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A Taxpayer Victory in the Most Recent Battle Over Documents Disclosed to Independent Auditors

On June 29, 2010 in *United States v. Deloitte LLP*, the US Court of Appeals for the DC Circuit affirmed a district court decision holding that certain tax accrual workpapers and related documents were work product and that disclosure by a taxpayer to its independent auditor of that work product did not waive work product protection. The DC Circuit Court of Appeals' decision in *Deloitte* is the latest case to address the debate over work product protection related to tax accrual workpapers and documents disclosed to an independent auditor.

Deloitte arises from tax litigation involving partnerships owned by Dow Chemical Co. in the Middle District of Louisiana. See *Chemtech Royalty Assocs., L.P. v. United States*, No. 05-944 (M.D. La. filed July 13, 2005). During discovery in *Chemtech*, the government subpoenaed documents from Deloitte, Dow's independent auditor, seeking production in Washington, D.C. Deloitte provided a privilege log to assert on Dow's behalf a privilege for work product prepared in anticipation of litigation.

The government filed suit in the US district court for the District of Columbia, to compel production of three types of documents that Dow had identified as work product protected from discovery. The first document was a 1993 draft memorandum summarizing a meeting between Dow employees, Dow's outside counsel, and Deloitte employees regarding the possibility of litigation arising from the partnership transaction and how to approach this in an ongoing audit (the “Deloitte Memorandum”). The second document at issue was a 1998 memorandum and flow chart prepared by a Dow accountant and Dow in-house attorney (the “Dow Memorandum”). The third document was a 2005 tax opinion prepared by Dow's outside counsel (the “Outside Tax Opinion”). According to the court, the second and third documents were disclosed to Deloitte so that it could “review the adequacy of Dow's contingency reserves for the ... transactions.” Access to these documents was required for Deloitte to provide an unqualified audit opinion for Dow's public financial statements.

The Opinion of the US District Court

The US District Court for the District of Columbia denied the government's motion to compel production of the three documents described above. See *United States v. Deloitte & Touche USA LLP*, 623 F. Supp. 2d 39 (D.D.C. 2009). The court concluded that the Deloitte Memorandum was prepared “because of the prospect of litigation with the IRS over the tax treatment of [the partnership].” Although created by Deloitte, the Deloitte Memorandum was nonetheless Dow's work product because “its contents record the thoughts of Dow's counsel

Upcoming Tax Events:

Tax Briefings – The International Tax Provisions of the Education Jobs and Medicaid Assistance Act of 2010 (H.R. 1586)

Palo Alto
August 27, 2010

Dallas
August 31, 2010

Chicago
September 1, 2010

Houston
September 1, 2010

New York
September 1, 2010

Washington, DC
September 28, 2010

10th Annual Transfer Pricing Forum

Amsterdam
September 15 – 16, 2010

State and Local Tax Roundtables

Houston
September 22, 2010

Dallas
September 23, 2010

Palo Alto
October 6, 2010

Seattle
October 7, 2010

regarding the prospect of litigation.” The district court also rejected the government’s argument that Dow had waived the work-product privilege for the three documents. Generally, disclosing work product to a third party waives work product protection only if such disclosure is “inconsistent with the maintenance of secrecy from the disclosing party’s adversary.” The district court concluded that Dow’s disclosure to Deloitte was consistent with maintaining secrecy for the documents in question because Deloitte was not a potential adversary and Dow reasonably expected Deloitte to maintain the confidentiality of the documents.

The DC Circuit Court’s Opinion

The government appealed the district court’s ruling on the grounds that: (1) the Deloitte Memorandum was not work product; and (2) even if the Dow Memorandum and the Outside Tax Opinion were protected by the work product privilege, Dow waived such protection when it provided them to Deloitte. To support its first argument, the government argued that Dow could not claim a privilege for the Deloitte Memorandum, because Deloitte prepared the document in its capacity as an independent certified public accounting firm, which has a “public responsibility” to creditors, stockholders, and the investing public.” Thus, the government argued, Deloitte could not be Dow’s representative under Fed. R. Civ. P. 26(b)(3), and a document prepared by it could not be protected work product.

Continuing Vitality of the “Because of” Test

The DC Circuit Court conclusively rejected the government’s arguments, stating that the key determining factor is whether the document contained the thoughts and opinions of counsel developed in anticipation of litigation, and not the identity of the person who committed those thoughts to paper. Further, Dow’s “representative” for purposes of Fed. R. Civ. P. 26(b)(3) was its counsel, whose thoughts and opinions were recorded in the Deloitte Memorandum.

The government also argued that the Deloitte Memorandum was not work product because it was generated during the annual financial audit, and was created in the ordinary course of business. The D.C. Circuit rejected the government’s categorical arguments and instead analyzed whether the document in question was “created because of anticipated litigation,” emphasizing its agreement with the tests adopted by the D.C., Second, Third, Fourth, Sixth, Seventh, Eighth and the Ninth Circuit Courts of Appeal. Under the “because of” test, the court asks whether, in light of the nature of the document and the facts of the case, the document at issue can fairly be said to have been prepared or obtained “because of” the prospect of litigation.

Importantly, the DC Circuit distinguished and questioned the First Circuit’s en banc opinion in *United States v. Textron*, 577 F.3d 21 (1st Cir. 2009), *cert. denied*, 2010 U.S. LEXIS 4373 (U.S. May 24, 2010), to the effect that tax accrual workpapers were tax documents prepared in the ordinary course of business to support the company’s financial statement, and were not “case preparation materials” prepared for “potential use in litigation.” See prior *Tax News and Developments* articles [US Supreme Court Denies Certiorari in Textron \(Vol. 10, Issue 3, June 2010\)](#) and [Textron: Teeing Up Tax Accrual Work Papers for the Supreme Court? \(Vol. 9, Issue 5, Oct. 2009\)](#) located under publications at www.bakermckenzie.com.

The DC Circuit distinguished *Textron* on the ground that the Deloitte Memorandum incorporated material developed by counsel in anticipation of litigation, and thus clearly served multiple purposes. The D.C. Circuit also took particular note of Judge Torruella's dissenting opinion in *Textron*, which questioned whether the First Circuit was actually applying the stricter "primary motivating purpose" test applied by the Fifth Circuit, rather than the "because of" test.

Although the DC Circuit rejected the government's categorical assertions that the Deloitte Memorandum was not work product, it remanded the case to the District Court for the purpose of determining whether the entire document was protected work product.

Case of First Impression on the Issue of Whether Providing Work Product to an Auditor Waives the Protection

The government also argued that Dow waived work-product protection for the second and third documents by disclosing them to Deloitte, on the theory that Deloitte was a potential adversary and a conduit to other adversaries. The D.C. Circuit first noted that the issue of whether disclosing documents to an independent auditor waived work-product protection was an issue of first impression in the Circuit Courts. In analyzing whether Dow waived such protection, the court first distinguished between attorney-client privilege and work product protection, noting that a voluntary disclosure waives the former because it is inconsistent with preserving the confidentiality of attorney-client communications, but disclosure to a non-adversary does not waive work-product production.

The D.C. Circuit observed that neither of the government's arguments demonstrated that Deloitte was a potential adversary. First, as an independent auditor, Deloitte would not be adversarial to Dow while it remained the company's auditor, because even threatened litigation against an independent auditor requires it to withdraw as the company's auditor. Moreover, Deloitte's ability to issue an adverse opinion does not make it an adversary.

The court also determined that the mere possibility of a future dispute between Deloitte and Dow does not make Deloitte a potential adversary for purposes of waiver. Instead, the appropriate question is whether Deloitte could be Dow's adversary in the type of litigation addressed by the Dow Memorandum and Outside Tax Opinion. The court concluded that in preparing these documents Dow anticipated a dispute with the IRS, not a dispute with Deloitte.

Finally, the Court determined that Deloitte could not be viewed as a "conduit to Dow's adversaries," because Dow reasonably expected that Deloitte would maintain the confidentiality of such documents. In support of such expectation, the court cited the auditor's obligation under the AICPA Code of Professional Conduct, to refrain from disclosing confidential client communications. Thus, Dow's disclosure of the Dow Memorandum and Outside Tax Opinion to Deloitte did not result in a waiver because such disclosure would not be inconsistent with the purpose of the work product rule.

Deloitte is significant for a number of reasons. First, *Deloitte* provides a rationale for distinguishing the First Circuit's en banc *Textron* decision. Second, *Deloitte* is the first Court of Appeals decision to address the waiver issue in the context of documents disclosed to independent auditors, and it rejected the idea that disclosure to an independent auditor waived work product privilege. *Deloitte* provides taxpayers with a well-reasoned opinion to challenge the IRS' arguments for seeking documents provided to auditors. Finally, the D.C. Circuit's opinion in *Deloitte* indicates that the issues of work-production and waiver will continue to be the subject of litigation in the near future as more circuits weigh in on the critical issues presented.

