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## IRS Addresses Relationship Among Section 338, Section 368 and Step Transaction Doctrine With Respect to Multi-Step Acquisition

Rev. Rul. 2008-25, 2008-21 I.R.B. 986, is the latest chapter in the continuing story of the interaction of the reorganization provisions under Code Section 368, the qualified stock purchase provisions under section 338, and the step transaction doctrine under US federal income tax law. That story picks up, in relevant part, with the case of *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5<sup>th</sup> Cir. 1951), *cert. denied*, 342 U.S. 827 (1951) in which the court held that the purchase of stock of a target corporation for purposes of obtaining its assets through a prompt liquidation should, though consisting of two separate steps, be treated as one transaction constituting a purchase of the target corporation's assets (hereafter, the "Kimbell-Diamond doctrine"). Congress subsequently enacted section 338 in 1982 with the intention that section 338 "replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine." H.R. Conf. Rep. No. 760, 97<sup>th</sup> Cong., 2d Sess. 536 (1982).

In Rev. Rul. 90-95, 1990-2 C.B. 67, the IRS refused to apply the step transaction doctrine to treat the all-cash merger of a newly formed wholly owned subsidiary corporation into a target corporation followed by the immediate merger of the target corporation into the parent corporation of the merged subsidiary as a purchase by the parent corporation of the target corporation's assets. Instead, the separate steps of the transaction were treated as a qualified stock purchase under section 338 followed by a liquidation under section 332 because of Congress' intent that section 338 replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine. The approach outlined in Rev. Rul. 90-95 was also incorporated in Treas. Reg. § 1.338-3(d). The holding in Rev. Rul. 90-95 as incorporated in Treas. Reg. § 1.338-3(d) stands in contrast to the holding in Rev. Rul. 67-274, 1967-2 C.B. 141, issued prior to the enactment of section 338. There, the IRS applied the step transaction doctrine to treat the acquisition of all of the stock of a target corporation solely in exchange for voting stock of the acquiring corporation followed by the immediate liquidation of the target corporation into the acquiring corporation as a single transaction constituting a reorganization described in section 368(a)(1)(C).

In Rev. Rul. 2001-46, 2001-2 C.B. 321, the IRS attempted to reconcile the apparently conflicting positions taken with respect to the application of the step transaction doctrine in Rev. Rul. 67-274 and Rev. Rul. 90-95. Rev. Rul. 2001-46 involved the merger (the

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“Merger”) of a newly formed wholly owned subsidiary corporation into a target corporation, with the target’s shareholders receiving 70% voting stock of the corporation controlling the merger subsidiary and 30% cash, followed by the immediate merger (the “Upstream Merger”) of the target corporation into the controlling corporation of the merged subsidiary. Standing alone, the Merger would not have qualified as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E) because the target’s shareholder did not exchange 80% of the stock of the target corporation for voting stock of the controlling corporation. As a result, the Merger could arguably be treated as a qualified stock purchase under section 338 and the Upstream Merger as a separate transaction that constituted a liquidation under section 332. However, if the step transaction doctrine were applied, the Merger and the Upstream Merger would be treated as an acquisition of the target corporation’s assets through a single statutory merger of the target corporation into the controlling corporation that qualifies as a reorganization under section 368(a)(1)(A) (without regard to section 368(a)(2)(E)). The IRS ruled that, because the controlling corporation would take a carryover basis in the target corporation’s assets under section 362 in such instance (rather than a cost basis under section 1012), the policy underlying section 338 would not be violated and the step transaction doctrine should apply.

In Rev. Rul. 2008-25, a newly formed wholly owned subsidiary corporation merged into a target corporation (the “Acquisition Merger”), with the target corporation’s shareholders receiving voting stock of the corporation controlling the merger subsidiary worth \$90X and \$10X of cash, followed by the immediate liquidation (the “Liquidation”) of the target corporation into the parent corporation of the merged subsidiary. Prior to the transactions described above, the target corporation had assets worth \$150X and \$50X of liabilities. In determining whether the step transaction doctrine should be applied to treat the Acquisition Merger and the Liquidation as a single integrated transaction, the IRS first evaluated whether that single integrated transaction could constitute a reorganization within the meaning of section 368 in which the controlling corporation would take carryover basis in the target corporation’s assets under section 362.

The IRS noted that if the Acquisition Merger and the Liquidation were treated independently of each other, the Acquisition Merger would qualify as a reorganization within the meaning of section 368(a)(1)(A) by virtue of section 368(a)(2)(E) and the Liquidation would be treated as a separate transaction constituting a liquidation under section 332. However, it also noted that Treas. Reg. § 1.368-1(a) required that a transaction be evaluated under the relevant provision of law, including the step transaction doctrine and that a liquidating distribution of the target corporation’s assets was not within the safe harbor of Treas. Reg. § 1.368-2(k), which generally allows the transfer of assets or stock following a reorganization. Consequently, the IRS concluded that the Acquisition Merger could not qualify as a reorganization described in section 368(a)(1)(A) by virtue of section 368(a)(2)(E) because the latter provision requires the target corporation to afterwards hold substantially all of its properties and those of the merged subsidiary and the Liquidation prevented this from being true.

On the other hand, the IRS noted that if the Acquisition Merger and the Liquidation were treated as a single integrated transaction in which the controlling corporation directly acquired the assets of the target corporation, that single integrated transaction could not qualify as a reorganization within the meaning of section 368(a)(1)(C) (and thus differed from the transaction described in Rev. Rul. 67-274). This is because, pursuant to section 368(a)(2)(B), the controlling corporation would be treated as acquiring the assets of the target corporation for both the liabilities assumed of \$50X and the \$10X of cash received and, therefore, less than 80% of such assets would be considered acquired solely for voting stock of the controlling corporation as required by section 368(a)(2)(B). In addition, the single integrated transaction could not constitute a reorganization within the meaning of section 368(a)(1)(D) because neither the target corporation nor its

shareholder controlled the controlling corporation immediately after the asset transfer. Furthermore, the single integrated transaction could not constitute a reorganization within the meaning of section 368(a)(1)(A) (and thus differed from the transaction described in Rev. Rul. 2001-46) because the target corporation did not merge into the controlling corporation under any relevant statute but instead liquidated. Finally, the controlling corporation's acquisition of the target corporation's stock in the Acquisition Merger could not qualify as a transaction governed by section 351 because the shareholder of the target corporation did not control the controlling corporation immediately after the exchange.

Based on the foregoing, the IRS noted that if the Acquisition Merger and the Liquidation were treated as a single integrated transaction under the step transaction doctrine, such transaction would not qualify as a reorganization under section 368 (or a section 351 transaction) and, therefore, the controlling corporation would take a cost basis in the target corporation's assets under section 1012 rather than a carryover basis under section 362. The IRS then noted that such a result would be contrary to the policy that section 338 replace any nonstatutory treatment of a stock purchase as an asset purchase. Consequently, the IRS analyzed the Acquisition Merger and Liquidation separately (and consistent with Rev. Rul. 90-95) and concluded that the Acquisition Merger constituted a qualified stock purchase within the meaning of section 338 (because it was not an exchange of stock to which section 351, section 354, section 355 or section 356 applied) and the Liquidation constituted a liquidation under section 332.

The IRS arguably reached two inconsistent conclusions regarding the application of the step transaction doctrine in Rev. Rul. 2008-25. It first concluded that neither the Acquisition Merger itself nor the Acquisition Merger integrated with the Liquidation constituted a valid reorganization within the meaning of section 368 because the step transaction doctrine applied. The IRS then, inconsistently, concluded that the Acquisition Merger and the Liquidation constituted a qualified stock purchase under section 338 followed by a section 332 liquidation, and not a direct acquisition of the target corporation's assets by the controlling corporation, because the step transaction doctrine did not apply. Despite the inconsistency, Rev. Rul. 2008-25 does seem to set forth a somewhat linear process for determining whether a transaction involving two or more steps constitutes a reorganization and, if not, whether it constitutes a qualified stock purchase (followed by some other transaction). In addition, it suggests a means (i.e., actual or deemed liquidation of the target corporation) to achieve a qualified stock purchase under section 338 with respect to a transaction that might otherwise qualify as a reorganization within the meaning of section 368(a)(1)(A) by virtue of section 368(a)(2)(E) under certain factual circumstances and thus should be of interest to both taxpayers on both sides of a particular transaction.

