

Supreme Court Decides *Maryland v. Wynne* and Rules that Maryland Tax Scheme Is Unconstitutional



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In addition to a discussion of the Supreme Court's recent decision in *Maryland v. Wynne*, this month's issue features articles about two recent developments on FTC Generator cases, two decisions regarding the attorney-client privilege and the need for a properly detailed privilege log, a recent FSA ruling on the deductibility of an equitable disgorgement payment to the Federal Food and Drug Administration, penalties imposed in *Castle Harbour* and a discussion of Notice 2014-58, which provides guidance on codification of the economic substance doctrine under section 7701(o).

Maryland's Tax Scheme Ruled Unconstitutional

On May 18, 2015, the United States Supreme Court in *Maryland v. Wynne* affirmed a ruling from Maryland's highest court and held that a Maryland tax scheme that credits residents for taxes paid on out-of-state income at the state income level but not at the county level, violated the dormant Commerce Clause.¹ The Court's 5-4 decision drew strong dissents from Justices Scalia, Thomas, Ginsburg and Kagan. The majority opinion by Justice Alito concluded that Maryland's tax scheme has the same effect as a state tariff and violates the "internal consistency test," which considers whether taxpayers would pay taxes at the same rate if every state adopted the same tax scheme.

A Maryland couple, Brian and Karen Wynne, brought the case. They owned stock in Maxim Healthcare Services, Inc., a subchapter S corporation. Maryland's personal income tax on state residents consists of a "state" income tax and a "county" income tax. The Wynne's reported Maxim's income and received a credit for state income tax paid to other states for their state income tax. However, in accordance with state law, Maryland would not grant a similar credit for income taxes paid to other states against

¹ 575 U.S. ___, No. 13-485 (May 18, 2015)

According to the Supreme Court the fact that a Maryland resident would pay more income tax in Maryland solely because the taxpayer earned income interstate fails the internal consistency test.

the Wynne’s county income tax. The Court of Appeals of Maryland, the state’s highest court, ruled that Maryland’s tax system violated the Commerce Clause. The Court of Appeals held because interstate commerce would be taxed at a higher rate than intrastate commerce that the tax law discriminated against interstate commerce.

The Supreme Court affirmed based on the Commerce Clause, which grants Congress the power to “regulate Commerce . . . among the several States.” (Art. 1, § 8, CL. 3). The Court held that the Commerce Clause contains a negative command, known as the dormant Commerce Clause, which prohibits States from discriminating against or imposing excessive burdens on interstate commerce even when Congress has failed to legislate on the subject. *See Oklahoma Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175, 189 (1995). The dormant Commerce Clause precludes States from “discriminat[ing] between transactions on the basis of some interstate element.” *Boston Stock Exchange v. State Tax Comm’n.*, 429 U.S. 318, 332 (1977). The goal is to prohibit a state from providing a direct commercial advantage to intrastate (local) business.

The majority relied principally on three prior cases involving the taxation of the income of domestic corporations.² In each case, the Court struck down a state tax scheme that may have caused double taxation of income earned out of the state. The schemes discriminated against interstate economic activity by creating an incentive to engage in intrastate rather than interstate business activity. The Court concluded that Maryland’s tax scheme was unconstitutional for similar reasons. The Court’s ruling is supported by the judicial doctrine referred to as the “internal consistency test.” This test looks to the structure of the tax at issue to determine whether its identical application by every State in the Union would disadvantage interstate commerce compared to intrastate commerce.³ The test has been invoked by the Court in seven cases.⁴ The Court concluded that Maryland’s income tax scheme failed the internal consistency test.

Comparing a hypothetical Maryland resident who earns income in another state to one who earns income only in Maryland, the Court concluded that the “internal

² *See J.D. Adams Mfg. Co. v. Storen*, 304 U.S. 307 (1938); *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434 (1939); *Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653 (1948)

³ *See Oklahoma Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995).

⁴ *See American Trucking Assn’s., Inc. v. Michigan Pub. Serv. Comm’n.*, 545 U.S. 429 (2005); *Oklahoma Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995); *Goldberg v. Sweet*, 488 U.S. 252 (1989); *American Trucking Assn’s Inc. v. Scheiner*, 483 U.S. 266 (1987); *Tyler Pipe Industries v. Washington Dept. of Revenue*, 483 U.S. 232 (1987); *Armco Inc. v. Hardesty*, 467 U.S. 638 (1984); *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

Justice Scalia called the dormant Commerce Clause “a judicial fraud”.

consistency test reveals what the undisputed economic analysis shows: Maryland’s tax scheme is inherently discriminatory and operates as a tariff.”⁵ A Maryland resident would pay more income tax in Maryland solely because he earns income interstate. This situation fails the internal consistency test. According to the Court, Maryland could remedy the “tariff” and satisfy the internal consistency test by offering a credit against income taxes paid to other states when determining the county tax. Under the Court’s rationale, any state that fails to provide a tax credit for taxes paid to another state, which is income subject to tax in the resident’s home state, is discriminatory and runs afoul of the dormant Commerce Clause.

