SHEARMAN & STERLING LLP

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District Court Rules for Taxpayer in STARS Case *Santander Holdings*; Court of Federal Claims Rules for Government in STARS Case *Salem Financial*

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On Tuesday, December 3, 2013, Shearman & Sterling will host its Year-End Tax Conference and Celebration at our New York office from 10:30 a.m. – 6:00 p.m. with a cocktail reception to follow. The conference will include panels comprised of Shearman & Sterling partners and client speakers. Topics will include: tax litigation, corporate transactions, cross-border transactions, financial products, executive compensation, and European tax. Ethics credits will be included. Please contact Lawrence.Hill@Shearman.com if you are interested in attending.

This month's issue features articles about the agreement between the United States and Switzerland on an amnesty program for Swiss banks; the *Sovereign Bancorp* decision, in which a Massachusetts district court held that a STARS transaction had objective economic substance; and the *Salem Financial* decision, in which the Court of Federal Claims held that a STARS transaction failed the economic substance test.

Swiss Bank Settlement Dilemma

On August 29, 2013, the United States Department of Justice ("DOJ") and the Swiss Federal Department of Finance, following nearly two years of negotiations, jointly announced a settlement program that offers amnesty to Swiss banks and resolution regarding involvement with individuals and entities that used Swiss accounts to evade

US taxes and reporting requirements.[1] The new program is similar to the IRS Offshore Voluntary Disclosure Program ("OVDP"), which incentivized US taxpayers to report undisclosed foreign accounts to the IRS to reduce substantial civil penalties and eliminate the risk of criminal prosecution. The settlement program provides a unique administrative solution to avoid legal challenge to Swiss bank secrecy law. In addition to the joint announcement, the DOJ issued a document captioned "Program for Non-Prosecution Agreements or Non-Target Letters for Swiss Banks", which explains the settlement program in greater detail.

Any Swiss bank that has reason to believe it may have committed tax related offenses and is willing to participate in the program must disclose its activity in a letter to the DOJ no later than December 31, 2013.

The settlement program entails a four-tiered ranking system which is based on respective degrees of culpability and categorizes each Swiss bank's exposure to illegal activity. Any Swiss bank that has reason to believe it may have committed tax-related offenses and is willing to participate in the program must disclose its activity in a letter to the DOJ no later than December 31, 2013. As of January 1, 2014, the DOJ may authorize new criminal investigations of Swiss banks who fail to notify the DOJ of their intent to enter into the settlement program.

Under the ranking system, Category 1 banks consist of the fifteen Swiss banks currently under criminal investigation. Recently, Swiss bank Rahn & Bodmer Co., one of the oldest private banks in Zurich, announced that it was under US criminal investigation. Credit Suisse and Jules Baer Group have also been reported to be under criminal investigation.[2] These banks are excluded from the program. Others who are excluded from the program include insurance companies, financial advisors, lawyers, asset managers, and fiduciaries.

Category 2 banks are those that "have a reason to believe" that they have committed tax or related criminal offenses under US tax law in connection with undeclared US taxpayer accounts. Category 2 banks are the only Swiss banks eligible for a non-prosecution agreement ("NPA"). Any Category 2 bank that wishes to obtain an NPA must submit a letter of intent to the DOJ Tax Division containing certain disclosures. The letter must include a plan for complying with the program requirements; provide the identity and qualifications of an independent examiner (a qualified attorney or accountant who will certify the information); represent that the bank will maintain all records required for compliance with the terms of an NPA,

[1] The press release can be found at http://www.justice.gov/iso/opa/resources/7532013829164644664074.pdf.

[2] Bank Frey & Co. AG was also the subject of a DOJ criminal investigation. On October 17, 2013, Bank Frey announced that it would cease operations as a bank, citing "unsustainable requirements" that resulted from Switzerland's tax dispute with the United States.

including all records that may be sought by treaty; and acknowledge that the bank will waive any potential defense based on the statute of limitations for the period August 29, 2013 to the issuance of the NPA. The bank has 120 days to comply with these requirements from the submission date of the letter of intent. The DOJ will permit a one-time extension of 60 days upon a showing of good cause.