*By Thomas R. May, Washington, DC*

## Post-Reorganization Assets and Stock Transfer Regulations Revised

In T.D. 9396, 73 Fed. Reg. 26322 (May 9, 2008), the IRS revised Treas. Reg. § 1.368-2(k) to make certain clarifying amendments to the previous final regulations (as revised, the "2008 Regulations") regarding the effect of a post-transaction transfer of assets or stock on the qualification of such transaction as a reorganization under Code Section 368(a). The IRS previously issued T.D. 9361, 72 Fed. Reg. 60552 (Oct. 25, 2007), containing final regulations (the "2007 Regulations") addressing the impact of a post-transaction transfer on the continuity of business enterprise ("COBE") requirement and which persons continued to be considered parties to a reorganization despite such a

transfer. The 2007 Regulations were significant in that they expanded the instances in which the transfer, either by way of distribution or other transfer, of the target or acquiring corporation's stock or assets following a transaction that otherwise qualified as a reorganization would not, provided the COBE requirement was satisfied, disqualify the transaction as such under the "remote continuity" doctrine associated with the Supreme Court's decisions in *Groman v. Commissioner*, 302 U.S. 82 (1937) and *Helvering v. Bashford*, 302 U.S. 454 (1938).

The 2008 Regulations retain the general principles enunciated in the 2007 Regulations but restrict their application in instances where the transfer is to the former shareholders of the target corporation in consideration for their proprietary interests in such corporation. Treas. Reg. § 1.368-2(k)(1) of the 2008 Regulations provides that a transaction otherwise qualifying as a reorganization will not be prevented from qualifying as such, or be recharacterized under general principles of Federal income tax law (including the step transaction doctrine) merely because there is a subsequent transfer (or successive subsequent transfers) of assets or stock if the transaction satisfies the COBE requirements of Treas. Reg. § 1.368-1(d) and the transfer is described in Treas. Reg. § 1.368-2(k)(1). Thus, as recognized in Rev. Rul. 2008-25, 2008-21 I.R.B. 986, Treas. Reg. § 1.368-2(k)(1) provides a "safe harbor" for post-reorganization transfers, including distributions or other transfers, of the assets or stock of the acquiring corporation or target corporation.

However, unlike the 2007 Regulations, the 2008 Regulations provide that the safe harbor will not apply to a transfer of stock or assets to the former shareholders of the target corporation to the extent it constitutes consideration for a proprietary interest in the target corporation. The preamble to the 2008 Regulations points out that the safe harbor should be unavailable in such instance because it might, for example, allow a transaction that failed the continuity of interest requirement of Treas. Reg. § 1.368-1(e) or violated the "solely for voting stock" requirement in section 368(a)(1)(B) or (C) (because of the stock or assets transferred to the target's shareholders) to nevertheless qualify as a section 368 reorganization. The safe harbor continues to be available (assuming its requirements are met) with respect to transfers to the former shareholders of the target corporation, such as certain pro-rata dividend distributions by the acquiring corporation, which do not constitute consideration for such shareholders' proprietary interests in the target corporation. In addition, the safe harbor continues to be available (assuming its requirements are met) with respect to a transfer of target stock or assets to a former shareholder of the target corporation that is the acquiring corporation in the reorganization.

Treas. Reg. § 1.368-2(k)(1) of the 2008 Regulations also provides that the safe harbor does not apply to a transfer by the former shareholders of the target corporation of consideration initially received in the potential reorganization to the issuing corporation or a person related to the issuing corporation. For these purposes, the term "related party" has the same meaning as in the continuity of interest rules under Treas. Reg. § 1.368-1(e)(1) and (4). It appears that making the safe harbor unavailable in this situation was also intended to prevent a transaction in which the continuity of interest requirement of Treas. Reg. § 1.368-1(e) or a solely for voting stock requirement was violated because, for example, the target corporation's former shareholders transfer the stock of an acquiring corporation which is also an issuing corporation that they received in the reorganization back to the issuing corporation or to a party related to the issuing corporation. The safe harbor continues to be available (assuming its requirements are met) if the former target shareholder is also the acquiring corporation in the reorganization.

The 2008 Regulations also make certain clarifying amendments to the 2007 Regulations including that a distribution to shareholders of stock or assets of the acquiring corporation or the target corporation is covered, if at all, only by the safe harbor rules applicable to

distributions and cannot be considered an “other transfer” for purposes of applying the safe harbor. The 2008 Regulations also clarify that the “termination of corporate existence” which makes the safe harbor unavailable in the case of an “other transfer” refers to the termination of such corporation’s corporate existence for US federal income tax purposes in connection with the transfer.

The 2008 Regulations apply to transactions occurring on or after May 9, 2008 (subject to a binding commitment exception).

*By Thomas R. May, Washington, DC*

## IRS Finalizes Rules Eliminating Asset Exception to Section 358(h) Basis Reduction

In T.D. 9397, 73 Fed. Reg. 26321 (May 9, 2008), the IRS issued Treas. Reg. § 1.358-5 finalizing temporary regulations (with no change) making the Code Section 358(h)(2)(B) “asset exception” unavailable for exchanges occurring on or after June 24, 2003 where certain obligations and liabilities of the transferor are assumed in the exchange.

Congress enacted section 358(h) to address certain transactions in which taxpayers could recognize a loss by transferring property to a corporation in exchange for stock and the transferee corporation’s assumption of the transferor’s contingent obligations or liabilities described in section 357(c)(3). In such transactions, the transferor would take the position, under section 358(a)(1), that its basis in the transferee corporation’s shares equaled the basis of the property (e.g., a promissory note) it transferred to the transferee corporation. In addition, the transferor would take the position that it was not required to treat the assumption of contingent obligations of the transferor as money received under section 358(d) because such obligations were not “liabilities” for purposes of section 358. Similarly, under section 358(d)(2), liabilities described in section 357(c)(3) are not required to be treated as money received. While not resulting in a reduction in basis in the shares of the transferee corporation under section 358(a)(1)(A)(ii), these contingent obligations and liabilities described in section 357(c)(3) reduced the value of such shares which could then be sold for a loss. *See, e.g., Coltec Industries v. United States*, 454 F.3d 1340 (Fed. Cir. 2006); *The Black & Decker Corp. v. United States*, 436 F.3d 431 (4<sup>th</sup> Cir. 2006).

Under section 358(h)(1), if the basis of property (e.g., shares in the transferee corporation) received in an exchange described in section 351, section 354, section 355, section 356 or section 361 exceeds its fair market value, such basis is reduced (but not below fair market value) by the amount of any liability which is assumed by another person as part of the exchange (and which is not already treated as money received under section 358(d)(1)). However, for purposes of section 358(h), the term “liability” is defined broadly by section 358(h)(3) to include any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for US federal tax purposes. Thus, contingent obligations and liabilities described in section 357(c)(3) assumed by the transferee corporation will reduce the basis of the transferee corporation’s stock in the hands of the transferor under section 358 to the extent there would otherwise be an excess of the basis of such stock over its fair market value.

Section 358(h)(2) provides that, except as provided by the Secretary, two exceptions to the general rule of section 358(h)(1) requiring basis reduction may apply. The first exception described in section 358(h)(2)(A) applies when the trade or business with which the liability is associated is transferred to the person assuming the liability as part

of the exchange (the “Trade or Business Exception”). The second exception described in section 358(h)(2)(B) applies when substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange (the “Asset Exception”). The Trade or Business Exception and the Asset Exception were intended to obviate the need for valuation or basis reduction in cases to which the exceptions apply and were not intended to apply to the “selective transfer of assets that may bear some relationship to the liability, but that do not represent the full scope of the trade or business,[sic] (or substantially all the assets) with which the liability is associated.” H. Conf. Rept. No. 106-1033 at 1018 (2000). Based on the prefatory language of section 358(h)(2), the Secretary has the authority to limit the application of either exception. Citing concerns of abuse, on May 26, 2005, in T.D. 9207, 70 Fed. Reg. 30334 (May 26, 2005), the IRS issued Temp. Treas. Reg. § 1.358-5T, which provided that the Asset Exception would not apply to exchanges under section 358(a)(1) in which liabilities are assumed on or after June 24, 2003.

