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Focus on Tax Controversy

Fifth Circuit Ruling in *BMC Software, Inc. v. Comm'r.* Is Good News for Taxpayers

By John T. Woodruff

The U.S. Court of Appeals for the Fifth Circuit recently overturned the U.S. Tax Court in a case that could have created significant additional hurdles for taxpayers electing to create an account receivable under Rev. Proc. 99-32. If the Tax Court's decision had been upheld, or if another circuit holds otherwise, many taxpayers could be forced to make a difficult decision: accept the implications of a secondary adjustment, such as a dividend inclusion or the imposition of withholding tax, or face a potential deficiency arising from the retroactive creation of a receivable under one of several statutory provisions. Rev. Proc. 99-32 was designed to ameliorate the negative consequences of a secondary adjustment. It should not be interpreted to require a taxpayer to navigate between a rock and a hard place.

In *BMC Software, Inc. v. Comm'r.*, 115 AFTR 2d 2015-1092 (5th Cir. 2015), BMC signed a transfer pricing closing agreement to correct its net overpayment for royalties from its foreign subsidiary, BSEH. This income should have been taxable income retained by BMC, but in fact had been paid to BSEH. Pursuant to the closing agreement, BMC agreed to a primary adjustment for each tax year from 2003 to 2006, increasing its taxable income by approximately $102 million in total. However, the $102 million remained in the cash accounts of BSEH. Therefore, a secondary adjustment had to be made to explain the cash in the accounts of BSEH and to conform the tax accounts to the cash accounts.

BMC had two options to make the secondary adjustments: It could treat the $102 million overpayment as a deemed capital contribution from BMC to BSEH. Alternatively, BMC could elect pursuant to Rev. Proc. 99-32 to treat the $102 million as an account receivable, payable by BSEH to BMC, with interest accruing from the date of deemed creation of the account. BMC elected to treat the $102 million primary adjustment as a series of interest-bearing accounts receivable from BSEH, arising in each of the tax years in question. In 2011, on exam, the Internal Revenue Service (IRS) asserted that the account receivable that was created pursuant to Rev. Proc. 99-32 created a debt that should be taken into account in determining BMC's eligibility to claim a § 965 deduction for remittances made during the 2006 tax year.

Congress enacted § 965 as a temporary stimulus provision to encourage corporations to repatriate funds sitting in the accounts of their foreign subsidiaries. Accordingly, § 965 permitted a one-time tax deduction in the amount of 85 percent of certain dividends paid by a controlled foreign corporation (CFC) to its U.S.-based parent corporation. However, Congress included an anti-abuse provision preventing U.S. corporations from making loans to their foreign subsidiaries to fund § 965 dividends. The exception provides that the amount of repatriated dividends otherwise eligible for a § 965 dividends-received deduction is reduced by the amount of any increase in related-party indebtedness between October 3, 2004, and the end of the taxable year in which the dividend was paid (Testing Period).

In its 2006 tax year, BMC claimed a § 965 deduction and remitted $721 million from BSEH. BMC accurately reported no related-party indebtedness on its 2006 tax return. However, four years after the execution of the 99-32 Closing Agreement,

IRS issued to BMC a notice of tax deficiency in the amount of approximately $13 million for the 2006 tax year, asserting that the accounts receivable that BMC established pursuant to Rev. Proc. 99-32 constituted related-party indebtedness during the Testing Period. As a result, IRS asserted that BMC was required to reduce the amount of the repatriated dividends eligible for the § 965 dividends-received deduction.

BMC challenged the deficiency in Tax Court. In holding for IRS, the Tax Court concluded, among other things, that the 99-32 receivable constituted "indebtedness" within the meaning of § 965 and existed during the Testing Period. In addition, the Tax Court rejected BMC's argument that because the accounts receivable were not actually created until 2007, after the conclusion of the Testing Period, BMC's § 965 dividends-received deduction should not be reduced. The Tax Court determined that "the accounts receivable qualify as indebtedness during the testing period because [BMC] and [IRS] agreed that they were established" during the Testing Period, albeit retroactively. Therefore, the Tax Court concluded that the retroactively established accounts receivable reduced the amount of BMC's 2006 § 965 dividend-received deduction.