Prior to the execution of an NPA, a Category 2 Swiss bank must disclose to the Tax Division the following evidence and information:

- How the cross-border business for US-related accounts was structured, operated, and supervised;
- Provide the name and function of employees who structured, operated, or supervised the cross-border business;
- Explain how the bank attracted and serviced account holders; and
- Disclose the total number of US-related accounts and maximum dollar value of accounts greater than $50,000 during three separate periods.

Upon execution of the NPA, the Category 2 bank must provide further details about US-related accounts that were closed after August 1, 2008, including the total number of accounts, and as to each account, the maximum value of each account, whether the account was held in the name of an individual or an entity, the number of US persons or entities affiliated with each account, the name and role of outside advisor, and information regarding transfers of funds into or out of the account. The Swiss bank must also agree to provide an in-person presentation to the DOJ to explain and support the disclosure.

As a condition of the NPA, the Swiss bank must also provide all necessary information for the United States to draft treaty requests to seek account information, and the bank must collect and maintain all records that are potentially responsive to any treaty requests to facilitate prompt responses. The Swiss bank must agree to retain records of all US-related accounts closed after August 1, 2013 for a period of 10 years from the termination date of the NPA. The NPA will further require that the Swiss bank, upon request, will provide testimony of competent witnesses as needed to the United States, and assist to translate significant documents at the bank's expense.

As a condition of the NPA, the Swiss bank must also provide all necessary information for the United States to draft treaty requests to seek account information, and the bank must collect and maintain all records that are potentially responsive to any treaty requests to facilitate prompt responses.

The Category 2 bank must also agree to close any and all accounts of recalcitrant account holders (as defined in I.R.C. Section 1471(d)(6)), agree not to open any US-related accounts except on conditions that ensure that the account will be declared to the United States and will be subject to disclosure by the Swiss bank, and implement procedures to prevent its employees from assisting recalcitrant account holders to engage in acts of further concealment.

If the Tax Division concludes that a Swiss bank has met all obligations set forth in the NPA, the DOJ will not prosecute the Swiss bank for any tax-related offenses in connection with undeclared US-related accounts held by the Swiss bank. However, if

If the Tax Division concludes that a Swiss bank has met all obligations set forth in the NPA, the DOJ will not prosecute the Swiss bank for any tax-related offenses in connection with undeclared US-related accounts held by the Swiss bank.

The settlement program would require the Swiss banks to pay a 20-percent penalty to the United States for all non-disclosed US-related accounts that were held by a Swiss bank on August 1, 2008. The penalty increases to 30 or 50 percent for accounts opened after August 1, 2008.

the Tax Division determines that the Swiss bank's conduct demonstrates extraordinary culpability, the Tax Division may require the Swiss bank to enter a Deferred Prosecution Agreement ("DPA") instead of an NPA. Upon execution of the NPA, a significant civil penalty will be imposed upon the Swiss bank. Penalties will be assessed based on the amount held in the account. The settlement program would require the Swiss banks to pay a 20-percent penalty to the United States of all non-disclosed US- related-accounts that were held by a Swiss bank on August 1, 2008. The penalty would increase to 30 percent if there is evidence that the accounts were opened after that date but before the end of February 2009, when UBS entered into a DPA and agreed to pay a $780 million fine and turn over information on thousands of US accounts. The penalty would increase to 50 percent for accounts opened after February 2009. It is not clear whether the Swiss bank will obtain credit from the Tax Division if an account holder participates in the IRS's voluntary disclosure program. In addition, it is not clear whether Swiss banks will be required to pay a penalty on the same funds, if the US account holder moved the account from one Swiss bank to another.

