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FOCUS ON TAX CONTROVERSY AND LITIGATION

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MAY 2014

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On Monday, June 30, 2014, Lawrence M. Hill of Shearman & Sterling will host a two hour CLE program on the tax treatment of damages. The CLE will be held at our New York office from 12:00 p.m. – 2:00 p.m. and will cover the deductibility of settlement payments, recent case law developments, planning considerations and audit defenses and litigation of these issues. Please contact Lawrence.Hill@Shearman.com if you are interested in attending.

This month's issue features articles regarding the Tax Court's decision in *Ad Investment 2000 Fund*, litigation surrounding Section 1603 grant program for renewable energy, upcoming FATCA deadlines, the Third Circuit's recent decision in *Estate of Thouron v. United States* regarding reliance on a tax expert to overcome a penalty for a late tax payment, and an update on Proposed Rule 37(e).

Tax Court Rejects Partnerships' Claim of Attorney-Client Privilege and Orders Release of Opinion Letters

On April 16, 2014, the Tax Court issued an opinion holding that two partnerships, AD Investment 2000 Fund LLC and AD Global 2000 Fund LLC, were required to release attorney opinion letters addressing "Son-of-BOSS" tax shelter transactions.[1]

The IRS had asserted section 6662 accuracy-related penalties against the partnerships with respect to any underpayment of tax as a result of the tax shelter transactions. The partnerships argued that the section 6662 penalties did not apply because they had a reasonable belief that their tax treatment of the transactions was more likely than not the proper tax treatment. The IRS responded by moving to compel the production of six opinion letters provided to the partnerships by the law firm Brown & Wood LLP. The partnerships claimed that the opinion letters, which addressed whether it was more likely than not that the anticipated tax benefits from the transactions would be upheld for US federal income tax purposes, were protected by attorney-client privilege.

The Tax Court found that the partnerships' legal knowledge, understanding and beliefs were placed into contention.

Under Treas. Reg. § 1.6662-4(g)(4), the reasonable belief defense to penalties can be satisfied by either: (i) the taxpayer analyzing the facts and authorities and concluding in good faith there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld, or (ii) the taxpayer reasonably relying in good faith on the opinion of a professional tax advisor that analyzes the facts and authorities and concludes there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld. The partnerships claimed that, because they were relying on their own tax analysis, rather than the analysis of a professional tax advisor, the partnerships did not waive attorney-client privilege with respect to the advice in the opinion letters when they asserted their reasonable belief and good faith as a defense to the penalties.

The Tax Court found that the partnerships' legal knowledge, understanding and beliefs were placed into contention as a result of the partnerships' use of the reasonable belief and good faith defense, and the court determined that the opinion letters may address such knowledge, understanding and beliefs. The court noted that each partnership received the opinions well before the filing of their 2000 tax returns, and the partnerships did not claim that the opinions were ignored.

[1] *Ad Investment 2000 Fund LLC et al. v. Commissioner*, 142 T.C. No. 13. A "Son-of-BOSS" transaction is a variant of the Bond and Options Sale Strategy (BOSS) tax shelter, and the purpose of such transaction is to create artificial tax losses to offset income from other transactions.

Because the opinion letters were relevant to the partnerships' reasonable beliefs and good faith, the court held that the partnerships forfeited the attorney-client privilege with respect to the opinion letters. The court concluded that if the partnerships continued to assert their reasonable belief and good faith as a defense against the section 6662 penalties, "it would be unfair to deprive the [IRS] of knowledge of the contents of the opinions and the opportunity to put those opinions into evidence."[2]

-*Mary Jo Lang*

Litigation Heats Up in Section 1603 Cash Grant Program for Renewable Energy Projects

Following the 2008 financial crisis, Congress enacted Section 1603 of the American Recovery and Reinvestment Act of 2009, which established a cash grant program for applicants with eligible energy properties. Energy industry participants relied upon the government to calculate the awards in a manner consistent with the calculation of tax credits under Internal Revenue Code section 48, but the government has, in some cases, awarded smaller grants after changing its formula for such calculations. Some energy participants, feeling shortchanged by the government's methodology, are now suing.