In a strongly worded dissent, Justice Scalia attacked the dormant or “negative” Commerce Clause, calling it, “a judicial fraud” - a judge invented rule that lacks logic and constitutional foundation. According to Justice Scalia, the Commerce Clause gave Congress the power to prohibit burdensome taxes and laws; it did not empower the judiciary to set aside state laws it deems too burdensome. Separate dissents were also issued by Justices Thomas and Ginsburg, who was joined by Justice Kagan.

–Lawrence M. Hill and Richard A. Nessler

“FTC Generator” Case Update

On May 18, 2015, two foreign tax credit (“FTC Generator”) cases were argued before the Second Circuit Court of Appeals.⁶ In both cases, *Bank of New York Mellon* and *American International Group*, the taxpayer lost the FTC Generator issue in the lower court. In *Bank of New York Mellon*, the Tax Court held that a structured trust advantaged repackaged securities (“STARS”) deal lacked economic substance (pre-codification under Section 7701). Consequently, the court held BNY could not claim foreign tax credits or deductions for expenses related to the transaction, and income from the transaction was treated as US-source income.

Bank of New York Mellon

The STARS transaction was structured to provide BNY with below market cost financing. The complex transaction structure involved BNY transferring income-producing property into a trust subject to UK tax. As part of the transaction, BNY entered into forward sale agreements, a zero coupon swap agreement, a credit

⁵ Slip. Op. at 22.

⁶ See *Bank of New York Mellon Corp. v. Commissioner*, 140 T.C. 15 (2013); *American International Group, Inc. v. United States*, 111 A.F.T.R. 2d 2013-1472 (S.D.N.Y. 2013).

The Tax Court found that the STARS transaction lacked economic substance because BNY did not demonstrate an expectation of making a non-tax profit.

default swap and security arrangements with a British bank. The arrangements created a \$1.5 billion secured loan from the British bank to BNY.

As a result of the STARS transaction, BNY claimed foreign tax credits of approximately \$200 million and expense deductions of approximately \$7.6 million in 2001 and 2002. BNY also reported the income from the assets transferred to the trust as foreign sourced.

The Tax Court shot down the STARS transaction under the economic substance doctrine. Under the objective prong of the doctrine, the Tax Court held that the STARS structure lacked economic substance because BNY did not have a reasonable expectation of making a non-tax profit by using the STARS structure. The court explained that the STARS structure did not increase the profitability of BNY's income-producing assets, and the structure's main activity was circulating income. The Tax Court refused to take into account the profit from the STARS assets when evaluating the transaction, stating that "[e]conomic benefits that would result independent of a transaction do not constitute a non-tax benefit for purposes of testing its economic substance."⁷

When evaluating the structure under the objective prong, the Tax Court followed its holding in *Compaq Computer Corp. v. Commissioner*⁸, which held that foreign taxes are treated the same as any other transaction cost when determining whether the transaction makes economic sense. The Tax Court acknowledged that "the Court of Appeals for the Fifth and Eighth Circuits have ... held that foreign taxes should not be taken into account in evaluating pre-tax effects for purposes of the economic substance analysis."⁹ Nevertheless, the Tax Court determined that it was not bound by the precedent in the Fifth and Eighth Circuits because the case would be appealable to the Second Circuit and neither the Supreme Court nor the Second Circuit has decided the issue.

BNY appealed to the Second Circuit, arguing, in part, that the Tax Court erred in applying the economic substance doctrine, and focused on the business purpose of the transaction – borrowed funds on favorable terms. The government cross appealed and argued that BNY was not entitled to an interest deduction. The three judge panel (Cabranes, PJ., Chin, Raggi, JJ.) gave BNY's counsel more pushback than government counsel and appeared skeptical of BNY's arguments.

⁷ 140 T.C. 15 at 36.

⁸ 113 T.C. 217 (1999).

⁹ 140 T.C. at 32 n. 9.

AIG was unable to show that “what was done, apart from tax benefits, was what Congress intended.”

American International Group

The same panel heard oral argument in a separate appeal by AIG, challenging the District Court’s decision denying AIG’s partial motion for summary judgment that it was entitled to certain foreign tax credits. The District Court agreed with the government that transactions resulting in foreign tax credits are subject to a requirement of economic substance.

