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Second Circuit Decides that Modification of Variable Prepaid Forwards was Taxable

The US Court of Appeals for the Second Circuit handed the taxpayer a major defeat in a case of first impression regarding the tax consequences of modifying variable prepaid forward contracts (“VPFCs”). In *Estate of McKelvey v. Commissioner*, No. 17-2554 (2nd Cir. 2018), the Second Circuit determined that the amendments to the VPFCs (i) resulted in an exchange of the original VPFC for the amended VPFC, and (ii) triggered constructive sales of the stock underlying the VPFCs.

Andrew McKelvey was the founder and CEO of Monster Worldwide. McKelvey owned millions of Monster shares. In 2007, he entered into a VPFC with each of two investment banks. Under the VPFCs, the banks paid McKelvey an upfront cash payment of approximately $194 million. The VPFC required McKelvey to deliver a variable number of Monster shares to the bank counterparty on the settlement dates specified in the VPFC. The number of shares McKelvey had to deliver to the bank depended upon the value of the shares on the settlement date and was subject to a cap and a floor. As security for his obligations under the contract, McKelvey delivered to the bank as collateral the maximum number of shares that could have been deliverable under the contract. When McKelvey entered the VPFCs, the share price for Monster shares was around $32-33 per share. Both VPFCs had a term of around 12 months and the settlement dates and valuation dates were in September 2008. A few months before the settlement date of the VPFCs, McKelvey and each bank agreed to amend the VPFC to extend the settlement dates into 2010. McKelvey paid the banks around $11 million for the amendment. When the parties extended the VPFC settlement dates, the share price for Monster shares was around $17-18 per share.

McKelvey died on November 27, 2008. His estate obtained a stepped-up basis in the shares. McKelvey's Estate closed out the VPFCs in 2009 by delivering Monster shares to the banks (the amended VPFCs provided for accelerated settlement in the event of certain contingencies, including McKelvey's death).

Neither McKelvey nor McKelvey's Estate paid any income tax on the Monster shares. The IRS determined a deficiency of more than $41 million asserting that McKelvey realized short-term capital gain of $88,096,811 from the exchange of the original VPFCs for the extended VPFCs and long-term capital gain of $112,789,808 from the constructive sale of the Monster shares.

Upcoming Tax Events

Tax Spotlight:
Healthcare Industry Webinar

► November 29, 2018

Tax Spotlight: Automotive Industry

Detroit, MI
► December 3, 2018

Sixth Annual TEI Houston
Tax Symposium

Houston, TX
► December 4, 2018

Breakfast Briefing: Tax Updates in the Latin America Oil & Gas Industry

Houston, TX
► December 13, 2018

41st Annual North America
Tax Conference

Mexico City, Mexico
► January 31, 2019

The Tax Court concluded that McKelvey did not exchange property for purposes of Code Section 1001 when he extended the settlement date of the VPFCs. 148 TC 312 (2017). The Tax Court reasoned that McKelvey had only obligations under the VPFCs (i.e., the obligation to deliver a variable amount of shares in the future) - and that obligations as such are not property. Therefore, McKelvey did not have property, which is a prerequisite to recognizing gain on an exchange under section 1001. In addition, the Tax Court concluded that extending the VPFCs did not result in constructive sale of the pledged shares under section 1259 because the extension did not close the original pre-amendment VPFC.

The Second Circuit agreed with the Tax Court that when McKelvey extended the settlement and valuation dates of the original VPFCs, he had only obligations. Effectively, his lone right under the VPFC was to receive the cash prepayment. The Second Circuit noted, however, that an exchange could occur because of a cancellation or termination of an obligation. The Second Circuit reasoned that the extension of the valuation dates of the original VPFCs fundamentally altered the bets of the parties. Thus, the amended VPFCs were new contracts that replaced the original VPFCs. The Second Circuit remanded to the Tax Court to determine whether the termination of McKelvey's obligation under the original VPFC gave rise to taxable income (and if so the amount and character of such income).