As finalized, Treas. Reg. § 1.358-5(a) provides that “Section 358(h)(2)(B) does not apply to an exchange occurring on or after May 9, 2008.” Treas. Reg. § 1.358-5(b) refers taxpayers to Treas. Reg. section 1.358-5T for exchanges occurring on or after June 24, 2003, and before May 9, 2008. The Treasury Department and IRS indicated that making the Asset Exception unavailable permanently was necessary to prevent abuse. Therefore, the reduction in basis required by section 358(h)(1) can be avoided only if the trade or business with which a liability is associated is transferred to the person assuming the liability under the Trade or Business Exception.

*By Thomas R. May, Washington, DC*

## Sala: Taxpayer Wins “Son of BOSS” Case . . . For Now

On April 22, 2008, the US District Court for the District of Colorado ruled in favor of the taxpayer in a so-called “Son of BOSS” case, involving transactions identical, or substantially similar, to those in Notice 2000-44. *Sala v. United States*, Dkt. No. 05-cv-0636 (D. Colo. Apr. 22, 2008). The taxpayer claimed a capital loss in excess of \$60 million from an investment program involving foreign currency options. Under the investment program, the investor made a minimum initial investment of \$500,000. If the investor believed that the initial investment was successful, the investor could continue to invest in the program by making an additional investment equal to at least 15% of the anticipated capital loss. The second investment was required to remain in the investment partnership through late 2000, when the partner’s interest in the partnership would be liquidated. If the investment partnership was profitable by the time of the liquidation, the investor was required to invest the proceeds in another partnership controlled by the investment manager for a minimum of five years.

The investment manager was an experienced foreign currency trader. The investment manager invested the funds of the investors in investments similar to those made by his other investment funds. There were several other investors in the same partnership as the taxpayer, and all but one of the other investors continued with the investment program through the full five year period. The investment manager had the investors invest through the partnership during the trial period so as to aggregate the investments and use the same trading account for the investments. Prior to the investment, the taxpayer investigated the investment manager’s past performance and his investment strategy.

The taxpayer set up an S corporation to hold his investment in the first investment partnership. The taxpayer contributed 24 foreign currency options, six groups of four options each, to the S corporation which then contributed them to the investment partnership. The taxpayer also contributed approximately \$9 million in cash to the investment partnership through the S corporation. On December 20, 2000, the investment partnership executed trades to acquire two options on foreign currencies. The trades settled on December 22, 2000, with the taxpayer's S corporation paying the amount due. On December 20, 2000, taxpayer's S corporation received a liquidating distribution from the investment partnership including the two options which the partnership acquired in the trade on December 20, 2000 and approximately \$8 million in cash.

The taxpayer through his S corporation recognized the \$60 million loss on the disposition of the two foreign currency options received in liquidation of the partnership interest. The taxpayer claimed the \$60 million loss based on a basis calculation that included the full purchase price of the 12 long foreign currency options and did not reduce the basis for the 12 short foreign currency options that were contributed to the S corporation and the partnership.

The court explained the issues presented as:

(1) whether the transactions creating Sala's 2000 tax loss constituted sham transactions; (2) whether Sala entered into the transactions creating his 2000 tax loss for profit; (3) whether the transactions creating Sala's 2000 tax loss, as executed, allowed the tax loss; (4) whether any allowable tax loss was rendered retroactively disallowed by 26 C.F.R. § 1.752-6; and (5) whether the Government is entitled to an offset of any excess interest payments made by Sala with an accuracy-related penalty. The second issue is an issue of fact. . . . The fourth issue is a question of law. The remaining issues are mixed questions of law and fact.

In a detailed opinion, the district court rejected every argument that the IRS offered. The court found a number of facts in favor of the taxpayer that supported his case. First, the court found that the "transaction" at issue was the entire five-year investment program. Second, the court found that the taxpayer entered into the transactions with a legitimate business purpose to earn a profit on the investment. Third, the court found that distribution of the executory contract to acquire the options was a distribution of property that retained the partnership interest basis. Fourth, the court found that the transactions were bona fide trades in foreign currencies options. Fifth, the court found that each step of the transaction had an independent business purpose.

In addition, the court resolved the legal and mixed question of law and fact in favor of the taxpayer. First, the court held that the proper basis for evaluation of the transaction was the entire investment program. Second, the court rejected the government's argument that the step transaction doctrine applied. Third, the court held that the transaction was not a sham in substance and did not lack economic substance. Fourth, the court held that the transactions were properly reported as a loss on the taxpayer's return, including the basis calculations for the S corporation stock, the investment partnership interest, and the property received in liquidation of the investment partnership.

Finally, the court invalidated the retroactive effect of Treas. Reg. § 1.752-6. In 2003, the IRS issued Treas. Reg. § 1.752-6 that stated contingent liabilities contributed to a partnership were liabilities that reduced the basis in the partnership interest and specifically addressed the situation described in Notice 2000-44. The 2003 regulations purported to overturn retroactively the holding in *Helmer v. Commissioner* that an option obligation held by a partnership was not a partnership liability under section 752. The IRS asserted that the new partnership regulation was authorized by the changes to section

358(h) enacted by Congress in 2000. The court held that the retroactive application of Treas. Reg. § 1.752-6 in the case was not supported by the statutory change to section 358(h) and was not promulgated to correct an abuse. The *Sala* court reached the same result with respect to the regulation as a Texas district court in *Klamath Strategic Investment Fund* and rejected the result reached in *Cemco Investors* by distinguishing that case.

*Sala* represents the IRS's first loss in a so-called "Son of BOSS" case. The IRS has vowed to appeal the result. The effect of the decision will turn on the final resolution of the case.

After the trial, the government filed a motion for a new trial on the basis that the investment advisor had recanted his deposition testimony. In a declaration under penalties of perjury, the investment advisor stated that his deposition testimony was misleading and untruthful, that tax savings were the motivation for the transaction, and that he was cooperating with the government in a criminal investigation into the transactions. The government had raised this issue prior to the trial when the government was informed that the investment advisor was negotiating a non-prosecution agreement with the US Attorney's office, but the court rejected the government's assertion because the evidence was not sufficient at that time. The government's motion for retrial and the declaration of the investment advisor undercut some of the court's key factual findings. The court has not yet ruled on this motion.

*By Robert S. Walton and Jenny A. Austin, Chicago*

## Legislation Impacting the Taxation of Internet Sellers: New York's Amazon Rule - Welcome to the Jungle

In an effort to increase revenues, New York recently amended its statute to expand the definition of out-of-state sellers required to collect New York sales tax. Implemented as part OO-1 of SB 6807-C/AB 9807-C, the amendment was colloquially referred to as the "Amazon Bill" prior to its enactment because it appeared to specifically target internet retailers such as Amazon.com. Not surprisingly, some impacted companies, including Amazon.com and Overstock.com, have already filed suit challenging the constitutionality of the new law.

In general, New York requires all "vendors" to collect and remit tax on sales made to New York customers. The Amazon Bill expands the statutory definition of "vendor" by providing that out-of-state sellers are presumed to be "vendors," and thus required to register and collect sales tax, if both of the following conditions are met: (1) the seller enters into an agreement with any New York resident representative, i.e., individual New York resident or legal entity doing business in New York, who directly or indirectly refers customers to the seller in exchange for a commission or other consideration; and (2) the seller's aggregate gross receipts from all New York referrals exceed \$10,000 in the past twelve months. N.Y. Tax Law section 1101(b)(8)(vi). The law provides that this statutory presumption may be rebutted if the out-of-state seller can establish that the New York resident representative(s) did not engage in any New York solicitation activity on behalf of the out-of-state seller that "would satisfy the nexus requirement of the United States Constitution."