The Origins of the Section 1603 Program

Section 1603 established a cash grant program for applicants with eligible energy projects.

Congress enacted Section 1603 of the American Recovery and Reinvestment Act of 2009 ("the Section 1603 Program") during the economic recession.[3] The 1603 Program reimburses eligible applicants for part of the cost of installing specified energy property used in a trade or business or for the production of income after the energy property is placed in service. An applicant who accepts a Section 1603 grant elects not to claim the energy tax credits under Internal Revenue Code section 48 or the renewable energy production tax credit under Internal Revenue Code section 45 for otherwise qualifying facilities placed into service on or after January 1, 2009.[4]

The Section 1603 Program created an investment incentive in the tax equity market in response to the reduced demand for investment tax credits that began during the

[2] *Id.*

[3] Pub. L. No. 111-5, 123 Stat. 115 (2009).

[4] *See id.; see also* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress at 109-110. JCS-2-11 No. 6 (I.R.S.), 2011 WL 940372.

Several participants in the Section 1603 program have filed suit against the United States alleging violation of the statutory and regulatory obligations of Section 1603.

recession. The program had several stated purposes, including preserving and creating jobs, promoting economic recovery, spurring technological advances, and investing in infrastructure and environmental protection. Originally set to expire at the end of 2010, the program was extended through the end of 2011.

Under the Section 1603 Program, the Treasury Department awarded more than 9,000 grants, totaling $18.5 billion.[5] Wind energy projects accounted for $12.6 billion of grants awarded, and solar power projects accounted for $4.4 billion.[6] Geothermal heat pump, biomass, hydropower, landfill gas, and fuel cell energy properties constituted the other ten percent of grant awards.[7]

Program Participants and Government Dispute Grant Awards

Controversy has now arisen over certain of the grant awards, and during the past two years several participants in the Section 1603 program have filed suit against the United States alleging violation of the statutory and regulatory obligations of Section 1603. Generally, the plaintiffs in these cases claim that the government paid less than the program mandated because the government changed its basis calculation for the projects, thereby undermining the economic expectations of the participants. Although Treasury is allowing unsatisfied participants to pay back grant awards received under the Section 1603 Program and claim tax credits instead, some participants have chosen to litigate the issue instead.

Legal Basis for Suit

Section 1603(a) generally provides that the Secretary of the Treasury shall provide a grant for reimbursement to each person who applies for such grant and has placed in service specified energy property, subject to certain other conditions. Under section 1603(b), the amount of the grant is the applicable percentage of the basis of the property, which is either thirty or ten percent depending upon the type of property. Treasury promulgated cost basis rules to determine the basis for investment property that are different from the basic rules that apply under Internal Revenue Code section 48.

[5] *Review of Section 1603 Grants in Lieu of Energy Investment Tax Credit*, Memorandum for Deputy Commissioner for Services and Enforcement from R. David Holmgren, ref. no. 2014-IE-R006, Dec. 17, 2013, p. 1.

[6] *Id.* at 2.

[7] *Id.* at 2.

Blue Heron Properties v. US

On July 24, 2013, Blue Heron Properties, LLC ("BHP"), a company with multiple energy projects, brought suit against the United States in the Federal Court of Claims complaining that the government made grant payments substantially less than the amounts to which BHP was entitled under Section 1603.[8] According to the complaint, BHP submitted an application for a grant payment in connection with its project First Brandon Oaks System.[9] BHP claimed the full purchase price as a cost basis, and Treasury awarded the full amount requested, $10.50 a watt.[10] After BHP purchased three additional solar panel systems at prices between $9.52 and $10.50 a watt, BHP applied for grant payments under Section 1603 for those projects.[11] The complaint alleges that BHP met all the program conditions and was therefore entitled to thirty percent of its basis in each project.[12] Instead, Treasury only awarded one of the three projects the full grant amount and accepted only $5.56 and $5.43 a watt for the two reduced grant awards.[13] The complaint alleges that this is a violation of Section 1603.[14]

