intent to suspend the statute of limitations. However, the Court looked to other Code provisions that dealt with the consequences of intentional tax evasion to conclude that fraud must be by the taxpayer, as opposed to by a third-party, who may have contributed to the filing of an inaccurate tax return.[21] First, the Court noted that Section 7454(a) provides that "[i]n any proceeding involving the issue of whether the petitioner has been guilty of fraud with intent to evade tax," the IRS bears the burden of proving the element of fraud. Thus, under Section 7454(a), Congress considered the fraudulent intent of only the taxpayer. Second, Section 6663(a), which requires the IRS to impose fraud penalties, provides that "[i]f any part of any underpayment of tax required to be shown on a return is due to fraud, their shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud." The Court noted that, like Section 6501(c)(1), Section 6663(a) does not specify whether the "fraud must be attributable to the taxpayer." Despite the similarities, the IRS argued that Section 6663(a)'s fraud penalty applied only when the taxpayer commits fraud. The Court found no basis where these two intent-based statutes could support the IRS's conflicting interpretation.

The Circuit Court did not find the Tax Court's analysis in *Allen v. Commissioner*[22] persuasive, where the Tax Court concluded that a tax preparer could supply the necessary fraudulent intent to evade tax. The Circuit Court noted that the Tax Court's analysis did not consider how its interpretation conflicted with the IRS's interpretation of Code Sections 7454(a) and 6161. Similarly, the Court found the IRS's reliance on *City Wide Transit, Inc. v. Commissioner*,[23] to be misplaced, because *City Wide* did not address the question of whether the tax preparer's intent was sufficient to trigger Section 6501(c)(1).

Lastly, the Circuit Court noted that the IRS's interpretation of Section 6501 was novel, and inconsistent with its own Field Service Advisory.[24] In the FSA, the IRS concluded that, although "[s]ection 6501(c)(1) does not by its express language require that the 'intent to evade tax' be the personal intent of Taxpayer[.] [w]e nonetheless conclude that the fraudulent intent of the tax return preparer is insufficient to make section 6501(c)(1) applicable."

Chief Judge Prost dissented and stated that in the case of Section 6501(c)(1), which must receive a strict construction in favor of the Government, Congress did not limit the statute to the taxpayer's intent. According to the dissent, judicial inquiry is complete by looking

[21] Slip Opn. at 13 – 15.

[22] 128 T.C. 37 (2007).

[23] 709 F.3d 102 (2d Cir. 2013)

[24] IRS Field Service Advice Mem. 200104006.

to the words of the statute where the statute's plan and unambiguous language does not limit the intent to evade tax to only the taxpayer's intent.

Accordingly, the dissent opined that the intent to evade tax must only be present in a false or fraudulent return, irrespective of who possesses that intent.

–Richard A. Nessler

Circuit Court Upholds Privilege for Internal Investigation Documents

On August 11, 2015, the United States Court of Appeals for the District of Columbia in *In Re Kellogg Brown & Root, Inc.*[25] granted a *writ of mandamus* and vacated two district court orders that directed the production of key documents related to an internal investigation conducted by petition, Kellogg Brown & Root ("KBR"), a defense contractor. This was the second time that the D.C. Circuit Court of Appeals granted petitioner a *writ of mandamus* regarding the application of the attorney-client privilege and work product protection to petitioner's internal investigation documents.[26] After vacating the earlier district court order, the case was remanded to the district court to consider "timely asserted other arguments for why these documents are not covered by either the attorney-client privilege or the work-product protection.[27]"

The Circuit Court rejected the claim that KBR waived privilege and granted petitioner a *writ of mandamus* regarding the application of the attorney-client privilege and work product protection to petitioner's internal investigation documents.

Background

The background facts of the case are not in dispute. Harry Barko, who worked for KBR, filed a False Claims Act complaint in 2005, alleging that KBR defrauded the US Government by inflating costs and accepting kickbacks in connection with military contracts in wartime Iraq. Barko sought documents related to a prior KBR internal investigation into the alleged fraud. KBR asserted that the internal investigation had been conducted for the purpose of obtaining legal advice and that the internal investigation documents were protected by the attorney-client privilege.[28] However, it was revealed during a corporate 30(b)(6) deposition of Chris Heinrich, KBR's Vice President (Legal), that Heinrich reviewed the disputed documents related to KBR's internal investigation in preparation for the deposition. At the deposition, KBR's attorney instructed Heinrich not to answer questions about the content of the internal investigation documents on the basis of the attorney-client privilege and work-product protection. Following the deposition, KBR moved for summary judgment. In its motion, KBR stated that KBR performed an internal investigation in accordance with its internal Code of Business Conduct ("COBC") policy, and concluded that KBR did not violate the Anti-Kickback Act. On November 20, 2014, the district court ruled that KBR waived privilege when Heinrich reviewed the internal investigation documents in preparation for his deposition, and