The new definition specifies that referrals, for purposes of the presumption, include all referrals, “whether by a link on an internet website or otherwise.” As a result, an out-of-state business whose only connection with New York is through one or more New York resident representative(s) who provide a link to the out-of-state business’ website is presumed to be a “vendor,” and thus required to collect and remit tax on all its New York sales, provided the sales made through the New York links exceed the arbitrary \$10,000 threshold.

The New York State Department of Taxation and Finance (“Department”) recently issued administrative guidance addressing the statutory change and provides various examples of what activities conducted by New York resident representative are sufficient to create nexus for the out-of-state seller. As mentioned above, New York’s law is currently under attack in the courts. New York’s assertion that an in-state representative’s solicitation via an internet link is sufficient to create nexus for the out-of-state seller certainly pushes the boundaries of existing Commerce Clause jurisprudence. Many feel the law goes too far. Although the US Supreme Court has previously determined that certain solicitation activities of in-state representatives can create nexus for the out-of-state seller, *see e.g., Scripto, Tyler Pipe*, none of these cases has considered activities as tenuous as simply maintaining a link on the internet.

In addition to the more traditional jurisdictional/constitutional arguments, taxpayers also claim, and perhaps rightly so, that the law’s presumption effectively eliminates the substantial nexus requirement of the Commerce Clause and violates Due Process. As enacted, the presumption essentially creates a taxable until proven otherwise scenario, with no guidance and very little hope that the alternative can ever be established. By design, the law puts out-of-state sellers in a difficult spot. Those sellers satisfying the presumption are forced to register and collect tax unless they are confident they can produce sufficient evidence to rebut the presumption. The law provides absolutely no guidance regarding the type or amount of evidence necessary to do so. The out-of-state seller must establish what the New York representative did not do on its behalf. The task amounts to proving a negative, at best.

While the presumption became effective on April 28, 2008, out-of-state seller’s should be prepared for New York to assert that certain internet links maintained by New York resident representatives are sufficient to create nexus in prior periods. The state legislature teed this issue up by placing an amnesty-type provision in the language of the bill. More specifically, the bill expressly prohibits the Department from issuing past assessments against out-of-state sellers whose only contact with the state is through internet links maintained by New York residents, but only if the out-of-state seller registered and began collecting New York sales tax on or before June 1, 2008. In an effort to force compliance with the new law, those sellers who voluntarily registered with the Department on a prospective basis were given a free pass for past liabilities. Unfortunately, out-of-state sellers were given very little time to evaluate the new law and make a decision regarding amnesty.

As illustrated, several aspects of the New York law represent somewhat novel concepts. The fate of the new statute will ultimately be decided by the courts. Both state tax practitioners and government revenue officials are watching the progression of these cases carefully, as the outcome may signal a new frontier in state tax jurisprudence. However, in the interim the law remains on the books and until it is struck down or otherwise invalidated, out-of-state sellers deriving significant revenue from New York resident representatives need to carefully consider its application and ramifications.

*By Scott Brandman, John Paek, and Ryan Servais (Summer Associate), New York*

## Another Defeat for the IRS in its Pursuit of Tax Accrual Workpapers: *Regions Financial Corporation v. United States*

On the heels of the District of Rhode Island's decision in *Textron v. United States*, the IRS recently suffered its second defeat in its pursuit of tax accrual workpapers. In *Regions Financial Corporation v. United States*, the District Court for the Northern District of Alabama concluded that certain tax accrual workpapers withheld from the IRS in response to a summons were protected by the work product privilege and that Regions Financial Corporation ("Regions") did not waive the privilege by disclosing the documents to Ernst & Young ("E&Y"). Because Regions had engaged in two transactions that qualified as "listed transactions", the IRS sought copies of Regions' tax accrual workpapers. In April 2006, the IRS served a summons on E&Y, Regions' attest auditors, seeking the tax accrual workpapers. E&Y produced 260,000 pages of documents to the IRS, but Regions instructed E&Y to withhold twenty documents that related to a transaction Regions entered into in 2000 with the European Bank for Reconstruction and Development (the "Transaction").

The court reviewed the documents *in camera*. There were four documents that expressed opinions, evaluated legal theories, and analyzed possible IRS attacks on Regions' tax reporting of the Transaction. Three of these documents were created by Alston & Bird. The fourth document, which was created by partners at E&Y who were not involved in auditing Regions, reviewed and evaluated the Transaction and the Alston & Bird opinions. These documents were created at the request of Regions' general counsel who became involved in analyzing Regions' tax liabilities only if litigation was likely to result from a tax position. Regions gave E&Y the opinions with the understanding that E&Y would keep confidential all information it received concerning the Transaction. The other 16 documents discussed, quoted, or explained the first four and were created either by Regions or by E&Y.

The court laid out a four step analysis for whether a taxpayer must produce its tax accrual workpapers in response to an IRS summons. First, the court must address whether the summons is proper under the four-part test laid out in *United States v. Powell*. In this case, Regions did not contest whether the IRS summons was proper on its face. Second, the court must determine whether any of the documents are privileged. Third, if any of the documents are privileged, the court must address whether the privilege has been waived. Fourth, the court must determine if the IRS has overcome those privileges by showing substantial hardship.

In evaluating whether the documents were "prepared in anticipation of litigation", the court first addressed whether the "primary motivating purpose" test of the Fifth Circuit or the "because of litigation" test articulated by other circuits applies in the Eleventh Circuit. The IRS asserted that the "primary motivating purpose" test should apply and that the documents are not entitled to work product protection "because they would have been prepared, even in the absence of the prospect of litigation, to comply with Region's public reporting requirement." The taxpayer argued that the "because of litigation" test applied and that, were it not for the anticipated litigation, Regions would not have to worry about creating a tax reserve for the Transaction in the first place. Both Regions and the IRS argued that they were entitled to prevail regardless of which test the court applies.

The court did not find it necessary to decide how the Eleventh Circuit would resolve the "primary motivating purpose" or "because of litigation" issue. Rather, the court concluded that, in this case, the result was the same regardless of which test applied. Nevertheless, the court stated, "if it were forced to decide the question, the court

concludes that the Eleventh Circuit would align itself with the majority of the other courts of appeal and adopt the ‘because of litigation’ test.” According to the court, under both tests, the critical issue is the purpose for which the documents were created. The court held that Regions has the “stronger argument.” Were it not for anticipated litigation, Regions would not have to worry about setting tax reserves and would have no need to elicit opinions regarding the likely results of litigation.

The court then cited *Textron* where the District Court of Rhode Island applied the “because of litigation” test and held that tax accrual workpapers were protected under the work product privilege. Even though the court in *Textron* did not consider the “primary motivating purpose” test, the court concluded that there was nothing to suggest that the outcome under the two tests would be different. Additionally, the court stated, “the fact that Regions undertook the time and expense of consulting outside firms to assess its potential liabilities shows that it believed litigation to be likely, and this court cannot say that Regions’ subjective belief was objectively unreasonable.”

The court rejected the IRS’s argument that Regions could not claim work product privilege if the documents had any use other than litigation preparation. The court found no support for the conclusion that a party must show that it was motivated by preparation for litigation *and nothing else* in order to claim that a document is protected work product. The court held that “while the documents may have had some utility outside of litigation, they would not have been created were Regions not primarily concerned with litigating with the IRS concerning the Transaction.”

The court then considered whether Regions had waived work product privilege by disclosing the documents to E&Y, its independent auditors. Regions argued that the E&Y auditors were not adversaries of Regions and were not conduits to Regions’ adversaries. Thus, the court held that disclosing the documents to E&Y did not waive the privilege. The court distinguished *United States v. MIT*, where MIT had waived work product privilege by disclosing the documents relating to its expenses to the Defense Contract Audit Agency (“DCAA”). In *MIT*, the DCAA was a potential adversary, but here the court found that there was “simply no conceivable scenario in which E&Y would file a lawsuit against Regions because of something E&Y learned from Regions’ disclosures.” The court also found it critical that a confidentiality agreement protected any documents Regions gave to E&Y. The confidentiality agreement provided that E&Y could not give the documents to another party. The court thus held that Regions had not waived the work product privilege.

