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FOCUS ON TAX CONTROVERSY & LITIGATION

New Partnership Audit Procedures May Dramatically Affect the Assessment and Collection of Taxes Relating to Partnership Activities

In addition to the discussion of the new partnership audit rules, this month's issue features articles regarding a recent district court decision in *Ellis v. United States* regarding the attorney-client privilege and work product protections, amendments to the Federal Rules of Civil Procedure, recent developments concerning the IRS' enforcement efforts regarding offshore accounts and a discussion of the benefits and potential pitfalls of making a tax deposit.

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New Partnership Audit Procedures May Dramatically Affect the Assessment and Collection of Taxes Relating to Partnership Activities

The Bipartisan Budget Act of 2015 (the "BBA"), which was signed into law in November 2015, includes sweeping changes to the rules governing federal tax audits of entities treated as partnerships for US federal income tax purposes. The new rules replace the long-standing regimes for auditing partnerships under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") and the Electing Large Partnership ("ELP") rules. The new rules allow the Internal Revenue Service (the "IRS") to deal with only a single "partnership representative," similar to the tax matters partner under TEFRA, during an audit and any related court cases. Unless a partnership elects out, the new rules impose an entity-level tax on the partnership at the highest rate of tax in effect for the reviewed year (subject to potential reduction) for any understatements of partnership income. The entity-level tax can be avoided, however, if the partnership elects to "push out" the adjustment to its partners by providing them with adjusted Schedule K-1s reporting their allocable share of any partnership-level audit adjustments. The purpose of the new rules is to streamline partnership audits under a single set of rules and to make it easier for the IRS to assess and collect tax after a partnership audit. Importantly, the new audit regime will apply only to partnership tax returns filed for taxable years beginning after December 31, 2017 unless a partnership elects to apply them to an earlier taxable year. The BBA contains profound changes affecting both partnerships and partners. Consequently, a review of partnership agreements to analyze how these rules will affect existing partnerships is advisable.

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Background

The TEFRA regime, which generally remains in place until the BBA's audit provisions become effective, provides for unified audit procedures to determine the tax treatment of all "partnership items" at the partnership level, after which the IRS can assess each audited-year partner individually based on the partner's allocated share of the adjustments. The TEFRA rules also include procedures for notice to, and participation by, partners in audits and any related litigation. The BBA audit provisions will replace both the TEFRA regime as well as the rarely-used tax provisions and audit procedures for ELPs (electing partnerships with more than 100 partners). Partnerships that elected to be treated as an ELP were subject to a unified audit under which any adjustments were generally reflected on the partners' current year return rather than on an amended prior-year return. The ELP rules were adopted to make audits of large partnerships less burdensome. But most large partnerships did not elect ELP treatment, and the IRS found the ELP regime to be underutilized. Under the BBA's audit provisions, partnerships with more than 100 partners will be governed by the new rules as no election to opt-out is permitted.

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Application of the New Partnership Audit Procedures

All partnerships will be subject to the new audit procedures provided for in the BBA unless they are permitted to elect out. Thus, partnerships with as few as two individuals will be covered by default under the BBA. Partnerships with more than 100 partners may not elect out of the BBA provisions.

A partnership with 100 or fewer partners can elect out of the new rules for a taxable year if all of its partners are individuals, C corporations (including entities treated for tax purposes as real estate investment trusts or regulated investment companies), foreign entities that would be treated as C corporations if they were domestic, or estates of deceased partners. A partnership with an S corporation partner may elect out of the new rules if all of the S corporation's shareholders are identified to the IRS. In that event, each of the S corporation's shareholders counts as a partner for purposes of the "100 or fewer partners" test. Partnerships with other types of partners, such as partnerships, trusts, or certain tax-exempt entities, cannot elect out of the new audit procedures. Accordingly, tiered partnerships cannot elect out of the BBA audit procedures.

To elect out of the new rules with respect to a taxable year, a partnership must:

- include the election with its timely-filed income tax return for that year;
- disclose the names of all of its partners and their tax identification numbers to the IRS; and
- provide its partners with notice of the election.

If a partnership with 100 or fewer partners elects out of the new rules, the general non-partnership assessment and collection rules will apply. As a result, partners in a partnership, where the partnership has filed the partnership return and disclosed the election out of the BBA, may take inconsistent positions regarding partnership items reported on their Schedule K-1s, without providing notice to the IRS of the inconsistent position. In the case of a partnership that elects out of the BBA, the IRS still may audit the partnership, but it must make all tax adjustments at the partner level (i.e., the partnership cannot settle issues on behalf of partners), and the partnership cannot extend the statute of limitations for the partners. Accordingly, in such a case, the IRS would need to timely issue 30-day letters or notices of deficiency to the individual partners.

While the ability to elect out of the new partnership audit regime may be useful in certain cases (such as closely held partnerships among sophisticated partners), the elect-out provisions may be of limited utility because, as a practical matter, most investment funds and widely-held partnerships are unlikely to satisfy the requirements for electing out.

Partnership Level Assessments and Collections — The Default Rule

Under the BBA, the IRS will audit the partnership's items of income, gain, loss, deduction, credit and partners' distributive shares for a particular year of the partnership at the partnership level (like under TEFRA), which is now called the

"The purpose of the new rules is to streamline partnership audits under a single set of rules and to make it easier for the IRS to assess and collect tax after a partnership audit."