[25] *In re: Kellogg Brown & Root, Inc.*, No. 14-5319 (D.C. Cir. August 11, 2015)

[26] *See In re: Kellogg Brown & Root, Inc.*, 756 F.3d 754 (D.C. Cir. 2014)

[27] *Id.*

[28] *See Upjohn v. United States*, 449 U.S. 383 (1981).

KBR's motion that affirmatively referenced the COBC documents created an implied waiver. On December 17, 2014, the district court issued a separate opinion and order compelling production of parts of the COBC documents on the alternative basis that they "are discoverable fact work-product and Barko shows substantial need."[29] The Circuit Court found that the district court erred and vacated both orders.

Waiver in the Context of the 30(b)(6) Deposition.

Barko argued that KBR waived privilege to the COBC documents under FRE 612 by permitting Heinrich to review the COBC documents prior to the 30(b)(6) deposition. The Circuit Court rejected Barko's claim. According to the Circuit Court, Rule 612 applies only where a witness uses a writing to refresh memory. Thus, the Circuit Court stated that "even if the witness consults a writing while testifying, the adverse party is not entitled to see it unless the writing influenced the witness's testimony."[30] The Court noted that Barko noticed the deposition to cover the topic of the COBC investigation itself. The Court held that Barko cannot overcome the privilege by putting the COBC investigation in issue at the deposition, and then demanding under Rule 612 to see the investigating documents. According to the Court, "permitting privilege and protection to be so easily defeated would defy 'reason and experience'."[31]

The Circuit Court held that Barko cannot overcome the privilege by putting the COBC investigation in issue at the deposition, and then demanding under Rule 612 to see the investigating documents.

Waiver in Context of Placing the COBC Documents "at Issue" in KRB's Motion.

The issue was whether KBR's reference to the COBC investigation in the motion in support of summary judgment placed the COBC documents "at issue" creating a waiver of the attorney-client privilege and work-product protection. Although Barko's argument had some appeal, the Circuit Court found that KBR had not waived privilege as to the COBC documents by referencing the COBC investigation related to Barko's claim and statement that it did not report any wrongdoing to the Government based on its internal investigation. The Court concluded that the context of KBR's statement supported the conclusion that KBR did not waive the privilege. First, KBR's reference to the COBC investigation relating to Barko's claim appeared only in a footnote in the motion's introduction. This fact was significant to the Court because (i) the statement was not in the argument section of the motion, and (2) generally, courts do not "indulge cursory arguments made only in a footnote."[32] In addition, the Court noted that in the context of summary judgment, all inferences were to be drawn against KBR at this stage of the litigation, thus, it was an error for the district court not to view KBR's statements in the light most favorable to Barko.

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[29] *United States ex. Rel. Banko v. Halliburton Co.*, 2014 WL 7212881 (D.D.C. Dec. 27, 2014)

[30] Slip. Opn at 10, citing 4 *Jack B. Weinstein & Margaret A. Berger*, Weinstein's Federal Evidence § 612.04(2)(b)(1) (2d ed. 1997).

[31] Slip. Opn at 12.

[32] Slip. Opn at 18.

Non-Privileged Fact Work-Product.

The Circuit Court also found that the district court erred in requiring disclosure of portions the of COBC report as fact work-product. Upon review of the compelled disclosed information, the Circuit Court concluded that the material was attorney-client privileged and opinion work-product. Accordingly, the Circuit Court concluded that the compelled production rulings dated November 20, 2014 and December 17, 2014 constituted error, and granted KBR's *writ of mandamus*.

–Richard A. Nessler

Court of Federal Claims Disallows Losses from DAD Transaction

The IRS challenged the DAD transaction under the sham transaction, economic substances and step transaction doctrines.

