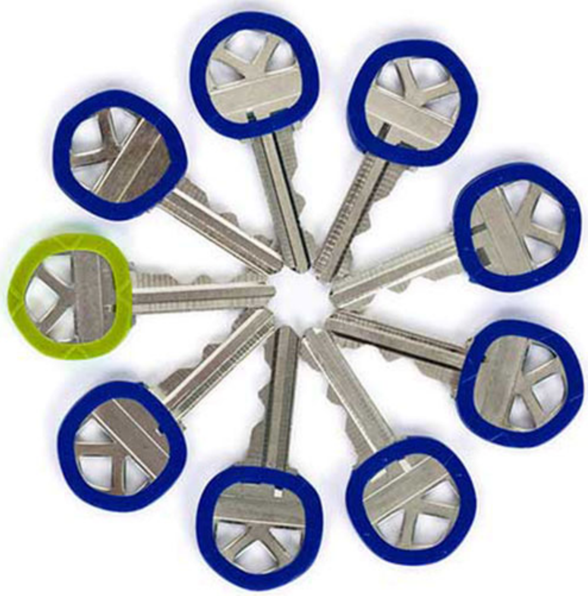

In this issue:

US Court of Appeals for the Federal Circuit rules that a taxpayer and its subsidiary foreign sales corporation are not the "same taxpayer" for purposes of the interest netting rules of Section 6621(d)

In *Ford Motor Co. v. United States*, Federal Circuit Court of Appeals held that Ford Motor Co. and its subsidiary foreign sales corporation did not satisfy the definition of "same taxpayer" for purposes of Section 6621(d) and thus Ford could not "net" its overpayments against the underpayments of its subsidiary.[1] The court applied the test from *Wells Fargo & Co. v. United States*,[2] which interpreted the meaning of "same taxpayer" in light of background legal principles in merger law that are summarized in the Supreme Court's decision in *Moline Properties v. Comm'r*.[3]

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[1] *Ford Motor Co. v. United States*, No. 17-2360 (Fed. Cir. 2018)
[2] *Wells Fargo & Co. v. United States*, 827 F.3d 1026 (Fed. Cir. 2016)
[3] *Moline Properties v. Commissioner of Internal Revenue Service*, 319 US 436 (1943)

Section 6621(d) allows the "same taxpayer" to net accrued interest on overlapping underpayment and overpayments of tax and ensure the taxpayer's interest liability is zero.[4] Ford Motor Co. ("Ford") attempted to utilize this provision, filing a claim for a refund and claiming that it and its subsidiary, Ford Export Services B.V. ("Export") were the same taxpayer and therefore entitled to interest netting under § 6621(d).

In 1984, Ford formed Export as its wholly-owned subsidiary. Export was a foreign sales corporation ("FSC"), a special corporate vehicle with distinct tax advantages that was created by Congress for the purpose of increasing exports. FSCs were designed by Congress to meet international treaty standards, requiring that they have sufficient foreign presence and economic substance to comply with the General Agreement on Tariffs and Trade ("GATT") standards.[5] The World Trade Organization later invalidated FSCs as an impermissible subsidy.

Ford and Export executed an agreement that designated export as an FSC. Under the agreement, Export assumed responsibility for Ford's export related activities and in exchange Ford paid export a commission for each sale. Ford exercised near complete control over Export, Export had no employees, its day to day affairs were run by a Dutch trust company that managed its affairs, and Ford controlled Export's accounting and tax filing and paid Export's tax liabilities. Between 1990 and 1998, Ford and Export filed separate tax returns using separate tax identification numbers. In 1992, Ford overpaid its federal tax liability by approximately $333 million. The overpayment accrued interest until it was refunded by the IRS in 2008. Export, by contrast, underpaid its taxes between 1990-93 and 1995-98. These underpayments accrued interest until Ford paid the amount owed between 1999 and 2005. In 2008, Ford filed a claim for refund, arguing that Ford and Export were the same taxpayer between 1992 and 1998 and therefore entitled to interest netting under § 6621(d). The IRS denied Ford's claim, and Ford sued in the US Court of Federal Claims. The Court of Federal Claims denied Ford's claim, and Ford appealed to the US Court of Appeals for the Federal Circuit.