If a Swiss bank believes that it has not assisted US taxpayers with undisclosed accounts, it may apply to the Tax Division as a Category 3 institution. Category 3 banks are those which are not under criminal investigation and believe to have not assisted US taxpayers with undeclared accounts. A Category 3 bank may request a "Non-Target Letter." A Non-Target Letter refers to a letter from the Tax Division stating that, as of the date of the letter, the Swiss bank is not the target of a criminal investigation by the Tax Division for violation of any tax-related offense in connection with undeclared US-related accounts. The Category 3 bank must engage an independent examiner to conduct an independent internal investigation. The independent examiner must verify the percent of the Swiss bank's account holdings and assets under management that are US-related accounts; verify that the Swiss bank has an effective compliance program, and provide the Tax Division with a written report that includes (i) the witnesses interviewed, (ii) a summary of the information provided by the witness, (iii) identification of the files reviewed by the examiner, (iv) the factual findings of the examiner, and (v) the conclusions reached by the examiner. The Tax Division may decline to provide a Non-Target Letter to any Swiss bank if it determines that the bank has failed to meet these requirements, or if the information provided is false, misleading, incomplete, or the DOJ has information that contradicts the examiner's report.

So-called "Category 3 banks" may request a "Non Target Letter." A Non Target Letter refers to a letter from the Tax Division stating that, as of the date of the letter, the Swiss bank is not the target of a criminal investigation by the Tax Division for violation of any tax related offense in connection with undeclared US-related accounts.

The Category 3 bank must submit a letter to the Tax Division no earlier than July 1, 2014 and no later than October 31, 2014. If a Swiss bank initially believes that it falls under Category 3, but after an internal investigation discovers that it should have instead requested a NPA as a Category 2 bank, the Tax Division may consider whether to grant the bank's request for an NPA so long as the request for such relief is made before October 31, 2014. Relief will be granted at the sole discretion of the Tax

Division, but only under "extraordinary circumstances." Moreover, the Tax Division may deny relief if the bank is under criminal investigation, or if the Tax Division has received information concerning wrongful conduct. This may not be known to the bank. Evidence of wrongful conduct may have already been provided to the Tax Division by an account holder who participated in the IRS's OVDP initiative. In addition, the DOJ has declared a moratorium on identifying new banks as criminal targets until January 2014. This means that a bank may miss the deadline to file for relief as a Category 2 bank and be denied Category 3 relief because the bank, unbeknownst to it, was under criminal investigation. Accordingly, both of these factors must be carefully considered before a Swiss bank elects to wait and apply as a Category 3 bank. Because this may leave Swiss banks in a difficult position if they miss the deadline for filing as a Category 2 bank, banks must immediately begin their internal investigation to determine if the bank is culpable under US tax law.

The Tax Division has 270 days from receipt of the independent examiner's report to inform the Swiss Bank whether it is eligible for a Non-Target Letter as a Category 3 bank.

The Tax Division has 270 days from receipt of the independent examiner's report to inform the Swiss Bank whether it is eligible for a Non-Target Letter as a Category 3 bank. The Tax Division may decline to provide a Non-Target Letter to any Swiss bank if it determines that the evidence or information contradicts the report of the independent examiner, or otherwise demonstrates criminal culpability. No penalty is imposed on a Category 3 bank.

The last category, Category 4, covers any Swiss bank that is not under formal criminal investigation and is a "Deemed Compliant Financial Institution" as a "Financial Institution with Local Client Base" under FATCA. A bank requesting a Non-Target Letter as a Category 4 bank must follow the same application time line as a Category 3 bank and include the same information as a Category 3 bank. No penalty is imposed on a Category 4 bank. Also, Category 3 and 4 banks must retain records for 10 years following the signing of a Non-Target Letter.

The decision to participate in the program should not be made lightly. Among the myriad of issues Swiss banks should consider are the following:

- What are the potential criminal, civil and reputational risks of electing not to participate in the program?
- What evidence should be compiled to determine whether US-related accounts are noncompliant?
- What are the potential civil penalties associated with those accounts?
- How should an acceptable plan be formulated to comply with the program requirements?
- What is the potential risk of filing as a Category 3 bank when the bank is already under investigation by the DOJ?
- What criteria should be used to select a qualified independent examiner?
- How should employees and advisors who structured, operated, or supervised the cross-border business be dealt with?