Despite the IRS’s losses in *Textron* and now in *Regions Financial*, the IRS is likely to continue to take the position that tax accrual workpapers are not prepared in anticipation of litigation and are not protected by the work product privilege. The IRS has already appealed *Textron* to the First Circuit and seems likely to appeal *Regions Financial* to the Eleventh Circuit. Ultimately, however, it may be up to the US Supreme Court to finally decide the issue of whether certain tax accrual workpapers are protected by the work product doctrine in the context of an IRS summons.

*By Paul E. Schick and Jenny A. Austin, Chicago*

## New Regulations Address Partnership Allocations to Look-Through Entities

The IRS recently released two sets of regulations dealing with the circumstances under which allocations of income, gain, loss, deduction and credit in a partnership will be respected for US federal income tax purposes. In T.D. 9398, the IRS released final regulations under Code Section 704(b) for testing whether the economic effect of an allocation is substantial where partners are look-through entities or members of a consolidated group. The IRS also released proposed regulations interpreting the anti-abuse rule under section 704(c). Both sets of regulations address the issue of allocations made to partners that are pass-through entities such as partnerships.

### Final Regulations under Section 704(b)

The final regulations under section 704(b) provide rules for testing whether the economic effect of an allocation is “substantial” where one or more partners are look through entities or members of a consolidated group.

Under section 704(b), an allocation of partnership income, gain, loss, deduction and credit (“Partnership Items”) generally will be respected if the allocation has substantial economic effect. Allocations of partnership Items that lack substantial economic effect generally must be reallocated among the partners in accordance with the partners’ interest in the partnership. An allocation has substantial economic effect if the allocation has economic effect (the “Economic Effect Test”) and the economic effect of that allocation is substantial (the “Substantiality Test”).

Even if an allocation has substantial economic effect, the IRS may be able to reallocate partnership items under provisions of the Code other than section 704(b). The determination of whether the economic effect of an allocation is substantial generally requires a comparison of the after-tax consequences to the partners arising from the allocation and the consequences that would occur if the allocation were not in the partnership agreement. In determining the after-tax consequences to a partner, tax consequences that result from the interaction of the allocation and a partner’s tax attributes that are unrelated to the partnership must be taken into account.

**Look-Through Rule.** The final regulations clarify whose tax attributes must be taken into account if a partner is a look-through entity. In the case of a partner which is a look-through entity, the tax consequences that result from the interaction of the allocation with the tax attributes of any person that is an owner (or in the case of a trust or estate, the beneficiary) of an interest in the look-through entity, whether directly or through one or more look-through entities, must be taken into account. In the case of a partner that is a member of a consolidated group, the tax consequences that result from the interaction of the allocation with the tax attributes of the consolidated group, and with the tax attributes of another member with respect to a separate return year, must be taken into account.

The final regulations define a “look-through entity” as (i) a partnership, (ii) an S corporation, (iii) a trust or estate, (iv) a disregarded entity (including a qualified subchapter S corporation and a qualified REIT subsidiary), and (v) certain controlled foreign corporations (“CFCs”).

A CFC is treated as a look-through entity for purposes of these rules only if United States shareholders of the CFC in the aggregate own, directly or indirectly, at least 10 percent of the capital or profits of the partnership on any day during the partnership’s taxable year. In addition, a CFC is treated as a look-through entity only with respect to allocations of

Partnership Items that (i) enter into the computation of a United States shareholder's inclusion under section 951(a) with respect to the CFC, (ii) enter into any person's income attributable to a United States shareholder's inclusion under section 951(a) with respect to the CFC, or (iii) would enter into the computations described in this paragraph if such items were allocated to the CFC. For purposes of determining whether United States shareholders own an indirect interest in the capital or profits of the partnership, the final regulations define indirect ownership of stock or another equity interest (such as an interest in a partnership) in accordance with section 318, but reduce the ownership threshold under section 318 from 50 percent to 10 percent.

The final regulations also specify that when a CFC is a look-through entity, the relevant tax attributes to be taken into account for purposes of the substantiality test are the tax attributes of any United States shareholder. In the case of a United States shareholder that is a look-through entity, the tax attributes of any United States person that owns an interest in that shareholder, directly or indirectly, through one or more look-through entities, must be taken into account.

Because of the difficulties partnerships may have in ascertaining the tax attributes of persons owning direct or indirect interests in look-through partners, the final regulations include an exception under which the tax attributes of de minimis partners do not need to be taken into account. For this purpose, a de minimis partner is defined as any partner, including a look-through entity, that owns, directly or indirectly, less than 10 percent of the capital and profits of a partnership, and who is allocated less than 10 percent of each Partnership Item.

***Baseline for Comparison of Tax Consequences of an Allocation.*** The final regulations also clarify that the consequences of the allocations must be compared to the consequences that would occur if the allocations were not contained in the partnership agreement and were instead determined in accordance with the partner's interests in the partnership. Thus, application of the Substantiality Test requires a determination of the tax consequences that would occur if allocations were made in accordance with the partners' interest in the partnership.

References to a partner's interest in the partnership or to the partners' interests in the partnership refer to the manner in which the partners have agreed to share the economic benefit or burden, if any, corresponding to the Partnership Item that is allocated. This sharing arrangement may or may not correspond to the overall economic arrangement of the partners. The determination of a partner's interest in the partnership is made by taking into account all the facts and circumstances relating to the economic arrangement of the partners. Prior to amendment by the final regulations, the regulations incorporated a rebuttable presumption that all partners' interests in the partnership are presumed to be equal (the "Per Capita Presumption").

***Elimination of Per Capita Presumption.*** The final regulations eliminate the Per Capita Presumption. The preamble to the final regulations explains that the per capital presumption was eliminated because it failed to consider factors relevant to a determination of the manner in which the partners agreed to share the economic benefits or burdens corresponding to the allocation of Partnership Items and therefore reached the correct result in only a few cases. As a result, whatever benefit the Per Capita Presumption may have provided in the form of reducing complexity was outweighed by the potential for incorrect determinations.

## Proposed Regulations under Section 704(c)

The IRS has also released proposed regulations interpreting the anti-abuse rule under Code Section 704(c). (See REG – 100798-06.)

Under section 704(c), a partnership must allocate Partnership Items attributable to contributed property to take into account any variation between the property's adjusted tax basis and its fair market value at the time of contribution. The treasury regulations under section 704(c) generally provide that taxpayers can use any reasonable allocation method consistent with the purposes of section 704(c) and describes three allocation methods that are generally reasonable and consistent with the purposes of section 704(c).

The treasury regulations under section 704(c) also contain an anti-abuse rule intended to prevent taxpayers from shifting the tax consequences of built-in gain or loss among the partners in an improper manner. Treas. Reg. § 1.704-3(a)(10) provides that an allocation method is not reasonable if the contribution of property and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

The proposed regulations clarify that section 704(c) and the allocation methods set forth in the regulations apply only to contributions of property that are otherwise respected. Thus, even if a partner's section 704(c) allocation method may be respected under the literal language of Treas. Reg. § 1.704-3, the IRS may be able to recast the contribution to avoid results inconsistent with the intent of subchapter K.

The proposed regulations also clarify that, for purposes of determining whether the anti-abuse rule applies, the tax effect of the allocation method on direct and indirect partners must be considered. The proposed regulations define an indirect partner as (i) any direct or indirect owner of a partnership, S corporation, CFC, or a direct or indirect beneficiary of a trust or estate that is a partner in a partnership; and (ii) any consolidated group of which the partner in the partnership is a member. For purposes of this rule, a CFC is treated as an indirect partner only with respect to allocations of Partnership Items that enter into the computation of a United States shareholder's inclusion under section 951(a) with respect to the CFC, enter into any person's income attributable to a United States shareholder's inclusion under section 951(a) with respect to the CFC, or would enter into the such computations if such items were allocated to the CFC.

