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Cross-Border Taxation

In the fifth of a series of Mayer Brown articles regarding the IRS enforcement campaign effort, partners Gary Wilcox, Thomas Kittle-Kamp and Brian Kittle look at the murky contours of the IRS Large Business & International Division's audit campaign regarding repatriation transactions. They write that despite a lack of guidance and clarity from the Service so far, taxpayers should prepare for ''a fact-gathering nightmare'' in a repatriation exam.

Repatriation Audits: Fact Gathering in Search of a Theory

BY GARY WILCOX, THOMAS KITTLE-KAMP, AND BRIAN KITTLE

In a webinar May 23, the Large Business & International Division of the Internal Revenue Service explained its repatriation campaign and confirmed what the tax community suspected: LB&I doesn't know which structures or issues will be the focus of the campaign—or it isn't going to tell.

LB&I's executive leading the repatriation campaign, John Hinding, was asked if LB&I is targeting the kind of triangular B reorganization described in Notice 2016-73, or a more commonplace transaction such as an intercompany loan or a return of basis distribution. Notwithstanding the campaign announcement's declaration that ''LB&I is aware of different repatriation structures'' and its reference to ''identified, high risk repatriation issues,'' Hinding stated that LB&I doesn't have a list at this time.

He explained LB&I will approach these audits by looking for ''indicators of compliance risk'' that may reveal ''questionable repatriation planning.'' But when asked what those indicators are, he and Barbara Harris (director of Northeastern Compliance) replied that announcing them would provide a ''road map'' and not help compliance. The only clarification given was that ''no single indicator is controlling.''

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When asked if LB&I will develop an International Practice Unit (IPU), Hinding replied there is no plan to do so, as existing IPUs should suffice. When asked if LB&I will develop training materials, he said it didn't contemplate a need for any. The plan is to use experienced cross-border agents, who know what to look for.

It is difficult to see how LB&I's repatriation campaign is anything more than a repeat of the tiered issue program. Some transactions were identified as issues in that program before LB&I could articulate what was potentially wrong with them. Take hybrid debt, for example. Its mere identification as a Tier 1 issue caused agents to presume it was bad. Over time LB&I field counsel developed theories for IRS Examinations (Exam) to assert (e.g., no business purpose, no economic substance, no borrowing of cash) and circulated model revenue agent reports (RARs). Eventually these theories were proven in *NA Gen. P'ship v. Commissioner (Scottish Power)*, T.C. Memo. 2012-172, to have no merit. Subject to the recent tax code Section 385 regulations, debt characterization continues to depend on the debt-equity factors, full stop.

Will repatriations follow a similar course? Is every repatriation of money to the U.S. presumptively bad if it isn't fully taxable as a dividend? Will Exam challenge repatriations by asserting similar soft doctrines such as business purpose and step transaction? While it is tough to make predictions, the lack of guidance and clarity doesn't augur well.

Business as Usual

In the meantime, however, one thing is certain. If Exam decides to pursue a repatriation of any kind, the taxpayer better get ready for what is often a fact-gathering nightmare. Unlike the hybrid debt audits where Exam audited very little before it issued an RAR, successful repatriation audits are believed to revolve around the facts. That is because taxpayers lost two recent repatriation cases—*Merck & Co. v. United States (Schering-Plough)*, 652 F.3d 475 (3d Cir. 2011) and *Barnes Grp., Inc. v. Commissioner*, 593 Fed. Appx. 7 (2d Cir. 2014)—due primarily to difficult facts. Exam apparently believes that finding some ''gotchas'' is the key to the next successful repatriation case.

There is no other explanation for the types of information document requests (IDRs) being issued in repatriation audits. Taxpayers are pressed for details that seemingly have nothing to do with the underlying tax issue. Exam wants to know who proposed the idea, how it was deliberated, and how it was approved. It has frequently asked for any and all documents relating to the repatriation such as proposals, slide presentations, notes, agendas, minutes of meetings, telephone calls, emails, and memoranda, whether draft or final, and whether in paper or electronic form.

Exam often asks early in the audit for privileged communications, including all opinions and any other form of written advice from outside advisers, whether it is draft, tentative, or final. Requests also are made to see engagement letters and invoices from advisers. Expect another set of inquiries about business purpose for the entire repatriation transaction as well as for some of the individual steps.

Exam may continue to gather facts until it begins to develop a theory that aligns with the facts, at which point it will become obvious that the taxpayer is in for a fight. In other cases Exam has determined that additional fact gathering isn't worth the effort, and withdrawn. Regardless of where Exam ends up, the audit stage can be an invasive, time-consuming process for taxpayers, often with no end in sight.

So what is a taxpayer supposed to do?

Get Ready While You Can

Exam's issue-focused audits often move at a faster pace than before because the issue has already been identified. The new IDR enforcement policy provides Exam with leverage to insist on timely responses. Delayed responses can generate suspicion. Facing the onslaught of repatriation IDRs on a real time basis can be challenging and, frankly, risky. For all of the above reasons a taxpayer is well advised to prepare a robust ''audit ready'' defense file in advance of the audit.