The Second Circuit disagreed with the Tax Court's constructive sale analysis. The constructive sale rules cause a taxpayer to recognize gain on the constructive sale of an appreciated financial position as if the taxpayer sold the position for its fair market value. The IRS argued that on the date that the valuation dates were extended under the VPFCs, the amount of Monster shares that McKelvey was required to deliver was substantially fixed. To reach this conclusion, the Second Circuit relied on the report of an IRS expert. The expert's report used the Black-Scholes option pricing model to determine that as of the date the original VPFCs were extended, there was an 85-87% probability that the amount of shares McKelvey would need to deliver on the new settlement date would not exceed the amount that needed to be delivered at the contract floor price. This was the case under the expert's pricing model because of the decline in the price of Monster shares that occurred between the original VPFC settlement and the extended VPFC settlement date.

Taxpayers entering into and modifying derivative positions need to consider *McKelvey's* implications. The Second Circuit's probably analysis is a novel approach to determining whether the amount of property is substantially fixed under section 1259 and this can have wide-ranging implications for taxpayers modifying non-debt derivatives.

By Paul DePasquale, New York

Closing Down the SILO: *Exelon Corp. v. Commissioner*

In *Exelon Corp. v. Commissioner*, Nos. 17-2964 et al. (7th Cir. Oct. 3, 2018), the Seventh Circuit affirmed the Tax Court's 2016 imposition of approximately $500 million in tax deficiencies and penalties, attributable to failed Code Section 1031 like-kind exchanges coupled with sale-in/lease out ("SILO") tax shelter transactions. This note analyzes Exelon's transactions, the courts' conclusions, and the key takeaways from the case.

Exelon, an Illinois-based energy company, sold its fossil-fuel power plants in 1999. Exelon intended to use all the proceeds to improve its nuclear plants and infrastructure, but it ended up generating over $2 billion more than it expected. Left with what would have otherwise been a significant tax bill, Exelon began to consider a strategy to defer the tax on the gain: a section 1031 like-kind exchange. Under section 1031, Exelon would be able to avoid recognizing gain or loss on a property exchanged solely for another property of like kind, if both properties are held for productive use in a trade or business, or for investment. Section 1031 was significantly limited by the 2017 Tax Cuts and Jobs Act (*i.e.*, only certain real property can now be exchanged) but in 1999, power plants were good candidates for like-kind exchanges.

The Transactions

Exelon entered into six nominal "sale-and-leaseback" transactions with a few tax-exempt public utilities: it purchased long-term master leases in three out-of-state power plants and leased them back to their original operators. To address tax risk, Exelon hired Winston & Strawn as legal counsel, which issued a tax opinion based on Deloitte's appraisals of the value and useful life of the power plants, as well as the financial implications of the transactions.

Exelon asserted that it had acquired a genuine ownership interest in their public utility power plants after the transactions, which allowed Exelon to (i) qualify for like-kind exchange treatment under section 1031 and (ii) defer tax on the billion-dollar gain from selling its power plants. Further, it claimed $93 million in deductions on its 2001 return for depreciation, interest, and transaction costs as the lessor of the power plants. The IRS asserted a deficiency of $431 million for 1999 and $5 million for 2001, as well as a 20% accuracy-related penalty for each year.

The Tax Court's Opinion

The Tax Court applied the substance-over-form doctrine, holding that Exelon structured the transactions as a variant of SILO tax shelters, thus failing to acquire "genuine ownership" of the power plants. The Tax Court concluded that Exelon was not entitled to like-kind exchange treatment or its claimed deductions

because the transactions substantively resembled loans, which are not like-kind properties for fossil-fuel power plants.

The Tax Court found that Exelon bore no burdens or indicia of ownership in the out-of-state power plants, because it did not face any significant risk indicative of genuine ownership. Exelon was to "fully recover its investment" in the unlikely event of either a lessee bankruptcy or an early termination of the sublease because the transactions had defeasance instruments, which entailed setting aside several deposits with third-party financial institutions for various payments due under the transaction documents, including purchase options. Exelon prepaid the entire sublease rent 6 months after the closing, which made the transactions resemble loans from Exelon to the public utilities. Exelon relied on the properties' residual values in an attempt to establish genuine ownership of the power plants, but the court rejected the argument, finding that the future fair market value of the plants at the end of the sublease terms was too low and Deloitte's appraisal reports were tainted in this regard.