"reviewed year." Except as described below, any adjustment, assessment and collection of tax, interest and penalties will be made at the partnership level and taken into account by the partnership in the year that the audit or any judicial review is completed. The year in which an audit becomes final is called the "adjustment year." If the IRS determines that any adjustments are required, the partnership generally will be required to pay the imputed underpayment of tax, plus interest and penalties. The imputed underpayment is determined by adding together or "netting" all adjustments to items of income, gain, loss and deduction and multiplying the result by the highest tax rate in effect for the reviewed year under section 1 (individuals) or section 11 (corporations) (i.e., under current law, the relevant rate would be 39.6%). The imputed underpayment is calculated without regard to the nature of the adjustments; all positive or negative adjustments to capital gains and losses, whether long or short term, items of ordinary income or other types of income or loss, are netted. Nor does it appear to matter that items might be subject to restrictions on deduction at the partner level such as the "at risk" or "passive activity" limitations.

A partnership's imputed underpayment may be reduced to the extent partners voluntarily file amended tax returns and pay any tax due for the audited year, or if the partnership demonstrates that partnership items are allocable to partners that are either not subject to tax (i.e., tax-exempt entities), or taxed at a reduced corporate tax rate or, in the case of an individual, a reduced capital gain rate or qualified dividend income rate. The BBA directs Treasury to establish procedures under which the imputed underpayment "may be modified" to specifically account for (i) adjustments to reflect amended returns filled by partners, (ii) adjustments to exclude income allocable to tax-exempt partners, (iii) adjustments to reflect the applicability of rates of tax lower than the highest rate to income or gains allocable to C corporation partners and capital gains or qualified dividend income allocable to individual partners and (iv) other factors as the Secretary "determines are necessary or appropriate." The scope of any additional reduction under such procedures is not yet known.

Partner Level Assessments and Collections — The Alternative Rule (i.e., the Push Out Election)

As an alternative to the general rule that an imputed underpayment is assessed and collected at the partnership level, a partnership that receives notice of a Final Partnership Administrative Adjustment ("FPAA") will be permitted to elect that, instead of the tax being assessed against the partnership, any adjustments are pushed out to its partners for the reviewed year through the issuance of adjusted Schedule K-1s. If this election is made, the reviewed year partners' tax for the adjustment year will be increased to reflect the adjustment amount. In addition, the tax will include any tax that would have resulted from those adjustments in the years after the reviewed year and before the adjustment year. The effect of this election is similar to a TEFRA adjustment, but instead of actually imposing tax with respect to the earlier years (which would require the filing of amended tax returns), the tax is

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reported on and paid with the partners' return for the adjustment year. Under this alternative, the reviewed year partners (rather than the partnership) are liable for the tax. In addition to the tax, the reviewed year partners will be liable for interest running from the due date of the return for the earlier years(s) that generated the liability and any penalties, and the interest rate used to calculate the amount of interest is increased by a "toll charge" of two percentage points above the typical underpayment rate. All tax attributes, such as basis, will be affected by these adjustments. In order to avail itself of the push-out election, a partnership must elect to issue adjusted Schedule K 1s no later than 45 days after the issuance of the FPAA. If it timely makes the election and furnishes the adjusted Schedule K-1s, the partnership will not be liable for any underpayment.

The decision whether the partnership should pay the imputed underpayment at the partnership level or elect to push-out the adjustment to its reviewed year partners has important implications. Unless the partnership agreement provides otherwise, under the general partnership tax rule, paying tax at the partnership level places the economic burden on the persons who are partners during the adjustment year. This could impose part of the economic burden of the adjustment on particular partners who were not partners in the partnership (or had a lower percentage interest in the partnership) in the reviewed year.

Partnership Representative

The BBA requires partnerships to designate a "partnership representative" with a role similar to that of the "tax matter partner" under TEFRA. The partnership representative can be any person (and not necessarily a partner) that has a "substantial presence in the United States." (Until guidance is issued, it is unclear what level of US presence is required to act as a partnership representative.) The partnership representative has the sole authority to act on behalf of the partnership in an examination (including extending the statute of limitations and settling issues raised on audit), and decisions made by the representative are binding on the partnership and all of its partners. Partners retain no rights in administrative proceedings and will be unable to challenge IRS determinations separately from the partnership. Partners do have the right to file inconsistently with the partnership return (unless and until the partnership representative reaches an agreement with the IRS to finalize an audit) with notification to the IRS. If a partnership does not designate a partnership representative, the IRS is free to designate anyone it chooses. Additionally, the IRS is no longer required to notify partners of partnership audit proceedings or adjustments.

Statute of Limitations

- The BBA provides that an adjustment generally must be made by the IRS (presumably "assessed") within three years from the later of:
- the date the partnership return for the reviewed year was filed,
- the due date for such partnership return, and

- the date the partnership filed an Administrative Adjustment Request for the year.

An adjustment made within three years of any of these dates is timely. If, however, the amount of unreported income exceeds 25 percent of the gross income of the partnership for the reviewed year, the IRS has six years (rather than three years) to make the adjustment. Moreover, if the partnership did not file a return or filed a fraudulent return, there is no limitation period. In addition, as noted above, the partnership representative can agree to extend the time to make the adjustment.

"The new partnership audit rules represent a dramatic change from existing law and will likely have a significant impact on partnership transactions."

The period for adjustment also will remain open (i) in the case of any imputed underpayment modification, for 270 days after the date that everything required to be submitted to the IRS is submitted and (ii) in the case of any proposed partnership adjustment, for 270 days after the date of the notice. The 270-day period gives the partnership time to produce documentation supporting lower tax rates for some or all of an imputed underpayment. The IRS must wait 90 days after issuing the FPAA before assessing the deficiency and, if the partnership timely files a petition in Tax Court, the IRS must wait until the court's decision is final before making an assessment. Petitions in Tax Court do not require pre-payment, but a partnership filing in district court or the Claims Court must first pay the asserted imputed underpayment.