BMC appealed this decision, and the Fifth Circuit reviewed the case under a *de novo* standard. BMC made two arguments: First, the 99-32 accounts receivable did not constitute "indebtedness" within the meaning of § 965(b)(3). Second, it did not contractually agree, in the 99-32 Closing Agreement, that the accounts receivable would be treated as indebtedness.

The Fifth Circuit, applying a plain language method of interpretation, first noted that the text of § 965(b)(3) specifically required that the determination of the amount of indebtedness be made "as of the close of the taxable year for which the election [under § 965] is in effect." Thus, the court reasoned that the accounts receivable could not have existed on March 31, 2006, the end of the Testing Period, because they were not created until after the parties executed the 99-32 Closing Agreement in 2007.

Next the Fifth Circuit addressed IRS's argument that BMC agreed in the 99-32 Closing Agreement to backdate the accounts receivable. The court reasoned that the fact that the accounts receivable were backdated did nothing to alter the reality that they did not exist during the Testing Period, noting that this was not a situation in which a subsequent adjustment was made in order to accurately reflect what actually happened in the taxable year. "Rather . . . BMC agreed to create previously nonexistent accounts receivable with fictional establishment dates for the purpose of calculating accrued interest and correcting the imbalance in its cash accounts that resulted from the primary adjustment." Thus the court concluded that because the accounts receivable were not created until 2007, they could not have existed "as of the close of" the applicable taxable year, and BMC's § 965 deduction could not be reduced under § 965(b)(3).

Finally, the Fifth Circuit noted that the dispute over the language of the Closing Agreement was an issue of contractual interpretation. IRS argued that the introductory clause, which states that "now it is hereby determined and agreed for federal income tax purposes . . . " contractually rendered the 99-32 account receivable indebtedness during the Testing Period. However, the court reasoned that this was a boilerplate provision required by IRS in every closing agreement. Further, the court applied the canon of construction *expressio unius est exclusio alterius* to hold that the Closing Agreement's expansive enumeration of tax consequences was exclusive. Since those terms did not require that the accounts receivable be treated as indebtedness for purposes of § 965, the court held that IRS's interpretation of the 99-32 Closing Agreement was foreclosed by its plain language. Accordingly, the Fifth Circuit held that under the 99-32 Closing Agreement, BMC did not agree to treat the accounts receivable as "indebtedness" for purposes of § 965.

Implications of the Case

This holding is good news for taxpayers. Had the Fifth Circuit held otherwise, taxpayers would be required to consider whether an election to create an account receivable under Rev. Proc. 99-32 in order to avoid the negative consequences of a secondary adjustment could result in negative consequences under another statutory provision. In fact, IRS could still assert this theory in other circuits or, albeit unlikely, seek *certiorari* from the Supreme Court.

There are a number of situations in which treating a 99-32 account receivable as indebtedness in an earlier year for all

purposes of the Internal Revenue Code could create unfavorable tax results. Could IRS assert that a 99-32 account receivable in favor of a CFC creates an investment in U.S. property? If so, the taxpayer might avoid the treatment of a secondary adjustment as a dividend only to find that the deemed indebtedness created a taxable investment in U.S. property of the same or a similar amount. Might IRS assert that deemed interest on the account receivable created subpart F income? Would it assert that a 99-32 account receivable created to avoid treating a secondary adjustment as a dividend to a foreign parent subject to withholding retroactively increased the debt-to-equity ratio of the U.S. subsidiary, creating disqualified interest when an earnings stripping limitation would not otherwise have applied? What if the taxpayer had engaged in a corporate restructuring during a previous year? Would IRS assert that the 99-32 account receivable created boot in a previous reorganization, disqualified a reorganization or created a § 304 dividend? What other implications could the creation of an account receivable have on a previous tax year?