On the other hand, the Tax Court concluded that the sublessees bore the costs and risks of owning the power plants, and that there was a reasonable likelihood that the sublessees would exercise their purchase options at the end of the sublease terms. After analyzing the return-condition requirements of the subleases, the Tax Court concluded that all of the parties fully intended and expected the sublessees to exercise their purchase options because meeting those return conditions would be "extremely burdensome . . . if not impossible." The sublessees were responsible for all costs and expenses associated with the "ownership, use, possession, control, operation, maintenance, repair, insurance, [and] improvement" of the plants, bearing all of the major burdens of owning the power plants.

In rejecting Exelon's reasonable cause defense to the imposition of accuracy-related penalties, the Tax Court found that Exelon knowingly relied on tainted appraisals from Deloitte. The Tax Court found that Winston & Strawn interfered with the integrity and independence of the appraisal process by providing Deloitte with the wording of the conclusions it expected to see in the final appraisal reports; Deloitte's final conclusions mirrored those in Winston & Strawn's letter almost word for word. The Tax Court found that Exelon unreasonably relied on the flawed tax opinion when it should have known, as a sophisticated plant operator, that Deloitte's appraisal reports were incorrect.

The Seventh Circuit's Opinion

The Seventh Circuit affirmed. The Seventh Circuit concluded that the Tax Court: (i) properly determined that Exelon was not entitled to like-kind exchange treatment under section 1031 because Exelon's transactions were a variant of the traditional SILO tax shelters; and (ii) did not err in imposing penalties because Exelon, as a sophisticated plant operator, should have known that the Deloitte appraisals were tainted.

On appeal, Exelon argued that it cannot be penalized for relying on Winston & Strawn's tax opinion because it did not know that Winston & Strawn provided Deloitte with the necessary conclusions. The Seventh Circuit rejected that argument, countering that Exelon "knew full well" that Winston & Strawn was supplying Deloitte with the necessary conclusions and tainting the appraisal reports: two employees of Exelon were *copied* on the emails from Winston & Strawn, and one of these employees sent the very list of appraisal conclusions to Deloitte multiple times. Thus, Exelon could not use the Winston & Strawn tax opinion as a defense to penalties.

Key Takeaways

Exelon Corp. may well be the last of the lease-in/lease-out ("LILO") and SILO tax shelter cases to be decided by the courts. Nevertheless, *Exelon Corp.* serves as the latest cautionary tale for taxpayers seeking reasonable cause penalty protection by reliance on tax advice. *Exelon Corp.* shows that merely having a tax opinion is not a "get out of jail free" card to avoid penalties, if reliance on that opinion is found to be unreasonable. Here, both the Tax Court and the Seventh Circuit concluded that Winston & Strawn's involvement in the Deloitte appraisals crossed the line, and that Exelon's attempt to distance itself from that involvement was belied by the facts.

By Daniel Rosen, New York, Daniel Cullen and Mary Yoo, Chicago

Common Interest Privilege Affirmed as Supreme Court of Canada Refuses to Hear Government Appeal

On October 25, 2018, the Supreme Court of Canada notified the public that it declined to hear the Canadian Government's appeal of a lower court decision limiting the Government's powers to request documents from taxpayers. Implicit in the Supreme Court's refusal is an acknowledgment that the lower court's decision affirming the principle of Common Interest Privilege ("CIP") is correct and precedential.

MNR v. Iggillis Holdings Inc. et al. (2016 FC 1352) raised the issue of whether solicitor-client privilege continues to apply to a legal opinion that is disclosed to a person who is not the client of the lawyer who wrote the opinion but who is involved in common transactions with the client of that lawyer. For context, solicitor-client privilege applies to communications between lawyers and their clients. This privilege is waived if the privileged communications are disclosed to third parties. An exception to this waiver is CIP, which allows for the disclosure of privileged communications without loss of that privilege. The CIP doctrine protects communications made between lawyers when all members of the community share a "common legal interest" in the shared communication. This can be broken down further into litigation CIP and advisory CIP, with the latter being relevant in the IGGillis context.