AIG entered into the six transactions at issue from 1993 to 1997 by selling a foreign lender preferred shares in an SPV with a commitment by AIG-FP to repurchase those shares after a fixed term of years for the original purchase price. Primarily using the proceeds from the sale of shares, the SPV acquired investments that generated income over time for which it paid taxes to the local tax authority. The income was generally distributed to the lender, which paid little to no taxes on the distribution by characterizing the preferred stock as an equity investment and the distribution as a tax-exempt distribution from a subsidiary to its parent under the tax law in the lender’s jurisdiction. AIG then claimed foreign tax credits for all foreign taxes paid by the SPV and applied the credit amounts in excess of its US tax liability on the transactions to other unrelated taxes. AIG argued that the sale of preferred stock was a loan and the SPV remained an AIG subsidiary under US tax law because there was an obligation to repurchase the stock. Accordingly, AIG deducted the amount of the distribution to the lender as interest and claimed foreign tax credits.

The government argued that the transaction lacked economic substance because it allegedly did not have purpose or utility beyond the expected tax benefits. The District Court accepted the government’s argument. Accordingly, AIG needed to demonstrate economic substance for its transaction and that “what was done, apart from tax benefits, is what was intended by Congress.”¹⁰

AIG argued that it anticipated a pretax profit of \$168.8 million for the transactions in question. It reached this amount by considering the SPV’s investment income and subtracting payments to the purported lender and operational costs. However, the court noted that this calculation took into account the effects of the tax exempt payments to the purposed lender, which in turn provided a more favorable dividend rate to AIG-FP because of its anticipated tax benefit. The government’s expert opined that there would be no gain for AIG if the dividend were taxable to the lender. AIG argued that the transaction should not be rewritten by the government as in a fictional “world without taxes.” But the court disagreed, stating that the tax exempt status of the dividend was

¹⁰ 111 A.F.T.R.2d 2013-1472, at 1473.

significant to the transactions and should be reflected in the profit calculation. The District Court found that the evidence in the record was not sufficient to satisfy AIG's burden for partial summary judgment on the foreign tax credit issue.

At oral argument in the Second Circuit, AIG's counsel argued that the economic substance doctrine should not apply to AIG's transaction, that AIG made a pre-tax profit and increased its tax burden and that no court had ever struck down a similar transaction with a pre-tax profit under the economic substance doctrine. On the other hand, the government explained that the foreign tax had never been paid by the taxpayer, which was inconsistent with the purpose of the credit: to eliminate double taxation. The panel seemed to be more receptive to the government's argument, but reserved decision. Stay tuned.

Salem Financial Inc.

On May 14, the Federal Circuit Court affirmed a decision by the Court of Federal Claims holding that a subsidiary of BB&T Corporation was not entitled to an estimated \$500 million in foreign tax credits associated with a STARS foreign tax credit generator transaction.¹¹ The court also upheld penalties for negligence and substantial underpayment of taxes. However, the court held that the taxpayer was entitled to claim interest deductions for the interest it paid on the STARS loan and remanded to the Court of Federal Claims for reassessment of the penalty amount.

The STARS transaction was jointly developed and marketed by Barclays Bank and an accounting firm to generate foreign tax credits for a US taxpayer. Pursuant to BB&T's STARS transaction, in effect from August 2002 through April 2007, BB&T established a trust containing approximately \$6 billion in revenue-producing bank assets, the revenues from which were cycled through a UK trustee before returning to the trust. The assessment of UK taxes generated UK tax credits that were shared evenly between Barclays and BB&T. There was also a \$1.5 billion loan from Barclays to BB&T, with a higher interest rate than BB&T's normal cost of borrowing. Barclays made monthly "Bx" payments to BB&T, representing BB&T's share of the foreign tax credits, which had the effect of reducing the interest cost of BB&T's loan.

BB&T argued that the STARS transaction should be viewed as a single integrated transaction, whereby the existence of the trust permitted Barclays to offer BB&T a \$1.5 billion loan at a favorable rate. However, looking at the economic realities of the

The Federal Circuit Court found that Salem's STARS transaction was "simply a money machine."

¹¹ *Salem Financial Inc. v. United States*, No. 14-5027 (Fed. Cir. May 14, 2015)

integrated transaction, the Court of Federal Claims concluded that the transaction must be disregarded for lack of economic substance.

On appeal, the Federal Circuit Court agreed with the trial court's holding that the loan and the trust transaction must be bifurcated for purposes of economic substance, and not considered as a single integrated transaction. Examining the economic reality of the STARS transaction, the Court concluded that the transaction, which generated tax credits, was "simply a money machine."¹² The Circuit Court agreed with the trial court that the STARS transaction was "a contrived transaction performing no economic or business function other than to generate tax benefits," which had no incremental effect on the taxpayer's activities and had no realistic prospect of producing a profit.¹³ The Court noted that the transaction exposed BB&T to no economic risk. The only risk was that the IRS may challenge the tax treatment of the transaction.