Planning Ahead

The BBA brings some long-needed reforms to a complex area of the tax code. Absent an election to apply the new rules before 2018, the BBA will not affect any partnership audits before 2019 (when returns for the 2018 taxable can first be audited). However, it is not too early for affected taxpayers to consider the potential impact of these new rules on new and existing partnerships and partnership agreements. The new partnership audit rules represent a dramatic change from existing law and will likely have a significant impact on partnership transactions. Considering the breadth of guidance the IRS will need to issue and the IRS's discretion in deciding how the elections and underpayment calculations will operate, partnerships may have to act quickly to respond once rules are effective. Partnerships, both existing and new, should consider steps now to prepare for potential audits under the new rules and should begin evaluating their partnership and operating agreements and consider whether changes will be needed to address a variety of issues, including:

- Whether the partnership should consider electing out of the new partnership audit regime (if the partnership is eligible to make such election);
- Whether to agree in advance that the partnership will elect to push out any adjustment to its partners;
- Whether to include a provision placing the burden of an adjustment on persons who were partners during the reviewed year, rather than those who are partners during the adjustment year;

- Who to designate as the "partnership representative" and how future replacement partnership representatives will be selected; and
- Whether and how partners should receive notice of any tax proceeding.

"The BBA contains profound changes affecting both partnerships and partners."

Anyone joining a partnership also should review existing agreements closely for implications under the new rules. Under the default entity-level payment procedures, new partners can be exposed to effective liability for tax positions taken before they entered the partnership, and new partners may wish to request mechanisms, such as indemnities or a requirement for the partnership to make the push-out election, to reduce or eliminate their potential exposure.

Finally, we note that the new partnership audit regime is viewed by the government as a "work in progress" and, as a result, it would not be surprising if significant changes were made to the regime before it becomes effective.

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District Court Upholds Summons and Rejects Attorney-Client and Work Product Privilege

On November 16, 2015, the United States District Court, Southern District of Mississippi, dismissed a petition to quash a third-party summons served on taxpayer's tax return preparer, and rejected the tax return preparer's assertion that documents requested by the summons were protected by the attorney-client privilege and the work-product doctrine.[1] The court ordered the tax preparer to appear before the Service for the purpose of testifying and producing requested documents to comply with the summons.

Background

The IRS issued a third-party summons to plaintiff, Alice Ellis ("Ellis"), to testify and produce documents to an IRS Special Agent, who was conducting an investigation of possible criminal offenses by Ellis' client McCool. The summons requested the production of documents related to financial transactions involving McCool. Ellis was listed as the tax return preparer on numerous federal tax forms related to McCool. Plaintiff's counsel responded to the summons and produced some of the requested documents but asserted the attorney-client privilege on all matters related to McCool. Shortly thereafter, plaintiff served a petition to quash the summons and Ellis did not appear to testify in response to the summons. The IRS filed a motion to dismiss the petition and to enforce the summons.

Discussion

The determination of whether the district court has jurisdiction to hear the petition to quash the summons depends on whether the Unites States has waived sovereign

[1] *Ellis v. United States*, 2015 WL 7289497 (S.D. Miss.)(November 16, 2015)

immunity. To resolve the jurisdictional issue, the district court looked to whether the Code provided plaintiff the right to bring a motion to quash the summons. The court considered Code § 7609 and concluded that only the taxpayer can initiate an action to quash a summons (not the third party tax preparer). The court found no authority where a summoned party who was not the taxpayer successfully quashed an IRS summons—noting that several court have rejected the argument that summoned parties can bring a pre-enforcement action to quash a summons.[2] Because Ellis was not a party entitled to notice, the United States had not waived sovereign immunity for her to challenge the summons. Accordingly, the court held that it lacked subject matter jurisdiction to hear Ellis' petition to quash the summons.

The court emphasized that it was the plaintiff's responsibility "to make specific assertions concerning particular documents and provide some justification as to why the attorney-client privilege applied."

In response to the summons request for the production of documents, plaintiff asserted that the requested information was protected by the attorney-client privilege and work-product doctrine. Plaintiff raised her privilege defense in a letter to the Service stating that her counsel "will be asserting privilege on all matters pertaining to [] McCool and their entities with regard to the May & Co., issues based on our on-going relationship and verbal contacts."[3] Plaintiff's letter failed to list or describe any of the documents withheld based on her assertion of the attorney-client privilege or work product doctrine.

The Federal Rules of Civil Procedure require a party claiming a privilege to "(i) expressly make the claim; and (ii) describe the nature of the documents, communications or tangible things not produced or disclosed and to do so in a manner that, without revealing information itself privileged or protected, will enable other parties to assert the claim."[4] Moreover, the district court's local rules require a party withholding privileged information to produce a privilege log that at a minimum included the names of the document, description of the document, requisite elements of the claimed privilege, date, authors, and nature of the privilege.[5]

The court concluded that plaintiff's blanket assertion of the attorney-client privilege made it impossible for the court to determine if all or any of the requested documents fell within the privilege. The court emphasized that it was the plaintiff's responsibility "to make specific assertions concerning particular documents and provide some justification as to why the attorney-client privilege applied."[6] Plaintiff's claim of privilege did not satisfy the requirements of Local Rule 26(a)(1) and the FRCP 26(b)(5) in that plaintiff did not provide the government or the court with any type of privilege log with reference to specific documents. In addition, the court rejected plaintiff's claim that the documents fell under the *Kovel* standard.[7] The court held that *Kovel* did not apply because tax preparation is not viewed as within the purview