On August 12, 2015, the Court of Federal Claims issued a decision, in *Russian Recovery Fund Ltd. v. U.S.*,[33] which sustained an IRS adjustment that disallowed approximately $50 million in losses on a partnership's tax return from a distressed asset debt transaction ("DAD"). The Claims Court also sustained a 40 percent gross valuation misstatement penalty pursuant to Section 6662. The issue at trial was whether Russian Recovery Fund Ltd. ("RRF") was entitled to claim built-in losses on disposition of securities derived from Russian sovereign debt.

Background

The IRS argued that Tiger had no business purpose in acquiring shares through a contribution in-kind to RRF, that Tiger was never a real partner in RRF and that the swap of assets for partnership shares should be ignored.

RRF was created in 1998 as a Cayman Islands limited liability corporation to invest in distressed Russian assets. At the time the Russian Federation defaulted on all of its sovereign debt obligations which caused the ruble to collapse, and significantly depressed the value of Russian debt (most had lost over 90 percent of their value). One of RRF's investors was Jaguar and Ocelot, two hedge funds managed by Tiger Management. In May 1999, the Tiger funds contributed to RRF credit-linked notes ("CLN"), which were derivatives of Russian sovereign debt. At the time of the transfer to RRF, the CLNs had a market value of approximately $15 million, but had a basis of over $230 million. At the time, the RRF Subscription Agreement required each investor to wait three years to redeem the investment. However, RRF and Tiger executed a "side letter" which permitted Tiger to redeem its shares on or after July 1, 1999. Almost immediately after makings its investment in RRF, Tiger made efforts to dispose of its new partnership shares to FFIP, an investor in RRF and a fund created by Bracebridge Capital.[34] Tiger sold all of its RRF partnership shares to FFIP on June 3, 1999. The effect of the sale was that, pursuant to Section 721, FFIP could move into Tiger's shoes with respect to its contribution of Russian securities to RRF. FFIP now had whatever basis in the CLNs contributed by Tiger to RRF. On June 22, 1999, RRF sold the majority of the CLN's to General Cigar for approximately $21 million, (the CLN's had built in tax loss of approximately $178 million). General Cigar paid $17.9 million in cash and the balance paid in preferred

33 *Russian Recovery Fund Ltd. v. U.S.*, No. 06-30T (Ct. Cl., August 12, 2015).

34 Bracebridge Capital also created RRF.

stock in General Cigar, value at $3.2 million. RRF sold its remaining 22.8 percent of the CLN's in the open market in 2000 generating a profit of over $7.4 million. However, RRF claimed a loss on its 2000 partnership tax return on the sale of the CLN securities in the amount of $49 million (reflecting the loss associated with the 22.8 percent sale). Later, in 2004, RRF claimed the balance of the loss ($170 million) on its redemption of its preferred stock in General Cigar.

In 2005, following an audit, the Service issued an FPAA for tax year ending December 31, 2000 disallowing the $49 million losses claimed by RRF. The Service also issued an FPAA disallowing RRF's partnership tax return for 2004, which claimed a loss of $170 million. The Service challenged the losses under the sham transaction, economic substance and step transaction doctrines. The Service argued that Tiger had no business purpose in acquiring shares through a contribution in-kind to RRF, that Tiger was never a real partner in RRF and that the swap of assets for partnership shares should be ignored so that what emerges is a sale of the CLNs by Tiger to FFIP. RRF argued that the transactions properly followed the Code. Thus, the Tiger funds, Jaguar and Ocelot, sustained large unrealized losses on their Russian assets and transferred those assets, along with their negative basis, in exchange for partnership interests in RRF. The losses did not need to be recognized on that exchange and become associated with the assets then acquired by RRF. FFIP, an RRF investor, then stood in Tiger's shoes when those losses were later dispersed when the assets were sold, in part to General Cigar.

The Court concluded that that Tiger had no interest in becoming a partner in RRF and that RRF was aware early on that Tiger had no real interest in becoming a partner and considered the transfer of its CLNs as a cash "sale."