The best time to prepare for an audit, naturally, is well before an audit begins. Ideally, audit preparation should begin soon after your repatriation transaction is done. At that time memories are fresh, documents are readily located, and key people are still around. Preparing early also may enable taxpayers to follow their document retention policies before any litigation is reasonably anticipated.

Take heed of lessons learned from the taxpayer losses in *Schering-Plough* and *Barnes*. In each case the government followed the old legal adage: When the law isn't on your side, argue the facts.

In *Schering-Plough*, the taxpayer reported that it sold financial assets to its controlled foreign corporation (CFC) in a repatriation strategy, but the IRS argued that the transaction was really a Section 956 loan by the CFC to its U.S. parent. In holding for the government, the Tax Court and U.S. Court of Appeals for the Third Circuit emphasized notes taken by the financial reporting director to the effect that the ''tax guys won't let me call it a loan,'' materials from investment bankers describing the transaction as a loan, an internal loan amortization schedule, failure to seek board committee approval for a ''sale'' transaction, and failure to report the transaction as a ''sale'' on Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations.

In *Barnes*, the Tax Court and Second Circuit stepped together a series of transactions and characterized them as, in substance, a taxable dividend from the CFC to its U.S. parent. Among the documents pointed out by the courts were an agreement acknowledging that the transactions constituted ''a single integrated plan'' and an ''exit strategy'' to ''unwind'' the plan. The courts also emphasized the taxpayer's inability to prove the nontax benefit for two financing subsidiaries (viewed as ''at best, a mere afterthought''), or that interest and dividends were paid on the key instruments involved.

The most recent repatriation case involving Illinois Tool Works Inc. (ITW) is awaiting a decision by the Tax Court (*Ill. Tool Works, Inc. v. Commissioner*, T.C., No. 10418-14). This case involves an upstream loan from a foreign subsidiary to its foreign parent followed by a return-of-basis distribution from the foreign parent to its U.S. parent. While there are significant factual issues, they relate mainly to whether the upstream loan should be respected as debt under traditional various debt-equity factors, rather than treated as a dividend.

In repatriation transactions there will, inevitably, be a step or two that is taken for no reason other than tax. In that regard, planning a repatriation is no different than other types of tax planning.

The government is also asserting that substance-over-form principles should treat the foreign subsidiary as paying a dividend directly to the U.S. parent. That argument, however, faces resistance from precedent in the Seventh Circuit of *Falkoff v. Commissioner*, 604 F.2d 1045 (7th Cir. 1979).

In short, the ITW fact pattern is the flipside of the more common form of leveraged repatriation, where the loan is downstream from the U.S. parent to the CFC, and for that reason it isn't expected to have wide application—regardless of the result—in the repatriation area.

The more likely battleground for leveraged repatriations will involve a determination of whether the taxpayer's transaction is closer to the transactions in *Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956), than the transactions in *Schering-Plough* and *Barnes*. In *Kraft*, a non-consolidated U.S. subsidiary issued debt to its U.S. parent as a dividend for the conceded purpose of generating interest deductions at the subsidiary level. The Second Circuit held that the debt couldn't be disregarded on economic substance grounds solely because of the tax motivation, and upheld the debt under traditional debt-equity factors.

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In *Falkoff*, a corporation borrowed money from a bank to make a return-of-basis distribution at year-end, with a plan to sell assets early in the next year (thereby generating earnings and profits) and use the cash proceeds to pay off the loan. The Service argued that the two transactions should be stepped together and treated as a taxable dividend, on the grounds that the leveraged distribution lacked business purpose and economic substance. The Seventh Circuit held that the transactions as a whole had economic substance and that their timing should be respected for tax purposes.

Kraft and *Falkoff* remain as significant as ever, despite the government's efforts to overrule them. For several years the Obama administration proposed legislation to eliminate return-of-basis treatment for leveraged repatriations. After prospects for this legislation grew dim, the Treasury attempted to override these cases in the repatriation context when it issued proposed regulations under Section 385. The final regulations, however, withdrew the application of those regulations to leveraged repatriations by exempting foreign issuers.

Develop Your Theme and Stick to It

In repatriation transactions there will, inevitably, be a step or two that is taken for no reason other than tax. In that regard, planning a repatriation is no different than other types of tax planning. One approach is to frame the business purpose for the transaction as a whole, and then describe each individual step (if Exam asks) as a step taken in furtherance of the broader business objective.

That approach was successfully followed by the taxpayer in *Countryside LP v. Commissioner*, T.C. Memo. 2008-3, in which a partnership redeemed two partners by using its cash to buy non-marketable notes and distribute the notes to the partners in a nontaxable transaction, rather than distribute the cash in a taxable transaction. The Tax Court held that since the overall redemption transaction served a business objective of removing two partners from the partnership, the means of accomplishing that objective couldn't be challenged on the grounds they were tax motivated.

