FEDERAL TAXATION: 2014–2015

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I. INTRODUCTION

In the period July 1, 2014, to June 30, 2015, five cases were selected for review and discussion. Complicated tax shelter transactions from an earlier period continue to occupy the time of the courts generally and the Fifth Circuit in particular. A variety of issues were present in the five reviewed cases. The decision in *United States v. Chemtech Royalty Associates, L.P.*, while a tax-shelter scheme by a large, publicly traded corporation, nevertheless has aspects warranting some attention to the case.[1] Other cases, such as *Salty Brine I, Ltd. v. United States*, are for the most part a waste of the court's time and would waste the reader's time to include.[2] Taxpayers undertake silly transactions with impossibly ambitious schemes so that the IRS and the courts entirely disregard them. Hence, cases such as *Salty Brine I, Ltd.* are not included.

II. *BNSF RAILWAY CO. V. UNITED STATES*

The Fifth Circuit's decision in *BNSF Railway Co. v. United States* is deceptive.[3] The case appears superficially to involve the narrow, obscure, and boring issues of whether non-stock options and moving expenses are within the meaning of "compensation" for purposes of the Railroad Retirement Tax Act (RRTA).[4] The case appears to be an employee benefits

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1. *See* Chemtech Royalty Assocs., L.P. v. United States, 766 F.3d 453 (5th Cir. Sept. 2014).
2. *See* Salty Brine I, Ltd. v. United States, 761 F.3d 484 (5th Cir. July 2014).
3. BNSF Ry. Co. v. United States, 775 F.3d 743 (5th Cir. Jan. 2015).
4. *See id.* at 748–60; I.R.C. §§ 3201–41 (2015).

case and, more narrowly, one that involves payroll tax issues of a railroad.[5] At first glance, therefore, this is a case that most would bypass in their review of current developments. Beneath the surface, however, is a heavyweight-boxing match involving exceptional lawyers and one of the finest judges on the Fifth Circuit. Any opinion of Judge Patrick Higginbotham deserves attention, and this one is no exception. Apart from the underlying issues, which would repel all but the most ardent of tax lawyers, Judge Higginbotham's decision is finely crafted, involving the intricate logic of *Chevron* deference and a masterful display of statutory construction.[6]

For the reasons just mentioned, the substantive issues in *BNSF Railway Co.* deserve only brief comment, but the meaningful case analyses are the court's handling of *Chevron* deference and its statutory construction methodology. BNSF Railway is the survivor of a combination of the Burlington Northern Railroad Company and The Atchison Topeka and Santa Fe Railway Company.[7] The railroad sought a refund of taxes paid when it included nonqualified stock options and moving expenses in taxable compensation.[8] The stock options were used as straightforward compensatory stock options.[9] Nonqualified options were granted for select employees.[10] Most of the time, employees exercised their stock options at the same time the stocks were sold, resulting in the employee receiving the difference in the exercise price and the sale price.[11] During the years at issue, 3,192 employees exercised nonqualified stock options for a total spread upon exercise of $348,805,183.[12]

Employee relocations caused the moving expenses.[13] For moving expenses coming within § 217, the railroad did not withhold any tax on these expenses, and they were not in dispute in this case.[14] The railroad argued that other moving expenses not excludable under § 217 were paid not as compensation but as a means of retaining qualified and knowledgeable employees.[15]

The years at issue were 1993–1998 for the stock options and 1994–1998 for the moving expenses.[16] The stock options issue was the predominate issue in the case. The tax statutes affecting railroads differ from most

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5. *See BNSF Ry. Co.*, 775 F.3d at 745–60.
6. *See id.* at 750–56.
7. *Id.* at 746.
8. *Id.*
9. *Id.* at 746–47.
10. *Id.*
11. *Id.* at 747.
12. *Id.*
13. *Id.* at 748.
14. *Id.*
15. *Id.*
16. *Id.* at 747–49.

companies.[17] The RRTA[18] provides a comparable tax system, as does the Federal Insurance Contributions Act (FICA),[19] by taxing both employers and employees to fund retirement and disability benefits.[20] In the railroad industry, there are two tiers of taxes and benefits.[21] Tier I compares with FICA and acts as the Social Security analog for railroad employees.[22] Tier II compares to a private pension system for railroads.[23]