By Joseph A. Myszka and Kristen B. Proschold, Palo Alto

Tenth Circuit Finds No Economic Substance in *Sala*

The Tenth Circuit Court of Appeals ("Tenth Circuit") recently reversed one of the "Son of Boss" decisions that had favored a taxpayer, *Sala v. United States*. The Tenth Circuit disallowed the claimed deductions on the grounds that the transaction at issue lacked economic substance. This decision is significant because the recently-enacted legislation concerning the economic substance doctrine effectively incorporates the judicial decisions that define the scope of that doctrine.

The Tenth Circuit noted that Carlos Sala participated in an investment program that included an initial phase designed primarily to generate a tax loss so as to offset over \$60 million in income he earned in 2000. Sala's wholly-owned S corporation, Solid Currencies, Inc. ("Solid") acquired a combination of \$61 million of long and \$61 million of short foreign currency options and contributed them plus \$8 million in cash to a partnership, Deerhurst GP. The Tenth Circuit noted that under a pre-determined plan, the partnership existed for only a few weeks and was liquidated before year's end. Relying on *Helmer v. Commissioner*, 34 TCM 727 (1975), Sala calculated Solid's basis in its partnership interest to be \$69 million by disregarding the short options and including in its basis the long options and the \$8 million of cash. Solid's basis in the property it received from the partnership upon liquidation was calculated as approximately \$61 million. Solid sold this property for less than \$1 million. The sale of the contracts produced a loss of approximately \$60 million, which Sala was able to use to offset his ordinary income because gain or loss on the sale of foreign currency contracts is ordinary under Code Section 988.

Sala originally claimed that the loss offset his income, but then filed an amended return which did not claim the loss; he then filed a claim for a refund based on the \$60 million loss. The IRS disallowed the claimed refund, but the district court in Colorado ruled in Sala's favor. The IRS appealed, claiming that the transaction giving rise to Sala's claimed tax loss lacked economic substance.

The Tenth Circuit first considered the scope of the transaction to which the economic substance doctrine applied. Sala had invested not only in the transaction described above that generated a tax loss, but also had invested (as part of the so-called Deerhurst Program) in post-2000 investments that provided no tax benefit. The taxpayer argued that the entire Deerhurst Program should be considered for purposes of determining whether there was economic substance, whereas the government argued that the economic substance test would be applied solely to the only investment that generated the large tax loss. The

appellate court agreed with the government that the loss-generating transaction had to stand on its own merit and could not be legitimized by being part of a larger transaction. The portions of the Deerhurst Program that occurred in 2001 and beyond had no connection with the loss generated in 2000 and were not viewed as relevant by the court.

The district court had concluded that, even if viewed on a stand-alone basis, the Deerhurst GP investment in 2000 had economic substance. The Tenth Circuit stated that it was necessary to consider both the taxpayer's subjective business motivation and the transaction's objective business purpose to determine if the transaction should be respected. Citing *Keeler v. Commissioner*, 243 F.3d 1212 (10th Cir. 2001), the Tenth Circuit noted that the fact that a transaction has some profit potential does not necessarily compel the conclusion that the transaction has economic substance.

The Tenth Circuit noted that the Deerhurst GP transaction was structured from the outset to be a complete fiction. The transaction was designed primarily to create a reportable tax loss that would almost entirely offset Sala's taxable income in 2000 with little actual economic risk. By acquiring a series of long and short options that largely offset one another, contributing them to Deerhurst GP in exchange for a partnership interest, and then almost immediately liquidating the partnership, the taxpayer was assured of generating a tax loss nearly equivalent to his taxable income.

Sala did not contest the conclusion that he did not incur an economic loss in the Deerhurst GP transaction; he claimed that the loss had to be respected because of the manner in which he was required to determine the basis of his partnership interest under *Helmer*. The Tenth Circuit did not reach the validity of *Helmer*, however, because it focused on the economic reality of the transaction in order to determine whether the tax loss should be respected.

The district court had also found that Sala had a profit potential in the Deerhurst GP transaction because it was possible for the taxpayer to earn a profit of \$550,000 over the course of one year from the transaction. The Tenth Circuit noted, however, that the expected tax benefit of \$24 million dwarfed any potential gain from the transaction. The Tenth Circuit concluded that the existence of some potential profit is insufficient to impute substance into an otherwise sham transaction where a common-sense examination of the evidence as a whole indicates the transaction lacked economic substance.

The district court had also found that Sala provided plausible business explanations for various components of the Deerhurst GP portion of the transaction, including the use of an S corporation, the creation and almost immediate liquidation of the Deerhurst GP partnership, and the selection of the particular foreign currency options that Sala acquired. The Tenth Circuit noted, however, that any anticipated economic benefit from participating in Deerhurst GP for a few weeks, and then quickly liquidating the partnership before year's end, was negligible in comparison to the \$24 million tax benefit which would not have been achieved but for this pre-determined course of action.

The Tenth Circuit also rejected the district court's factual finding that Sala had entered into the Deerhurst Program primarily for profit. The court stated that the mere presence of an individual's profit objective did not require the court to recognize for tax purposes a transaction which lacks economic substance, citing

Jackson v. Commissioner, 966 F.2d 598 (10th Cir. 1992). More importantly, the district court had focused on the profit potential of the multi-year Deerhurst Program and not on the specific transaction, involving Deerhurst GP, which gave rise to the loss. The economic substance test should have been applied only at the Deerhurst GP level, and that transaction clearly generated a substantial tax loss and minimal gain. Therefore, the losses arose from a transaction that lacked economic substance and could not be recognized by Sala.

Sala was one of the Son of Boss cases that had been decided in favor of the taxpayer, and the court had based its decision on factual findings that usually make the decision harder to reverse on appeal.

Code Section 7701(o), as enacted this year, provides statutory guidance for applying the economic substance doctrine (and penalizing taxpayers through a 40% penalty which applies to persons who enter into transactions that lack economic substance). However, the application of section 7701(o) depends upon the scope of the “common law” doctrine which was applied in Sala, since the statutory language provides that the new law is applicable only with respect to transactions where the doctrine is “relevant,” i.e., transactions that would have been subject to the economic substance doctrine under common law. The Tenth Circuit’s decision in Sala is therefore relevant, because although it stated the doctrine in customary terms (a transaction has to have both a subjective and an objective business purpose), the court actually applied the doctrine somewhat more loosely by simply comparing the tax benefits received against the profit potential in the transaction.

As a practical matter, Sala raises the question of whether Son of Boss transactions are likely to be respected by courts. As a result, taxpayers must be wary that a court could adopt a broad view of the economic substance doctrine, which could result in substantial penalties if applied to disallow losses that the taxpayer has claimed.

By Richard M. Lipton, Chicago

Why the IRS Needs to Give Up Stock Option Ghost in Cost Sharing Arrangements

Given that the IRS in AOD 2010-33 has acquiesced in the result in *Xilinx v. Commissioner*, 598 F.2d 1191 (9th Cir. 2010), the battle over the inclusion of stock options in cost sharing pools shifts to post-2003 years subject to the stock-based compensation regulations issued in 2003 and 2009. In an article written before the issuance of AOD 2010-33, James M. O'Brien and Mark A. Oates urge the IRS to accept reality – the inclusion of stock options is contrary to the arm's length standard. J.M.O'Brien & M.A.Oates, [*No Mas! Why the IRS Needs to Give up the Stock Option Ghost*, 36 Int'l Tax J. 5 \(July 2010\).](#)

The last sentence of AOD 2010-33 means that the IRS will concede the stock option inclusion for stock options covered by the 1995 regulations. In light of AOD 2010-33 and the *Xilinx* decision going final in June, cost-sharing companies may be entitled to the following tax relief:

- To the extent that a company has open pre-2004 taxable years in which stock options had been included in their cost sharing pools, in 2004 or subsequent years the company is entitled to tax refunds.
- To the extent that a company included section 83 spreads, that were attributable to pre-2004 stock option grants, in 2004 or subsequent open years, the company is entitled to tax refunds.
- If a company had a stock option clawback provision in its cost-sharing agreement that would be triggered by the Xilinx final decision, the company should take steps to timely invoke its clawback rights under the cost sharing agreement.

By James M. O'Brien and Mark A. Oates, Chicago

***Calloway v. Commissioner*. The Tax Court Issues the First of Two Consecutive Unfavorable Rulings in Share Lending Transactions**

Within a span of two weeks, the Tax Court ruled in favor of the IRS in two consecutive decisions involving share lending transactions, the first of which was a case of first impression for this court. In *Calloway v. Commissioner*, 135 T.C. 3 (2010), the court found that a deal teeming with bad facts and parading as a Code Section 1058 share lending transaction was actually, in substance, a sale for United States federal income tax purposes. Almost immediately after ruling in *Calloway*, the court decided *Anschutz Co. v. Commissioner*, 135 T.C. 5 (2010). *Anschutz* involved another share lending transaction with different, albeit more complex, facts in which the court stepped together the taxpayers' purportedly separate prepaid variable forward contracts and share lending agreements and recharacterized the purported loan as a taxable sale. While both cases should be carefully analyzed by taxpayers considering share lending transactions, the *Calloway* case is the focus of this article.