The issue before the court was whether Ford and Export were the "same taxpayer" for the purpose of 6621(d). The court noted that the term of "same taxpayer" is not defined in the Internal Revenue Code, or in the legislative history. The court instead relied on its prior decision in *Wells Fargo & Co. v. United States*, which interpreted the meaning of the term "same taxpayer" against background legal principles.[6]

The background legal principles that the court identified in its opinion focused on corporate identity. The court adopted the principles laid down by the Supreme Court in *Moline Properties v. Commissioner*, which recognized that corporations and their subsidiaries are formally distinct entities for tax purposes.[7] In *Moline Properties*, the Supreme Court held that corporations with legitimate business purposes are separately taxable, regardless of the degree of control that a parent corporation may exercise over a subsidiary. In *Wells Fargo*, the Federal Circuit Court of Appeals adopted these principles and applied them to the interest netting provisions of section 6621(d), finding that although two companies became the same taxpayer following a merger, they were different taxpayers at the time of the overpayment and underpayment. Therefore, they were not the "same taxpayer" under § 6621(d).

Ford tried to argue that the FSC statute provided background legal principles that displace those outlined in *Moline Properties*. The court stated that this argument was premised on a misunderstanding of the type of background legal principles that inform the *Wells Fargo* test. The court noted that the FSC statute did not state that a FSC and its parent corporation should be treated as sharing a corporate identity for tax purposes. Rather, the FSC statute stated unambiguously that a FSC and its parent corporation were separate entities attempting to establish sufficient economic substance to conform to international treaties. For these reasons, the court held that Ford and Export were not the "same taxpayer" under § 6621(d) and were therefore not entitled to interest netting.

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[4] IRC Section 6621(d)
[5] *Ford Motor Co. v. United States*, No. 17-2360 at 5-6
[6] *See Wells Fargo & Co. v. United States*, 827 F.3d 1026, (Fed. Cir. 2016)
[7] *Moline Properties v. Commissioner of Internal Revenue Service*, 319 US 436, 438 (1943)

District Court enforces IRS summons of a taxpayer internal memoranda cited in a valuation report prepared by a law firm

In *Sanmina Corporation and Subsidiaries v. United States*,[8] the district court enforced an Internal Revenue Service ("IRS") summons of a taxpayer's internal memoranda cited in a valuation report by the taxpayer's law firm, which was prepared for submission to the IRS. The court held that while the internal memoranda of Sanmina Corporation ("Sanmina") were protected by the work product doctrine and attorney-client privilege, those protections were waived by Sanmina when it produced the documents to Sanmina's law firm, to use in preparing a valuation report for submission to the IRS.[9] Accordingly, the district court enforced the IRS summons requiring Sanmina to produce the requested internal memoranda to the IRS.

The summons at issue was issued by the IRS in connection with its examination of Sanmina and its subsidiaries' federal income tax returns for tax years 2008, 2009 and 2010. On those returns, Sanmina claimed a $503 million deduction for worthless stock it held in its subsidiary.

To substantiate the deduction, Sanmina provided the IRS with a report prepared by its lawyer. The report referenced two internal memoranda of Sanmina and substantiated the law firm's conclusion that that Samina's largest asset, an intercompany receivable worth $113 million, should be disregarded. The IRS issued a summons for the memoranda but, Sanmina refused to produce them invoking attorney-client privilege and the work product doctrine. The court reviewed the documents in camera to consider whether attorney-client privilege and work product protection applied and, secondly, whether these protections were waived.

The court found that the documents were protected by the attorney-client privilege. Attorney-client privilege not only covers the substance of the client's communication but also extends to the attorney's advice in response to its client's communication. The court held that the memoranda, drafted by in-house counsel in response to a request for legal advice, fit squarely within the bounds of attorney client privilege.