In this case, Abacus Capital Corporations Mergers and Acquisitions (“Abacus”) provides tax advice in relation to corporate transactions. In this instance, Abacus structured a series of transactions which resulted in an Abacus entity acquiring the shares of the corporations that had been held by IGGillis Holdings Inc. and Ian Gillis (collectively, “IGGillis”).

Abacus and IGGillis were represented by their own respective lawyers. The tax plan memorandum (“tax memo”) behind the share acquisition was prepared through input by lawyers on both sides of the transaction. The tax memo described a number of discrete steps or transactions that would be necessary for the sale to Abacus. Each step included a diagram visually explaining the transaction. Each diagram was accompanied by a detailed description of the tax consequences in reference to relevant statutory and jurisprudential principles that were said to apply. The tax memo was sent to Abacus and IGGillis. IGGillis was not the client of Abacus counsel and Abacus was not the client of IGGillis counsel.

Following the completion of the transactions, the Canadian Government served requirements under subsection 231.2(1) of the *Income Tax Act* to produce the tax memo. Abacus and IGGillis refused to produce the tax memo. Abacus and IGGillis claimed CIP to protect the solicitor-client privileged tax memo which had been prepared during the negotiation of a commercial transaction and that pertained to a common legal interest of the contracting parties to enable the completion of the sale.

Upon application by the Canadian Government, the Federal Court ordered the tax memo to be produced to the Government. The Government had submitted that two parties mandating their lawyers to work together on behalf of both clients to find a “business solution” to their mutual advantage renders the fruit of their labour a mere business record if the consequences of implementing their legal advice are specific to the issue of tax savings. The Court disagreed with this submission and found that the tax memo was legal advice to a client which fell within the ambit of solicitor-client privilege. However, the Court found that privilege had been waived when the tax memo was circulated amongst the various Abacus and IGGillis parties and that CIP could not apply as an exception to that waiver because Advisory CIP was not considered to be a valid constituent form of solicitor-client privilege and therefore had no application to the facts in IGGillis. The taxpayers appealed this decision to the Federal Court of Appeal (the “FCA”).

In a decision widely heralded as the most important Canadian decision on CIP, the FCA allowed the taxpayers’ appeal and ruled that the parties were not required to produce the tax memo to the Government (*IGGillis Holdings Inc. et al. v. MNR* 2018 FCA 51). The FCA rejected the two principal reasons the Federal Court had relied on in ordering the production of the tax memo. First, the FCA disagreed with the lower court's finding that advisory or transactional CIP had the adverse affect of limiting relevant evidence before the Court when deciding on these issues. The FCA rejected this finding because the tax memo was a series

of opinions on the application of the law, and those opinions would ordinarily be inadmissible at trial in any event.

Second, the FCA found that that the lower court relied heavily on an article by an American academic ("End the Experiment: The Attorney-Client Privilege Should Not Protect Communications in the Allied Lawyer Setting" (2011) 95 Marq. L. Rev. 475) and the Ambac decision (*Ambac Assurance Corp. v. Countrywide Home Loans Inc.*, 36 N.Y.S. 3d 838 (Ct. App., 2016) from the New York Court of Appeals. Both the article and the *Ambac* decision reject the application of CIP in commercial transactions. The FCA found this to be a serious error by virtue of the following analytical framework. Requirements issued by the Government do not apply to a document that is protected from disclosure by solicitor-client privilege as defined in subsection 232(1) of the *Income Tax Act*. That subsection indicates that solicitor-client privilege will arise as a provincial matter, so in this case the only relevant provinces for the purposes of the definition of solicitor-client privilege were Alberta and British Columbia.

Therefore, the question became whether a Superior Court in Alberta or British Columbia would find that the tax memo was protected from disclosure by solicitor-client privilege. To the FCA, the question was not whether the New York Court of Appeals or the court of any other state in the United States (including the court in *Ambac*) would find that the tax memo was protected from disclosure by solicitor-client privilege. Ultimately the FCA found that the tax memo would be privileged in those provinces and that, based on decisions by the courts in Alberta and British Columbia, solicitor-client privilege is not waived when an opinion provided by a lawyer to one party is disclosed, on a confidential basis, to other parties with sufficient common interest in the same transactions.