In *Calloway*, a case reviewed by the entire court, the taxpayer transferred shares of IBM stock to Derivium Capital LLC ("Derivium") as part of a program in which Derivium would loan the taxpayer approximately \$93 million and the shares would serve as collateral for the loan. The terms of the agreement governing the transaction allowed Derivium to sell the stock, and it did so immediately after receiving the shares. The agreement did not require the taxpayer to make any payments toward principal or interest on the purported loan, and the taxpayer did not do so. At maturity, the taxpayer could elect to pay the balance due and collect an equivalent amount of IBM shares from Derivium. Alternatively, he could renew the loan, or he could satisfy the loan by surrendering the right to reclaim the shares. When the loan matured, Derivium notified the taxpayer that the aggregate principal and interest due on the loan was approximately \$124 million, and that the then-current value of the IBM shares was approximately \$83 million. The taxpayer elected to surrender his right to receive the IBM shares. The taxpayer never made any payments of principal or interest on the remaining balance due, and he did not report any cancellation of indebtedness income as a result of the transaction.

During the term of the loan, Derivium provided the taxpayer with quarterly and year-end account statements. These statements reported “end-of-quarter collateral value” and dividends, giving the appearance that Derivium still held the IBM shares. The taxpayer neither received a Form 1099-DIV, Dividends and Distributions, from Derivium, nor did the taxpayer include any dividend income on his tax returns for the applicable years to reflect the dividends allegedly paid on the IBM shares.

The Majority’s Holding

The court applied the “benefits and burdens of ownership” test previously established by the court in *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981), to the transaction to determine if it was at its substance a sale or a loan. The court first looked to see if legal title to the shares had passed from the taxpayer to Derivium and determined that it had. The agreement provided that once Derivium received the shares, it was authorized to sell them without notice to the taxpayer. The court concluded that this was sufficient to establish transfer of legal title upon Derivium’s receipt of the shares. The court noted that, “at best” the taxpayer had an option to repurchase the IBM shares in three years, but even that depended upon Derivium’s ability to acquire IBM shares at or prior to that time.

The court then examined the parties’ treatment of the transaction and found that the parties’ behavior reflected a stock sale, despite it being described on paper as a loan. The court concluded that Derivium’s immediate sale of the shares and the fact that it calculated the proceeds from the sale prior to valuing the loan was the behavior of a buyer, not a lender. Likewise, the taxpayer’s failure to report dividends paid on the shares, to repay any of the interest or principal on the purported loan, to report the sale of the shares on his 2004 return (the year during which the taxpayer claimed to have surrendered the shares), or to report any cancellation of indebtedness income on the 2004 return was, in the eyes of the court, more indicative of the behavior of a seller, as opposed to a borrower.

The court also noted that once the taxpayer received the approximately \$93 million from Derivium, the taxpayer bore no risk of loss with respect to the shares. That is, the taxpayer was entitled to retain the full amount of the funds he received, irrespective of the future performance of the shares. In short, upon consideration of these and certain other of the *Grodt* factors, the court found that the taxpayer relinquished the “benefits and burdens” of ownership with respect to the shares at the time it transferred the shares to Derivium. Accordingly, the court held that, “even though the documents prepared by Derivium use the term ‘loan’, the transaction lacked the characteristics of a true loan.”

In support of its holding, the court cited two recent decisions in which other courts concluded that transfers of securities to Derivium under its “90-percent-stock-loan-program” were sales, and not loans, for federal income tax purposes. See *Nagy v. United States*, 104 AFTR 2d 2009-7789 (D.S.C. 2009), and *United States v. Cathcart*, 104 AFTR 2d 2009-6625 (N.D. Cal. 2009). While the court might very well have found the same way if this prior precedent did not exist, one cannot help but wonder if Derivium’s tarnished image played a role in this court’s findings.

The taxpayer argued that the transaction was a nontaxable Code Section 1058 securities lending arrangement. Section 1058 generally provides for nonrecognition treatment of certain securities transfers where the securities are exchanged for identical securities or the obligation to provide identical securities to the transferor. To qualify under this provision, the transferee must pay to the transferor “amounts equivalent to all interest, dividends, and other distributions which the owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the transferor and ending with the transfer of identical securities back to the transferor.” Furthermore, the “risk of loss or opportunity for gain of the transferor of the securities in the securities transferred” must not be reduced.

Because the court found that the taxpayer had not retained the benefits and burdens of ownership with respect to the shares, it rejected this argument on the basis that the taxpayer’s risk of loss and opportunity for gain had ceased to exist when the shares were first transferred to Derivium. The court furthered its point by citing its prior holding in *Samueli v. Commissioner*, 132 T.C. 37 (2009), where it held that, in order to retain the benefits and burdens of ownership of transferred securities, the taxpayer must “be able to terminate the ... agreement upon demand.” Here, the taxpayer could only reacquire the securities at maturity, and the court held that this “severely diminished” the taxpayer’s opportunity for gain with respect to the shares.

Concurrence

Judges Halpern and Holmes concurred with the result in *Calloway*, but disagreed with the reasoning of the majority. Judge Halpern argued that the *Grodt* test, while appropriate for resolving issues of ownership for nonfungible assets such as cattle (the assets at issue in *Grodt*), was inappropriate for determining ownership of assets such as securities, which are fungible. Instead, Judge Halpern asserted that “whether legal title to the assets and the power to dispose of them are joined in the supposed owner” was the appropriate inquiry. Judge Halpern concluded that the taxpayer’s transfer of the shares to Derivium stripped title to the same from the taxpayer and triggered a realization event. Accordingly, in Judge Halpern’s view, the majority’s analysis of anything beyond this first event was superfluous.

Judge Holmes also concurred in the result, but solely on the basis that Treas. Reg. § 1.1001-2(a)(4)(i) provides that ‘the sale *** of property that secures a nonrecourse liability discharges the transferor from the liability.’ Accordingly, Judge Holmes asserted that, when Derivium sold the shares, the taxpayer “must recognize income at that point” in the amount of the discharged liability. To this end, Judge Holmes argued that the majority was wrong in analyzing the two transactions together and that the second sale should be “analyzed for its own tax consequences” and not serve as a factor in the court’s “characterization of the purported loan.” Judge Holmes reminded the reader that Derivium’s contractual right to resell underlying stock without notice to the borrower is a common practice in securities transactions that should not, in and of itself, give rise to a sale, and that the unintended effect of this part of the majority’s opinion “would be to treat all nonrecourse lending against stock collateral as sales.”

Judge Holmes then spurned the majority's use of the *Grodt* test as a "frolic and detour through an inappropriate multifactor test" giving rise to "an overly broad holding with potentially harmful effects on other areas of the law." Specifically, Judge Holmes pointed out that the court in *Grodt* was distinguishing between a sale and a sham transaction, whereas the choice here was between a sale and a loan. Furthermore, Judge Holmes asserted that *Grodt's* focus on "title and possession" was inappropriate for securities which are held indirectly, usually through a nominee.

Judge Holmes also criticized the majority for its conclusion that, barring a substantial increase in the value of the shares, it would not have made sense for the taxpayer to repay the principal or interest to Derivium. Holmes stated that the determination of whether it makes economic sense to repay a nonrecourse loan is determined at the loan's inception, and the loan here was over-collateralized by 10%, giving rise to a "bona fide obligation to repay." Accordingly, Judge Holmes cautioned that an "unconditional obligation to pay as a key characteristic of debt shouldn't be read to say that secured, but nonrecourse, financing isn't a species of loan."

By Shelly N. Boehler, Dallas

The Arm's Length Standard in the Real World: The Federal Court of Appeals Decision in *GlaxoSmithKline Inc.*

Transfer pricing practitioners should be encouraged by the manner in which the Canadian Federal Court of Appeals applied the arm's length standard in the decision *GlaxoSmithKline Inc. v. The Queen* ("GSK case") rendered on July 26, 2010. This high profile decision, together with recent decisions in the United States in *Xilinx Inc. v. Commissioner* and *Veritas Software Corp. v. Commissioner* as well as the Indian High Court decision in "*Maruti*" *Suzuki India Ltd v. Additional Commissioner of Income Tax Transfer Pricing Officer of New Delhi*, evidence a growing judicial intolerance for aggressive audit behavior in transfer pricing cases by the respective tax authorities.

The GSK case involved the prices paid by GlaxoSmithKline Inc. ("GSK Canada"), a Canadian corporation, for the purchase of an active pharmaceutical ingredient, ranitidine, used in a drug marketed by it under the brand name Zantac. GSK Canada acquired ranitidine from a related non-resident Swiss company, Adechsa SA ("Adechsa").

As a result of using a resale price method which provided GSK Canada with a 60% gross margin, the purchase prices paid by GSK Canada varied between \$1,512 and \$1,651 per kilogram. Canadian law permitted non-patent holders to manufacture generic drugs in payment for royalty to the patent holder. During that same period, the government adduced evidence that Apotex and Novopharm, two unrelated Canadian generic drug manufacturers, had purchased ranitidine from arm's length suppliers for \$194 and \$304 per kilogram.