The court also addressed whether the work product doctrine protects documents prepared in anticipation of litigation.[10] The court used the "because of" test to weigh whether the memoranda were drafted primarily because of litigation or for other reasons. The court found that although there was no pending litigation when the documents were composed, the chance of future scrutiny of Sanmina's large deduction by the IRS prompted the creation of the documents and thus they were therefore protected as work product.

As the district court determined that the memoranda were potentially protected by the attorney-client privilege and work product doctrine, it next addressed whether those protections were waived by Sanmina. In *Weil v. Inv./Indicators, Research & Mgmt.*, Inc. 647 F.2d 18 (9th Cir. 1981) the 9th Circuit ruled that "voluntary disclosure of the content of a privileged attorney communication constitutes waiver of the privilege as to all other communications on the same subject."[11]

The district court observed that the disclosure by Sanmina to its lawyers was not made for the purpose of soliciting legal advice but rather so that the law firm could conduct a valuation analysis. This fact proved to be dispositive to the court's determination as the court held that Sanmina surrendered its work product and attorney client privilege protections when it disclosed the memoranda to its layers for the purpose of preparing a valuation report to be turned over to the IRS. The court further noted that Sanmina's law firm's valuation report could not be critically evaluated without access to the foundational material – Sanmina's internal memoranda.

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8 *Sanmina Corp. v. United States*, No. 3:15-cv-00092 (N.D. Cal. 2018).
URL: https://www.taxnotes.com/lr/resolve/no-315-cv-00092/28hbm

[9] Previously, a Magistrate Judge had issued an order denying enforcement of the IRS summons. The Ninth circuit remanded the Magistrate's decision for a more informed analysis after the Magistrate had declined to review the memoranda at issue in camera.

[10] Fed. R. Civ. P. 26(b)(3)

[11] *Weil v. Inv./Indicators, Research & Mgmt.*, Inc. 647 F.2d 18 (9th Cir. 1981)

Khafra v. IRS: What Constitutes an Extension of Time to File for Purposes of the Lookback Period Under Section 6511(b)(2)(A)?

In *Khafra v. IRS*,[12] the taxpayers filed an original return and claim for refund three years and one day after the due date of the return. The United States District Court for the District of Maryland held that the refund was barred because the date on which the tax was deemed paid fell outside the lookback period under section 6511(b)(2)(A).

Khafra v. IRS

In *Khafra*, the taxpayers filed their Form 1040, *US Individual Income Tax Return*, which had a due date of Sunday, April 15, 2012 on Thursday, April 16, 2015, three years and one day late. The 2011 Form 1040 claimed a refund for amounts that were deemed to be paid on April 15, 2012.[13] April 16, 2012 was a legal holiday.

The parties agreed that the taxpayers' refund claim was timely under section 6511(a). Section 6511(a) provides that a refund claim must be filed by the date that is the later of (1) two years from the time the tax was paid and (2) three years from the time that the original return was filed. The refund claim was timely under section 6511(a) because the original return was filed at the same time as the refund claim.

The parties disagreed, however, whether the day that the payment of the taxpayers' 2011 tax liability was deemed to have been made was within the lookback period under section 6511(b)(2)(A). Section 6511(b)(2)(A) provides that, where a refund claim is filed within three years from the filing of the original return, a refund claim will only be allowed with respect to tax paid during the period preceding the refund claim that is "equal to 3 years plus the period of any extension of time for filing the return." The IRS argued that the day that the taxpayers' payment of their 2011 tax liability was deemed to have been made – April 15, 2012 – was not within the lookback period under section 6511(b)(2)(A) because the refund claim was not filed until three years and one day from such date. The taxpayers argued that the day that the payment of their 2011 tax liability was deemed to have been made was within the lookback period under section 6511(b)(2)(A) because the due date for them to timely file the original return was extended under section 7503.