Under Tier I, the RRTA imposes upon "the income of each employee a tax equal to the applicable percentage of the compensation received during any calendar year by such employee for services rendered by such employee."[24] The statute defines "compensation" as "any form of money remuneration."[25] In regulations, the Service continued the same idea when it provided that compensation is defined as "'any form of money remuneration paid to an individual for services rendered as an employee to one or more employers,' subject to certain enumerated exceptions."[26]

The critical phrase in the case is "money remuneration" from the above regulation definition of "compensation."[27] The IRS argued for treating the nonqualified stock options as compensation since, in its view, the meaning of money compensation is identical to wages under the FICA statute.[28] The railroads argued that "money remuneration" has a clear meaning and does not include nonqualified stock options.[29] Since nonqualified stock options are not paid in cash or currency, it is not money and thus not compensation under the RRTA.[30] The district court agreed with the railroad.[31]

Judge Higginbotham wrote the Fifth Circuit decision. He considered the question of whether and under what circumstances to defer to IRS regulations.[32] He used the two-step analysis required by *Chevron, U.S.A., Inc. v. National Resources Defense Council, Inc.*,[33] which is the process required for Treasury regulations.[34] First, has Congress spoken directly to

17. *Id.* at 749.
18. I.R.C. §§ 3201–41 (West 2015).
19. *Id.* §§ 3101–02.
20. *BNSF Ry. Co.*, 775 F.3d at 750.
21. *Id.*
22. *Id.*
23. *Id.*
24. I.R.C. § 3201(a).
25. *Id.* § 3231(e)(1).
26. *BNSF Ry. Co.*, 775 F.3d at 750 (quoting I.R.C. § 3231(e)(1)). "Compensation" is defined as identical in meaning to "wages" in § 3121(a), with some exceptions. Treas. Reg. § 31.3231(e)–1(a)(1) (2015).
27. *BNSF Ry. Co.*, 775 F.3d at 750.
28. *Id.*
29. *Id.* at 750–51.
30. *Id.* at 751.
31. *Id.*
32. *Id.*
33. Chevron, U.S.A., Inc. v. Nat'l Res. Def. Council, Inc., 467 U.S. 837 (1984).
34. *BNSF Ry. Co.*, 775 F.3d at 751; *see* Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. 44, 59 (2011).

the precise question at issue?[35] If congressional intent is clear, then judicial analysis ends and courts defer to unambiguous congressional intent.[36] Second, if a court concluded that Congress has not spoken clearly to the precise question at issue, then the court does not offer its own statutory interpretation but decides whether the administrative construction is a permissible construction of the statute.[37]

Judge Higginbotham employed statutory construction to discern congressional intent.[38] He employed a four-part analysis using rules of construction, examining the text, structure, purpose, and legislative history.[39] First was his reading of the statutory language. In the statutory text, no ordinary meaning was ascribed to "money remuneration."[40] Judge Higginbotham found the word "remuneration" to be broad, but "money," narrows it.[41] Dictionary definitions were considered, but cautiously, while attempting to "illuminate true ambiguity."[42] While not conclusive, the dictionaries consulted by the court suggested multiple meanings to "money," including assets such as cash or easily convertible to cash.[43] Other dictionary sources limited the meaning of "money remuneration" to cash.[44] Judge Higginbotham found dictionaries "less than helpful."[45]

Judge Higginbotham then considered the statutory structure under the statutory construction rule of *noscitur a sociis*, which means "an ambiguous term may be given more precise context by the neighboring words with which it is associated."[46]

Section 3231(e)(1) defines "compensation" as "money remuneration" but contains four exclusions: (1) health insurance paid by employer, (2) tips, (3) travel expenses, and (4) remuneration treated as wages under § 3121(a)(5).[47] Using the interpretative rule, Judge Higginbotham determined the statutes referenced the exclusions as payments, and thus "compensation" is "a more expansive term than currency or cash, which suggests in turn that 'money remuneration' should be interpreted broadly."[48]

The second rule of construction utilized by Judge Higginbotham was the rule that courts should not construe a statute "in a manner that would