- How will disclosure impact customer relationships and how can the bank mitigate reptuational risk associated with such disclosure?

Because of the rapidly approaching deadline and the many uncertainties concerning what the Tax Division's state of knowledge of the Swiss bank's operations, banks must promptly commence an internal review, and complete it expeditiously. The deadline for the submission of the Category 2 application is December 31, 2013. The effort to review accounts and prepare the necessary paperwork will be a costly and time consuming exercise, but failure to act quickly and correctly may lead to more severe treatment if no application or the wrong application is filed with the Tax Division. Although far from optimal, the settlement program provides a unique remedial opportunity for Swiss banks to obtain closure of US criminal tax exposure. A Swiss bank that ignores the settlement program may face years of litigation and uncertain reputational, financial and criminal risks.

– Lawrence M. Hill & Richard A. Nessler

District Court Upholds STARS Transaction Ruling Payment Is Included in Pre-Tax Profit

On October 17, 2013, the US District Court of Massachusetts issued an opinion holding that a STARS transaction entered into by Sovereign Bancorp, Inc. was not a sham, but rather had objective economic substance as a result of a payment Sovereign received from the counterparty which was included in Sovereign's pre-tax profit.

On October 17, 2013, Judge George A. O'Toole of the US District Court of Massachusetts issued an opinion holding that a structured trust advantaged repackaged securities ("STARS") transaction entered into by Sovereign Bancorp, Inc. (now known as Santander Holdings USA, Inc.) ("Sovereign") was not a sham, but rather had objective economic substance as a result of a payment Sovereign received from the counterparty which was included in Sovereign's pre-tax profit.[3] The opinion was consistent with the remarks of the district court judge in a September 25, 2013 pretrial conference when ruling that Sovereign's motion for partial summary judgment would be granted.[4] The ruling marks a significant taxpayer victory in the so-called "foreign tax credit generator" cases.

Background

The STARS transaction involved a complex structure in which Sovereign transferred $6.7 billion in income-producing property to a trust subject to UK income tax. The income from the trust, which was attributed to Sovereign, was also subject to US income tax, and Sovereign claimed a foreign tax credit under section 901 for the

[3] *Santander Holdings USA, Inc. v. United States*, 1:09-11043-GAO (D. Mass. 2013).

[4] The transcript of the pretrial conference may be found on the Tax Analysts website: http://www.taxanalysts.com (see Doc. 2013-23149, 2013 T.N.T. 191-19).

amount of UK income taxes paid.[5] The transaction allowed the counterparty to obtain favorable UK tax treatment and, as a result of the favorable tax treatment, the counterparty extended a loan to Sovereign at a below-market rate. As part of the loan, the counterparty made a payment to Sovereign equal to one-half of the amount of UK income taxes paid on the trust income.

The government asserted that the payment from the counterparty to Sovereign should be excluded from Sovereign's calculation of pre-tax profit as an "effective rebate," which would mean that Sovereign did not in substance pay one-half of the UK taxes. According to the government, because the payment was an effective rebate and, as such, a "tax effect," the transaction failed the objective economic substance doctrine as it did not have a reasonable possibility of a pre-tax profit.

The district court concluded that the government's rebate argument was "wholly unconvincing" in light of the explicit provisions in the Code and the regulations addressing when a payment of foreign taxes may be considered rebated to the taxpayer.

Rebate and Pre-Tax Profit Analysis

The district court concluded that the government's rebate argument was "wholly unconvincing" in light of the explicit provisions in the Code and the regulations addressing when a payment of foreign taxes may be considered rebated to the taxpayer. The court disregarded the expert witness testimony of the government regarding whether the payment was a rebate, explaining that the question is not one of fact for an expert witness, but rather a question of law to be answered by the judge.[6] The court ultimately determined the payment was not a tax effect because the payment was not an actual rebate of taxes from the UK to Sovereign and there was no authority for characterizing the payment as an "effective" or "constructive" rebate. The court supported its conclusion by citing to case law and private letter rulings that have addressed payments with respect to taxes between private parties and have concluded that such payments are not tax items.