Section 7503 provides that, "[w]hen the last day prescribed under authority of the internal revenue laws for performing any act falls on Saturday, Sunday, or a legal holiday, the performance of such act shall be considered timely if it is performed on the next succeeding day which is not a Saturday, Sunday, or a legal holiday." Because the due date of the taxpayers' 2011 Form 1040, that being April 15, 2012, fell on a Sunday and the following day was a legal holiday, the taxpayers argued that the due date for filing their original return was April 17, 2012. If this two-day "extension" is added to the lookback period, then the date that the taxpayers' 2011 tax liability was deemed to be paid would be within such period.

The court disagreed with the taxpayers' assertion that section 7503 provides an extension of time to file under all circumstances. The court observed that the performance of an act is only considered timely under section 7503 if it is actually performed on the "next succeeding day which is not a Saturday, Sunday, or a legal holiday."[14] The court further explained that "[t]o apply section 7503 to acts *not* performed on the next succeeding day would contravene the plain language of this provision."[15] Because the taxpayers did not actually file their 2011 tax return on the next succeeding day – *i.e.*, April 17, 2012 – but, instead, several years later, section 7503 is inapplicable. Accordingly, the court held that section 6511(b)(2)(A) precludes a refund in this case because the date that the taxpayers' 2011 tax liability was deemed paid – *i.e.*, April 15, 2012 – was more than three years before the filing of the refund claim on April 16, 2015.

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[12] No. 8:17-cv-03100-PX (D. Md. Nov. 6, 2018).
[13] *See* IRC § 6513(a), (b)(1).
[14] IRC § 7503.
[15] *Khafra*, Slip Op. at 5.

Revenue Ruling 2003-41

The result in *Khafra* is consistent with the holdings of Revenue Ruling 2003-41.[16] In situation 1 of Revenue Ruling 2003-41, a taxpayer timely filed an original return on Monday, April 17, 1995, and filed a refund claim on April 17, 1998. The ruling held that the three-year lookback period under section 6511(b)(2)(A) did not preclude the payment of the refund because the original return was deemed to be timely filed on April 17, 1995 under section 7503.[17] Therefore, the two additional days provided for the filing of the original return under section 7503 are included in the lookback period under section 6511(b)(2)(A).

By contrast, in situation 3 of Revenue Ruling 2003-41, a taxpayer timely filed an original return on March 1, 1995 that was due on April 15, 1995 and filed a refund claim on Friday, April 17, 1998. The ruling held that the lookback period under section 6511(b)(2)(A) precluded the payment of the refund because the date that the tax was deemed paid under section 6513(a) and (b)(1) was more than three years before the filing of the refund claim and the last day for filing a refund claim was not a Saturday, Sunday or legal holiday.[18] In addition, although April 15, 1995 was a Saturday, the return was not filed on the succeeding day that was not a Saturday, Sunday, or legal holiday.

Thus, like the court concluded in *Khafra*, Revenue Ruling 2003-41 holds that section 7503 does not provide for an extension of time to perform a required act unless the taxpayer actually performs such act on the next succeeding day that is not a Saturday, Sunday, or legal holiday.

GAO Report Recommends Reforms to Improve the Case Resolution Timeliness of the IRS Appeals Office

In September 2018, the United States Government Accountability Office ("GAO") released a report ("GAO Report") that makes several recommendations for improving the case resolution timeliness of the Internal Revenue Service ("IRS") Office of Appeals ("Appeals").[19]

Funding and staffing[20]

Funding for Appeals has declined from $247 million ($282 million in 2018 dollars) in FY 2010 to $175 million in FY 2018. In addition, staffing levels for Appeals declined from 2,172 in FY 2010 to 1,345 in FY 2017. Moreover, an internal Appeals report stated that approximately one-third of Appeals employees are eligible for retirement and Appeals officials reported that nearly half of its mission-critical employees are eligible for retirement.