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[2] 2015 WL 7289497 *3 citing *Gutierrez v. United States*, 1996 WL 751342 (E.D. Wash. 1996); *Foundation of Human Understanding v. United States*, 2001 WL 1386051 (D. Or. 2001)

[3] 2015 WL 7289497 *6

[4] Fed. R. Civ. P. 26(b)(5)(a)

[5] Miss. District Court Local Rule 26(a)(1)

[6] 2015 WL 7289497 *6

[7] *United States v. Kovel*, 296 F.2d. 918, 922 (2nd Cir. 1961)

of the attorney-client privilege and plaintiff produced no facts to demonstrate how her communications were to assist McCool's legal representation.

With regard to plaintiff's work-product claim, the court found that plaintiff's conclusory statements that the documents were covered by the work-product doctrine "fell woefully short of meeting his burden." To qualify for the privilege, the documents must be created in anticipation of litigation. The court reviewed the summons and concluded that the summons "reflects documents created in the normal course of business without any obvious nexus to anticipated litigation." As such, the court concluded that the work product doctrine did not apply.

Richard A. Nessler

Amendments to the Federal Rules of Civil Procedure

Amendments to the Federal Rules of Civil Procedure ("Federal Rules") covering discovery rules and exchange of information in civil lawsuits, which were adopted by the Supreme Court in April 2015 and accepted by Congress, took effect in December. The changes, which are the result of five years of review and debate, affect civil rules 1, 4, 16, 26, 30, 31, 33, 34, 37, 55 and 84. The amendments will govern all federal civil proceedings commenced on or after December 1, 2015, and all civil proceedings then pending "insofar as just and practicable." The overarching goal of the amendments is to secure a just, speedy and inexpensive determination of every federal civil action and proceeding. The new rules attempt to achieve this goal, in part, by limiting the amount of document discovery "proportional to the needs of the case," which is meant to curb overbroad document requests that traditionally drove up costs, and delay an early case management.[8]

Case Management

The changes to early case management focus on expediting the initial stages of litigation. The amendments that impact the surge of discovery emphasize proportionality and reasonableness and require more specificity in objecting to discovery requests. The amendments also directly address preservation and sanctions for spoliation of electronically stored information ("ESI").

The new rules attempt to limit the amount of document discovery "proportional to the needs of the case," which is meant to curb overbroad document requests.

Significant changes to the Federal Rules include, among others:

1. Rule 1 has been amended to state that lawyers and parties as well as courts have an obligation to secure the just, speedy, and inexpensive determination of every action.

2. The time for service of process under rules 4(m) is shortened from 120 days to 90 days.

3. The time for holding the initial case management conference under rule 16(b) has been shortened by 30 days, and new topics for the Rule 26(f) and Rule 16 conferences have been added.

[8] Fed. R. Civ. P. 26(b)

4. The scope of discovery in Rule 26(b)(1) has been amended, and the need for proportional discovery tailored to the reasonable needs of the case has been highlighted.
5. Rule 37(e) has been rewritten to address the preservation and loss of electronically stored information.

The purpose of the amendments are clear—to reduce delay and improve cooperation in civil litigation.

Amendments to Rules 1, 4 and 16

Federal Rule 1 is designed to improve cooperation and encourage active judicial case management. Rule 1 seeks to make it clear that the parties have an obligation to make litigation efficient, adding that the Rules "should be construed, administered, and employed by the court and the parties to secure the just, speedy, and inexpensive determination of every action and proceeding."[9] The amended rule requires judges and lawyers to work cooperatively in controlling the expense and time demands of litigation.[10] The amendments to Federal Rules 4 and 16 seek to reduce delay in the early stages of litigation through more active gradual case management and reduced timelines in distinct ways. Rule 4(m) reduces the time to serve a defendant with the complaint from 120 to 90 days.[11] Rule 16(b)(2) reduces the time to issue a scheduling order to the earlier of 90 days (down from 120 days) after any defendant has been served with the complaint, or 60 days (down from 90 days) after any defendant has appeared.[12] However, the rule permits that a court may set a later date for issuing the scheduling order upon a finding of "good cause." Rule 16(b)(3) identifies three additional topics for discussion and possible inclusion in the scheduling order: (i) the preservation of ESI; (ii) whether any agreement can be reached under FRE 502 pertaining to the disclosure of privileged information or work product protected material; and (iii) whether the parties should be required to request an informal conference with the court prior to filing any discovery motions.[13]

"The amended rule requires judges and lawyers to work cooperatively in controlling the expense and time demands of litigation."

Amendments to Rule 26

The key change to Rule 26 replaces language that is often used to argue that the scope of discovery should be broad and crystalizes the concept of reasonable limits on discovery. Thus, the "reasonably calculated to lead to the discovery of admissible evidence," has been replaced with the language "and proportional to the needs of the case."[14] The new rule requires attorneys to limit discovery requests to what is needed to prove a claim or defense and to eliminate unnecessary or wasteful discovery.[15]

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[9] Fed. R. Civ. P. 1

[10] *See* Chief Judge John Roberts Annual Report of the Judiciary, at 6 (December 31, 2015).

[11] Fed. R. Civ. P. 4(m)

[12] Fed. R. Civ. P. 16(b)(2)

[13] Fed. R. Civ. P. 16(b)(3)

[14] Fed. R. Cir. P. 26

[15] Chief Judge John Roberts Annual Report of the Judiciary, at 7 (December 31, 2015).