Perhaps some of these scenarios are fanciful. But so is the retroactive creation of a receivable for purposes of § 965. If IRS challenges similar cases in other venues, taxpayers will be forced to carefully review their prior period transactions in order to avoid creating one tax liability while trying to avoid another.

When Is a Second Inspection Not a Second Inspection?

By Robin L. Greenhouse

In *United States v. Titan International, Inc.*, the Illinois district court enforced an Internal Revenue Service (IRS) administrative summons and rejected the taxpayer's claim that the summons, issued in connection with the examination of the taxpayer's 2010 income tax return but seeking the taxpayer's 2009 books and records, violated the "second inspection rule" in Internal Revenue Code Section 7605(b). The court concluded that a re-examination of the 2009 books and records would be prohibited if the IRS was seeking to make additional assessments for 2009. The court, however, accepted the IRS's assertion that the taxpayer's 2009 books and records were necessary to verify a deduction claimed on the taxpayer's 2010 income tax return, and the IRS did not intend to make any additional tax assessments with respect to tax year 2009.

In order to ensure the proper determination of a tax liability, Congress "has endowed the IRS with expansive information-gathering authority." *United States v. Arthur Young & Co.*, 465 U.S. 805, 816 (1984). Code Section 7602 is the "centerpiece of that congressional design." *Id*. at 816. Under Section 7602, the IRS is authorized to "examine any books, papers, records, or other data which may be relevant or material to" a tax investigation, and to summon any person to produce such documents. Section 7602(a)(1), (2).

That authority, however, is subject to judicial review. When a summoned party refuses to comply, the IRS must petition a federal district court to enforce the summons. Code Sections 7402(b), 7604(a). Fifty years ago, in *United States v. Powell*, 379 U.S. 48 (11964), the Supreme Court of the United States sketched out the analytical framework governing summons enforcement. To establish a *prima facie* case, the government must demonstrate the following:

- Its investigation is "conducted pursuant to a legitimate purpose."
- The information sought "may be relevant to that purpose."
- The IRS does not already possess the "information sought" to be summoned.
- All statutorily imposed administrative steps have been followed.

Id. at 57-58. Generally, the government can satisfy this initial burden by filing an affidavit executed by the investigating agent simply stating that the four criteria have been met. *See*, *e.g.*, *United States v. Kis*, 658 F.2d 526, 536 (7th Cir. 1981); *United States v. Davis*, 636 F.2d 1028, 1034 (5th Cir. 1981).

Once the government satisfies these minimal requirements, the burden shifts to the summoned party to either disprove one of the four elements of the government's *prima facie* showing or demonstrate that judicial enforcement of the summons would constitute an abuse of the court's process. *Powell*, 379 U.S. at 58. Although there is no all-inclusive list as to what constitutes such an abuse, *Powell* did provide some guidance: it stated that an "abuse would take place if the summons had

been issued for an improper purpose, such as to harass the taxpayer or put pressure on him to settle a collateral dispute, or for any other purpose reflecting on the good faith of the particular investigation." *Id*.

In *Titan*, the taxpayer maintained that the summons was issued for an improper purpose—to commence a second inspection of the taxpayer's books and records for 2009 in violation of the provision in Code Section 7605(b), commonly referred to as the second inspection rule. The taxpayer maintained that the IRS was conducting an improper second inspection of its 2009 records in connection with the audit of the taxpayer's 2010 income tax return.

Code Section 7605(b) provides, "No taxpayer shall be subjected to unnecessary examinations or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that additional inspection is necessary."

The notice required under Section 7605(b) is not treated as a perfunctory matter and is not designed to warn taxpayers of impending inspections. The second inspection rule "is designed rather, to curb an abuse of investigatory powers of lower-echelon revenue agents. The provision imposes this curb by reallocating decision-making power within the administrative system. . . . [T]he revenue agent retains power to decide whether to conduct an initial inspection of books and accounts but the 'Secretary or his delegate, after investigation' must approve all subsequent inspections and give notice that they are necessary." *United States v. Schwartz*, 469 F.2d 977, 985-86 (5th Cir. 1974) (Bell dissenting) citing Powell, 379 U.S. at 55-56 (1964).