RP1 Fuel Cell LLC v. US

In *RP1 Fuel Cell LLC v. US*, another grant application that had placed in service two fuel cell power plants in California brought suit against the United States for reduced grant awards.[15] The plaintiffs began construction of their fuel cells in 2011 and placed them into service in 2012, within the timeframes specified in Section 1603(a).[16] According to the complaint, Treasury, without explanation,

[8] Compl. filed in *Blue Heron Properties, LLC v. United States*, No. 1:13-cv-00505 (Fed. Ct. Jul. 24, 2013).

[9] *Id.* at 5-6.

[10] *Id.* at 6.

[11] *Id.* at 6-7.

[12] *Id.* at 7-8.

[13] *Id.* at 7-9.

[14] *Id.* at 9.

[15] Comp. No. 1:13-cv-00552 (Fed. Cl. Aug. 6, 2013).

[16] *Id.* at 19.

awarded a grant payment reduced by $1.6 billion after removing all costs relating to gas conditioning equipment associated with the project.[17]

Other 1603 Litigation

The litigants in four other Section 1603 cases allege similar harms and focus on the government's calculation of cost basis. In *Vasco Winds, LLC v. US*, the grant applicant filed a complaint after the government used a reduced cost basis to calculate the grant aware for its wind farm in California.[18] As a result the grant applicant received approximately $6 million less than requested. After being denied a full grant award for their energy facilities, the plaintiffs in *Sequoia Pacific Solar I, LLC, v. US*[19] and *Mustang Hills, LLC v. US*[20] filed a complaint alleging, among other things, that Treasury improperly changed the rules of the Section 1603 Program, reduced grant payments by improperly changing the basis calculation, and undermined the economic assumptions of industry participants. Most recently, the plaintiff in *Fire Island Wind LLC v. United States*, alleged that the government improperly denied reimbursement to the plaintiff for construction costs associated with the construction of a Doppler Navigation System ("DNS"), in Anchorage Alaska.[21] Construction of the DNS was required by the Federal Aviation Administration to obtain approval for the construction of a 17.6 megawatt wind turbine project on Fire Island.

All these cases are still in the early stages of litigation, and it is likely that more plaintiffs will come forward. Grant applications have six years after a grant is paid to file suit.

Report by the Treasury Inspector General for Tax Administration

Presently, the government is not appearing to back down from its tough stance on the Section 1603 Program grants either. On January 31, the Treasury Inspector General for Tax Administration ("TIGTA") released a report finding significant compliance problems among participants in the energy grants in lieu of tax credits program in its

[17] *Id.* at 13, 19.

[18] Compl. No. 1:13-cv-00697 (Fed. Cl. Sept. 18, 2013).

[19] Compl. No. 1:13-cv-00139-ECH (Fed. Cl. Feb. 2, 2013).

[20] Compl. No. 1:14-cv-00047-TCW (Fed. Cl. Jan. 22, 2014).

[21] Compl. No. 1:14-cv-403T (Fed. Cl. May 12, 2014).

first review of returns claiming Section 1603 grants.[22] After examining the returns of 83 taxpayers seeking Section 1603 grants, the IRS's Small Business/Self-Employed Division found that changes were necessary to 51 of the returns.[23] Large Business and International reviewed 16 returns and found significant issues resulting in changes for eight.[24]

The review's initial focus was on taxpayers' 2009 tax returns but has been expanded to include 2010 and 2011 tax returns now, too.[25] The stage is set for more litigation.

-*Doug McFadyen*

Upcoming July FATCA Deadlines

The July 1, 2014 deadline for the implementation of certain requirements of foreign financial institutions and certain non-financial foreign entities under the Foreign Account Tax Compliance Act ("FATCA") is quickly approaching.