[5] All section references are to the Internal Revenue Code (the "Code") and all references to regulations are to the Treasury regulations issued thereunder, unless otherwise noted.

[6] The court noted that recent decisions in similar STARS transaction cases appear to have treated the question of whether the payment was a rebate or tax effect as a matter of fact rather than a matter of law. *See Salem Fin., Inc. v. United States*, -- Fed. Cl. --, 2013 WL 5298078, at *39-40 (Sept. 20, 2013); *Bank of N.Y. Mellon Corp. v. Commissioner*, 140 T.C. 15, 40-43 (Feb. 11, 2013). For a discussion of *Bank of N.Y. Mellon Corp. v. Commissioner*, you may refer to "Tax Court Disregards STARS Transaction as Lacking Economic Substance," *Focus on Tax Controversy and Litigation*, at 1 (February, 2013), available at http://www.shearman.com/files/Publication/528b88d0-8154-4ee1-be90-3c6e45042fc7/Presentation/PublicationAttachment/22667e17-0aa7-4675-8d2f-4ba7afbdfff0/Tax-Court-Disregards-STARS-Transaction-02-2013-TAX.pdf. *See also* Kevin Dolan, "The Foreign Tax Credit Diaries – Litigation Run Amok," *Tax Notes* (Aug. 26, 2013) (explaining the main issue in foreign tax credit borrowing cases, such as the STARS transaction cases, should be how to apply the for-profit test of the economic substance doctrine in the context of foreign tax credits).

After concluding the payment from the counterparty to Sovereign was not a rebate or tax effect, the court held that the payment was properly regarded as income to Sovereign for purposes of determining whether the transaction had a reasonable prospect of a pre-tax economic profit under the economic substance doctrine. The court explained that treating the payment as revenue to Sovereign is consistent with substance of the regulations and existing case law, such as *Compaq Computer Corp. v. Commissioner*[7] and *IES Industries, Inc. v. United States*,[8] which affirmed the basic principle articulated in *Old Colony Trust Co. v Commissioner*[9] that income tax paid on behalf of a taxpayer is income to the taxpayer. Because the payment was treated as pre-tax income to Sovereign, the transaction had a reasonable prospect of profit and, thus, the transaction had economic substance.

The court rejected the government's argument that the transaction was a sham to generate foreign tax credits for Sovereign.

In addition, the court rejected the government's more general argument that the transaction was a sham to generate foreign tax credits for Sovereign. The court stated that even if the payment was intended to be an assumption of half of the UK tax liability by the counterparty, Sovereign still paid the full UK tax for purposes of the foreign tax credit and was entitled to claim the resulting foreign tax credit on its US tax return.

Economic Substance Analysis

Unlike other STARS transaction cases, such as *Bank of N.Y. Mellon Corp. v. Commissioner*, the court did not apply the subjective economic substance test, which generally requires a court to consider the subjective purpose or motivation of a taxpayer. The court, which is located in the First Circuit, did not expect that the First Circuit Court of Appeals would require a court to apply the subjective economic substance analysis when it objectively determines that a transaction has economic substance. Thus, the court concluded it was not necessary to analyze Sovereign's subjective intent for entering into the transaction.

–Mary Jo Lang

[7] 277 F.3d 778, 784-85 (5th Cir. 2001).

[8] 253 F.3d 350, 354 (8th Cir. 2001).

[9] 279 U.S. 716, 731 (1929) ("The question in this case is, 'Did the payment by the employer of the income taxes assessable against the employee constitute additional taxable income to such employee?' The answer must be 'Yes.'")