Rule 26(b) also deleted language authorizing the court to "order discovery of any relevant subject-matter involved in the action." Rule 26(b)(1) now makes proportionality considerations part of the definition of the scope of discovery and reinforces parties' obligations to consider proportionality in making discovery requests, responses, and objections.[16] The court will consider the following proportionality factors:

- The importance of the issues at stake;
- The amount in controversy;
- The parties' relative access to relevant information;
- The parties' resources;
- The importance of the discovery in resolving the issues; and
- Whether the burden or expense of the proposed discovery outweighs its likely benefit.

In addition, Rule 26(c)(1)(B) will authorize courts to issue cost-shifting orders, determining the "allocation of expenses" for certain discovery.[17] Parties will need to consider these factors and draft discovery requests with the proportionality limits in mind and consider the costs associated with responding to the requests. In addition, in negotiating the scope of its response, the responding party should be prepared to discuss specifics about the burdens and expenses they assert.

Amendments to Rules 30, 31, 33 and 36

The initial proposal to these Federal Rules imposed numerical limits to discovery requests to encourage efficiency and cooperation through early case management. The August 2013 Rules had proposed reducing the presumptive limits on the number of depositions (from 10 to five depositions per party); length of depositions (from seven to six hours each); number of interrogatories (from 25 to 15); and number of requests for admission (from no limit to 25). But public comments opposed these limits and many feared that the proposed limits would become hard limits and deprive parties of evidence needed to prove their claims or defenses. The Committee withdrew the limits, concluding that the goals of proportionality and effective case management could be achieved through other rule changes. The Committee instead amended Rules 30, 31, and 33 to refer to Rule 26(b)(1) and incorporate its emphasis on proportionality.

Amendments to Rules 26(d), 34(b), and 37(a)

Amendments to three rules result in a number of changes to the timing of requests for production of documents ("RFPs") and substance and timing of responses to RFPs. Rule 26(d)(2) will now permit a party to serve RFPs in advance to the Rule 26(f) conference, but no earlier than 21 days after the receiving party was served in

[16] Fed. R. Civ. P. 26(b)(1)

[17] Fed. R. Civ. P. 26(c)(1)(B)

the litigation. RFPs served prior to a Rule 26(f) conference will be deemed to have been served at the first Rule 26(f) conference. Rule 34(b)(2) requires responding parties to (i) be more specific in objections to RFPs; (ii) state whether documents actually will be withheld pursuant to each objection; (iii) state whether they will produce copies or permit inspection; and (iv) complete production "no later than the time for inspection specified in the request or another reasonable time specified in the response."[18] No more boilerplate objections are permitted. Rule 37(a)(3)(B)(iv) permits a party to move for an order compelling production if another party fails to produce documents.

Amendments to Rule 37(e)

"Rule 37 now provides broad discretion for courts to cure prejudice caused by loss of ESI and resolves a circuit split as to when courts may impose more severe sanctions for failure to preserve ESI."

Federal Rule 37(e) covers preservation issues regarding Electronically Stored Information ("ESI"). The amended Rule 37(e) adopts the common law principle that duty to preserve arises when litigation is reasonably anticipated. The rule now provides broad discretion for courts to cure prejudice caused by loss of ESI and resolves a circuit split as to when courts may impose more severe sanctions for failure to preserve ESI. The proposed rule as originally drafted applied to all types of discoverable information, but the final amendment is limited to ESI. The Committee decided to confine Rule 37(e) to ESI because "the law of spoliation for evidence other than ESI is well developed and longstanding, and should not be supplanted without good reason."[19] Rule 37(e) provides that "If [ESI] that should have been preserved in the anticipation or conduct of litigation is lost because a party failed to take reasonable steps to present it, and it cannot be restored or replaced through additional discovery" the court, if prejudice exists, may "order measures no greater than necessary to cure the prejudice."[20]

As the first step, therefore, a party moving for sanctions for failure to preserve ESI must show: (i) the relevant ESI "should have been preserved in the anticipation or conduct of litigation"; (ii) relevant ESI was lost because the party charged with safeguarding the lost ESI "failed to take reasonable steps to preserve" the information; and (iii) the lost ESI "cannot be restored or replaced through additional discovery."[21] If this predicate showing is made, then the court " upon finding prejudice to another party from loss of the information, may order measures no greater than necessary to cure the prejudice. The amended rule requires only "reasonable steps" to preserve ESI. Perfection is not required and courts may consider the parties' resources and sophistication. If the loss of ESI results from a party's intent to deprive another party of the ESI's use in the litigation, the court may impose "very severe" sanctions, including: (i) presumption that the lost information was unfavorable to the jury; (ii) instruct the jury that it may or must presume the information was unfavorable to the party; or (iii) dismiss the action or enter a default judgment.

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[18] Fed. R. Civ. P. 34(b)(2)

[19] 2015 Notes of Advisory Committee to Fed. R. Civ. P. 37

[20] Fed. R. Civ. P. 37(e)

The amended rules and supporting documentation related to their recent adoption—including excerpts from the reports of the Judicial Conference Committee on Rules—are posted on the Judiciary's website at: www.uscourts.gov/rules-policies/current-rules-practice-procedure.

Richard A. Nessler

IRS Remains Focused on Off Shore Tax Enforcement

The IRS and DOJ are now focusing bank investigations in Belize, the British Virgin Islands, Cayman Islands, the Cook Islands, India, Israel, Liechtenstein, Luxemburg, the Marshall Islands and Panama, to name a few.