FATCA Overview

To be compliant with FATCA, participating FFIs must register with the IRS and report certain information about their US accounts.

FATCA, the offshore account information reporting and withholding regime codified in sections 1471 through 1474 of the Internal Revenue Code and the Treasury Regulations promulgated thereunder, generally requires US financial institutions ("USFIs") and other withholding agents to withhold 30 percent of payments made to (1) foreign financial institutions ("FFIs") that have not agreed to report information with respect to their US person account-holders to the IRS and (2) non-financial foreign entities ("NFFEs") that are the beneficial owners of the payments and that do not report information with respect to their substantial U.S. owners to the withholding agent.[26]

[22] Eric Kroh, "IRS Compliance Review finds Problems with Energy Grants Program." Tax Analysts, Feb. 3, 2014.

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] Under sections 1471(d)(4) and (5) and Treasury Regulation sections 1.1471-5(d) and (e), FFIs include foreign entities that (1) accept deposits in the ordinary course of a banking or similar business; (2) hold financial assets for the account of others as a substantial part of their business; (3) are engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, and derivatives; (4) are insurance companies; or (5) are holding companies and treasury centers for the other types of FFIs or formed in connection with a hedge fund, levered buyout fund, venture capital fund, private equity fund, or other

In order to be compliant with FATCA and avoid being withheld upon, participating FFIs ("PFFIs") must register with the IRS and enter into an agreement with the IRS (an "FFI agreement"), meeting the requirements of section 1471(b) and Treasury Regulation section 1.1471-4, to report certain information about their US accounts. Accordingly, PFFIs must generally agree to (1) comply with due diligence procedures in order to identify US account-holders, (2) report information on US account-holders to the IRS on an annual basis, (3) comply with requests by the IRS for additional information, (4) obtain waivers from each US account-holder of domestic law that would otherwise prevent the disclosure of such information, and (5) act as a withholding agent on certain foreign pass thru payments made to recalcitrant account holders[27] and nonparticipating FFIs ("NPPIs"). FFIs in jurisdictions that have entered into an intergovernmental agreement ("IGA") with the United States will generally be deemed FATCA compliant if they comply with the requirements of the IGA and register accordingly and will not need to enter into a separate FFI agreement with the IRS ("deemed-compliant FFIs").[28]

In order to be compliant with FATCA and avoid being withheld upon, NFFEs must report identifying information about their substantial US owners or certify that they have no substantial US owners to the withholding agent.

FATCA Withholding "Go-Live" Date

Pursuant to IRS Notice 2013-43, on July 1, 2014, USFIs and other withholding agents[29] will be required to start withholding on payments of US source dividends,

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collective investment vehicle. Under Treasury Regulation 1.1471-1(a)(74), a non-US entity that is not an FFI is an NFFE.

[27] Under section 1471(d)(7), "passthru payments" are any payments to the extent attributable to a withholdable payment. Under section 1471(d)(1)(6), "recalcitrant account holders" are those that do not comply with requests for information.

[28] Two categories of IGAs exist between the US and foreign jurisdictions: "Model 1" agreements, which generally require the FFI to report required information to its domestic jurisdiction which in turn reports the required information to the IRS, and "Model 2" agreements which generally require the FFI to report required information directly to the IRS. The list of jurisdictions that have entered into either type of IGA can be found at http://www.treasury.gov/resource-center/tax-policy/treaties/pages/fatca-archive.aspx.