The FCA importantly noted that sharing of opinions may well lead to efficiencies in completing complicated transactions and that clients may well be better served by this collaborative approach, as the application of the *Income Tax Act* will be of interest to all of the parties to the series of transactions. The ultimate conclusion of the FCA is that common interest privilege "is strongly implanted in Canadian law and indeed around the common-law world".

The Canadian Government appealed this decision to the Supreme Court of Canada. The Supreme Court refused to grant leave and the matter is now closed (*Minister of National Revenue v. Iggillis Holdings Inc. et al.,* (October 25, 2018 – 2018 SCC File 38103, Abella, Gascon, Brown JJ.S.C.C.). The main takeaway is that the FCA's decision is now precedential, which provides significant certainty to parties - who wish to share privileged communications with other parties to a transaction - that those communications will likely be protected by CIP. Thus Canadian law is now settled on CIP, which should be a relief to advisors and transactional parties alike.

By Amit Ummat, Toronto

New IRS Guidance Opens Door to Use of Qualified Opportunity Zones

In October, the IRS and Treasury released proposed Regulations and Revenue Ruling on Qualified Opportunity Zones under Code Sections 1400Z-1 and 1400Z-2. Significant points addressed by the guidance include managing and deploying cash in qualified opportunity funds reflecting commercial realities in manner that preserves the tax benefits, improvement parameters for properties in qualified opportunity zones, and meaningful guidance on business plan requirements to ensure continued qualification for the tax benefits.

Baker McKenzie's tax team will continue to monitor developments for this important tax benefit and provide practical updates as they arise. For a more thorough discussion, please see the Baker McKenzie Client Alert, "*New IRS Guidance Opens Door to Use of Qualified Opportunity Zones*," distributed on October 30, 2018.

By Sam Kamyans, Washington, DC

China Expands Scope of Reinvestment Incentive to All MNC Projects

China recently announced welcome news for multinational companies ("MNCs") who are planning to increase their investments into China. On September 26, 2018, the Ministry of Finance ("MOF") and the State Administration of Taxation ("SAT") released Notice 102 to allow all foreign enterprises to defer paying withholding tax if they reinvest dividends back into China. This deferral should provide cash flow benefits to MNCs that reinvest in China. For more details, please see the Baker McKenzie Client Alert "*China expands scope of reinvestment incentive to all MNC projects*" distributed in October 2018. The October alert discussed the key changes introduced under Notice 102 and their major implications for MNCs. Also outlined is how MNCs can obtain the dividend tax deferral treatment.

By Shanwu Yuan, New York

UK Budget 2018: What You Need to Know

In what was in many respects a give-away UK Budget, the UK Government continued to increase the pressure on multinational businesses by announcing two important new measures that will affect many US groups. The first is a new extra-territorial UK income tax charge at 20% on gross intellectual property ("IP") revenues received by low or no-taxed entities, with take effect from April 6, 2019. This new tax has significant implications for all groups with UK sales that hold IP in low-tax jurisdictions. The second is a digital services tax from April 2020 charged at 2% of revenues derived from advertising directed at UK users by

social media platforms and search engines, and commissions earned by online marketplaces facilitating transactions between UK users.

In addition to these major changes, important (and in most respects helpful) changes to the diverted profits tax ("DPT") regime were announced, in particular to make clear that diverted profits may only be subject to DPT or corporation tax, but not both. A new corporation tax relief for the cost of goodwill on the acquisition of certain IP rich businesses was also announced. These measures, while welcome, will be cold comfort to groups impacted by the other changes. For a more thorough discussion, please see the Baker McKenzie Client Alert, "*UK Budget 2018 What You Need to Know*" distributed in October 2018.