On January 27, 2016, the US Department of Justice announced that it had signed the final non-prosecution agreement with a Category 2 Swiss bank.[22] The DOJ-Swiss Bank Program, which began on August 29, 2013, provided a path for Swiss banks to resolve potential criminal liabilities in the United States. More than 80 Swiss banks voluntarily reported under the program and paid more than $1.3 billion in penalties to the United States. Under the Program, Swiss banks have revealed information on thousands of US accountholders, which has driven many of these taxpayers into the IRS voluntary disclosure programs. As last reported by the IRS, more than 54,000 taxpayers have participated in the voluntary disclosure program, and the IRS has collected more than $8 billion in taxes, penalties and interest. The IRS considered the Swiss program a success and is now looking beyond Switzerland to find additional US accountholders who may have engaged in offshore tax evasion.

At the recent American Bar Association meeting held on January 29, 2016, the acting Attorney General for the tax division disclosed that the IRS and DOJ are now focusing bank investigations in Belize, the British Virgin Islands, Cayman Islands, the Cook Islands, India, Israel, Liechtenstein, Luxemburg, the Marshall Islands and Panama, to name a few. The government is pursuing both civil and criminal enforcement efforts to pursue taxpayers who continue to conceal foreign accounts and assets and evade their US tax obligations. The government has encouraged financial institutions and individuals who have engaged in criminal conduct to contact the DOJ to discuss their options.

In September, the US District Court for the Southern District of Florida authorized the issuance of "John Doe" summonses to Citibank and Bank of America to produce records identifying US taxpayers with offshore bank accounts in Belize.[23] The "John Doe" Summonses sought information regarding US persons who hold offshore accounts at Belize Bank International Limited and Belize Bank Limited (the "Belize Banks"). These summonses permit the IRS to seek records of the Belize Banks' correspondent accounts at Bank of America, N.A. and Citibank, N.A.

Pursuant to the summonses, Bank of America and Citibank have been directed to produce records which identify US taxpayers with accounts at the Belize Banks. The court also granted permission to the IRS to seek records of Corporate Services'

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[21] *Id.*

[22] *See* US Dept. of Justice Press Release dated January 27, 2016 (www.justicre.gov/opa/pr/justice-department).

[23] *In the Matter of the Tax Liability of John* Doe (Index No. 1:15-mc-23475) (Sept. 16, 2015)

Taxpayers who desire to disclose to the Service a foreign account have a choice between the OVDP, the latest iteration of which is an open-ended program that began in January 2012 (modified in 2014), and the newer streamlined procedures.

correspondent accounts at Bank of America and Citibank, as well as information related to Corporate Service's deposit account at Bank of America.[24] The "John Doe" class includes US taxpayers, who at any time from 2006 through 2014 had interests in, or authority with respect to, any financial accounts maintained at, monitored by, or managed through the Belize Entities. The IRS believes that these John Doe summonses will enable it to ascertain the identity of US taxpayers that it believes are using the Belize Entities and correspondent accounts to avoid their obligation to report and remit associated taxable income to the United States.

Taxpayers who desire to disclose to the Service a foreign account have a choice between the OVDP, the latest iteration of which is an open-ended program that began in January 2012 (modified in 2014), and the newer streamlined procedures, offered beginning in 2012 and also modified in 2014 to accommodate a broader group of US taxpayers. The two programs are mutually exclusive, and a taxpayer must choose between them. The key difference in participating in the streamlined procedures requires a certification of non-wilfulness. A false certification filed under the streamlined procedures could lead to possible criminal liability. Most US taxpayers who enter the IRS OVDP to resolve undeclared offshore accounts will pay a penalty equal to 27.5 percent of the high value of the accounts. On August 4, 2014, the IRS increased the penalty to 50 percent if, at the time the taxpayer initiated their disclosure, either a foreign financial institution or a facilitator, who helped the taxpayer establish or maintain an offshore account, had been publicly identified as being under investigation, or received a John Doe summons or cooperating with a government investigation, including the execution of a deferred prosecution agreement or non-prosecution agreement.

If 2016 is anything like recent tax years, it is likely the IRS and DOJ will announce additional civil enforcement actions and new criminal investigations and prosecutions related to foreign accounts.

Richard A. Nessler

The Benefits and Potential Pitfalls of Making a Tax Deposit

Taxpayers who anticipate owing money to the Internal Revenue Service may file a "deposit" with the government. A deposit benefits a taxpayer by stopping the running of interest on an underpayment and penalties.[25] Unlike a payment, a deposit does not prevent a taxpayer from challenging a deficiency in Tax Court,[26] nor does it trigger the statute of limitations for filing a refund claim.[27] And if it is later determined that no tax is due to the government, the taxpayer can simply ask the government to

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[24] A correspondent account is a bank account that one bank maintains for another bank. Typically, a foreign bank that does business in US dollars but does not have a US office will obtain a correspondent account in order to provide services to its US customers.

[25] *Principal Life v. United States*, 95 Fed. Cl. 781, 796 (2010)

[26] *Baral v. United States*, 528 US 431, 439 n.2 (2000)

[27] *Rosenman v. United States*, 323 US 658, 662-63 (1945)

return the money with neither the formality of filing a claim for refund nor the need to show that there had been an overpayment of tax. In addition, if the deposit is requested to be returned, the taxpayer is entitled to the payment of interest on the deposit at the applicable Federal short-term rate to the extent the deposit is attributable to a "disputed tax item"[28] (meaning you can't "deposit" funds with the IRS just to earn interest.)