Economic Substance Analysis

The Claims Court framed the issue as follows: "[d]id Tiger's losses travel intact through the series of transactions at issue and legitimately flow to RRF's partners by way of the K-1 forms, or, as defendant [IRS] asserted, did the built-in loss vanish immediately at Tiger's transfer to RRF because this was a disguised sale."[35] The Claims Court found that Tiger and RRF were not partners and that their transaction was a sham, that the transaction lacked economic substance, that Tiger's contribution can be ignored and that the transaction should be characterized as a sale.[36]

The Claims Court found that RRF was created for a legitimate business purpose—to make money following the collapse of the Russian bond market—and that its initial marketing efforts were genuine to fund investors. However, the Court could not reach the same conclusion for the Tiger transaction. The Court concluded, based on the testimony of various employees of Tiger, that Tiger had no interest in becoming a partner in RRF and that RRF was aware early on that Tiger had no real interest in becoming a partner and considered the transfer of its CLNs as a cash "sale." The Court also cited to various written communications which demonstrated RRF's desire to move the highly depreciated assets to RRF in a way that preserved their tax characteristics, and the

[35] Slip Opn. at 30.

[36] Slip Opn. at 31.

taxpayer's admission that preserving tax losses was a RRF goal prior to Tiger's entry into the partnership.

On the issue whether RRF should be subject to the gross valuation misstatement penalty, RRF argued that it had reasonable cause by relying on tax advice provided by E&Y. But the Court rejected RRF's claim, because E&Y provided no tax advice other than preparing RRF's tax returns. The Court found that there were "no back-up memos or records of conversations concerning the propriety of claiming the built-in losses."[37] The Court rejected RRF's assertion that E&Y, by signing off on the tax returns, provided advice on whether it was appropriate to take the loss deduction. Accordingly, the Claims Court held that RRF was liable for the penalty because RRF did not reasonably rely on any objection advice from a tax professional based on all the pertinent laws, facts and circumstances.

–Richard A. Nessler

District Court Grants Evidentiary Hearing in Dispute Over IRS Use of Private Firm in Microsoft Audit

On June 17, 2015, the United States District Court for the Western District of Washington granted Microsoft Corporation an evidentiary hearing on whether the IRS' use of lawyers from Quinn Emanuel Urquhart & Sullivan LLP in the summons process was lawful.[38] The IRS has been auditing Microsoft's transfer pricing arrangements from the company's 2004 to 2006 tax returns, and seeking to enforce the related summonses in *United States v. Microsoft Corp. et al*.[39]

What began as a routine IRS audit of Microsoft's cost-sharing arrangements with affiliates soon became a case full of rare happenings: the first time the IRS has hired a private law firm to aid in the audit process.

What began as a routine IRS audit of Microsoft's cost-sharing arrangements with affiliates soon became a case full of rare happenings: the first time the IRS has hired a private law firm to aid in the audit process, and one of the rare instances where a District Court has granted an evidentiary hearing in a summons enforcement proceeding. The IRS contracted for Quinn Emanuel Urquhart & Sullivan LLP to help in its Microsoft audit, relying on the temporary regulations it issued in June 2014. Microsoft challenged both that contract and the validity of the regulation that permitted it. US District Judge Ricardo S. Martinez found that Microsoft had carried its burden for an evidentiary hearing, distinguishing this case from prior ones where hearings had been denied. On July 17, 2015, Judge Martinez also denied the Government's motion to exclude witnesses, allowing Microsoft's attorneys to testify at the hearing and agreeing with the company that an evidentiary hearing is not a trial.

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37 Slip Opn. at 41.

38 *United States v. Microsoft Corp. et al*, No. 2:15-cv-00102 (W.D. Wa., June 17, 2015).

39 *See United States v. Microsoft Corp. et al* No. 2:15-cv-00102 (W.D. Wa. filed Dec. 11, 2014); No. 2:15-cv-00103 (W.D. Wa. filed Dec. 19, 2014).

Timeline of Events

The saga started in 2007, when the IRS began investigating Microsoft's activities from 2004 to 2006. The IRS audit focused on two of the company's cost-sharing arrangements, one with Microsoft affiliates in Puerto Rico and another with affiliates in Asia, a process that continued over the next seven years. The fact gathering had been done by just the agency thus far, but on June 9, 2014, the Treasury and the IRS issued a "temporary regulation" without notice and comment that would allow third-party contractors like private law firms to "receive books, papers, records or other data summoned by the IRS and take testimony of a person who the IRS has summoned as a witness to provide testimony under oath."[40]

Based on this temporary regulation, the IRS entered into a $2,185,500 contract with Quinn Emanuel for help on the audit of the Puerto Rico arrangement, which included services such as analysis of issues, identification of any further documents needed and participation in interviews. Quinn Emanuel's involvement allegedly did not begin until July 15, 2014, however, the IRS did not inform Microsoft it had retained private civil litigators for the audit until August 28, 2014. Quinn Emanuel attorneys were present at interviews, reviewed documents and independently assessed the Puerto Rico arrangement from September to October 2014.