Court of Federal Claims Holds for Government in BB&T STARS Transaction

The Court of Federal Claims ruled that a subsidiary of BB&T Corporation was not entitled to $660 million in tax benefits that BB&T claimed based on its participation in a Structured Trust Advantaged Repackaged Securities ("STARS") foreign tax credit generator transaction.[10] Furthermore, the Court imposed $112 million in penalties.

The Court bifurcated the trust and loan components of the STARS transaction and applied the economic substance doctrine separately to each component.

Background

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

Economic Substance Analysis

The Court bifurcated the trust and loan components of the STARS transaction and applied the economic substance doctrine separately to each component. In doing so, the Court found that the trust component of the STARS transaction "quite clearly is an abusive tax avoidance scheme" without a non-tax business purpose and should be disregarded as a sham structure. In its analysis of the loan component, the Court found that the loan lacked economic substance because it was not structured to make a profit, but instead to provide BB&T with a pretext for a purported business purpose for the trust component of the transaction. The Court found that for nearly the first three years of the transaction, Barclays made Bx payments to BB&T exceeding by millions the interest payments due from BB&T to Barclays. The Court determined that the loan had no non-tax business purpose and no possibility of pre-tax profit.

BB&T had argued that the Court should review the STARS transaction as a single integrated transaction, whereby the existence of the trust permitted Barclays to offer BB&T a $1.5 billion loan at a favorable rate. Looking at the economic realities of the

[10] *Salem Financial, Inc. v. United States*, No. 10-192 (Fed. Cl. Sept. 20, 2013).

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

Penalties

The Court found BB&T liable for penalties for negligence and substantial underpayment of tax for its participation in the transaction.

The Court found BB&T liable for penalties for negligence and substantial underpayment of tax for its participation in the transaction. The Court found that the tax advice, which BB&T had received from the accounting firm and the law firm providing the tax opinion, was unreasonable; that BB&T's reliance on such advice was unreasonable; that substantial authority did not support the tax treatment claimed by BB&T; and that BB&T did not act with reasonable cause and good faith with regard to any portion of the underpayment determined.

–Judy Fisher

Tax Court Allows Interest Deduction for Loan Connected with STARS Transaction

The Tax Court considered BNY's request for consideration based on the law of the Second Circuit, where an appeal from the Tax Court in the case would lie.

On September 23rd, the Tax Court issued a supplemental opinion finding interest paid by the predecessor of Bank of New York Mellon Corporation (both entities referred to herein as "BNY") on a loan connected with a Structured Trust Advantaged Repackaged Securities ("STARS") transaction to be a deductible expense.[11] BNY entered into the transaction through ancillary agreements with Barclays and by forming a new structure, including a trust subject to tax in the United Kingdom that would pay UK tax and generate foreign tax credits for BNY. In a previous opinion in February of 2013, the Tax Court found this structure to be lacking economic substance and disallowed BNY's purported foreign tax credits and expense deductions generated by the plan.[12] In the earlier decision, the Tax Court bifurcated the challenged transaction into the STARS portion and a separate loan from Barclays to BNY for purposes of the economic substance analysis. BNY did not challenge the Tax Court's primary findings regarding the economic substance of the STARS structure or the disallowance of the foreign tax credits. Instead, it argued that it should be entitled to deduct the interest expense on the bifurcated loan portion based on the Tax Court's earlier finding that the loan proceeds were available for use by BNY in its banking business throughout the STARS transaction period. BNY suggested that the Tax Court's finding logically leads to the conclusion that the loan was not a necessary

[11] *Bank of New York Mellon Corp. v. Commissioner*, T.C. Memo. 2013-225.

[12] *Bank of New York Mellon Corp. v. Commissioner*, 140 T.C. 15 (2013).

component of the structure that created the disallowed foreign tax credits, and therefore served some legitimate purpose other than generating tax benefits.