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35. *Chevron*, 467 U.S. at 842–43.
36. *Id.*
37. *Id.* at 843.
38. *BNSF Ry. Co.*, 775 F.3d at 751–52.
39. *Id.* at 751.
40. *Id.* at 751–52.
41. *Id.* at 752.
42. *Id.*
43. *Id.* at 752–53.
44. *Id.* at 753.
45. *Id.* at 752.
46. *Id.* at 754 (quoting United States v. Stevens, 559 U.S. 460, 474 (2010)).
47. *See* I.R.C. § 3231(e)(1) (West 2015).
48. *BNSF Ry. Co.*, 775 F.3d at 754 (quoting United States v. Quality Stores, Inc., 134 S. Ct. 1395, 1400 (2014)).

render another provision superfluous."[49] Section 3231(e) excludes other items generally characterized as noncash benefits.[50] Thus, if money remuneration were construed as cash equivalent, then Judge Higginbotham concluded that the noncash exceptions to compensation would be meaningless.[51]

Third, Judge Higginbotham considered the legislative purpose. The RRTA and FICA statutes are parallel, said Judge Higginbotham.[52] Courts often look to FICA to interpret the RRTA.[53] Under the rule of construction known as *in pari materia*, "statutes addressing the same subject matter generally should be read as if they were one law."[54] Since compensation is broadly interpreted in FICA to achieve the remedial purpose of the statute, Judge Higginbotham felt the RRTA should be interpreted similarly.[55] Though he acknowledged the rule of construction that "[s]tatutory definitions control the meaning of statutory words," and RRTA and FICA define "compensation" differently, suggesting a narrower interpretation in the RRTA, Judge Higginbotham reasoned that these rules of construction led to the conclusion that the statutory provision was ambiguous.[56]

Finally, Judge Higginbotham looked to legislative history, which he found tangled and inconclusive.[57] So, he concluded that the rules of construction led to an indeterminate result.[58] The text, structure, purpose, and legislative history did not yield a conclusion that Congress spoke clearly in defining money remuneration.[59] Thus, Judge Higginbotham proceeded to the second step of the *Chevron* analysis.

The second *Chevron* step requires the court to answer the question whether the IRS's definition "is based on a permissible construction of the statute," not whether the court would conclude that the agency interpretation was the only permissible interpretation, or whether the court would have reached another interpretation if the matter was in a judicial context from the outset and not in a review of an administrative decision.[60] IRS regulations interpret the term "compensation" in the RRTA to have the same meaning as "wages" in § 3121(a), which defines "wages" to include all remuneration from employment, whether cash or noncash.[61] Judge Higginbotham found

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49. *Id.* (quoting Bilski v. Kappos, 561 U.S. 593, 607–08 (2010)).
50. *Id.*
51. *Id.*
52. *Id.*
53. *Id.*
54. *Id.* (quoting Wachovia Bank v. Schmidt, 546 U.S. 303, 315–16 (2006)).
55. *Id.* at 755.
56. *Id.* (alteration in original) (quoting Burgess v. United States, 533 U.S. 124, 129 (2008)).
57. *Id.*
58. *Id.*
59. *Id.*
60. *Id.* at 775–76 (quoting Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 843 & n.11 (1984)).
61. I.R.C. § 3121(a) (West 2015); Treas. Reg. § 31.3231(e)–1(a)(1) (2015).

this IRS interpretation reasonable.[62] The statutory text does not exclude the broad regulatory interpretation.[63] Section 3231 excludes forms of noncash compensation, including qualified stock options.[64] To limit money remuneration to cash items would render these exclusions redundant.[65] Thus, the IRS's interpretation is reasonable.[66] Further, the Supreme Court, in *United States v. Quality Stores, Inc.*, recently interpreted FICA's definition of "wages" by looking at the surrounding exceptions.[67]

The Fifth Circuit also determined that the IRS's interpretation consistent with the rule of construction "that similar language in similar statutes should be interpreted similarly."[68] Thus, the court held that the IRS's interpretation of the RRTA by reference to FICA was not unreasonable.[69]

In conclusion, Judge Higginbotham found the definition of "compensation" in Regulation § 31.3231(e)–1 to be a reasonable definition.[70] Thus, the court reversed the district court below and held the nonqualified stock options were properly taxed as compensation under the RRTA.[71]