The Tax Court determined that Apotex's and Novopharm's purchases of ranitidine constituted comparable uncontrolled prices which could be used for purposes of determining whether the purchase prices by GSK Canada were reasonable in the circumstances.

GSK Canada had entered into both a Supply Agreement for the purchase of ranitidine and also a License Agreement for the payment of royalties to GSK UK, its parent company. The Tax Court of Canada (“Tax Court”) determined that because these were separate agreements, it was bound to find that the License Agreement should not be considered in determining the arm’s length price paid to Adechsa. The Tax Court also stated that it was bound to ignore (1) an essential term of the Supply Agreement that required GSK Canada to acquire the active ingredient from one of two related suppliers; and (2) the fact that the royalty which GSK Canada paid allowed it to access the entire portfolio of Glaxo World drugs rather than just the one particular ingredient.

During the years under appeal, subsection 69(2) of the Income Tax Act (the “Act”) provided that where a taxpayer had paid to a non-resident with whom the taxpayer was not dealing at arm’s length an amount greater than the amount that would have been reasonable “in circumstances” if the non-resident person and the taxpayer had been dealing at arm’s length, the reasonable amount shall be deemed to have been the amount that was paid or was payable therefore. Subsection 69(2) has been replaced by section 247, but essentially the arm’s length standard continues to be applied in the new provision.

GSK Canada’s main complaint argued that the Tax Court failed to consider the License Agreement between it and the Glaxo Group as one of the relevant circumstances. The Tax Court had held that it could not consider the License Agreement because it and the Supply Agreement covered separate matters and it was bound by the Supreme Court of Canada decision in *Singleton v. Canada* [2001] 2 SCR 1046 to treat those agreements as being separate. The Tax Court also buttressed its opinion by referring to the decision of the United States Tax Court in *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525, 1989, where the Court refused to collapse the license and sales transactions involving Bausch & Lomb, Inc. and its Irish manufacturing subsidiary and treat the Irish subsidiary as a contract manufacturer.

Canada’s Federal Court of Appeal (“Appeals Court”) determined that the Tax Court had erred in its approach. The Appeals Court stated that *Singleton*, which dealt with an unrelated section of the Act regarding deductibility of interest, was of no relevance for determining whether the Appeals Court could consider the License Agreement and the Supply Agreement together. The Appeals Court also reaffirmed the decision of the Exchequer Court in *Gabco Limited v. MNR*, 68 DTC 5210 in which the Court stated that:

“It is not a question of the Minister or this Court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or the Court coming to the conclusion that no reasonable business man would have contracted to pay such an amount having only the business considerations of the Appellant in mind”.

The Appeals Court held that this standard was entirely apposite to the issues before it.

The Appeals Court also considered the decision in *Safety Boss Limited v. The Queen*, 2000 D.T.C. 1767, in which Chief Justice Bowman of the Tax Court held that the “reasonable business person” standard enunciated in *Gabco* was also applicable in matters arising under subsection 69(2). As a result, the test in

Gabco required an inquiry into those circumstances which an arm's length purchaser, standing in the shoes of the Appellant, would consider relevant in deciding whether it should pay the price paid by the Appellant to Adechsa for its ranitidine.

The Appeals Court found that the Tax Court was bound to consider all the circumstances which an arm's length purchaser would necessarily have had to consider. In other words, the test mandated by subsection 69(2) does not operate without consideration of the real business world in which the parties to a transaction participate.

The Appeals Court noted that the Tax Court had instead determined the fair market value of the ranitidine as the price paid by Apotex and Novopharm, and then found that anything paid by the Appellant over that amount (save for a \$25 per kilo upward adjustment) was in excess of the reasonable amount. As a result, the Appeals Court determined that the Judge's approach was mistaken.

The Appeals Court found that in the real business world an arm's length purchaser could always buy ranitidine at market prices from an arm's length seller. However, the real test was whether the arm's length purchaser would be able to sell the ranitidine under the Zantac trademark. It was clear to the Appeals Court that this would not be possible. Accordingly, looking at the business reality, the License Agreement with Glaxo Group was a circumstance which had to be considered by the Judge. Failing to address that circumstance meant that the Judge made his determination in a fictitious business world where a purchaser is able to buy ranitidine at a price which does not take into account the circumstances which make it possible for that purchaser to obtain the rights to make and sell Zantac.

The Appeals Court found that there were a number of "circumstances" indicating that the License Agreement was a crucial consideration in determining the amount that would have been reasonable in the circumstances if the Appellant and Adechsa had been dealing at arm's length. The Court identified these as:

1. Glaxo Group owned the Zantac trademark and would own it even if the Appellant were an arm's length licensee;
2. Zantac commanded a premium over generic ranitidine drugs;
3. Glaxo Group owned the ranitidine patent and would have owned it even if the Appellant had been in an arm's length relationship;
4. Without the License Agreement, the Appellant would not have been in the position to use the ranitidine patent and Zantac trademark. Consequently, under those circumstances, the only possibility open to the Appellant would be to enter the generic market; and the cost of entry into that market would likely have been high, considering that both Apotex and Novopharm were already well placed and positioned; and
5. Without the License Agreement, the Appellant would not have had access to the portfolio of other patented and trademarked products to which it had access under the License Agreement.

The Appeals Court determined that these circumstances arose from the market power attached to the Glaxo Group's ownership of intellectual property associated with ranitidine, the Zantac trademark and the other products covered by its License Agreement with GSK Canada.

Therefore, the Appeals Court concluded that the Tax Court erred in law in failing to apply the proper test in determining the amount that would have been reasonable in the circumstances if the Appellant and Adechsa had been dealing at arm's length.

The Appeals Court allowed the appeal and sent the matter back to the Tax Court for reconsideration on the basis that the License Agreement should be considered in determining the arm's length price. Whether this will result in a complete victory for GSK Canada remains to be seen. What is clear is that the Appeals Court refused to allow the application of the arm's length standard in a way that ignored the real business world circumstances in which the parties to the transaction participated. If so, this decision may transcend the Canadian border.

**By *Salvador M. Borraccia* and *Chris Raybould*, Toronto
and *Marc M. Levey*, New York**

State Tax Developments

Illinois Offers a Tax Amnesty Program

As expected and reported in the previous *Tax News & Developments* edition ([*2010 Illinois Tax Amnesty \(Vol. 10, Issue 3, June 2010\)*](#)), on August 16, 2010 Governor Quinn signed the Illinois Tax Amnesty Act into law thereby establishing a tax amnesty program that will run from October 1, 2010 to November 8, 2010. Illinois last offered a tax amnesty in 2003. Although the upcoming program is largely similar to the 2003 program, there are some notable differences. The Illinois Tax Amnesty Program provides certain incentives and benefits to taxpayers who satisfy their liabilities during the amnesty period including, in particular, abatement of all interest and penalties. There are, however, adverse consequences for those taxpayers who fail to participate, including those with protested matters pending before the Department --- more specifically, the doubling of interest and penalties on tax liabilities paid after the amnesty period. All Illinois taxpayers must review their Illinois returns, past filing positions and protested matters, explore all their options and determine the appropriate course of action in light of the Illinois amnesty program.

By *Theodore R. Bots* and *Matthew S. Mock*, Chicago

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Supreme Court Held Comity Barred Federal-Court Adjudication of Challenges to Certain State Tax Schemes

On June 1, 2010, the Supreme Court unanimously held that the doctrine of comity prevented federal courts from deciding a case concerning the constitutionality of state tax exemptions for a particular industry. *Levin v. Commerce Energy, Inc.*, 560 U.S. ____ (2010). *Levin* involved claims by independent marketers (“IM”) of natural gas selling to Ohio consumers. Ohio law provided certain exemptions from taxation, both sales/use and Commercial Activities Tax, for local distribution companies (“LDCs”). Although direct competitors, the IMs did not qualify for the same exemptions. As a result, the IMs sued the Ohio Tax Commissioner alleging discriminatory taxation of IMs and their patrons in violation of the Commerce and Equal Protection Clauses. The IMs brought suit in the federal district court seeking declaratory and injunctive relief. The IMs requested that the LDC’s tax exemptions be invalidated and, as a result, its competitor’s tax burden be increased.

Levin addressed two concepts that limit the jurisdiction of federal courts to hear state tax issues: (1) the Tax Injunction Act (26 U.S.C. § 1341); and (2) the comity doctrine. The Tax Injunction Act serves to prohibit lower federal courts from restraining the assessment, levy or collection of any tax under state law where a plain, speedy and efficient remedy exists in state court. The comity doctrine is broader and reflects a general deference to states with respect to carrying on their respective governments. Under the comity doctrine, federal courts should resist taking on certain cases that are better decided by state courts.