On October 30, 2014, the IRS issued a summons to Microsoft pursuant to 26 U.S.C. §§ 7602 and 6503(j), followed by filed petitions in the District Court for the Western District of Washington to enforce those summonses beginning in December 2014. After finding that the IRS had made the requisite initial showing for enforcement, the Court issued an Order to Show Cause to Microsoft. Microsoft responded by filing motions seeking an evidentiary hearing, alleging IRS abuse of process in contracting the audit out to a private law firm, and that discovery is therefore warranted prior to the Court's decision on summonses enforcement. Microsoft also filed Freedom of Information Act ("FOIA") requests in the meantime for documents relating to the IRS's retention of Quinn Emanuel.

The crux of this case is whether the IRS can use outside private attorneys in an audit, and whether the temporary regulation it relied upon to do so is valid.

Legal Background and Issues

The crux of this case is whether the IRS can retain outside private attorneys in an audit, and whether the temporary regulation it relied upon to do so was valid. The IRS acted well within the law when it brought an enforcement action. *See* 26 U.S.C. § 7604(b). Once the court has found that the IRS has made a *prima facie* case, the burden shifts to the taxpayer to show that enforcement of the summons would result in an abuse of the court's process. *United States v. Powell*, 379 U.S. 48, 58 (1964). However, in such enforcement proceedings, the court is limited to deciding only whether the IRS issued the

[40] *See* 79 Fed. Reg. 34,625 (June 18, 2014); 26 C.F.R. § 301.7602-1T(b)(3).

The district court concluded that Microsoft had met its burden requiring whether enforcing the summons may be abusive.

summons in good faith and without improper purpose.[41] Taxpayers are also entitled to a pre-enforcement evidentiary hearing if they can point to "specific facts or circumstances plausibly raising an inference of bad faith" or of another "appropriate ground" to defeat the summons, a threshold showing that can be satisfied via circumstantial evidence.[42]

Microsoft made two arguments in support of an evidentiary hearing: first, that the IRS, in hiring a private law firm to conduct audit interviews, improperly outsourced an inherently governmental function and thus abuses court process; and second, the facts and circumstances of how Quinn Emanuel was retained raised a "plausible inference" that the IRS may have also improperly delegated other aspects of the tax audit to the firm. The company also asserts that this is the first time that the IRS has retained private civil litigators in a US income tax audit, and that while the contract covers four non-severable phases for the firm's services, only the first phase is detailed.

The IRS countered that whether the outsourcing was improper or not is a legal question, and not one requiring factual discovery. The hiring of Quinn Emanuel was also one fully supported by law, and challenges the idea that the circumstances raised any inference of impropriety.

Circumstantial Evidence Deemed Sufficient

In ruling for Microsoft, Judge Martinez distinguished the present case from past denials for hearings because Microsoft had carried its burden to trigger an evidentiary hearing: Microsoft was able to point to specific circumstances from which the court could infer that the temporary regulation was invalid; and the company was also able to point to facts and circumstances raising an "inference of impropriety."[43]

According to the court, while the IRS was correct in saying that the challenge to the validity of the temporary regulation was a question of law, the challenge itself raises questions of fact that may warrant discovery.[44] Whether the temporary regulation expanding the parties able to assist in tax audits is valid could then turn on the facts: the regulation might be one that the IRS could issue without notice and comment procedures, as listed in 5 U.S.C. § 553(b)(3); the regulation might be found arbitrary and capricious—and therefore invalid—because it could not be reconciled with the plain language of the IRC.

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41 *See United States v. Clarke*, __ U.S. __, 134 S.Ct. 2361, 2367 (2014) (quoting *United States v. Stuart*, 489 U.S. 353, 369 (1989)).

42 *Id.*

43 Microsoft filed a supplemental brief regarding the recent Tax Court decision in *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (2015). According to Microsoft, the *Altera* decision is relevant to its claim that enforcing the IRS summonses would be an abuse of the court's process.

44 Prior to the temporary regulation, the Internal Revenue Code allows only the Secretary or any duly authorized "officer, employee or agency of the Treasury Department" to examine documents, issue summons or take testimony under oath to investigate tax liability. *See* 26 U.S.C. § 7602(a)(1)-(3); § 7701(a)(11)(B), (a)(12)(A)(i).