The Tax Court considered BNY's request for consideration based on the law of the Second Circuit, where an appeal from the Tax Court in the case would lie. The court cited Second Circuit tax shelter cases involving loans, stating that interest is not deductible if the payment arises from an "economically empty" transaction, which is one that does not have a "purpose, substance or utility" other than the expected tax considerations.[13] BNY argued that the loan was deductible under this standard because the proceeds were not used to finance the disallowed STARS transaction and were instead to be considered separately. The government noted that the precedent cases involved a single tax benefit rather than a bifurcated structure but argued that the addition of a second tax benefit should not change the result. The Tax Court disagreed with the government, distinguishing the tax shelter precedents where loans were "integral or intertwined with [the] transaction lacking economic substance."[14] In those cases, the loans in question were used to finance the transaction that lacked economic substance and their sole benefit and purpose were the generation of deductions from the tax shelter to offset unrelated income. In contrast, BNY's loan was not required to generate or finance the foreign tax credits in the STARS transaction. Instead, the proceeds were available for BNY to use in its banking business for other purposes, thus serving some utility other than generating the relevant tax benefits.

The Tax Court disagreed with the government, distinguishing the tax shelter precedents where loans were "integral or intertwined with [the] transaction lacking economic substance."

The government also challenged the deductibity of the interest payments because BNY could have found financing at a lower cost in the marketplace had the loan not been related to the STARS transaction. Although gross mispricing is evidence of a sham, the Tax Court stated that interest may still be deductible if there is a "real loan that is used for economically substantive activity", even if the borrower is motivated by favorable tax treatment.[15] Therefore, the court found that BNY was entitled to deduct the interest because, although the financing may have been overpriced, the proceeds were available for BNY's use in its banking business for legitimate purposes, suggesting that this was a real loan rather than a sham.

–Daniel B. Smith

[13] T.C. Memo 2013-225 (citing *Lee v. Commissioner*, 155 F.3d 584, 586 (2d Cir. 1998); *Goldstein v. Commissioner*, 364 F.2d 734, 740 (2d Cir. 1966, *aff'g* 144 T.C. 284 (1965)).

[14] T.C. Memo. 2013-225.

[15] *Id.*

Supreme Court Hears Oral Arguments in *United States v. Woods*

On October 9, 2013, the Supreme Court heard oral arguments in *United States v. Woods*.[16] Woods involves the question of whether the section 6662 overstatement penalty applies to an underpayment of tax resulting from a determination that a transaction lacked economic substance because the sole purpose of the transaction was to generate a tax loss by artificially inflating the taxpayer's basis in property. The Supreme Court, *sua sponte*, directed the parties to additionally brief and argue the question of whether the federal district court had jurisdiction to consider the section 6662 penalty.[17]

Woods is being closely watched as it is expected to resolve the split among lower courts and will affect many cases in which the IRS is attempting to collect section 6662 penalties from taxpayers involved in transactions involving an overstatement of basis.

Oral arguments focused on whether the district court had jurisdiction to consider the section 6662 penalty. Under section 6662(f), a district court in a partnership-level proceeding has authority to apply any penalty "which relates to an adjustment of a partnership item." Counsel for the government contended that a district court has authority to impose such a penalty if it makes a threshold determination that the type of error the IRS identified on a partnership return typically will trigger a penalty on an individual partner when that partner prepares his or her return consistent with the partnership return.

Counsel for taxpayer contended that the government's position was an overly broad interpretation of the Code and instead focused on the argument that outside basis was not a partnership item. Counsel for the government countered this by arguing that the transaction giving rise to the penalty—the sham transaction which artificially inflated basis—was a partnership item. Justice Kagan noted that both parties agreed that the sham transaction was a partnership item, but that they disagreed as to whether the section 6662 penalty may relate to an item that is indirectly related to a partnership item.

Lower courts have disagreed as to the proper treatment of this issue. Both the D.C. Circuit[18] and the Federal Circuit[19] have concluded that penalties relating to outside basis cannot be determined in a partnership-level proceeding. The Tax Court in *Tigers*

[16] *United States v. Gary Woods*, No. 12-562.