In *Titan*, the taxpayer cited to *Reineman v. United States*, 301 F.2d 267 (7th Cir. 1962), to support its claim that the IRS summons for its 2009 general ledger and 2009 airplane flight logs issued in connection with the 2010 audit must be quashed. In *Reineman*, the IRS audited the taxpayers' 1954 income tax return and determined a deficiency that was satisfied in 1957. In August 1957, another agent notified the taxpayers that he was assigned to audit the taxpayers' 1955 income tax return; no mention was made about re-examining the 1954 tax return. The taxpayers first learned that the agent had reopened their 1954 return when they received in the mail a 10-day letter. The taxpayers protested the re-examination. The agent stated that although he reopened the 1954 return, he did not examine the taxpayers' books and records from 1954, but obtained the information and data necessary to adjust the allowable depreciation expenses from the taxpayers' accountant's workpapers for 1955. The court discredited the agent's testimony and concluded that the agent would have had to reopen and re-examine the 1954 records in order to make the proposed adjustments. Accordingly, the court concluded that the deficiency assessment for 1954 "should be set aside because the Commissioner made a second inspection of taxpayers' books of account for the year 1954" without providing the required notice. *Id*. at 268.

In *Titan*, the district court distinguished *Reineman* on the basis that the IRS in that case attempted to make a second tax assessment for the same tax year. The court concluded that in *Titan*, the IRS was not attempting to inspect the 2009 records in order to make an additional assessment with respect to tax year 2009. Instead, the records for 2009 were sought to assist the IRS in verifying the amount of the deduction claimed on the taxpayer's 2010 tax return. Moreover, the court found no basis to conclude that "the IRS is requesting the records for a 2010 audit under the guise of seeking to make an additional assessment for tax year 2009."

Courts have historically interpreted the second inspection rule narrowly. For example, the second inspection rule has been found inapplicable where the adjustment to an already "inspected" year was based upon information already in the Commissioner's possession. *See Hough v. Commissioner*, 882 F.2d 1271, 1275-1276 (7th Cir. 1989) *affg*. T.C. Memo 1986-229, or *Pleasanton Gravel Co. v. Commissioner*, 64 T.C. 510 (1975) *affd*. *per curiam* 578 F.2d 827 (9th Cir. 1978). Moreover, if presented with an IRS violation of the second inspection rule, taxpayers must take care not to waive their rights to a second inspection notice by failing to object or voluntarily consenting to a re-examination. *See Philip Mangone Co. v. United States*, 54 F.2d 168 (Ct. Cl. 1931). Finally, to limit the IRS's ability to re-examine prior years, taxpayers should keep track of the statutes of limitations for assessment for prior audited tax years, and should not execute Form 872-A, which provides for an open-ended statute extension.

Captive Insurance Litigation: Key 2014 Cases

By Elizabeth Erickson

In 2014, the U.S. Tax Court issued two opinions with significant implications in the captive insurance world. On January 14, 2014, the court issued a reviewed decision in *Rent-A-Center, Inc. v. Commissioner*. On October 29, 2014, the court issued its opinion in *Securitas Holdings, Inc. v. Commissioner*. In both cases, the court held for the taxpayer.

The ultimate issue in both cases was whether the taxpayers could deduct premiums paid for workers compensation and other liability coverages to affiliated captive insurance companies. Captive insurance companies are companies related by ownership to the companies that are insured. In *Rent-A-Center*, subsidiaries of the taxpayer paid premiums for insurance coverage to Legacy, a related Bermudian insurance subsidiary of the taxpayer. In *Securitas*, the U.S. Securitas group paid premiums for insurance coverage to Protectors Insurance Co. of Vermont (owned by the taxpayer), which reinsured these coverages with an Irish reinsurer, Securitas Group Reinsurance Limited (owned by Securitas AB, the taxpayer's parent).