[29] Under section 1474 and Treasury Regulation 1.1473-1(d), any person in whatever capacity having control, receipt, custody, disposal, or payment of any "withholdable payment" is a withholding agent for this purpose. Additionally, PFFIs having control, receipt, custody, disposal or payment of a "passthru payment" are also withholding agents.

interest, rents, salaries, wages, premiums, annuities and other types of fixed and determinable annual payments ("withholdable payments") made after June 30, 2014 to NPFFIs and NFFEs that fail to meet the reporting requirement unless the payments are made with respect to debt obligations outstanding as of July 1, 2014.[30]

FFI Registration Effective Dates

Registering as a PFFI or deemed-compliant FFI with the IRS is done primarily through the IRS website.[31] Once registration is finalized, FFIs will receive a notice that the registration has been accepted and will be issued a Global Intermediary Identification Number ("GIIN"), to be used for reporting purposes and to identify the status of the FFI to withholding agents. The IRS will post the first list of registered FFIs on June 2, 2014, electronically, on the IRS website and is expected to update the list on a monthly basis. In order to be included on the first registered FFI list, FFIs must register by May 5, 2014. However, FFIs that miss the May 5 registration date can still make it onto the July 1, 2014 list if registration is finalized by June 3, 2014.[32] A withholding agent generally must obtain an FFI's GIIN and confirm that the FFI is on the list of registered FFIs in order to avoid withholding.

FFI Agreement Effective Dates

FFI agreements entered into before June 30, 2014 between the IRS and PFFIs that have registered and received a GIIN before June 30, 2014 will have an effective date as of June 30, 2014.

Beginning on July 1, 2014, USFIs and other withholding agents will generally be required to implement new account opening procedures to determine whether such accounts are to be treated as US accounts, accounts of PFFIs, accounts of NPFFIs, accounts of deemed-compliant FFIs, accounts of NFFEs, or other types of account classifications under FATCA. In the case of PFFIs, withholding agents will be

[30] Debt obligations, including debt instruments, lines of credit, derivatives transactions, certain insurance contracts and certain annuity contracts, among other things, outstanding as of July 1, 2014 are considered "grandfathered obligations" for purposes of FATCA, and payments of interest on such debt obligations are not subject to the FATCA withholding requirements.

[31] The online FATCA registration system, commonly referred to as the "Portal," is located at http://www.irs.gov/Businesses/Corporations/Foreign-Account-Tax-Compliance-Act-FATCA. The IRS will also accept paper registrations, albeit with slower processing times.

[32] Ann. 2014-17.

required to implement new account opening procedures as of the effective date of its FFI agreement.

-*Ryan Roberts*

Taxpayer May Raise Reasonable Cause Defense to Excuse Late Payment Penalty

On May 13, 2014, the Third Circuit Court of Appeals ruled that a fiduciary of an estate may assert a reasonable cause defense to a late payment penalty if the taxpayer relied on the advice of a tax expert which caused the failure to pay by the deadline.[33] According to the Third Circuit, the taxpayer must also show either an inability to pay or undue hardship from paying at the deadline.

The Third Circuit held that a "taxpayer's reliance on the advice of a tax expert may be reasonable cause for failure to pay by the deadline if the taxpayer can also show either an inability to pay or undue hardship from paying at the deadline."

The case involved the Estate of Sir John Thouron ("Estate") who died in 2007 leaving behind a substantial estate. The executor retained Cecil Smith, an experienced tax attorney, to provide tax advice for the Estate. On November 6, 2007, the Estate's tax return and payment were due to the Service. On that date the Estate asked for an extension of time to file its return and made a payment of $6.5 million as an estimated tax payment. Smith advised the Estate that the full amount of the Estate tax should not be paid because of the possibility of electing to defer the payment of tax under Section 6166. The Estate eventually filed its return within the six-month extension period, but did not elect to defer taxes under Section 6166 because it had determined it did not qualify for the election. The Estate requested an extension of time to pay the tax. The Service denied, as untimely, the Estate's request for an extension of time to pay, and imposed on the Estate a failure to pay penalty, which the Estate unsuccessfully appealed administratively. The Estate paid the tax and penalty of $999,072, and sought a refund; the Service refused to refund the penalty amount. Thereafter, the Estate brought a refund action alleging that its failure to pay resulted from reasonable cause and not willful neglect.

The district court granted summary judgment to the Service, holding that the Estate could not show reasonable cause based on expert advice under these facts, citing *United States v. Boyle*, 469 US 241 (1985).