The Circuit Court also found that the STARS transaction had no non-tax business purpose: the STARS Trust was a "prepackaged strategy" created to generate US and UK tax benefits. The Court rejected BB&T's argument that it sought to earn a profit in the form of the Bx payment, and that earning a profit is a business purpose. The Court held that the Bx payment did not represent profit from any business activity; it was simply the way the parties shared in the tax benefits of the trust transaction.

BB&T also argued that it was entitled to deduct interest it paid on the \$1.5 billion STARS loan, which the trial court disallowed, holding that the loan, like the trust, lacked economic substance. The Circuit Court agreed with the taxpayer and concluded that the loan resulted in a substantive change in BB&T's economic position. It had "real economic utility to BB&T."¹⁴

Accordingly, BB&T was entitled to claim interest deductions for the interest it paid on the loan. On the subject of penalties, the Circuit Court upheld the trial court's decision to impose an accuracy-related penalty under Section 6662(a). The Circuit Court was not satisfied that the taxpayer established reasonable cause for the underpayment by relying on a tax opinion and advice from PWC.

The chart below summarizes the status of other currently-docketed FTC cases.

—Richard A. Nessler

¹² Slip. Opn. at 31.

¹³ *Id.* at 30.

¹⁴ *Id.* at 43.

Tax Court

Case	Background	Status
<i>Hewlett Packard Co. v. Commissioner</i> , No. 21976-07 (T.C. filed Sept. 25, 2007)	The IRS disallowed claimed FTCs, arguing that the substance of the transaction was a loan, not an equity investment. In the alternative, the IRS argues that the transaction lacked economic substance and business purpose.	Tax Court issued decision for the Commissioner. On October 1, 2014, taxpayer filed a notice of appeal to Ninth Circuit Court of Appeals. Taxpayer's reply brief filed May 18, 2005. Oral argument date not yet calendared.

District Court

Case	Background	Status
<i>Sovereign Bancorp Inc. v. United States</i> , No. 1:09-cv-11043 (D. Mass. Filed June 17, 2009). Sovereign Bancorp Inc. changed its name to Santander Holdings USA Inc. on Feb. 3, 2010. Appealable to the First Circuit.	The taxpayer seeks a refund of \$275 million in federal income taxes, penalties and interest related to its 2003, 2004 and 2005 tax returns. The IRS disallowed FTCs along with other deductions, arguing that the transaction lacked economic substance. The IRS asserted accuracy-related penalties under section 6662. District Court granted taxpayer's motion for partial summary judgment that payment it received in the STARS transaction counterparty/bank should be treated as revenue to taxpayer in assessing reasonable prospect of profit in transaction.	Taxpayer moved in November 2013 for summary judgment on its refund claim. United States cross-moved for partial summary judgment on the following issues: (1) whether the step transaction doctrine applies to the STARS transaction, and (2) whether the conduit doctrine applied to require the STARS Trust be treated as a mere conduit and disregarded for tax purposes. Oral argument on motion held in May 2014. Awaiting decision from District Court.
<i>Wells Fargo & Co. v. United States</i> , No. 0:09-cv-02764 (D. Minn. Filed Oct. 5, 2009). Appealable to the Eighth Circuit.	Wells Fargo seeks an \$162 million refund of taxes, penalties and interest related to its 2003 tax return. Approximately \$70 million of that amount relates to the IRS's disallowance of claimed FTCs. The IRS asserted a negligence penalty related to the claimed FTCs under section 6662. Special Master denied taxpayer's motion for partial summary judgment regarding the reasonable possibility of pre-tax profit.	Taxpayer filed objection to Special Master's decision. Hearing held on December 29, 2014. Awaiting decision from District Court on objection to Special Master's Order.

FSA Rules that Equitable Disgorgement May be Deductible Expense

On May 22, 2015, the IRS released a field service advice ("FSA") memorandum regarding the application of I.R.C. § 162(f) to a consent decree between a taxpayer and the Food and Drug Administration ("FDA").¹⁵ The issue presented in the FSA was whether the decree's equitable disgorgement provision was a "fine or other penalty"

¹⁵ I.R.S. Field Serv. Adv. Mem. 20152103F, at 2 (May 22, 2015).

The IRS concluded that the disgorgement was not a non-deductible fine. The key consideration is the “origin and character of the liability giving rise to the payment.”

within the meaning of section 162(f). Although the Service acknowledged that disgorgements have deterrent effects, the Service stated that the FDA’s intent was not punitive. Hence, the Service concluded that the disgorgement was not a nondeductible expense.