*By Michael T. Donovan, Chicago*

## IRS Ruling on 332/Insolvent Subsidiary Liquidation

On May 2, 2008, the IRS released CCA 200818005 concluding that the cancellation of indebtedness by a parent corporation immediately prior to the sale of its insolvent subsidiary's stock, which causes the subsidiary to become solvent, does not permit a corporation to claim that a tax-free deemed liquidation under Code Section 332 occurs as a result of a section 338(h)(10) election. A section 338(h)(10) election allows taxpayers to treat a stock sale as an asset sale through a deemed transaction that provides the benefits, while avoiding the problems associated with an actual asset sale. In an actual asset sale, the purchaser receives a tax basis in the purchased assets equal to cost. Moreover, the corporation which sells its assets may liquidate into its parent corporation,

transferring the liquidating corporation's favorable tax attributes, such as NOLs, to the parent. However, an actual asset sale is more complicated than a stock sale because of title transfer, contract assignment, and other similar issues.

In CCA 200818005, P, the parent corporation of a consolidated group, owned all the stock of S1. S1 owned 80% of S2 and the public owned the remaining 20% of S2. S2 owned all the stock of S3. S1 was the lender of an inter-company indebtedness of S3. The liabilities of S3 were in excess of the fair market value of its assets. Additionally, the liabilities of S2 were in excess of the fair market value of its assets. S1 entered into an agreement with Purchaser, an unrelated third party, to sell all its stock in S2. Purchaser insisted that S1 cancel its indebtedness to S3 as a condition to the sale. Immediately after the cancellation of the debt, the net value of S3's assets exceeded its liabilities so that it was no longer insolvent. Because of the increase in value of S3 caused by forgiveness of indebtedness, the net value of S2's assets also exceeded its liabilities. P and Purchaser made a joint section 338(h)(10) election with respect to the sale of the stock of S2 and the deemed sale of the stock of S3.

Under section 338(h)(10), the target corporation is deemed to sell all of its assets and distribute the proceeds in complete liquidation. Other rules of law apply to determine the tax consequences to the parties as if they had actually engaged in the transactions that are deemed to occur. Thus, the taxpayer is required to look to the provisions of the liquidation statutes to determine the treatment under the deemed transactions. Section 332 governs the liquidation of a subsidiary corporation into its parent. Under section 332(a), no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation if the recipient corporation owns at least 80% of the voting and value of the stock in the liquidating corporation pursuant to the requirements of section 1504(a)(2). Also, the distribution must be in complete cancellation or redemption of all of the liquidating corporation's stock occurring in the same taxable year, or in accordance with a plan of liquidation that is to be completed within 3 years. Finally, section 332 only applies to those cases in which the recipient corporation receives at least partial payment for the stock that it owns in the liquidating corporation. Therefore, an insolvent corporation may not utilize section 332. An important benefit that results from the application of section 332 is the fact that section 381 allows a carryover of favorable tax attributes including net operating losses.

In the present case, P cancelled the debt owed to it by its second-tier subsidiary, S3, which resulted in S3 and S2 both becoming solvent prior to the deemed liquidation. Presumably, section 332 should apply to the deemed liquidation, which would have resulted in the following steps: (1) S1 canceled a portion of the indebtedness owed to it by S3, (2) S3 (Old S3) sold all of its assets, subject to its remaining liabilities, to New S3, (3) Old S3 distributed to S2 the assets it received on the sale to New S3, (4) S2 (Old S2) sold its assets, subject to its liabilities, to New S2, and (5) Old S2 distributed to S1 the assets it receives on the sale to New S2. The Public, as 20% shareholders of S2, do not recognize gain or loss nor is the Public's basis or holding period affected due to the 338(h)(10) election.

However, in CCA 200818005 the IRS concluded that the cancellation of indebtedness should be disregarded and, thus, section 332 does not apply. The IRS cited Rev. Rul. 59-296, which concluded that where the acquiring corporation was a creditor of its wholly-owned subsidiary in an amount greater than the fair market value of the subsidiary's assets, a distribution of the subsidiary's assets to the parent in complete liquidation of the subsidiary was not covered by section 332 because no part of the transfer was attributable to the stock interest of the parent. Furthermore, Rev. Rul. 68-602 concluded that a Parent's cancellation of indebtedness of a note held by its subsidiary immediately prior to the subsidiary's liquidation should be disregarded in determining whether section 332 applies to the liquidation. In Rev. Rul. 68-602, a subsidiary corporation had sustained a sizeable amount of net operating losses that its parent corporation wished to avail itself

of. The parent corporation liquidated the subsidiary attempting to take advantage of section 332 and receive the corresponding carryover of the subsidiaries assets under section 381. However, the subsidiary corporation was indebted to the parent corporation in an amount that exceeded the subsidiary's assets. Therefore, the parent corporation cancelled the debt of the subsidiary prior to the liquidation to make the subsidiary solvent. The IRS concluded that the cancellation of indebtedness should be disregarded and thus the subsidiary did not meet the requirements of section 332 because it was insolvent.

CCA 200818005 stated that, in the deemed section 338(h)(10) transactions, after the assets and liabilities of S3 and S2, other than the indebtedness between S1 and S3, were sold to New S3 and New S2, respectively, the transaction became substantially similar to the transaction described in Rev. Rul. 68-602, except for the fact that the indebtedness was between a parent corporation and its second-tier subsidiary rather than its direct subsidiary. Both scenarios involved a cancellation of indebtedness of an insolvent subsidiary immediately before the liquidation of the corporation. In Rev. Rul. 68-602, the Treasury concluded that the debt cancellation should be considered transitory and, thus, disregarded because it was an integral part of the liquidation and had no independent significance other than to secure the tax benefits of the section 332 liquidation. On the other hand, in Rev. Rul. 78-330 the IRS concluded that a Parent's cancellation of debt to its insolvent subsidiary should be respected, because it had independent economic significance, when the Parent cancelled the debt immediately prior to a statutory merger. The IRS concluded that the cancellation of indebtedness had independent economic significance because it resulted in a genuine alteration of a previous bona fide business relationship. Contrarily, in CCA 200818005 the IRS stated that although there was independent economic significance in the cancellation of the indebtedness, due to the Purchaser's insistence that the debt be cancelled, the result remained that the cancellation of indebtedness should be disregarded. The IRS distinguished Rev. Rul. 78-330 by stating that no liquidation occurred in that instance. Therefore, section 332 should not apply. However, the parent corporation should be allowed a worthless security and bad debt deduction on the liquidation of the subsidiary.

By *Steven Hadjiligiou, Miami*

## ***Kentucky v. Davis: High Court Upholds Discriminatory Tax Treatment of Interest Income from Municipal Bonds***

On May 19, 2008, the US Supreme Court upheld a Kentucky law providing preferential tax treatment of interest derived from in-state municipal bonds as compared to interest derived out-of-state municipal bonds. *Dep't of Revenue of Kentucky v. Davis et ux*, 553 U.S. \_\_\_, (2008). In sum, Kentucky exempts interest derived from in-state municipal bonds while, at the same time, imposing tax on interest earned on bonds issued by out-of-state municipalities.

The case represents a class action challenge to the validity of Kentucky's discriminatory tax regime under the commerce clause of the US Constitution. The Kentucky Court of Appeals struck the law down finding that it amounted to a regulatory measure designed to benefit in-state economic interests by burdening out-of-state competitors. The appellate court concluded the law violated the commerce clause's prohibition against economic protectionism and declared it invalid. After the Kentucky Supreme Court declined the State's appeal, the US Supreme Court granted review.

Upon review, the US Supreme Court reversed. The Court determined that, although discriminatory, the Kentucky law fell within a recently articulated exception to the commerce clause analysis. This exception, first articulated by the Court last term in *United Haulers Assn., Inc. v. Oneida-Herkimer Solid Waste Management Authority*, 550 U.S. \_\_\_, (2007), recognizes a distinction between discriminatory laws that provide a public benefit as compared to those that discriminate in favor of private facilities.

The exception adopted in *United Haulers*, and applied in *Davis*, comes into play when a discriminatory law favors of the government and advances a traditional government function. In *United Haulers*, the Court upheld a “flow control” ordinance requiring trash haulers to deliver waste to a processing facility owned and operated by the state. The Court explained that when a state or local government is performing a traditional government function, such as waste disposal, it is not susceptible to standard dormant commerce clause scrutiny. This exception to, or, rather, the Court’s abstention from application of the standard dormant commerce clause analysis is due to the state or local government’s “likely motivation by legitimate objectives distinct from the simple economic protectionism the clause abhors.”