By James Wilson, Washington, DC

IRS Announces Five New International Tax Compliance Campaigns

The IRS Large Business and International Division ("LB&I") announced five new compliance campaigns on October 30, 2018. The general purpose of the campaigns is to focus the IRS's limited resources on issues presenting a risk of non-compliance. Targets of these campaigns were identified through LB&I data analysis and IRS employee suggestions. The October 30, 2018 campaigns are in addition to the rollout of its first 13 campaigns on January 31, 2017, followed by 11 campaigns on November 3, 2017, five campaigns on March 13, 2018, six campaigns on May 21, 2018, five campaigns on July 2, 2018, and five more on September 10, 2018. A list of the LB&I's approved campaigns can be found on the IRS's website.

The newest additions are: (1) Individual Foreign Tax Credit Phase II, (2) Offshore Service Providers, (3) Foreign Account Tax Compliance Act Filing Accuracy, (4) 1120-F Delinquent Returns Campaign, and (5) Work Opportunity Tax Credit.

Under the Individual Foreign Tax Credit Phase II campaign, the IRS plans to address taxpayers who have claimed the foreign tax credit without meeting the requirements to qualify for such credit. Under the Offshore Service Providers campaign, the IRS will focus on US taxpayers who have engaged offshore service providers to help create foreign entities and tiered structures that conceal the beneficial ownership of foreign financial accounts and other assets. Under the FATCA Filing Accuracy campaign, the IRS will identify Foreign Financial Institutions and certain Non-Financial Foreign Entities that have reporting obligations but fail to meet their compliance responsibilities. Under the Form 1120-F Delinquent Returns Campaign, the IRS will encourage non-US corporations to timely file their claims for deductions and credits against any income effectively connected with a US trade or business. Under the Work Opportunity Tax Credit Campaign, the IRS plans to collaborate with industry stakeholders to produce an LB&I directive that addresses existing issues related to late certifications and inconsistent examinations.

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The LB&I is continuing to review the 2017 Tax Cuts and Jobs Act, in order to determine the extent to which existing campaigns will be affected by the new law. For a more detailed discussion of the October 30, 2018 campaigns, please see the Baker McKenzie client alert "*IRS Announces Five New International Tax Compliance Campaigns*" distributed in November 2018.

By Daniel Meier, New York

Utah Supreme Court Sides with Taxpayer in Transfer Pricing Dispute

The Utah Supreme Court handed taxpayers a victory on October 5, 2018 when it issued a unanimous (5-0) decision in the closely-watched *Utah State Tax Commission v. See's Candies, Inc.*, 2018 UT 57 (Oct. 5, 2018). The Court affirmed the district court's holding that the Utah State Tax Commission's ("Commission") discretionary authority to reallocate a taxpayer's income under Utah Code Section 59-7-113 ("Utah Section 113") is limited by the "arm's-length" standard set forth in the federal Treasury regulations interpreting Code Section 482.

At issue in the case was the proper interpretation of Utah Section 113—Utah's analog to section 482—which permits the Commission to allocate income between two or more related corporations if the allocation is "*necessary* in order to prevent evasion of taxes or clearly reflect the income of any of such corporations" (emphasis added). The Commission asserted that an adjustment under Utah Section 113 is appropriate whenever the Commission, in its sole discretion, deems such an adjustment "necessary." The taxpayer, See's Candies, Inc., argued that the Commission may only adjust income under Utah Section 113 if the transaction does not satisfy the "arm's length" standard of section 482 and the accompanying Treasury regulations. The Court ultimately sided with the taxpayer, holding that allocation is "necessary" under Utah Section 113 only when "related companies enter into transactions that do not resemble what unrelated companies dealing at arm's length would agree to do." The Court reached this conclusion based on the "striking similarity" between the language of section 482 and Utah Section 113, and because the two statutes share similar functions.

See's Candies is a significant case because it supports looking to federal authorities for interpretive guidance regarding analogous state statutes in the absence of other state authority—a tool of statutory construction that some state departments of revenue have pushed back on when it does not suit them. For a

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more in-depth summary of the case, along with our thoughts on what it may mean for taxpayers, please see *A Sweet Win for Utah Taxpayers* on the SALT Savvy blog, available at www.saltsavvy.com.

By Michael Tedesco, New York

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