"If the deposit is requested to be returned, the taxpayer is entitled to the payment of interest on the deposit at the applicable Federal short-term rate."

Historically, the genesis of a tax "deposit" has had a tortured path. The concept of a tax deposit was first recognized in the Supreme Court's decision in *Rosenman v. United States*, which found a basis for the concept in implications from the Internal Revenue Code.[29] Mr. Justice Frankfurter, writing for a unanimous court in *Rosenman*,[30] first described a remittance that was not a "payment" of a tax, but rather "a deposit made in the nature of a cash bond for the payment of taxes thereafter found to be due."[31] But, neither the term "deposit" nor Justice Frankfurter's concept of one "made in the nature of a cash bond for the payment of taxes thereafter found to be due" could be found in any of the income tax provisions in the 1939 Code.[32] The Federal Circuit later interpreted *Rosenman* in *New York Life Ins. Co v. United States*,[33] concluding that a "circumstances" test controlled the question of whether a remittance was a deposit. Over time, the decisions in this area focused less on the tax attributes of deposits, and more on whether a particular remittance was a "deposit" versus a "payment."

The IRS eventually issued a series of revenue procedures, designed to provide taxpayers with guidance as to how "deposits" should be made and would be processed.[34] Rev. Proc. 84-58 and the patchwork of judicial decisions were later replaced by I.R.C. section 6603 (part of the American Jobs Creation Act of 2004),[35] which was enacted to permit a taxpayer to make a deposit and suspend the running of interest under section 6601 on a potential underpayment of tax that was not been assessed at the time of the deposit. Today, this Code provision controls the question of whether a remittance is a "deposit" not *New York Life*.

"A taxpayer may request the withdrawal of any amount of the deposit at any time. There is no limitations period for recovering a deposit with the IRS."

Section 6603 was enacted to permit taxpayers to make a deposit with the Service that may be used by the Secretary to pay any income, gift, estate, or generation-skipping taxes imposed under the Code, which has not been assessed at the time of the deposit. To the extent that such deposit is used by the Service to pay tax, for purposes of

[28] *See* IRC section 6603.

[29] *See Rosenman v. United States*, 323 US 658, 662-63 (1945)

[30] *Id.* at 662-63.

[31] *Id.*

[32] *See New York Life Ins. Co. v. United States*, 118 F.3d 1553, 1556 (Fed. Cir. 1997), *cert. denied*, 523 US 1094 (1998)

[33] *New York Life Ins. Co v. United States*, 118 F.3d 1553, 1556 (Fed. Cir. 1997)

[34] *See* Rev. Proc. 84-58, 1984-2 C.B. 501; Rev. Proc. 82-51, 1982-2 C.B. 839; Rev. Proc. 64-13, 1964-1 C.B. 674; Rev. Proc. 63-11, 1964-1 C.B. 497; *see also Baral*, 528 US at 439 n.2 (noting the existence of this guidance)

[35] Pub. L. No. 108-357, 118 Stat. 1418

section 6601 (relating to interest on underpayments), the tax shall be treated as paid when the deposit is made. Interest will not be charged on the portion of the underpayment that is deposited for the period that the amount is on deposit. Except in the case where the Service has determined that the collection of tax is in jeopardy, section 6603 provides that the Service shall return to the taxpayer any amount of the deposit the taxpayer requests in writing. A taxpayer may request the withdrawal of any amount of the deposit at any time. There is no limitations period for recovering a deposit with the IRS.[36]

Under section 6603, deposits will earn interest at the applicable Federal short-term rate to the extent they are attributable to a disputed tax item. A disputable item is any item for which the taxpayer (1) has a reasonable basis for the treatment of the item, and (2) reasonably believes that the Service also has a reasonable basis for disallowing the taxpayer's treatment of such item.[37] All items included in a 30-day letter (letter of proposed deficiency subject to administrative review) to a taxpayer are deemed disputable for purposes of section 6603.

"Generally, the Circuit Courts have held that determining whether a remittance is a payment or a deposit involves consideration of the facts and circumstances of the case, with no one factor being conclusive."

A deposit shall be made in the manner prescribed by the Service. Section 6603(a) was explicated by Revenue Procedure 2005-18, which provides that a taxpayer may make a deposit by filing a "written statement designating the remittance as a deposit."[38] Rev. Proc. 2005-18 provides the procedures to make, withdraw or identify deposits to suspend the running of interest on potential underpayments. "[A] remittance that is not designated as a deposit (an "undesignated remittance") will be treated as a payment and applied by the Service against any outstanding liability for taxes, penalties or interest."[39] Rev. Proc. 2005-18 superseded Rev. Proc. 84-58.

Under Rev. Proc. 2005-18 the procedures for making a deposit under section 6603 are as follows:

1. A taxpayer may make the deposit to the IRS Service Center at which the taxpayer is required to file its return or to the appropriate office at which the taxpayer's return is under examination.
2. A check or money order must be accompanied by a written statement designating the remittance as a deposit. The written statement must also include the following:
    i. The type of tax;
    ii. The tax year(s), and
    iii. The statement described in section 7.02 (of Rev. Proc. 2005-18) identifying the amount of and basis for the disputable tax.