[17] See Transcript of Oral Argument, *United States v. Woods* (Oct. 9, 2013) (No. 12-562); *see also* Madara and Velarde, "TEFRA Jurisdiction Dominates Woods Oral Arguments," *Tax Notes Today* (Oct. 10, 1013).

[18] *Petaluma FX Partners, LLC v. Commissioner*, 591 F.3d 649 (D.C. Cir. 2010), *aff'g in part, rev'g in part* 131 T.C. 84 (2008).

[19] *Jade Trading, LLC, v. United States*, 598 F.3d 1372 (Fed. Cir. 2010), *aff'g in part, rev'g in part and remanding on penalty issues* 80 Fed. Cl. 11 (2007).

Eye Trading, LLC v. Commissioner, disagreed with the conclusion reached by the D.C. Circuit in Petaluma FX Partners, LLC.[20] *Woods* is being closely watched as it is expected to resolve the split among lower courts and will affect many cases in which the IRS is attempting to collect section 6662 penalties from taxpayers involved in transactions involving an overstatement of basis. A decision in this case is expected by June 2014.

–Melissa Henkel

Swiss Bank Frey Ceases

Bank Frey's decision follows the announcement of Switzerland's oldest bank, Wegelin & Co., who closed its doors following its indictment on tax evasion and plea deal in which it agreed to pay the DOJ $74 million in fines and restitution.

On October 17, 2013, Swiss Bank Frey & Co. AG announced that it had decided to cease business activities as a bank stemming from "increasingly difficult market conditions, ever-growing regulations and the unsustainable requirements that smaller private banks are required to comply with" related to the tax dispute with the United States. Dr. Markus Frey, Chairman of the Board, stated that "[a]s a result of developments in recent years, circumstances and challenges have presented themselves, especially in Switzerland, that means it no longer makes sense for a small bank to continue its cross-border services." The Bank is reportedly financially healthy and will not be liquidated.

Bank Frey reported in its Annual Report for 2012 that it was under a criminal tax evasion investigation by the Department of Justice, but the Bank was not under indictment. However, Bank Frey's decision to cease banking operations will not end the DOJ's investigation and an indictment is still a possibility. Bank Frey's decision follows the announcement of Switzerland's oldest bank, Wegelin & Co., who closed its doors following its indictment on tax evasion and plea deal in which it agreed to pay the DOJ $74 million in fines and restitution.

The DOJ and Switzerland's Federal Department of Finance announced in August a settlement program that offers amnesty to Swiss banks and resolution regarding involvement with individuals and entities that used Swiss accounts to evade US taxes and reporting requirements. The new program is similar to the IRS Offshore Voluntary Disclosure Program, which incentivized US taxpayers to report undisclosed foreign accounts to the IRS to reduce substantial civil penalties and eliminate the risk of criminal prosecution. However, Swiss banks currently under criminal investigation, including Bank Frey, are excluded from the disclosure program. Also weighing on Bank Frey was Switzerland's recent approval to amend the Swiss intergovernmental

[20] *Tigers Eye Trading, LLC v. Commissioner*, 138 T.C. 67 (2012).

agreement with the United States to implement FATCA, which must be implemented by July 1, 2014.

In April 2013, Bank Frey's former head of private banking and member of the Executive Board, Stefan Buck, was indicted in the United States along with Edgar Paltzer, a Swiss lawyer, with conspiracy for assisting US taxpayers to file false tax returns and committing tax evasion. Buck remains at large. Also on the run was Raoul Weil, former head of UBS's Global Wealth Management division, who was indicted by the DOJ in 2008 for conspiring to defraud the US by helping US clients conceal taxable accounts. The indictment alleged that Weil conspired with others to help Americans conceal nearly $20 billion in Swiss bank counts. Weil was recently arrested by Italian police in Bologna, and faces possible extradition to the United States for aiding and abetting tax evasion. The DOJ's aggressive stance directed at the Swiss banking community appears to have claimed another victim, but time will tell if other Swiss banks follow Frey's decision to cease operations.

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Tax Controversy and Litigation at Shearman & Sterling

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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