Another approach is to attempt a justification of every step with a business purpose. But that can make matters worse if the proof of business purpose isn't compelling. Taxpayers might review the importance of proving business purpose for each step before deciding how to proceed. The Service's litigating position in Notice 2014-58 is that each step must be independently analyzed for economic substance, but that position is far from certain and is still being sorted out by the courts (compare the foreign tax credit generator cases with cases like *Countryside* and *Shell Petroleum, Inc. v. United States*, 2008-2 USTC Para. 50,422, S.D. Tex. 2008).

The IRS also argues, and sometimes successfully, that each step must have a business purpose to avoid step transaction (*Long-Term Capital Holdings, LP v. United States*, 150 Fed. Appx. 40, 2d Cir. 2005). But there again some key decisions focus more on whether the step is legally or economically significant than whether it has a business purpose (*Esmark, Inc. v. Commissioner*, 886 F.2d 1318, 7th Cir. 1989).

Sometimes the best approach is to be bold and take the position that you had the right to do what you did. The taxpayer in *NAGP (Scottish Power)* had no business purpose for issuing debt to acquire its foreign parent's stock in a triangular B reorganization, yet it claimed it had the right to decide how to capitalize itself as between partly debt and partly equity. The Tax Court kindly agreed: "NAGP's desire to minimize tax is not conclusive, however, of the characterization of an advance as debt or equity . . . . Indeed, tax considerations permeate the decision to capitalize a business enterprise with debt or equity."

Another good example of forthrightly embracing the right to engage in tax planning is *Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554 (1991), where the taxpayer conceded it exchanged one mortgage for another solely to trigger a taxable loss.

The recent decision of *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2017), also provides a treasure trove of principles that can be cited by the unapologetic taxpayer that is just exercising its rights under the Internal Revenue Code to return basis, issue debt, or whatever the case may be. That case involved the payment of commissions by Summa Holdings to a domestic international sales corporation (DISC) that was owned indirectly by Roth individual retirement accounts (IRAs). The taxpayer conceded that the arrangement was designed to maximize the value of the Roth IRAs (owned by the children of the Summa Holdings shareholders) and avoid the excess contribution limits. The government argued that the taxpayer's tax-avoidance motive justified a substance-over-form recharacterization of the arrangement as dividends to the Summa Holdings shareholders followed by excess contributions to the Roth IRAs. In reversing the Tax Court and holding that taxpayer had the right to apply the code as intended by Congress, the Sixth Circuit stated:

> In assessing the Tax Court's decision, we begin with a basic point: The Internal Revenue Code allowed Summa Holdings and [its shareholders] to do what they did . . . . Commissioner claims a right to reclassify Code-compliant transactions under the "substance-over-form doctrine" in order to respect "overarching . . . principles of federal taxation" . . . . It's one thing to permit the Commissioner to recharacterize the economic substance of a transaction—to honor the fiscal realities of what taxpayers have done over the form in which they have done it. But it's quite another to permit the Commissioner to recharacterize the meaning of statutes—to ignore their form, their words, in favor of his perception of their substance . . . . [T]he substance-over-form doctrine does not authorize the Commissioner to undo a transaction just because taxpayers undertook it to reduce their tax bills . . . .

Exercise Your Rights on Audit

One of the taxpayer's rights almost certain to be tested in a repatriation audit is the right to claim privilege when privileged documents are requested. Viewing privilege as a right may make it easier for taxpayers to resist the temptation to offer privileged documents as an olive branch. Taxpayers obtained an opinion in order to comply with the law, not to do the government's work for it.

Handing over a privileged opinion could open the taxpayer to invasive IDRs asking for copies (including emails) of communications with the taxpayer's advisers, under a subject matter waiver argument by the IRS. Taxpayers should consider whether Section 502(a) of the Federal Rules of Evidence would be helpful in that situation to prevent a subject matter waiver.

A request for emails catches many taxpayers off guard and may seem overly burdensome. The main point to remember is that Exam's authority to request emails is governed by tax code Section 7602, which was enacted before computers and says simply that Exam is entitled to the production of ''any books, papers, records, or other data.'' Unlike the Federal Rules of Civil Procedure and the Tax Court's Rules of Practice and Procedure, the summons authority in the tax code hasn't been amended to authorize discovery of ''electronically stored information'' or ESI.

Further, in contrast to the ESI rules, Section 7602 doesn't require a taxpayer to create a document that doesn't otherwise exist. The IRS Office of Chief Counsel believes the term ''other data'' permits it to summons original electronic data files containing the unaltered metadata, after the taxpayer has produced copies of the relevant data files (CCA 201146017). That remains a gray area. In most cases taxpayers are able to satisfy Exam by producing copies of non-privileged emails on a thumb drive.

Taxpayers who don't understand the underlying issue for a particular IDR have the right to request that Exam be more explicit in explaining what is driving the request. An explanation by Exam that it wants to understand who originated the idea for the transaction or how it was approved doesn't really explain the underlying issue to the taxpayer. The real reason, most likely, is that Exam is looking for facts to paint its overall picture of a tax avoidance transaction, to set itself up for an argument that *Schering-Plough* and *Barnes* are controlling authorities. But Exam won't tell you that. Taxpayers need to decide when it makes sense to go up the chain of authority to complain, or just begrudgingly comply with the request and save the battle with Exam for another day.

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