[33] *Estate of Thouron v. United States*, No. 13-1603 (3d Cir. 2014).

On Appeal, the Third Circuit agreed that *Boyle* applied to failure-to-pay cases, but concluded that the district court "applied *Boyle* more bluntly than would we."[34] Accordingly to the Circuit Court, the district court misread *Boyle* to preclude any finding of reasonable cause based on reliance on an expert or other agent. *Boyle* was a late-filing case, where the taxpayer relied on an agent for the ministerial task of filing or paying tax owed. That is not what occurred in this case, where the taxpayer relied on the advice of an expert. The Third Circuit held that a "taxpayer's reliance on the advice of a tax expert may be reasonable cause for failure to pay by the deadline if the taxpayer can also show either an inability to pay or undue hardship from paying at the deadline."[35] The Third Circuit remanded the case to the district court, for further fact finding, to apply the law in light of the Third Circuit's holding.

-Richard A. Nessler

Committee issued Updated Proposed Rule 37(e) on E-Discovery

In April, the Advisory Committee on Civil Rules publicly released the updated version of proposed Federal Rule of Civil Procedure 37(e), which concerns sanctions for failure to preserve electronically stored information ("ESI"). The new version of proposed Rule 37(e) is a substantial rewrite of the version published in August 2013, and will provide courts more flexibility in determining sanctions or curative measures if a litigant fails to properly preserve ESI.

The Committee noted two goals: (1) "to establish greater uniformity in the ways in which federal courts respond to a loss of ESI," and (2) "to relieve the pressures that have led many potential litigants to engage in what they describe as massive and costly over-preservation."

The continual expansion of ESI affecting all aspects of civil litigation and the lack of uniformity in the various circuits on how to deal with the loss of ESI[36] convinced the Discovery Subcommittee (the "Committee") that a rule addressing the loss of ESI in civil litigation was greatly needed. The Committee previously recommended that sanctions associated with the loss of ESI required a showing of substantial prejudice and willfulness or bad faith. However, since publishing the proposal last summer, the Committee received public comments and concluded that the showing of substantial prejudice and willfulness or bad faith is too restrictive, and did not afford trial courts the flexibility they need to deal with the wide range of ESI issues they will confront in

[34] *Id.* at 4.

[35] *Id.* at 7.

[36] The Committee noted that the Second Circuit has held that adverse inference jury instructions can be imposed for negligence or grossly negligent loss of ESI. Whereas, other circuits, like the Tenth Circuit, require a showing of bad faith before an adverse inference instruction can be given.

the future. The Committee noted two goals in addressing newly proposed Rule 37(e): (1) ”to establish greater uniformity in the ways in which federal courts respond to a loss of ESI,” and (2) ”to relieve the pressures that have led many potential litigants to engage in what they describe as massive and costly over-preservation.” In its proposal, the Committee made clear that the proposed Rule 37(e) does not affect any common-law tort remedy for spoliation that may be established by State law.

The proposed Rule 37(e) provides:

FAILURE TO PRESERVE ELECTRONICALLY STORED INFORMATION. If a party failed to preserve electronically stored information that should have been preserved in the anticipation or conduct of litigation, the court may:

(1) Order measures no greater than necessary to cure the loss of information, including permitting additional discovery; requiring the party to produce information that would otherwise not be reasonably accessible; and ordering the party to pay the reasonable expenses caused by the loss, including attorney’s fees.

(2) Upon a finding of prejudice to another party from loss of the information, order measures no greater than necessary to cure the prejudice.

(3) Only upon a finding that the party acted with the intent to deprive another party of the information’s use in the litigation:

> (A) presume that the lost information was unfavorable to the party;
>
> (B) instruct the jury that it may or must presume the information was unfavorable to the party; or
>
> (C) dismiss the action or enter a default judgment.