The GAO Report expressed concern regarding the ability of Appeals to retain sufficient expertise to accomplish its mission. The GAO Report recommended that Appeals perform a skills gap analysis to ensure that it retains sufficient expertise to do so.[21]

Delays in transferring cases to Appeals[22]

Taxpayers can appeal a variety of proposed IRS compliance actions. Compliance employees review the information that taxpayers provide to support their appeal request and may attempt to resolve the case before forwarding the request and any compliance response to Appeals. Appeals processing staff enter each case into an Appeals database

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[16] 2003-17 I.R.B. 814.
[17] The ruling also held that the claim for refund was timely under section 6511(a) because the claim for refund was filed within three years of the filing of the original return.
[18] The ruling further held that the refund claim was untimely under section 6511(a) because the claim for refund was filed more than three years after the original return was deemed filed under section 6513(a).
[19] *See* GAO, *Tax Administration: Opportunities Exist to Improve Monitoring and Transparency of Appeal Resolution Timeliness*, GAO-18-659 (Sept. 2018), https://www.gao.gov/assets/700/694840.pdf.
[20] *See id.* at 10 – 12, 22 – 26.
[21] *See id.* at 50.
[22] *See id.* at 13 – 22, 26 – 38.

and review the appeal request for completeness. An Appeals manager then assesses a case's complexity and assigns the case to an Appeals officer.

Appeals has a centralized database that allows it to monitor Appeals resolution timeliness. Appeals also measures the time it takes for IRS compliance units to review and transfer a taxpayer appeal.

Transfer times for examination appeals vary considerably across IRS operating divisions. For cases closed in FY 2017 that originated in the Small Business/Self-Employed Division ("SB/SE") or Large Business and International Division, more than two-thirds of the appeals were transferred within 90 days. By contrast, fewer than half of the appeals that originated in the Wage & Investment Division ("W&I") were transferred within 90 days, and fewer than half of the appeals that originated in the Tax Exempt & Government Entities Division were transferred within 120 days.

IRS officials in SB/SE and W&I stated that they do not specifically track incoming appeal requests or receive feedback on the timeliness of the transfers from Appeals. Moreover, IRS campus officials stated that appeal requests are received by the compliance units as ordinary taxpayer correspondence, and an appeal request may sit for months before being identified as such.

To address concerns regarding the monitoring and timeliness of compliance unit review of taxpayer appeal requests, the GAO Report recommended that the IRS establish time lines and monitoring procedures for the timely transfer of cases to Appeals across all workstreams.[23] In addition, the GAO Report recommended that Appeals provide the IRS compliance units with the data that it already collects regarding the timeliness of appeal request transfers.[24]

Appeals transparency and customer service feedback[25]

The GAO Report also addressed the transparency of Appeals to taxpayers and Appeals' solicitation of customer service feedback. The GAO Report found deficiencies in how Appeals communicates estimated time lines for resolving a case in Appeals. Although the IRS website tells taxpayers that appeals are generally resolved within 90 days to a year, this time line does not accurately reflect actual Appeals case resolution time lines. In addition, the IRS does not provide estimated resolution times across workstreams, and an estimated appeal resolution time lines is not included in Appeals acknowledgement letters.

The GAO Report was also critical of how Appeals solicits customer service feedback. Although Appeals regularly solicits feedback from tax professionals, it does not do so prospectively. In addition, the GAO Report found that Appeals may miss opportunities to improve the Appeals experience of individuals and small businesses that lack professional representation because it does not solicit customer service feedback from such taxpayers.

To address these concerns, the GAO Report recommended that the IRS provide historical average appeal resolution times to taxpayers.[26] In addition, the GAO Report recommended that the IRS adopt mechanisms to prospectively solicit public input on proposed policy changes and to solicit customer service feedback on current policies and procedures.[27]

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[23] *See id.* at 50 – 51.
[24] *See id.* at 51.
[25] *See id.* at 38 – 48.
[26] *See id.* at 51.
[27] *See id.*