Taxpayer (a drug manufacturer) and the FDA reached the consent decree after the United States sued the taxpayer in US District Court for violations of the Federal Food, Drug and Cosmetics Act (“FDCA”).¹⁶ On behalf of the FDA, the United States sought a permanent injunction, disgorgement and other equitable relief for violations of 21 U.S.C. §§ 331(a) and (k), which restrict the transport and creation of adulterated drugs. Although “[d]isgorgement is not specifically authorized by the FDCA,” the Service noted that courts have interpreted the FDCA to include “the court’s full equity jurisdiction, including” disgorgement.¹⁷

The consent decree placed certain restrictions on the taxpayer’s “manufacturing practices” and required disgorgement of profits made during the period of violations. Paragraph k of the decree provided: “the parties acknowledge that the payment(s) under this Decree are not a fine, penalty, forfeiture or payment in lieu thereof.”¹⁸ In addition, the parties acknowledged that “the FDA views disgorgement as an equitable remedy, not intended as punitive, intended to be a deterrent for other FDA-regulated companies, but not compensatory.”¹⁹

Section 162(a) provides that “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business” can be deducted from taxable income. However, section 162(f) prohibits taxpayers from deducting fines or penalties “paid to a government for the violation of any law.” The issue, then, is whether the equitable disgorgement was a non-deductible fine or penalty.

The Service concluded that the disgorgement was not a non-deductible fine. The key is to examine the “origin and character of the liability giving rise to the payment.”²⁰

Payments imposed for punitive or deterrent purposes are fines within the meaning of section 162(f); however, compensatory damages are not. If the statute that gave rise to

¹⁶ 21 U.S.C. § 331 (2012).

¹⁷ I.R.S. Field Serv. Adv. Mem. 20152103F, at 9 (citing *United States v. Rx Depot, Inc.*, 438 F.3d 1052, 1058 (10th Cir. 2006); *United States v. Universal Mgmt. Servs.*, 191 F.3d 750, 760-62 (6th Cir. 1999)).

¹⁸ *Id.* at 7.

¹⁹ *Id.* at 8.

²⁰ *Id.* at 9 (citing *Bailey v. Commissioner*, 756 F.2d 44, 47 (6th Cir. 1985); *Ostrom v. Commissioner*, 77 T.C. 608 (1981); *Middle Atl. Distributors. v. Commissioner*, 72 T.C. 1136 (1979)).

liability serves both punitive and compensatory purposes, then courts must examine the parties’ intent to determine the nature of the payment.²¹

The Service acknowledged that the FDCA serves both punitive and compensatory purposes. The FDCA “protect[s] public health” by stopping and deterring violations, but also “protect[s] consumer’s financial interests” through compensatory remedies intended to make consumers whole.²² Because of this dual purpose, the parties’ intent is determinative. But the FDA’s intent was ambiguous because, although equitable disgorgement is usually a deterrent, “the FDA [] denied a punitive intent” in paragraph k of the consent decree.²³ The Service concluded that the totality of the circumstances pointed to a non-punitive intent. The Service observed that paragraph k does not explicitly mention the tax consequences of the disgorgement, indicating that it was not meant to implicate section 162(f). (Paragraph k may relate to “double jeopardy concerns.”²⁴) Moreover, the Service posited that the United States, on behalf of the FDA, could have sued for violations of section 333 of the FDCA, which are “more clearly penal.” Hence, the FDA did not intend to penalize the taxpayer through disgorgement. As such, the disgorgement payment to the FDA was not a fine or penalty for purposes of section 162(f).

–Richard A. Nessler and Chris Milazzo²⁵

District Court Upholds Attorney-Client Privilege and Work Product

On May 20, 2015, the US District Court for the Northern District of California denied the IRS’ petition to enforce its summons, which sought two memoranda prepared by Sanmina Corporation’s tax department counsel and distributed to members of Sanmina’s internal tax team and accountants (Ernst & Young and KPMG) to obtain tax advice.²⁶ The government sought the memoranda in connection with a claimed worthless stock deduction totaling roughly \$500 million.

Background

Sanmina filed its 2009 federal income tax return and attached a reportable transaction disclosure statement related to Sanmina’s claimed worthless stock deduction. The deduction was approximately \$500 million for its shareholders in Sanmina AG. The

The District Court held that the distribution of the tax department’s memoranda to outside accountants did not waive the attorney-client privilege.

²¹ *Id.*; see also *Fresenius Med. Care Holdings Inc. v. United States*, 763 F.3d 64 (1st Cir. 2014).

²² *Id.*

²³ *Id.* at 10.

²⁴ *Id.*

²⁵ Chris Milazzo is a 2015 summer associate at Shearman & Sterling LLP.

²⁶ *United States v. Sanmina*, No. 15-0092 (N.D. Cal. May 20, 2015).