The federal district court dismissed the IM’s case as a matter of comity, holding that the Ohio legislature chose to provide the challenged tax exemptions to LDCs and that thus the requested relief would amount to the federal court forcing Ohio to collect taxes which its legislature has not seen fit to impose. The IMs appealed and the US Court of Appeals for the Sixth Circuit reversed. The appellate court held that federal comity concerns do not bar an action that challenges tax benefits provided to four specific entities, but not all other similarly situated taxpayers. Both the District Court and the Sixth Circuit found that the Tax Injunction Act did not bar the suit because (1) the plaintiffs were third parties challenging the constitutionality of another’s tax benefit; and (2) the requested relief would not disrupt the flow of tax revenue to the State.

The US Supreme Court granted review and, reversing the Sixth Circuit, held that comity prevented the IM’s case from being heard in the federal courts. The Court pointed to three factors in support of its conclusion. First, the IMs were seeking federal court review of commercial matters over which Ohio enjoys wide, regulatory latitude – their suit did not involve any fundamental right or classification that attracts heightened judicial scrutiny. Second, the IMs were seeking federal court aid in order to improve their competitive position. Third, the Court reasoned that the Ohio courts are better positioned than their federal counterparts to correct any violation because they are more familiar with state legislative preferences. Taken together, the above-described facts compelled a finding that the matter would be properly heard by a state, rather than a federal court.

As noted above, the IMs sought declaratory and injunctive relief invalidating the tax exemptions enjoyed by LDCs. Given the difficulty in forcing collection of a tax the Ohio legislature expressly decided not to impose, the Supreme Court

reasoned that the only way to remediate the discrepancy resulting from the application of the tax exemptions would be to reduce the IM's Ohio tax liability. However, this remedy was not available because the Tax Injunction Act prohibits federal courts from enjoining the collection of state taxes. The other possible remedy, revision of the Ohio statutes providing the exemptions, would require the courts to interfere with state taxation and state legislative powers – exactly what the comity doctrine was in place to prevent.

Levin highlights the difficulty of bringing suit in federal court to address a Commerce or Equal Protection Clause claim with respect to state tax laws. Even if the case is not barred by the Tax Injunction Act, it is possible that the comity doctrine will serve to prevent federal jurisdiction as well.

By Maryann H. Luongo, Washington, DC

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Throwout Rule Withstands Constitutional Challenge in Whirlpool

The Superior Court of New Jersey, Appellate Division, affirmed the Tax Court's finding that New Jersey's "Throwout Rule" does not offend the Due Process, Commerce or Supremacy Clauses of the US Constitution. *Whirlpool Prop., Inc. v. Dir., Div. of Taxation*, No. A-1180-08T2, Unpub. (N.J. Super. Ct. App. Div. July 12, 2010). Although this ruling upholds the facial constitutionality of the Throwout Rule, the decision does not prevent other taxpayers from challenging the constitutionality of the Throwout Rule as it applies to their particular facts and circumstances.

The Throwout Rule, which was recently repealed for tax years beginning on or after July 1, 2010, was implemented by the Business Tax Reform Act of 2002 and contained in former N.J.S.A. § 54:10A-6(B). The Throwout Rule required corporate taxpayers to exclude receipts sourced to states or other jurisdictions where "the taxpayer is not subject to a tax on or measured by profits or income, or business presence or business activity" from the denominator of their New Jersey sales fraction. States generally include all gross receipts from business income in their sales fraction denominator, so, by excluding gross receipts sourced to certain states, i.e., where the taxpayer was "not subject to a tax on or measured by profits or income," New Jersey effectively *increased* the New Jersey sales fraction by reducing the denominator. Because the New Jersey apportionment fraction consists of a three factor double-weighted sales formula, the Throwout Rule has had a significant effect on the New Jersey Corporation Business Tax liabilities of many corporate taxpayers.

The present matter was initiated when Whirlpool and Pfizer filed actions in New Jersey Tax Court to challenge the constitutionality of the Throwout Rule on its face. Both taxpayers claimed the provision violated the Due Process Clause, the Commerce Clause, and the Supremacy Clauses of the US Constitution. The Tax Court granted the Director's cross-motion for partial summary judgment, holding that the Throwout Rule was facially constitutional, as it operated constitutionally in some instances. More specifically "(1) where the income being excluded from the denominator of the sales fraction is generated in whole or in part by activities in New Jersey, (2) where the application of the Throwout Rule has no material effect on the sales fraction because the income generated in the non-taxing state is

insignificant in relation to the total income of the corporation, and (3) where the property and payroll fractions substantially temper the impact of the sales fraction on the allocation factor (even though the sales fraction is double-weighted under N.J.S.A. 54:10A-6).” *Pfizer, Inc. v. Dir., Div. of Taxation*, 24 N.J., 116 (N.J. Tax Ct. 2008). Moreover, the court noted that New Jersey law also granted the Director discretionary relief in the case of improper results, commonly referred to as “Section 8 Relief.”

Although appellants’ subsequent motions for leave to file interlocutory appeals were denied by the Appellate Division, appellants successfully appealed to the New Jersey Supreme Court. The New Jersey high court remanded the case to the Appellate Division for consideration on the merits. On remand, the Appellate Division upheld the Tax Court’s decision on all issues. First, the court upheld the standard applied by the Tax Court in determining the facial constitutionality of the Throwout Rule, namely, that “a challenger must establish that no set of circumstances exists under which the Act would be valid.” *U.S. v. Salerno*, 481 U.S. 739, 745 (1987). The court then reviewed each of the plaintiffs’ constitutional challenges in turn.

The court rejected appellants’ Due Process Clause argument, holding that plaintiffs incorrectly argued that the Throwout Rule violated the Due Process Clause by taxing transactions that did not reflect a sufficient degree of in-state activity. Rather, the court noted that the key issues supporting a facially unconstitutional Due Process Clause claim were whether each plaintiff had nexus with New Jersey that was independent of its unitary business, and whether each plaintiff’s contested Throwout sales to non-taxing states were part of that non-unitary business. The court similarly rejected plaintiffs’ Commerce Clause argument, finding that the Throwout Rule did not, on its face, subject income on sales outside of New Jersey to a greater tax on income derived from sales made within New Jersey, nor did the Throwout Rule tax interstate commerce to a greater degree than similar in-state commerce. Turning to the facial challenge on Supremacy Clause grounds, the court also upheld the Tax Court’s decision, finding that there were some circumstances in which the Throwout Rule could operate consistently with federal law.

Whether the Appellate Division’s decision will be further appealed is uncertain. Regardless, the constitutionality of the Throwout Rule as applied to each taxpayer’s unique facts and circumstances may still be challenged. Taxpayers should consider the historic impact of the Throwout Rule on their New Jersey Corporation Business Tax liability and consider whether a refund claim could be filed on constitutional grounds.

By John Paek, New York

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Remedies in State Tax Controversies: Fighting the Tide of Retroactive Tax Policy

It certainly is not headline news that state and local governments are desperate to raise revenue. It should be no surprise, then, that they are aggressively increasing efforts to prevent the loss of funds already collected by reason of successful refund claims. This has led to a recent trend toward retroactive legislation, administrative actions, and court decisions denying taxpayers refunds

of illegally collected taxes. This summer, the Iowa Supreme Court became the most recent “fox in the henhouse” when it blessed the Iowa General Assembly’s retroactive authorization of a tax that had been expressly prohibited under state law, thereby leaving a class of aggrieved taxpayers with nothing but a moral victory to show for successfully challenging the illegal action of an overreaching municipality.

In *Zaber v. City of Dubuque*, Dkt. No. 07-1819 (Iowa S. Ct., June 4, 2010), the Iowa Supreme Court denied refunds to successful plaintiffs in a case challenging a prohibited municipal tax disguised as an authorized fee. In 2002, the Iowa high court held that under state law a municipal franchise “fee” becomes an illegal tax if the fee exceeds the cost of regulating the franchised activity. Three years later, in 2005, the City of Dubuque nevertheless imposed a franchise fee on cable television services that deliberately exceeded the cost of regulation. In 2006, plaintiffs in *Zaber* filed a class action for refunds of the excessive franchise fees paid. In 2007, the Iowa General Assembly eliminated the requirement that cable television franchise fees must relate to the cost of regulation and retroactively authorized the excessive municipal franchise fees. The plaintiffs in *Zaber* objected, arguing that the retroactive legislation deprived them a vested right to refund of an illegally imposed tax. The Iowa Supreme Court disagreed, holding that the legislation was rationally related to the legitimate state purpose of protecting Iowa cities against demands for refunds of money collected and already spent. This holding denied the aggrieved taxpayers any refunds of the tax illegally imposed. Adding insult to injury, the court further opined that the period of retroactivity may be as long as needed to achieve the legislature’s purpose, providing no disincentive to even more egregious legislative actions in the future. The troubling significance of this decision was not lost on all of the members of the Iowa Supreme Court; Justice Wiggins stated in his dissent that retroactively blessing unauthorized taxes is “as repugnant to the American system of taxation as the concept of taxation without representation” and “illustrate[s] why many ordinary citizens distrust their elected officials.”