With respect to the nature of state and local participation in the bond market as a government function, the Court in *Davis* found that “the issuance of debt securities to pay for public projects is a quintessentially public function, with a venerable history....” It is important to note that the majority expressly left as an open question, however, whether the same rationale would apply to “private activity,” “industrial-revenue” or “conduit” bonds, which are issued by government bodies but used to finance projects by private entities.

The Court’s decision in *Davis* was not surprising to many. Indeed, some had taken the unusual step of predicting the outcome based on the *United Haulers* decision. Further, invalidating Kentucky’s law would have had significant repercussions. These collateral consequences were not lost on the Court. Emphasizing its reluctance to upset long-standing and widespread public practice, the majority placed great importance on the fact that the policy of exempting interest from bonds issued by in-state government entities is common to 41 states, and all 50 states (49 of whom were the victims of the Kentucky discriminatory regime under review) supported Kentucky’s position. The majority also recognized that exemptions like Kentucky’s foster the market for state-specific municipal bond funds, and noted that “many single-state funds would disappear if the current differential tax schemes were upset.” As many expected, the majority was clearly uncomfortable with the notion of altering, or potentially eradicating, the mechanism by which many local governments fund public projects.

While some may argue that *Davis* cracks open the door for additional discriminatory state tax regimes, given its peculiar set of facts and circumstances, the decision would appear to be of limited application in future state tax cases.

*By Theodore Bots and Matthew Mock, Chicago*

## IRS Wins in Two LILO Cases

The IRS recently won two cases against taxpayers who had engaged in so-called lease-in lease-out (“LILO”) transactions. The IRS was victorious in the Fourth Circuit against BB&T Corporation. The IRS also won in front of a jury against Fifth-Third Bankcorp.

### *BB&T Corporation v. United States*

On April 29, 2008, the Fourth Circuit affirmed the district court’s decision in *BB&T Corporation v. US* granting the government’s motion for summary judgment based on stipulated facts.

BB&T entered into a head lease under which it leased for 36 years a 21.94% undivided interest in certain pulp-making equipment from Sodra, a Swedish manufacturer of paper pulp. BB&T then sublet the equipment back to Sodra for 15.5 years (the basic lease term), or less than half of the head lease term. The head lease required BB&T to pay rent to Sodra in two installments. The first installment of approximately \$86.2 million (the “advanced head lease payment”) was due on the closing date. The second installment of approximately \$557.8 million was due in 2038, five years after the expiration of the head lease term (the “deferred head lease payment”). The head lease allocated the advanced head lease payment (and BB&T’s corresponding rent deductions) to the first five years of the head lease term, and allocated the deferred head lease payment to the last 31.5 years. BB&T’s leasehold interest under the head lease as of the closing date was valued at \$98.73 million. BB&T had a valuation report that further concluded that the sum of the advanced head lease payment and the present value of the deferred head lease payment as of the closing date was a reasonable estimate of the FMV of the head lease.

BB&T derived the money to pay the advanced head lease payment in part from Hollandische Bank-Unie N.V. (HBU), from which BB&T borrowed slightly more than \$68 million (the HBU loan), and in part from \$18.2 million of its own funds. Thus, after entering into the head lease and making the advanced head lease payment, BB&T did not owe annual rent to Sodra, but BB&T was required to pay debt service to HBU on the HBU loan. The sublease required Sodra to pay rent to BB&T exactly equal to the debt service on the HBU loan, as well as all costs related to the use and maintenance of the equipment. At the closing date, Sodra was required to deposit this same amount (\$68 million) with ABN-Amro Bank, N.V. (ABN), the parent of HBU, pursuant to a debt payment undertaking agreement (the debt PUA), which provided for payment of rent equal to the debt service on the HBU loan. Thus, on the closing date, the funds needed to satisfy the HBU loan were deposited with its parent corporation, ABN, and were effectively made available to assure that the HBU loan was paid in full during the term of the basic lease. The money in the debt PUA was sufficient to make all of the interest and principal payments on the HBU loan during the term of the sublease, as well as the final principal payment of \$11.5 million due on the HBU loan.

After depositing \$68 million with ABN, Sodra was left with \$18.2 million put into the transaction by BB&T. Sodra was required to deposit \$12 million with Fleet National Bank, however, as trustee for BB&T under the equity payment undertaking agreement (the equity PUA). These funds were used to purchase government securities. The equity PUA provided funds to be used by Sodra to exercise its option to terminate the head lease at the end of the basic lease term. The remaining balance of the advanced head lease payment (some \$6 million) was the only unrestricted amount received by Sodra.

The transaction provided a series of options to BB&T and Sodra. The most important options become exercisable at the end of the basic lease term. First, Sodra had the option

(the purchase option) to buy the remainder of BB&T's leasehold interest under the head lease by (1) paying a purchase option price of \$46.8 million, which included the final \$11.5 million due on the HBU loan, and (2) assuming BB&T's remaining obligations under the head lease. Fleet purchased investments under the equity PUA that, together with the remaining funds in the debt PUA, were expected at the end of the basic lease to have a value equal to the purchase option price. Thus, Sodra would not have to provide additional funds if it wished to exercise the purchase option.

If Sodra did not exercise the purchase option, BB&T had several choices. First, BB&T could require Sodra to renew the lease (the lease renewal option) for an additional 13.3 years (the lease renewal term) for specified rent. Second, BB&T could lease the equipment to a third party (the replacement lease option). Third, BB&T could take possession of the equipment (the return option). Under any of these options, BB&T would remain obligated to make the \$557.8 million deferred head lease payment.

On its tax return for 1997, BB&T reported rental income of approximately \$3.4 million, but this was more than offset by claimed rent deductions of approximately \$9.9 million and interest deductions of approximately \$2.8 million. On audit, the IRS effectively disregarded the transaction, disallowing both the income and deductions. BB&T paid the deficiency and interest and sued for a refund in the US District Court for the Middle District of North Carolina.

The district court granted the government's motion for summary judgment. The court held that BB&T had not acquired a leasehold interest in the equipment. The court also concluded that the HBU loan did not reflect a genuine indebtedness of BB&T.

BB&T appealed the district court's decision to the Fourth Circuit, arguing that the district court erred in its conclusion that BB&T did not acquire a genuine leasehold interest or incur genuine indebtedness as a result of the transaction. The Fourth Circuit affirmed the lower court's decision. Relying on the Supreme Court's decision in *Frank Lyon Co. v. Commissioner*, the Fourth Circuit held that BB&T did not acquire a genuine leasehold interest in the equipment. The court found that (1) BB&T only had a right to make an annual inspection of the equipment; (2) the only money that changed hands was the \$6 million incentive paid to Sodra for doing the deal; (3) Sodra could unwind the transaction without ever losing dominion and control over the equipment; and (4) BB&T was insulated from any risk of losing its initial investment or of investing additional funds. The court next distinguished BB&T from the taxpayer in *Frank Lyon Co.* because BB&T failed to establish any regulatory or economic reality driving the transaction's simultaneous conveyance and retraction of rights and obligations and did not offer any non-tax-related purpose for structuring the transaction as it did. The Fourth Circuit held that in substance, the transaction was a financing arrangement and not a genuine lease and sublease. The court summarized the transaction succinctly: "All that BB&T has done is paid Sodra approximately \$6 million dollars to sign documents meeting the formal requirements of a lease and sublease, arranged a circular transfer of funds from and then back to ABN, and invested approximately \$12 million in government bonds. Sodra, meanwhile, maintains uninterrupted possession and control of the Equipment..."

The Fourth Circuit next considered whether BB&T was entitled to deduct the interest paid on the HBU loan. The court found that it was difficult to see how the interest BB&T paid could represent compensation for the forbearance of money because ABN, which treated the loan as an off-balance sheet transaction, did not forbear any money during the time period BB&T sought to claim interest deductions. Additionally, the court found that BB&T had no right to use the money after the closing of the transaction. BB&T argued that there was no circular flow of funds, but the court disagreed: "A party simply does not incur genuine indebtedness by taking money out of a bank and then immediately returning it to the issuing bank."