[36] *Blatt v. United States*, 34 F.3d 252, 254-55 (4th Cir. 1994)

[37] *See* IRC Section 6603(d)(3)

[38] Rev. Proc. 2005-18 § 4.01(1)

[39] Rev. Proc. 2005-18 § 4.01(2)

3. Section 7.02 requires that the taxpayer provide a written statement to include:
    i. The taxpayer's calculation of the amount of disputed tax;
    ii. A description of the item of income, gain, loss, deduction or credit for which the taxpayer has a reasonable basis for the treatment of the item;
    iii. The basis for the taxpayer's belief that it has a reasonable basis for the treatment of any item described in section 7.02 on its return.

Remittances to the IRS may be a deposit in the nature of a cash bond, which the IRS holds until resolution of a case and may be refunded at any time, or the remittance may be a payment of tax which may only be refunded if a timely refund claim is filed.[40] Courts have noted that though Rev. Proc. 84-58 still provides important "guideposts" for distinguishing between deposits and payments, ultimately the courts must apply a facts and circumstances test.[41]

When making a deposit, it is important to designate in writing that the remittance is a "deposit" and not an "advanced payment."[42] In *Bedrosian*, Tax Court rejected taxpayers' argument that they made an undesignated remittance while they were under examination, but before a liability was proposed in writing, and therefore the remittance was a deposit. Without such designation described in the Revenue Procedures discussed above, the failure "weighs against a finding that the remittance was a deposit."[43] The purpose of such designation is to clearly indicate the intention of the taxpayer, a significant factor in the analysis.[44] The Fourth Circuit has held that the distinction between a payment and a deposit is based on "intent[,] which may be determined from the circumstances, such as when the tax liability was created, the taxpayer's purpose in remitting the money, and how the IRS treated the payment."[45]

Generally, the Circuit Courts have held that determining whether a remittance is a payment or a deposit involves consideration of the facts and circumstances of the case, with no one factor being conclusive.[46] Relevant factors include: (1) whether the tax has been assessed by the IRS prior to the remittance; (2) whether the remittance is "disorderly," i.e. made without careful consideration of the potential tax liability;[47] (3) whether the taxpayer contests liability; (4) whether the taxpayer indicates to the

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[40] *Rosenman v. United States*, 323 US 658, 662-63 (1945)

[41] *See, e.g. Winford v. United States*, 970 F. Supp. 2d 548 (W.D. La. 2013), *aff'd*, 587 Fed. App'x 207 (5th Cir. 2014) (adopting the lower court's analysis in full)

[42] *See Bedrosian v. Commissioner*, TC Memo 2007-376 (The written statement accompanying the check remitted by petitioners states that the check is for an "advance payment," not a deposit)

[43] *Winford v. United States*, 970 F. Supp. 2d 548, 555, citing *VanCanagan v. United States*, 231 F.3d 1349, 1353 (Fed. Cir. 2000)

[44] *Ford Motor Co. v. United States*, 768 F.3d 580, 589 (6th Cir. 2014).

[45] *Blatt v. United States*, 34 F.3d 252, 255 (4th Cir. 1994) (citing *Rosenman v. United States*, 323 US 658, 662 (1945))

[46] *See e.g., VanCanagan*, 231 F.3d at 1353 (Fed. Cir. 2000); *New York Life Ins. Co. v. United States*, 118 F.3d 1553, 1557 (Fed. Cir. 1997); *Cohen v. United States*, 995 F.2d 205, 208-09 (Fed. Cir. 1993) (citing *Charles Leich & Co. v. United States*, 329 F.2d 649 (Ct. Cl. 1964))

[47] *See Northern Natural Gas Co. v. United States*, 354 F.2d 310, 315 (Ct. Cl. 1965)

IRS that the remittance is a deposit;[48] (5) whether the IRS viewed the remittance as a deposit; and (6) whether the remittance was made when payment was due and submitted with a request for an extension of time within which to file a return.[49]

In *Deaton v. Commissioner*,[50] the court considered the following facts and circumstances to classify remittances made prior to assessment: (1) evidence that the taxpayer intended the remittance to be a deposit when remitted, (2) evidence that the taxpayer was disputing its tax liability, (3) and whether the taxpayer availed itself of the procedure available for making deposits.[51] Collectively, these factors indicate that the a taxpayer must appropriately avail itself of the procedures available in a manner that indicates clear intention. In *Deaton*, the remittance was made in conjunction with a request for an extension to file a return and the court determined that the remittance was a payment of tax under the facts and circumstances it reviewed.[52] A similar conclusion was recently reached in *Bolt v. United States*.[53] In *Bolt*, the taxpayers remitted a payment to the Service with a signed copy of IRS Form 4549 "Income Tax Examination Changes," which notified the Bolts of the amount of their tax liability. The Bolts did not submit any written statement with the remittance designating it as a deposit, pursuant to section 6603 or Rev. Proc. 2005-18. The IRS treated the remittance as an "advance payment of deficiency," and not as a deposit. The court concluded that the Bolts intended the remittance to be a payment and not a deposit, and dismissed the Bolts' claim for refund as time barred.

Transmitting a deposit to the Service provides certain benefits to taxpayers. However, taxpayers must follow the prescribed requirements of Rev. Proc. 2005-18 and clearly articulate that the payment should be treated as a deposit and not as a payment of tax. Failure to do so may result in an undesirable outcome, as the taxpayers experienced in *Bedrosian*, *Deaton* and *Bolt*.

Richard A. Nessler

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[48] *See VanCanagan*, 231 F.3d at 1353.

[49] *Id.*

[50] 440 F.3d 223 (5th Cir.2006)

[51] *Id.* at 232.

[52] *Id.*

[53] *Bolt v. United States*, 116 AFTR 2d. 2015-651 (D.S. Car. 2015)

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