While taxpayers can hope that conscientious members of the judiciary, and better economic times, will stem the tide of retroactive tax policy, there is a clear lesson to be learned from *Zaber* and many recent decisions like it. Taxpayers should avoid refund claims if at all possible. Instead, taxpayers should take affirmative return positions up-front, withhold payment of disputed taxes, and pursue prepayment or payment under protest procedures to the fullest extent possible. Unfortunately, not all states provide taxpayers with prepayment options to challenge a tax. Further, care must be taken even where pre-deprivation remedies are available, as some states impose additional penalties for understatements of tax that could raise the potential cost of pursuing such remedies. In any event, refund claims must and will be pursued in many circumstances, and taxpayers should be prepared to challenge not only the tax at issue, but also the trend of extinguishing a prevailing litigant’s right to refunds of illegal taxes.

By Matthew S. Mock, Chicago

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Washington Implements Key Changes to the B&O Tax: Economic Nexus and Single Sales Factor

The Washington Department of Revenue recently adopted emergency rules to implement statutory changes made to the Business & Occupation (“B&O”) tax. Effective June 2, 2010, the Department of Revenue’s emergency rules implement, *inter alia*, a minimum nexus threshold applicable to the “apportionable activities” of nonresident taxpayers, the single sales factor, and rules affecting income apportionment. Wash. Admin. Code. §§ 458-20-19401-19404.

“Physical Presence” Replaced by “Economic Nexus.” Wash. Admin. Code. § 458-20-19401(1)(a) imposes a new minimum nexus standard for the B&O tax applicable to those deriving income from services or the use of intellectual property. Under the new standard, such taxpayers are deemed to have substantial nexus with the state if they: (i) have more than \$50,000 of property in this state; (ii) have more than \$50,000 of payroll in this state; (iii) have more than \$250,000 of sales from the state; or (iv) have at least twenty-five percent of their property, payroll, or sales in the state. Wash. Admin. Code. § 458-20-19401(3)(c)(i)-(iv). These new standards are effective as of June 1, 2010. It is important to note that these standards are not intended to “clarify” existing law. As such, the historic “physical presence” nexus standard still applies to service and intellectual property related activities prior to June 1. Further, the historic “physical presence” nexus standard remains applicable to sellers of tangible personal property for all periods.

Single Sales Factor Apportionment. For gross income generated on or after June 1, 2010, Washington will utilize single sales factor apportionment for certain taxpayer classifications under the B&O tax. The new single sales factor replaces Washington’s historic “cost apportionment” formula for businesses reporting under the service and other B&O classification as well as the three-factor apportionment formula applied to financial institutions. Under the new formula, Washington’s portion of taxable gross income will be equal to the gross income attributable to the state divided by gross income everywhere. Washington has adopted a “market” based approach for sourcing service receipts. This is a dramatic shift from the prior “cost” based approach utilized by the state. More specifically, under the new sourcing rules, service receipts will be sourced to the state where the customer received the benefit of the underlying services. The new apportionment formula also requires taxpayers to “throw out” from the denominator of their sales factor formula sales attributable to those states in which they do not have nexus, under Washington’s newly established economic nexus standards. As noted above, New Jersey’s historic “throw out rule” is currently subject to challenge. The same may hold true in Washington.

These Washington developments represent significant changes under the B&O tax. Out-of-state taxpayers should review the impact of these changes on their historic reporting positions and consider protective/proactive measures.

By Sahang-Hee Hahn, New York

The First Round to the Taxpayer – Court Holds that Intercompany Transactions are Excluded in the Calculation of the Research Credit

The research credit is generally calculated by taking 20% of the excess of a taxpayer's qualified research expenses for the year over its so-called "base amount." Generally, the base amount is determined by multiplying the taxpayer's "fixed base percentage" by the taxpayer's average annual gross receipts for the four taxable year period prior to the year for which the credit is being determined. The fixed base percentage is determined by dividing the taxpayer's qualified research expenses by its gross receipts for the period from 1984 through 1988. Thus, the determination of the taxpayer's gross receipts is an important part of the calculation of the research credit.

Code Section 41 does not define the term "gross receipts." It does, however, provide that gross receipts shall be reduced by returns and allowances and that in the case of a foreign corporation only gross receipts that are effectively connected with a US trade or business are to be taken into account. Treasury has issued regulations that provide that the term "gross receipts" is to be interpreted broadly and includes all of a taxpayer's receipts from all sources.

Section 41(f)(1) provides, in part, that in determining the credit, all members of a controlled group of corporations are to be treated as a single taxpayer. The term controlled group generally includes all corporations, both domestic and foreign, where there is more than 50% common ownership. Section 41(f)(1) is often referred to as the "single taxpayer rule." The single taxpayer rule is also set forth in the Treasury Regulations under section 41. The Regulations, however, simply mirror the statutory language, and do not expand on or provide any further explanation of the rule.

Section 41(f)(1) has been in the Code, largely unchanged, since the research credit was first enacted in 1981. When the credit was first enacted, it was calculated based solely on a taxpayer's research expenses. Gross receipts did not become part of the calculation of the credit until 1989 when Congress amended the statute.

In 2002, IRS Chief Counsel issued CCA 200233011, which concluded that a US taxpayer's intercompany sales to its foreign CFCs are not included in the calculation of gross receipts for purposes of the research credit. This conclusion was seen as generally favorable for taxpayers. If a taxpayer's gross receipts increase year after year (a noble goal common amongst all business enterprises), excluding receipts from intercompany sales will generally result in a larger credit for the taxpayer.

In 2006, IRS Chief Counsel changed its mind. Specifically, IRS Chief Counsel issued CCA 200620023, which concluded that a US taxpayer's intercompany sales to its CFCs were included in the calculation of gross receipts for purposes of the research credit. The facts and legal analysis in CCA 200620023 are virtually identical to that of CCA 200233011. Stated differently, in CCA 200620023, the IRS Chief Counsel applied essentially the same legal authorities to the same question and reached the opposite conclusion. Thus, CCA 200620023 reflected a clear shift in position at least at IRS Chief Counsel.

The 2005-2006 IRS Priority Guidance Plan included the issue of whether intercompany sales between members of the same controlled group of corporations should be included or excluded. This issue has remained on the IRS' Priority Guidance Plan with no indication from the IRS as to when guidance will be issued.

As one might expect, since CCA 200620023, IRS Exam has been taking the position on audit that intercompany sales to foreign affiliates are included in the calculation of gross receipts. Many taxpayers have disagreed, and the issue has found its way to Appeals in a number of cases. Appeals has deemed the issue to be a significant one and has coordinated it across the country to offer uniform settlements to taxpayers.

At first, it was rumored that Appeals was requesting that taxpayers concede 50% – 65% of the intercompany gross receipts (i.e., taxpayers would include 50% - 65% of the intercompany gross receipts and the research credit would be calculated on that basis). Given the nuances of the research credit calculation, depending on a taxpayer's specific facts, a 50/50 settlement at the gross receipts level, for example, may or may not correspond to a 50% reduction in the taxpayer's research credit. In light of this, Appeals was rumored to change the model settlement to be calculated at the credit level.

These settlements were rumored to be set forth in Appeals Settlement Guidelines that were to be used by Appeals Officers to resolve the gross receipts issue. No taxpayer, however, had actually seen the settlement guidelines until they were finally released to the public on June 15, 2010, in redacted form (the "ASG"). See *Appeals Settlement Guidelines: Intra-Group Receipts from Foreign Affiliates*, June 15, 2010, available at TaxAnalysts, doc. 2010-13299. The ASG is 35 pages long and describes in detail the gross receipts issue, including the relevant arguments put forth by both taxpayers and IRS Exam. Appeals, however, redacted the entire section of ASG that sets forth how an Appeals Officer is to settle the issue. So the ASG does not address the prior rumored model settlements, and it also does not provide much insight into Appeals' thinking on the issue.

The P&G Decision

In a case of first impression as part of a refund suit brought by the Proctor & Gamble Company ("P&G"), the US District Court for the Southern District of Ohio held on June 25, 2010, in *Proctor & Gamble Co. v. US*, Case No. 1:08-cv-00608 (June 25, 2010) that "gross receipts" do not include a company's intercompany sales to its CFCs.

P&G was the parent of an affiliated group of corporations that engaged in the sale of well-known consumer products throughout the world. During its 2001-2005 tax years, P&G's domestic and foreign subsidiary corporations regularly engaged in intercompany transactions with one another. P&G excluded these dealings from gross receipts when calculating its research credit for these tax years. The IRS examination team issued a written determination on August 29, 2005, concluding that P&G's calculation of the research credit was proper.

This, of course, was before CCA 20060023 was issued. Soon after CCA 20060023 was issued, the IRS examination team sent a notice of proposed adjustment to P&G, which stated that intercompany transactions with foreign members of P&G's controlled group should no longer be excluded from gross

receipts for purposes of calculating the research credit. The notice of proposed adjustment, however, did not affect the taxpayer's treatment of intercompany sales to its domestic subsidiaries. P&G paid the additional tax that resulted from the IRS redetermination of its research credit and brought a refund action in the Southern District of Ohio to recover what it believed was an overpayment of tax.