The memoranda was work-product protected because taxpayer could reasonably have anticipated that the IRS would scrutinize and challenge Sanmina's tax treatment.

IRS issued an information document request to examine the worthless stock deduction, and in response, Sanmina produced a valuation report drafted by its outside counsel. The valuation report relied, in part, on two Sanmina internal memoranda to support the conclusion that Sanmina's accounts receivable should be disregarded.

Sanmina's tax department counsel prepared the memoranda and distributed them to members of Sanmina's internal tax team and accountants Ernst & Young and KPMG. The 2006 memorandum contained legal analysis supporting the execution of certain agreements among Sanmina and its subsidiaries, including the reason for the agreements, their legal enforceability and their tax treatment. The 2006 memorandum included citations to, and analysis of, certain IRS letter rulings and tax court decisions. The second memorandum, prepared in 2009, analyzed the tax effect of the liquidation of Sanmina, and cited IRS revenue rulings, tax code provisions and court decisions. Sanmina refused to produce the two memoranda and asserted that the documents were privileged.

Legal Standard

The IRS has "broad latitude" when adopting enforcement mechanisms to perform tax collection and assessment. Under *United States v. Powell*, to enforce a summons, the government must show that (1) its investigation has a legitimate purpose; (2) the inquiry may be relevant to that purpose; (3) the information sought is not already in the possession of the government; and (4) the administrative steps required by the Internal Revenue Code have been followed. The government may make a *prima facie* case for enforcement by showing good faith compliance with summons requirements, once the government has met this burden, the taxpayer may rebut the government's *prima facie* case by showing that the *Powell* requirements were not met or that enforcing the summons would be an abuse of the court's enforcement powers.

The IRS satisfied the required *Powell* showing and Sanmina in turn properly raised the attorney-client privilege and the work product doctrine and timely provided a privilege log. Thus, the questions determined by the court were whether the attorney-client privilege applied; if so, whether it was waived and whether the work product applied, and if so, whether it was waived. The District Court upheld Sanmina's privilege claim and found no evidence of waiver.

Attorney-Client Privilege

The IRS argued that Sanmina did not establish that the memoranda were prepared for legal, rather than business, purposes and that the communications related to business advice. The court found that both memos contained legal analysis, were prepared by Sanmina's tax department lawyers and were provided confidentially to company employees who had a need to know the legal advice. On the question of waiver, Sanmina did not waive the privilege by producing the valuation report to the IRS, which cited and relied on the memoranda. The Court found that the valuation report

did not summarize or disclose the content of the memoranda. Nor did distribution to Sanmina’s accountants or federal tax practitioners waive the attorney-client privilege.

Work Product Doctrine

Sanmina established that both memoranda were properly withheld from production under the work product doctrine. The court applied a “because of” standard to determine if the documents were created in anticipation of litigation and considered the totality of the circumstances surrounding the documents creation. The IRS argued that the documents were not created in anticipation of litigation because no litigation or audit was pending at the time the memoranda were drafted. The Court stated:

Sanmina’s description of the memoranda indicates an analysis of complex business and legal issues that ultimately supported Sanmina’s decision to take a worthless stock deduction arising from its ownership of Sanmina International AG. The size of the worthless stock deduction meant that Sanmina could reasonably have anticipated that the IRS would scrutinize and challenge Sanmina’s tax treatment of its holdings in Sanmina International AG, as the IRS has here.²⁷

The Court also rejected the IRS’ claim of waiver. The standard for determining waiver of work product is whether the disclosure to a third party is consistent with maintaining secrecy against an adversary. The Court concluded that Sanmina did not waive work product because the valuation report provided to the IRS merely referenced the two memoranda, rather than summarize them.

-Richard A. Nessler

Inadequate Privilege Log Fails to Shield Email from Disclosure

On May 26, the United States Tax Court held that a privilege log was “plainly inadequate” and ordered the petitioner to turn over to the IRS several emails because petitioner failed to show the items were protected by the attorney-client privilege.²⁸ The Tax Court granted the IRS’s Motion to Compel Production.

Background

Before trial, the IRS served a subpoena *duces tecum* on Steven Dunning, a general business attorney and trusted advisor for the taxpayers. At trial, Dunning produced some documents, but declined to produce numerous emails on the ground that they were protected by the attorney-client privilege. Dunning produced a privilege log

Absent from the privilege log was any description of the content of any email.

²⁷ Slip. Op. at 6.

²⁸ *Pacific Management Group, et al. v. Commissioner*, T.C. Memo 2015-97 (May 26, 2015).

which contained a table with four columns: Column 1 listed the name of the person who sent the email; Column 2 identified the names of persons to whom the email was addressed; Column 3 listed the names of persons who were copied on the email and Column 4 provided the email sent date. The privilege log covered approximately 2,000 emails. Conspicuously absent from the privilege log was any description of the contents of any email.