Historically, the Internal Revenue Service (IRS) has been skeptical about captive insurance arrangements, reflecting a prejudice that related-party transactions should generally not enjoy the benefits of insurance reserve accounting for federal income tax purposes. The IRS attack on captives was initiated by a 1977 Revenue Ruling, which was followed by an initial wave of significant litigation. In a second wave of litigation in the 1990s, the courts established the following four criteria to determine whether a captive arrangement constitutes insurance for federal income tax purposes:

- The arrangement must involve insurable risks.
- The arrangement must shift the risk of loss to the insurer.
- The insurer must distribute risks among policyholders.
- The arrangement must be insurance in the commonly accepted sense.

Rent-A-Center and *Securitas* are the leading cases in a third wave of captive litigation focusing on particular elements of the insurance criteria. The Tax Court in these cases addressed two significant issues: whether the presence of a guarantee of the captive insurer by its parent *per se* vitiates risk transfer, and whether a high concentration of risks in a single insured violates the risk distribution criteria.

The IRS position in *Rent-A-Center* and *Securitas* was that a parental guarantee *per se* prevented risk shifting from brother-sister subsidiaries to the captive insurer. In prior cases, the IRS had successfully challenged captive arrangements where a parent guaranteed the performance of a captive subsidiary. In *Rent-A-Center*, the court found that the guarantee, which was issued for accounting purposes and to meet Bermuda's solvency requirements, did not prevent the shifting of risk. Similarly, in *Securitas*, the non-insured parent taxpayer guaranteed the liabilities of the intermediate insurance company, Protectors. The court stated that "the existence of a parental guaranty by itself is not enough to justify disregarding a captive insurance arrangement." The court then analyzed the facts and found that risks were shifted to the captive. Thus, *Rent-A-Center* and *Securitas* establish that parental guarantees do not *per se* vitiate risk shifting in captive arrangements; instead, the issue requires a facts and circumstances analysis.

With regard to risk distribution, the court ruled that it is the number of risks, rather than the number of insureds, that determines whether risk is adequately distributed. In the context of brother/sister captive insurance arrangements, where the operating subsidiaries of an affiliated group insure risks with a sister captive insurance company, the IRS has found no risk distribution where only a few related corporations insure a significant number of risks with the captive. In both *Rent-A-Center* and *Securitas*, the IRS contended that such arrangements did not constitute insurance because they did not distribute risk among a sufficient number of policyholders. For example, in *Securitas*, the government argued that the arrangement did not adequately distribute risk among policyholders because too much of the risk (more than 75 percent in one year) was concentrated in one of the policyholders.

The court in *Rent-A-Center* stated that "[i]n analyzing risk distribution, we look at the actions of the insurer because it is the insurer's, not the insured's, risk that is reduced by risk

distribution." Because Legacy insured thousands of statistically independent risks, the court found that there was adequate risk distribution. The court similarly reasoned in *Securitas*:

> Risk distribution is viewed from the insurer's perspective. As a result of the large number of employees, offices, vehicles, and services provided by the U.S. and non-U.S. operating subsidiaries, [the Irish reinsurer] was exposed to a large pool of statistically independent risk exposures. This does not change merely because multiple companies merged into one. The risks associated with those companies did not vanish once they all fell under the same umbrella. As the SHI Group's expert, Dr. Neil Doherty, explained in his expert report: "It is the pooling of exposures that brings about the risk distribution—who owns the exposures is not crucial." We agree and find that by insuring the various risks of U.S. and non-U.S. subsidiaries, the captive arrangement achieved risk distribution.

These Tax Court decisions unmistakably adopt the position that risk distribution depends on the presence of a sufficient number of individual risks and not on the number of insureds.

McDERMOTT TAX CONTROVERSY HIGHLIGHTS

McDermott Adds Team of Three Leading Partners to its U.S. and International Tax Practice

McDermott welcomed three leading tax lawyers to the Firm's partnership. M. Todd Welty, Mark P. Thomas and Laura L. Gavioli join the Firm to expand McDermott's Tax Controversy practice, which was named "Tax Litigation Firm of the Year" by *U.S. News & Best Lawyers* in 2014.

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