The gross receipts issue was brought before the District Court on a motion for partial summary judgment. The court held that the plain language of the statute (*i.e.*, the single taxpayer rule in section 41(f)(1)) and the Treasury Regulations were clear – all members of a controlled group of corporations are to be treated as a single taxpayer. Therefore, transactions between members must be disregarded.

In reaching this conclusion, the court rejected the IRS' argument that the single taxpayer rule applies only for purposes of determining research expenses. The IRS made this argument because the heading of section 41(f)(1) is "Aggregation of Expenditures." The court reasoned that this heading was a vestige of the research credit as originally enacted in 1981, when the credit was calculated based solely on expenditures, and that the heading of the section could not limit the plain language of the statute itself.

The court also held that the IRS had no principled basis for distinguishing between intercompany transactions with foreign and domestic subsidiaries. The court found that the provision was designed to exclude sales that do not represent sales to a taxpayer's customers and serve only legal or administrative purposes. Failing to exclude such transactions could result in double or triple counting of transfers. Because the location of the subsidiary had no impact on this result, the court found the distinction unpersuasive.

Because the court held that the plain language of the statute and Regulation were sufficient to find for P&G, it could have stopped there, but it didn't. The court went on to reason that the legislative history of section 41 also supported P&G's position. The court stated that the gross receipts component of the research credit was added because businesses typically determine their research budgets as a percentage of their gross receipts. Thus, the intent of the research credit was to reward expenditures by measuring the expenditures against a relevant metric: gross receipts. The court noted that businesses do not typically include intercompany sales receipts in this measure, and thus to do so would be to introduce an element unrelated to the research expenditure decision making process and the credit's incentive effect.

Finally, the court dismissed the two cases the IRS cited to support its position. The court found that *Deere & Co. v. Comm'r*, 133 T.C. 11 (2009) was not directly relevant because it pertained to international sales to third parties by a foreign branch, not international intercompany sales. The court also stated that *Union Carbide Corp. v. Comm'r*, T.C.M. 2009-50 had little bearing on the gross receipts issue because that case was based on the specific and unique method of accounting provisions of section 41(c)(4) – not the single taxpayer rule in section 41(f).

Ultimately, the court's holding provides welcome guidance on the gross receipts issue and a favorable answer for taxpayers that have not already resolved their research credit cases. It should be noted that at the time of publication, the writers understand that Appeals is considering whether to revise the ASG in light

of the P&G case. It is also unclear at this time whether the IRS will file an appeal in the P&G case. Thus, only time will tell as to the true importance of Judge Black's ruling. However, in the ongoing battle between taxpayers and the IRS, this round goes to the taxpayer.

By Todd A. Schroeder and Stephen W. Long, Dallas

Special "Split-Waiver" Election Permits Five-Year Carryback Without Forfeiting NOLs to Former Consolidated Group—Calendar Year Taxpayers Have Until September 15, 2010 to Take Advantage of the New Rules

In contrast to 2008 and 2009, tax years 2003 through 2005 were profitable for many businesses. Yet, under normal rules net operating losses ("NOLs") sustained in the current economic downturn could not be carried back to offset taxable income in such earlier years. As a fiscal stimulus to businesses, Congress sought in 2009 to extend the NOL carryback period to these earlier years. Unfortunately, for some consolidated groups which had acquired new members during the extended carryback period the benefit of the five-year carryback came at the expense of forfeiting NOLs to the "target's" former consolidated group. As discussed in more detail in this article, on June 22, 2010, Treasury and IRS eliminated this disincentive by issuing Temp. Reg. § 1.1502-21T(b)(3)(ii)(C) ("Temporary Regulation"), effectively extending the stimulus measure to additional taxpayers. T.D. 9490, 2010-31 I.R.B. 176. Affected calendar year consolidated groups have until September 15, 2010, to take advantage of the new rules.

The American Recovery and Reinvestment Act of 2009 (February 17, 2009) ("ARRA") amended Code Section 172(b)(1)(H) to allow eligible small businesses ("ESBs") to carry back their 2008 NOLs for up to five years. The measure had limited reach, however, because it applied only to businesses with \$15 million or less in gross receipts. The second stimulus measure passed in 2009 had much broader application. The Worker, Homeownership, and Business Assistance Act of 2009 (November 6, 2009) ("WHBAA"), granted the five-, four- or three-year NOL carryback period to businesses of *any* size ("Extended Carryback Period"). (WHBAA also allowed life insurance companies to elect to carry back an applicable loss from operations for either four or five tax years). The IRS issued helpful guidance under section 172(b)(1)(H) in Revenue Procedure 2009-52, 2009-49 I.R.B. 744, but many consolidated groups may find that the Temporary Regulation, holds the real key to unlocking the benefits of section 172(b)(1)(H). For instance, in the absence of the Temporary Regulation, electing under section 172(b)(1)(H) could mean that a recently acquired member's *former* consolidated group would benefit from the NOL carryback. The following discussion examines the section 172(b)(1)(H) election under WHBAA and its application under the Temporary Regulation to taxpayers filing consolidated returns.

Generally, section 172(a) allows a deduction for NOL carryovers and carrybacks. An NOL is the amount by which deductions exceed gross income, with modifications. Sections 172(c) and (d). Under the general rule, taxpayers can carry back an NOL to each of the two tax years preceding the loss year or carry over the NOL to each of the 20 tax years following the loss year. Section 172(b).

Any taxpayer can also elect to relinquish the carryback period and only carry over its NOLs. Normally, this election is irrevocable.

Different NOL carryback and carryover periods can apply to losses incurred during specified periods of time. For example, NOLs that arose in a tax year ending in 2001 or 2002 can be carried back for five years instead of the normal two. Similarly, both ARRA and WHBAA extended the carryback period available to electing taxpayers. Unlike the election under ARRA, the section 172(b)(1)(H) election under WHBAA is not limited to small businesses. WHBAA also allows taxpayers to select the source year of the NOL as any one tax year ending after December 31, 2007, and beginning before January 1, 2010—i.e., either tax year 2008 or 2009 for calendar year taxpayers. Importantly, however, the WHBAA election generally is not available to TARP recipients or to any taxpayer that was a member of the TARP recipient's affiliated group during 2008 or 2009. The WHBAA amendments to section 172(b)(1)(H) superseded those made by ARRA. However, an ESB taxpayer that made an ARRA election is permitted to make a WHBAA election for another tax year. Section 172(b)(1)(H)(v). For example, a calendar year ESB taxpayer which elected to carry back a 2008 NOL under ARRA may now also elect to carry back a 2009 NOL.

The WHBAA election must be made no later than the extended due date for filing the return for the last tax year beginning in 2009, whether the taxpayer selects 2008 or 2009 as the source year for the NOL. Taxpayers who filed their 2009 tax return on time without making the election, have an additional six months from the normal due date of the 2009 tax return to make the election. In effect, calendar year taxpayers have until the extended due date of their return, September 15, 2010, to elect. The election is irrevocable and, in general, may be made for only one tax year.

WHBAA introduced a limitation on the carryback election, not present under ARRA, in the event of an NOL carryback to the fifth year preceding the loss year. In such a case, WHBAA limits the amount of an NOL that a taxpayer may carry back to 50 percent of taxable income for the carryback year. Section 172(b)(1)(H)(iv). The taxable income for the carryback year is computed without regard to the NOL for the loss year or any taxable year thereafter. Any NOL from the loss year in excess of the 50 percent limitation remains available for carryback and carryover to other tax years. A similar rule applies for alternative minimum tax purposes. Specifically, the carryback of an alternative tax NOL to the fifth tax year preceding the loss year is limited to 50 percent of alternative minimum taxable income ("AMTI").

A taxpayer that has elected to forgo the carryback of a loss for a taxable year ending before the date of enactment of WHBAA (i.e., November 6, 2009) may revoke that election before the extended due date of the taxpayer's 2009 tax return. WHBAA, Section 13(e)(4).

The carryback of NOLs by consolidated groups presents unique issues. For instance, when a group member ("New Member") is responsible for incurring a portion of the consolidated NOL ("CNOL") that is then carried back to a year in which such member was part of another consolidated group, the tax benefit of the carryback inures to the former consolidated group. Existing regulations address this issue by permitting a so-called "split-waiver" election pursuant to which the consolidated group can partially forego the carryback of the CNOL. The split-waiver permits the carry back of the CNOL to pre-acquisition years, while

preserving the portion of the CNOL attributable to the New Member for carryback and carryover to post-acquisition years. At the time it is made, the split-waiver election must be made for all future CNOLs attributable to the New Member. The waiver of the carryback applies to the portion of the carryback period during which the member was a member of another group. Treas. Reg. § 1.1502-21(b)(3)(ii)(B). If a split-waiver election is made for a New Member, the election must also be made for any other corporation joining the consolidated group that was affiliated with the New Member immediately before it joined the group. The split-waiver election ordinarily must be made with the original return for the year during which the member joined the consolidated group. For example, absent discretionary relief from the IRS under Treas. Reg. § 301.9100, a split-waiver election could not now be made for a member that joined a calendar year consolidated group before 2009.