(4) [In applying Rule 37(e), the court should consider all relevant factors, including:

> (A) the extent to which the party was on notice that litigation was likely and that the information would be relevant;
>
> (B) the reasonableness of the party’s efforts to preserve the information;
>
> (C) the proportionality of the preservation efforts to any anticipated or ongoing litigation; and
>
> (D) whether, after commencement of the action, the party timely sought the court’s guidance on any unresolved disputes about preserving discoverable information.]

One of the key revisions to Rule 37(e) is the removal of the word “sanctions.” This is significant, and demonstrates the Committee’s focus has turned away from punishment and primarily to the concern of how to cure the loss of ESI that should have been preserved. In addition, the rule leaves it to the courts to develop the tests to determine whether ESI should have been preserved in the anticipation or conduct of litigation.

The proposed Rule 37(e) does not itself create a duty to preserve; rather, the duty to preserve is well established by case law.

The overarching theme of the proposal is to preserve flexibility in the rule. The Committee notes that the "preservation of ESI remains a very complex subject, and one that continues to evolve" and recognized that "complex organizational structures and information systems often thwart perfect preservation, even when every reasonable effort is made."[37] Subsection (e)(1) provides what the Committee states is "the court's first concern," which is "to cure the loss of the ESI that should have been preserved." The court is permitted only "measures no greater than necessary to cure the loss of information." Subsection e(2) permits, upon a finding of prejudice due to the loss of information, "measures no greater than necessary to cure the prejudice." The Committee notes explain that this subsection" preserves the trial court's ability to use some of Rule 37(b)(2)(A) measures to cure any prejudice for failure to preserve ESI."[38] Subsection (e)(3) limits the court's ability to issue more severe sanctions of dismissal, entering a default judgment, and issuing an adverse inference jury instruction to situations in which a court has found that a party "acted with the intent to deprive another party of the information's use in the litigation."[39] The Committee has not adopted existing case law that permits the giving of adverse-inference instructions on a finding of negligence or gross negligence.

Lastly, the Committee vigorously debated the benefit of providing a list of factors in the rule – subpart (4) in the proposal. Some Committee members believed the list should be moved to the Committee Notes. Other members argued that the list may help potential litigants make reasonable preservation decisions, may help counsel frame effective arguments, and may help courts to understand and respond to arguments. For this reason subpart (4) has brackets around the rule. These factors will be the subject of further debate and may, after further consideration, be moved to the Committee Notes.

-*Richard A. Nessler*

[37] *See* Discovery Subcommittee Report Rule 37(e) at 4 (April 10-11, 2014).

[38] *Id.* at 4.

[39] *Id.* at 17.

Credit Suisse Pleads Guilty and Agrees to Pay $2.6 Billion

On May 19, 2014, Credit Suisse plead guilty to criminal charges that it facilitated tax evasion by helping US clients avoid paying taxes to the IRS. The $2.6 billion fine imposed is the largest ever monetary penalty in a criminal tax case. The guilty plea by Credit Suisse is the result of a years-long investigation by the US Department of Justice that has also produced indictments of eight Credit Suisse executives, two of those individuals have plead guilty so far. No Credit Suisse employees were required to plead guilty as part of Credit Suisse's plea agreement.

As part of the plea, Credit Suisse acknowledged that, prior to and through 2009, it operated an illegal cross border banking business that "knowingly and willfully" aided and assisted thousands of US clients in opening and maintaining undeclared accounts and concealing their offshore assets and income from the IRS. According to the statement of facts filed with the plea agreement, Credit Suisse employed a variety of means to assist US clients in concealing their undeclared accounts, including by:

Credit Suisse agreed to make a complete disclosure of its cross-border activities, cooperate in treaty requests for account information, provide detailed information as to other banks, and to close accounts of account holders who fail to come into compliance with US reporting obligations.

(i) Assisting clients in using sham entities to hide undeclared accounts;

(ii) Soliciting IRS forms that falsely stated, under penalties of perjury, that the sham entities were the beneficial owners of the assets in the accounts;

(iii) Failing to maintain in the United States records relating to the accounts;

(iv) Destroying account records sent to the United States for client review;

(v) Facilitating withdrawals of funds from the undeclared accounts by either providing hand-delivered cash in the United States or using Credit Suisse's correspondent bank accounts in the United States.