Legal Analysis

The Tax Court began its analysis by noting that the burden of establishing that the attorney-client privilege applies to particular communications or documents rests with the party asserting the privilege.²⁹ A blanket assertion of the privilege is not adequate; the “proponent must conclusively prove each element of the privilege.”³⁰ The Tax Court Rules of Practice and Procedure do not contain specific provisions addressing the content of a privilege log, but in practice, the Tax Court has generally required the submission of a privilege log whenever a party asserts the privilege over a large group of documents. In such cases, the Tax Court has given particular weight to the Federal Rules of Civil Procedure, which provides that “[a] person withholding subpoenaed information under a claim that it is privileged” must expressly make the claim and must also “describe the nature of the withheld documents, communications or tangible things in a manner that, without revealing information itself privileged or protected, will enable the parties to assess the claim.”³¹

Courts have required that a privilege log contain facts that establish, as to each document, each element of the claimed privilege, including the “author(s), date of preparation and subject matter of the documents, as well as facts establishing each element of the privilege.”³² A privilege log must indicate why the document was intended to be confidential. However, the need to demonstrate that specific communications are privileged must be balanced with the risk of inadvertently waiving the attorney-client privilege log by disclosing too much information.

The Tax Court held that the log provided by Dunning was inadequate and failed to establish each element of the attorney-client privilege because (i) it did not state the subject of any email; (ii) it did not describe the contents of any email; (iii) it did not indicate whether documents were attached to any email; (iv) it did not indicate the

A privilege log must include the “author(s), date of preparation, and subject matter of the documents, as well as facts establishing each element of the privilege.”

²⁹ See *Bernardo v. Commissioner*, 104 T.C. 677, 682 (1995); *FTC v. Lukens Steel Co.*, 444 F. Supp. 803, 806 (D.D.C. 1977).

³⁰ *In Re Lindsey*, 148 F.3d 1100, 1106 (D.C.Cir. 1998).

³¹ Fed. R. Civ. P. 45(e)(2); see also Fed. R. Civ. P. 26(b)(5).

³² *United States v. Western Elec. Co.*, 132 F.R.D. 1, 3 (D.D.C. 1990).

content of attachments; (v) it did not describe the purpose for why the document was created and (vi) it failed to include facts indicating that any particular communication was intended to be confidential. Without this information, the court could not determine from the privilege log whether Dunning’s communications included legal advice, as opposed to general business advice or transactional matters that do not entail legal services. Accordingly, the Tax Court granted the IRS’s Motion to Compel Production for the documents in question.

–Richard A. Nessler

TIFD III-E (Castle Harbour) Hit With Negligence Penalty

In *TIFD III-E Inc. v. United States*, the Second Circuit Court of Appeals reversed a judgment of the District Court and granted the Government’s motion to impose a 20-percent accuracy-related penalty against plaintiff TIFD III-E, a subsidiary of General Electric Capital Corporation, under Section 6662.³³ Section 6662 imposes a 20-percent penalty on any portion of an underpayment of tax that is attributable to, in part, “[n]egligence or disregard of rules or regulations.”³⁴ Taxpayer argued that it should not be subject to the negligence penalty because it had a “reasonable basis” for treating the Dutch banks’ interest in a partnership as equity rather than debt.

This case, often referred to as “Castle Harbour,” has a long and winding history, lasting more than a decade and had already been appealed twice to the Second Circuit.³⁵ The underlying tax issue was whether a pair of Dutch banks who joined with TIFD’s parent company, General Electric Capital Corporation, to form an aircraft leasing company, should be considered partners in the leasing company. The Circuit Court previously rejected TIFD’s claim that the two Dutch banks were equity partners and had a meaningful stake in the success of the partnership.³⁶ In addition, the Second Circuit held that the IRS could impose a 20% accuracy penalty under Section 6662 against TIFD for substantial understatement of its income taxes in 1997 and 1998. However, the Second Circuit’s decision did not end the dispute. The government later realized that the substantial understatement penalty could not be assessed because the 10% substantial understatement threshold had not been satisfied. As a result, the Service sought to impose the 20% accuracy penalty attributable to negligence.

The Circuit Court held that the taxpayer failed to undertake a proper investigation of the correctness of its tax position and lacked reasonable cause, contrary to the previous District Court decision.

³³ *TIFD III-E, Inc. v. U.S.*, No. 14-1952 (2d Cir. May 19, 2015).

³⁴ I.R.C. § 6662 (a), (b)(1).

³⁵ See *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006); *TIFD III-E, Inc. v. United States*, 666 F.3d 836 (2d Cir. 2012).