In addition, the court found that Microsoft was able to point to sufficient facts and circumstances "plausibly raising an inference of impropriety." In support of its allegation that the IRS was improperly delegating government functions in the audit, Microsoft showed language in the contract that could suggest the firm was inspecting books and taking testimony, activities that are statutorily limited to the Government alone. Microsoft also alleged that the IRS retained Quinn Emanuel before the temporary regulations were issued, raising an inference that the firm played a larger role in the issuance of summonses and information documents requests and had access to confidential taxpayer information in violation of the Code.[45]

Evidentiary Hearing is Not a Trial

Exactly one month after his order granting an evidentiary hearing, Judge Martinez also allowed Microsoft's attorneys to participate as witnesses in the same trial in which they were also advocates, denying the IRS's motion to exclude. Microsoft had sought to allow their attorneys to testify about IRS' contract, a move the IRS said was barred by Washington's rules of professional conduct—rules that forbade attorneys from being both witnesses and advocates at the same trial.

Judge Martinez once again sided with Microsoft, saying that while the state rules of professional conduct did apply in District Court, the attorneys' testimonies would not violate them because an evidentiary hearing was not a trial. After the court's decision, Microsoft said that the attorneys would be acting only as witnesses for the hearing, with other attorneys taking on their former roles as advocates.

The IRS retaining outside counsel for a tax audit is an unprecedented move, and while grants for evidentiary hearings are rare, the unique circumstances of this case may have affected the decision. The evidentiary hearing is scheduled for August 25, 2015.

–Richard A. Nessler & Eva Yung[46]

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[45] *See* 26 U.S.C. § 6103.

[46] Eva Yung is a 2015 summer associate at Shearman & Sterling LLP.

CONTACTS

If you wish to receive more information on the topics covered in this publication, you may contact your usual Shearman & Sterling representative or any of the following:

LAURENCE M. BAMBINO
lbambino@shearman.com
+1.212.848.4213

ROGER J. BANEMAN
rbaneman@shearman.com
+1.212.848.4894

RYAN BRAY
ryan.bray@shearman.com
+1.650.838.3726

LAURENCE E. CROUCH
lcrouch@shearman.com
+1.650.838.3718

D. KEVIN DOLAN
kevin.dolan@shearman.com
+1.202.508.8016

GERALD M. FEIGE
gerald.feige@shearman.com
+1.202.508.8115

KRISTEN M. GARRY
kgarry@shearman.com
+1.202.508.8186

IAN C. FRIEDMAN
ian.friedman@shearman.com
+1.202.508.8012

RICHARD J. GAGNON, JR.
rgagnon@shearman.com
+1.202.508.8189

LAWRENCE M. HILL
lawrence.hill@shearman.com
+1.212.848.4002

ALFRED C. GROFF
agroff@shearman.com
+1.202.508.8090

ETHAN D. HARRIS
ethan.harris@shearman.com
+1.202.508.8163

MARY JO LANG
maryjo.lang@shearman.com
+1.202.508.8175

THOMAS D. JOHNSTON
thomas.johnston@shearman.com
+1.202.508.8022

DEREK KERSHAW
derek.kershaw@shearman.com
+1.212.848.7964

RICHARD A. NESSLER
richard.nessler@shearman.com
+1.212.848.4003

SANJEEV MAGOON
smagoon@shearman.com
+1.212.848.7442

DOUGLAS R. MCFADYEN
dmcfadyen@shearman.com
+1.212.848.4326

JEFFREY A. QUINN
jeffrey.quinn@shearman.com
+1.202.508.8000

EILEEN M. O'PRAY
eileen.opray@shearman.com
+1.650.838.3724

KYLE PHILLIPS
kyle.phillips@shearman.com
+1.650.838.3744

ROBERT A. RUDNICK
rrudnick@shearman.com
+1.202.508.8020

MICHAEL B. SHULMAN
mshulman@shearman.com
+1.202.508.8075

ADAM STERNBERG
adam.sternberg@shearman.com
+1.212.848.7003

JOHN M. SYKES III
jsykes@shearman.com
+1.212.848.8666

NATHAN TASSO
nathan.tasso@shearman.com
+1.202.508.8046

JEFFREY B. TATE
jeffrey.tate@shearman.com
+1.202.508.8084

LAWRENCE M. HILL
Editor, *Focus on Tax Controversy & Litigation*

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