As part of the plea agreement, Credit Suisse agreed to make a complete disclosure of its cross-border activities, cooperate in treaty requests for account information, provide detailed information as to other banks that transferred funds into secret accounts or that accepted funds when secret accounts were closed, and to close accounts of account holders who fail to come into compliance with US reporting obligations. However, as part of the plea agreement, Credit Suisse did not have to disclose the names of US account holders, which drew condemnation from Congress. In a joint statement, US Senators John McCain and Carl Levin said that they "cannot comprehend why" federal prosecutors didn't require name disclosures, stating "with more than 20,000 unidentified Americans having held accounts at Credit Suisse in Switzerland during the relevant period – most of whom never disclosed their accounts

as required by US law – this agreement provides no direct accountability for those taxes owed."[40] The DOJ released a statement after the pleas, stating that "this case shows that no financial institution, no matter its size or global reach, is above the law."[41]

Despite the guilty plea and unprecedented fine imposed, Credit Suisse retained its bank's license to operate in the United States, but sets a precedent for the nearly two dozen other banks currently under criminal investigation by the DOJ. The plea is also much tougher than the UBS settlement reached with the DOJ in 2009. UBS was allowed to enter in to a deferred prosecution agreement and pay a fine of $780 million to settle similar charges. The criminal charges were later dropped against UBS after turning over names of US customers. Credit Suisse's CEO Brady Dugan said, "We deeply regret the past misconduct that led to this settlement. The US cross-border matter represented the most significant and long-standing regulatory and litigation issue for Credit Suisse. Having this matter fully resolved is an important step forward for us."

It may take time to determine how the plea and settlement will adversely affect Credit Suisse's operations in the United States. As for US taxpayers, the Justice Department reminded taxpayers that the IRS continues to offer an offshore voluntary disclosure program for taxpayers with unreported foreign banks accounts and related unreported income. The time for voluntary disclosure is running out.

-Richard A. Nessler

Wells Fargo Petitions Supreme Court to Review Economic Substance Decision

On February 26, 2014, Wells Fargo ("WFC") petitioned the Supreme Court to review the Eighth Circuit's decision in *WFC Holdings Corp. v. United States*,[42] where it held that a lease restructuring transaction lacked economic substance even though it produced nontax economic benefits. The transaction was intended to facilitate a transfer of commercial real estate leases from two WFC subsidiaries to Charter Holdings, Inc. ("Charter"), a non-bank subsidiary. WFC argued that banks are subject

[40] Senator John McCain Press Release (May 20, 2014).

[41] *See* U.S. Department of Justice, Press Release, at 1 (May 19, 2014).

[42] 728 F.3d 736 (8th Cir. 2013)

to stricter federal regulations on holding interests in real estate than non-banks, so this transfer allowed WFC to earn millions of dollars in additional revenue. Despite these nontax benefits from the lease restructuring transaction, the Eighth Circuit held that Charter's issuance of a new class of preferred stock and WFC's subsequent arm's-length sale of that stock made the entire transaction lack economic substance.

WFC argued that certiorari is warranted because the Eighth Circuit's decision exceeds the limits of the economic substance doctrine in Supreme Court precedent, deepens the split between the circuit courts over whether a transaction that objectively changes a taxpayer's economic position can still lack economic substance, and implicates a question of critical importance to taxpayers. With its decision in WFC Holdings, the Eighth Circuit joined the Sixth and Tenth Circuits in holding a transaction to lack economic substance even when the transaction was profitable. WFC also argued in its petition that, if a profitable transaction can be disregarded for tax purposes on the grounds that some aspects were designed solely to make it tax efficient, then all tax planning would become subject to IRS challenge in the Eighth Circuit.

At least eight amicus briefs have been filed with the Supreme Court urging the court to grant the appeal.

-*Judy Fisher*

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