For this reason, consolidated groups may have found the section 172(b)(1)(H) election unattractive. That is, if the CNOL to be carried back three, four or five years was attributable to a New Member and would be carried back to a pre-acquisition year, without the availability of the split-waiver election, the benefit of the Extended Carryback Period might well be forfeited to the former consolidated group. (It should be noted that, even if in effect, a tax sharing agreement with the former consolidated group may not provide adequate compensation for the forfeited CNOL). This result loomed over the section 172(b)(1)(H) election especially given that Rev. Proc. 2009-52 warned taxpayers, “nothing in this revenue procedure permits a consolidated return group to otherwise *make* or *revoke* a carryback waiver election for the CNOL attributable to a member acquired from another group....” (Emphasis added).

Fortunately, Temp. Reg. § 1.1502-21T(b)(3)(ii)(C) makes a split-waiver election available to any consolidated group that avails itself of the section 172(b)(1)(H) election (“Special Split-Waiver Election”). Under the Temporary Regulation, a consolidated group may forego carryback of the New Member’s portion of the CNOL (a) to the three years of the Extended Carryback Period comprising the fifth, fourth and third years preceding the loss year or (b) to all of the five years preceding the loss year. Unlike the regular split-waiver election, which must be made for all future CNOLs attributable to the New Member, the Special Split-Waiver Election applies only to a group’s CNOL for the single tax year covered by the section 172(b)(1)(H) election. For example, assume that a calendar year consolidated group will carry back a 2009 CNOL to 2004. Assume further that the New Member was a member of another consolidated group in 2004, 2005, and 2006. Under the Temporary Regulation, the consolidated group is permitted to waive carryback of the New Member’s portion of the 2009 CNOL to 2004, 2005 and 2006, and still carry back such portion to 2007 and 2008. Alternatively, the consolidated group may waive carryback of the New Member’s portion of the 2009 CNOL entirely and opt only for its carryover. Calendar year taxpayers have until September 15, 2010, to make the Special Split-Waiver Election—the same due date as applies to the section 172(b)(1)(H) election itself.

Once made, the section 172(b)(1)(H) election is irrevocable. Therefore, in addition to taking into account any New Member acquisitions during the Extended Carryback Period, taxpayers should carefully consider several issues that may bear on the net tax benefits to be realized.

For instance, NOLs are generally used before foreign tax credits (“FTCs”). Carrying back NOLs therefore may release FTCs that were otherwise used to shelter the taxpayer’s foreign source income. FTCs have a ten-year life and may expire unused. Furthermore, although the taxpayer may have had sufficient foreign source income in the carryback years to utilize the FTCs, there is of course no guarantee that foreign source income will be available in the FTC carryover period. The FTCs therefore may have limited use in the future.

In addition, certain deductions are limited to a percentage of taxable income (e.g., deductions for charitable contributions under section 170 and for domestic production activities under section 199). Carrying back NOLs may therefore reduce the tax deductibility of such items. If the amount of the expense exceeds the applicable limitation and the excess may be carried forward indefinitely, the NOL carryback may not be a significant issue. If on the other hand the excess deduction is not eligible to be carried forward the carryback of an NOL may be detrimental.

Since late 2009, an extended NOL carryback period has been available broadly to taxpayers ranging in size from small businesses to large multinational corporations. The Temporary Regulation issued in June 2010 further liberalizes the carryback rules to the advantage of taxpayers filing consolidated returns. Nevertheless, the decision to elect under section 172(b)(1)(H) should be considered carefully. Consolidated groups should evaluate whether the Special Split-Waiver Election will adequately protect post-acquisition CNOLs against forfeiture to unrelated groups. Because the section 172(b)(1)(H) election has the potential to free up, as well as limit, other tax attributes in the carryback period, the post-election tax effect of those attributes should be taken into account. Undoubtedly, however, the section 172(b)(1)(H) election will produce net benefits to taxpayers with the right facts. Calendar year taxpayers must bring their fact finding to a close by September 15, 2010.

By Andrew T. Szymulanski, Chicago

Notice Outlines Forthcoming Entity Classification Regulations to Target Domestic Partnership Blocker Structures

On May 14, 2010, the IRS issued Notice 2010-41 (the “Notice”) to address certain domestic partnership blocker transactions that it first identified as transactions of interest almost two years ago in Notice 2009-7. The targeted structure involves a US taxpayer (“Taxpayer”) that wholly owns two or more controlled foreign corporations (“CFCs”). Collectively, the wholly owned CFCs own a domestic partnership that owns another CFC (“CFC3”). Taxpayer takes the position that it does not have any income inclusion under Code section 951(a)(1) with respect to CFC3’s Subpart F income because the domestic partnership is the first United States person in the chain of ownership of CFC3. As a technical matter, the domestic partnership is a US shareholder that must recognize the Subpart F income, but the domestic partnership is not itself a US taxpayer and all of its partners are foreign persons that do not recognize any of CFC3’s Subpart F income.

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Under section 951, as a technical matter, the first US shareholder in a chain of ownership that includes a CFC picks up any Subpart F income of the underlying CFC. The IRS applies the definition of US shareholder in section 951 literally so that a domestic partnership is treated as a US shareholder even though it is not a US taxpayer. These rules were intended to avoid double inclusions of Subpart F income by US shareholders, but they fail to yield a sensible result in this context. By contrast, if the partnership were foreign, the attribution rules of Code Section 958 would apply to look through the foreign partnership and its foreign partners to attribute underlying Subpart F income to the ultimate US shareholder(s).

Even before the IRS identified the domestic partnership blocker as a transaction of interest, many practitioners took the view that such blocker structures did not work or that such structures should only work in the rare cases where the domestic partnership has a non-tax business purpose. In the Notice, the IRS concedes that the domestic partnership blocker structure works, as a technical matter, under section 951. Nevertheless the IRS states that it will issue regulations to change the technical result because the result is “manifestly incompatible” with the intent of Subpart F.

Specifically, Treasury plans to issue regulations pursuant to its authority under Code Section 7701(a)(4) to classify certain partnerships as domestic or foreign for US tax purposes. According to the Notice, the future regulations will treat a domestic partnership as a foreign partnership for purposes of identifying the US shareholders of a CFC required to include in income the Subpart F income of the CFC. The regulations would reclassify a domestic partnership as foreign only when the following conditions are met: (1) the partnership is a US shareholder of a CFC and (2) if the partnership were treated as foreign (a) the CFC would continue to be classified as a CFC and (b) at least one US shareholder of the CFC (i) would be treated under section 958(a) as indirectly owning stock of the CFC owned by the partnership that is indirectly owned by a foreign corporation and (ii) would be required to include an amount in gross income under section 951(a) with respect to the CFC. Importantly, the IRS will treat a domestic partnership reclassified as a foreign partnership under the Notice and forthcoming regulations as a foreign partnership solely for purposes of identifying the US shareholders that will be required to include in their income the Subpart F income of the underlying CFC.

Treasury’s decision to approach the perceived abuse by way of entity classification regulations surprised many practitioners as an awkward and counterintuitive approach to address a loophole in the Subpart F rules. In particular, the IRS could have targeted the abuse more directly and intuitively under partnership tax law. For example, the IRS could have proposed regulations that would preserve the character of the underlying CFC’s income as it flows through the US partnership to its partners. Under such an approach, each partner’s distributive share of the partnership’s income attributable to Subpart F income of CFC3 could flow through to the CFC partners as Subpart F income in the CFCs’ hands under Code Section 702. Alternatively, the IRS could have approached the problem from a partnership anti-abuse perspective, treating the partnership as an aggregate, because a domestic partnership with the sole purpose to absorb Subpart F income that would otherwise flow up to one or more US shareholders could be viewed as violating long-standing partnership anti-abuse provisions. As such, the IRS could have chosen to attack this structure under existing anti-abuse rules and treat the domestic partnership as an aggregate for US tax purposes.

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Not only does the approach proposed in the Notice introduce an awkward classification rule that fails to address the intuitive problem with the current technical result the approach also treats US taxpayers inconsistently depending on whether they hold indirect or direct interests in the domestic partnership that owns a CFC. For example, most practitioners have taken the view that all US partners in a domestic partnership that owns a CFC, regardless of how small their interests in the domestic partnership or how small their beneficial interests in the underlying CFC, must recognize their distributable share of any Subpart F income that flows through the domestic partnership from the CFC. By contrast, if the Notice applies to reclassify a domestic partnership as foreign, only US persons with a 10% or greater interest in the underlying CFC must recognize Subpart F income. The inconsistent result does not have any clear policy basis and invites taxpayers to engage in further tax planning in connection with partnership structures that involve flow-through Subpart F income.

Practitioners have widely criticized the approach of the Notice. Nevertheless, for now, taxpayers must assume that the IRS will follow through on issuing the regulations outlined in the Notice, rather than developing some alternative anti-abuse provision. Taxpayers will have to wait for the regulations to learn the details of the reclassification rules, but taxpayers should expect the forthcoming regulations to apply to reclassify certain domestic partnerships as foreign partnerships for all tax years of partnerships ending on or after May 14, 2010.

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