³⁶ *TIFD III-E, Inc. v. United States*, 459 F.2d 220 (2d Cir. 2006).

The District Court denied the government’s motion, finding that TIFD had a “reasonable basis” for treating the Dutch banks’ stake in Castle Harbor as an equity interest rather than debt. According to the District Court, it was entirely reasonable for TIFD to rely upon a “mountain of authority” that classified preferred stock as equity, even if the holders were guaranteed a result and their profits did not depend on corporate growth.³⁷ The District Court described the government’s position as defying common sense and “mind boggling,” noting that the government declined to respond to TIFD’s many supportive authorities.³⁸

The Circuit Court reversed and found that the District Court erred in finding that TIFD’s underpayment was not attributable to negligence. The Circuit Court stated that TIFD did not create an equity interest. “The Dutch banks’ interests were designed to have a superficial appearance of equity participation,” and the taxpayer failed to undertake a proper investigation of the correctness of its tax position. Accordingly, TIFD failed to satisfy its burden of establishing the absence of negligence.³⁹

As to reasonable cause, the Circuit Court found that TIFD had pointed to no authorities to treat the interests of the Dutch banks’ as equity. The preferred-stock authorities relied on by TIFD provided no support for its treatment of the Dutch banks’ interest as equity, according to the Court.

–Richard A. Nessler

IRS Issues Guidance under the Codified Economic Substance Doctrine and Related Penalties

In Notice 2014-58, the IRS provided guidance on the codification of the economic substance doctrine under section 7701(o) of the Code and related penalties. In particular, the notice defined the term “transaction” for purposes of applying section 7701(o) and explained the meaning of “similar rule of law” as described in the accuracy-related penalty under section 6662(b)(6).

The codified economic substance doctrine tests whether a “transaction” has economic substance within the meaning of section 7701(o)(1), but the Code does not define the term “transaction” for this purpose. Section 7701(o)(5)(D) provides that the term transaction includes a series of transactions, and the legislative history to section 7701(o) explains that the provision does not alter the court’s ability to

The term “‘transaction’ generally includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement and any or all of the steps that are carried out as part of a plan.”

³⁷ *Id.* at 150.

³⁸ *TIFD III-E, Inc. v. U.S.*, No. 14-1952, at 3.

³⁹ 2014-44 IRB 746

aggregate, disaggregate or otherwise recharacterize a transaction when applying the economic substance doctrine. The notice applies the definition of “transaction” from the analogous context of reportable transactions to section 7701(o). That is, for purposes of determining whether the codified economic substance doctrine applies, the term “‘transaction’ generally includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan or arrangement and any or all of the steps that are carried out as part of a plan.”

Furthermore, the notice clarifies that facts and circumstances determine whether a plan’s steps are aggregated or disaggregated when defining a transaction. The notice states that, generally, when a plan that generated a tax benefit involves a series of interconnected steps with a common objection, the “transaction” includes all the steps taken together. However, when a series of steps includes a tax-motivated step that is not necessary to achieve a non-tax objective, this “aggregation approach” may not be appropriate, and the “transaction” may include only the tax-motivated steps that are necessary to accomplish the non-tax goals – a “disaggregation approach.”

Section 6662(b)(6) imposes a penalty on an underpayment of tax attributable to tax benefits that were disallowed because a transaction lacked economic substance within the meaning of section 7701(o) or failed to meet the requirements of any “similar rule of law.” Neither section 7701(o) or 6662(b)(6) define “similar rule of law.” The notice follows language from the legislative history and states that “‘similar rule of law’ means a rule or doctrine that applies the same factors and analysis that is required under section 7701(o) for an economic substance analysis, even if a different term or terms (for example, ‘sham transaction doctrine’) are used to describe the rule or doctrine.” The notice also clarifies that the IRS will not apply a penalty under section 6662(b)(6) (or otherwise argue that a transaction is described in section 6662(b)(6)) unless it also raises section 7701(o) to support the underlying adjustments. If the IRS instead relies on other judicial doctrines to support the underlying adjustments (e.g., the substance over form or step transaction doctrines), the IRS will not apply a section 6662(b)(6) penalty (or otherwise argue that a transaction is described in section 6662(b)(6)) because the IRS will not treat the transaction as failing to meet the requirements of a similar rule of law. The notice clarifies that Code sections and Treasury regulations, other than section 7701(o) and the regulations thereunder, that disallow tax benefits are not similar rules of law for purposes of section 6662(b)(6).

The notice also states that it is relevant with respect to the availability of the reasonable cause exceptions under sections 6664(c) and (d) and the reasonable basis exception under section 6676, because these exceptions are inapplicable to transactions described in section 6662(b)(6).

–*Judy Fisher*

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