### *Fifth Third Bancorp v. United States*

In May 2005, Fifth Third Bancorp (“Fifth Third”) sued the United States in the District Court for the Southern District of Ohio for a tax refund of \$4,060,381, plus interest, for its taxable year 1997. In a unique twist, the United States answered and demanded a jury trial. On April 18, 2008, the jury ruled that Fifth Third was not entitled to a refund.

In 1997, Fifth Third Leasing Company, a subsidiary of Fifth Third, entered into three lease transactions involving the lease and leaseback of passenger railcars (“Railcars”) for public transit systems in Boston, Massachusetts, Paris, France, and Gelsenkirchen, Germany (collectively, the “Lease Transactions”). According to Fifth Third, Fifth Third Leasing had been in the commercial leasing business since 1973 and developed an asset specialization in transportation equipment and railcars. An important segment of its business always consisted of transactions involving significant domestic or foreign assets (usually valued at \$25 million and above) that were financed or refinanced in complex leveraged lease transactions. Fifth Third asserted that of the hundreds of leases completed by Fifth Third Leasing in 1997, the IRS only challenged the treatment of the three Lease Transactions. Comparing the Lease Transactions to tax shelters, Fifth Third asserted that Fifth Third Leasing would make a substantial pre-tax profit on the Lease Transactions.

The United States alleged that under the substance over form doctrine, Fifth Third Leasing did not obtain a genuine leasehold interest in the Railcars and that the third-party loans obtained to finance a portion of its investment in the Lease Transactions did not institute genuine indebtedness. The United States alleged that the rent paid by Fifth Third Leasing at closing traveled in a circle from the initial equity and debt financing to transit authorities into their defeasance accounts and then ultimately back to either Fifth Third Leasing or the lender. Therefore, according to the Government, Fifth Third Leasing had no economic interest in the residual value of the Railcars.

The jury returned a verdict for the government and answered three special interrogatories with respect to their findings. The jury found that Fifth Third obtained a genuine leasehold interest in the Lease Transactions; but it also found that the loans did not constitute genuine indebtedness that created deductible interest and that the transactions did not appreciably affect the taxpayer’s economic interest aside from tax benefits. Fifth Third has challenged the verdict as inconsistent and moved for judgment notwithstanding the verdict.

*By Robert S. Walton and Jenny A. Austin, Chicago*

## **The Cascading Tax Theory Resurrected in the Context of the Federal Excise Tax on Non-US Reinsurers**

On March 7, 2008, the IRS simultaneously issued Revenue Ruling 2008-15 and Announcement 2008-18.

### **Revenue Ruling 2008-15**

In four scenarios, Revenue Ruling 2008-15 clarified when the IRS believes Federal Excise Tax (“FET”) may apply in a purely “foreign-to-foreign” reinsurance transaction, regardless of whether a bilateral tax treaty of the United States exempts the preceding “US-to-foreign” transaction from FET.

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Code Section 4371 imposes the FET on certain premiums paid to non-US insurers and reinsurers not engaged in a US trade or business. The FET applies at the rate of 1% any time a non-US insurer issues an insurance or annuity policy with respect to the life of a US citizen or resident. The FET also applies at the rate of 1% upon each premium payment on a policy of reinsurance, whereby a contract of reinsurance is made, continued, or renewed, if issued by a non-US reinsurer with respect to the life of a US citizen or resident.

The FET applies at the rate of 4% on premiums paid to a non-US carrier on the policy of casualty insurance, if issued to or for, or in the name of, an insured that is a US corporation, partnership or individual, or non-US corporation, partnership or individual engaged in a US trade or business. The FET also applies at the rate of 1% upon each premium payment to a non-US reinsurer on a policy of reinsurance covering a casualty insurance contract that would be subject to the 4% FET.

This Ruling has rekindled a long controversy regarding the IRS's reading of the FET statute and its application to non-US reinsurers; the IRS first took this position over a decade ago in TAM 9621001, but has never attempted to enforce it. The IRS's reading of the statute would apply the FET *ad infinitum* to transaction between non-US reinsurers as long as a US risk is insured, with the FET potentially exceeding the initial premium payment. This Ruling is not the first occasion on which the IRS has asserted the imposition of a cascading tax. It has been previously asserted by the IRS – and rejected by the US Tax Court – in the context of royalty payments.

### Announcement 2008-18

In Announcement 2008-18, the IRS set forth a voluntary compliance initiative that encourages non-US insurance and reinsurance companies who have failed to pay the “cascading” FET, or failed to disclose that they have claimed a waiver from the taxes pursuant to an income tax treaty, to become compliant with their obligations.

The IRS announced that it will not examine issues arising under the four scenarios set forth in Revenue Ruling 2008-15 in respect of reinsurance premiums paid by one non-US insurer or reinsurer to another prior to October 1, 2008, the first day of the quarterly FET period beginning six (6) months after the publication of the Announcement, provided the taxpayer timely files Form 720, and pays the cascading FET, for period beginning October 1, 2008.

Eligible to participate in the voluntary compliance initiative are non-US insurers or reinsurers which have failed to timely file one or more Form 720 returns (Quarterly FET Return) and pay or remit any FET due with respect to premiums paid or received during any quarterly tax period ending prior to October 1, 2008. Failures to file by non-US insurers or reinsurers that have entered into certain closing agreements with the IRS are not, however, eligible for protection under the initiative.

*By Marnin Michaels, Zurich*

## Getting Better All the Time . . . Strengthening an Already Stellar Tax Practice

Baker & McKenzie's North American Tax Group continues to develop its Transfer Pricing and Economics practice with the addition of **Christopher Raybould**, a senior-level economist, who has recently joined our Toronto office as Director of Economics. Coming to the group from a Big 4 accounting firm, Chris has spearheaded work on a wide variety of transfer pricing projects, including compliance studies, planning studies, business conversions, audit defense representation, appeals, competent authority requests and advance pricing agreements. He has experience in a variety of industry sectors, including manufacturing, specifically automotive, technology and consumer business with an emphasis on franchising. Chris' commitment to client service and his extensive knowledge in transfer pricing will greatly complement our existing practice and will be an asset to the established tax and transfer pricing practice in Toronto and worldwide. Chris joins our network of over 150 attorneys, tax advisors and economists working in the Firm's Global Transfer Pricing practice to provide comprehensive tax and economic and valuation services in connection with transfer pricing planning, documentation and controversy resolution.

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Baker & McKenzie is pleased and proud to share the news that our US tax group was recently honored by Chambers USA with their 2008 Award for Excellence for 'Tax Team of the Year'. The award was announced at a ceremony held in New York on June 12<sup>th</sup> which was attended by over 2,000 attorneys from most every prominent law firm around the globe. The Chambers USA awards are based on extensive research interviews over a period of a year and reflect a recognition of notable achievements of the group including outstanding work, impressive strategic growth and excellence in client service. Thanks to those of our clients who were contacted and who provided their input to Chambers and thanks as well to the other law firms who were interviewed and who recognized our efforts and accomplishments. We are honored to have been recognized with such a prestigious award and remain dedicated in our efforts to build upon our strengths to further expand our ability to deliver best in class tax planning and controversy services to our clients in the US and Canada, and around the globe.

*Tax News and Developments* is a periodic publication of Baker & McKenzie's North American Tax Practice Group. The articles and comments contained herein do not constitute legal advice or formal opinion, and should not be regarded as a substitute for detailed advice in individual cases.

*Tax News and Developments* is edited by Senior Editors, [David G. Glickman](#) (Dallas) and [David R. Tillinghast](#) (New York), and an editorial committee consisting of [James H. Barrett](#) (Miami), [Theodore R. Bots](#) (Chicago), [Jonathan J. Martin](#) (Houston), [Holly K. McClellan](#) (Chicago), and [Robert S. Walton](#) (Chicago).

For further information regarding the North American Tax Practice Group or any of the items or Upcoming Events appearing in this Newsletter, please contact Carol Alexander at 312-861-8323 or [carol.alexander@bakernet.com](mailto:carol.alexander@bakernet.com).

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