Statutory construction principles were also used to resolve the issue of moving expenses.[72] There was a category of moving expenses in the case that everyone conceded was properly excluded under § 3231(e)(5), "which provides that benefits excludable under § 132 are excluded under RRTA compensation."[73] The dispute in the case concerned another grouping of moving expenses not excluded under § 3231(e)(5).[74] The railroad argued, and the lower court accepted, that this second grouping of moving expenses should nevertheless be excluded under § 3231(e)(1)(iii) because the expenses were bona fide and necessary, meaning they were used to retain skilled and knowledgeable workers.[75] On appeal, the Government argued, and the Fifth Circuit accepted, that the lower court violated two rules of construction, the specific–general cannon and the rule against superfluities.[76] The first rule, the specific–general rule, provides that a court should not interpret a general statutory rule in a way that would have the effect of subsuming a specific rule.[77] "[Section] 3231(e)(5) provides a specific exclusion for certain moving

62. *BNSF Ry. Co.*, 775 F.3d at 756.
63. *Id.*
64. *Id.*; I.R.C. § 3231.
65. *BNSF Ry. Co.*, 775 F.3d at 756.
66. *Id.*
67. United States v. Quality Stores, Inc., 134 S. Ct. 1395, 1400 (2014).
68. *BNSF Ry. Co.*, 775 F.3d at 756 (quoting United States v. Sioux, 362 F.3d 1241, 1246 (9th Cir. 2004)).
69. *Id.*
70. *Id.* at 757.
71. *Id.*
72. *Id.* at 759.
73. *Id.* at 758.
74. *Id.*
75. *Id.*
76. *Id.* at 758–59.
77. *Id.* at 759.

expenses, while § 3231(e)(1)(iii) provides a broader exclusion for travelling expenses and bona fide and necessary business expenses."[78] The court pointed out that to read § 3231(e)(1)(iii) to include moving expenses would subsume all of the specific exclusions of § 3231(e).[79] Further, a broad interpretation of § 3231(e)(1)(iii) would render every exception of § 3231(e)(5) inoperative, thus violating the second rule of construction, the rule against superfluities, which provides that a statute should not be interpreted when doing so would render part of the statute superfluous.[80] This the court was unwilling to do.[81]

An unusual aspect of the *BNSF Railway Co.* case is that the Fifth Circuit panel first issued its opinion on March 13, 2014, and then withdrew it and reissued it again on January 15, 2015.[82] The difference between the earlier and later opinions, both by Judge Higginbotham and involving no change in the voting on the case, concerned the *Chevron* analysis.[83] Following the first opinion, five amici curiae briefs were filed, each suggesting rehearing en banc.[84] Four of the briefs supported the railroad's arguments.[85] One amicus curiae brief appears to have influenced the court to revise its opinion.[86] The brief argued that the court's first opinion insufficiently dealt with the interpretative standards required of *Chevron* and its progeny by failing to examine statutory language and seeming to rely on dictionary meanings.[87] The court's January 15, 2015, opinion appears to have addressed the brief's criticisms by beefing up its *Chevron* analysis.

III. *CHEMTECH ROYALTY ASSOCIATES, L.P. V. UNITED STATES*

Every year, vestiges of the tax shelter era continue to appear in judicial decisions like some ancient archaeological find. This Survey reviewing Fifth Circuit federal taxation decisions has been reviewing tax shelter opinions in the Fifth Circuit for years. There is always a tax shelter decision in the Fifth Circuit. The *Chemtech Royalty Associates, L.P. v. United States* decision is

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78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

82. BNSF Ry. Co. v. United States, 745 F.3d 774 (5th Cir. Mar. 2014), *withdrawn and substituted*, 775 F.3d 743 (5th Cir. Jan. 2015).

83. *See BNSF Ry. Co.*, 775 F.3d at 751–57; *BNSF Ry. Co.*, 745 F.3d at 781–84.

84. *See* Brief for Am. Payroll Ass'n & Gregg D. Polsky as Amici Curiae Supporting Rehearing En Banc, *BNSF Ry. Co.*, 745 F.3d 774 (No. 13-10014), 2014 WL 1878470; Brief of Amicus Curiae Ass'n of Am. R.R.s in Support of Rehearing En Banc, *BNSF Ry. Co.*, 745 F.3d 774 (No. 13-10014), 2014 WL 2158645; Brief of Amici Curiae Cato Institute et al. as Amici Curiae in Support of the Petition for Rehearing of Plaintiff-Appellee, *BNSF Ry. Co.*, 745 F.3d 774 (No. 13-10014), 2014 WL 2158646.

85. *See* sources cited *supra* note 84.

86. Brief of Amici Curiae Cato Institute et al. as Amici Curiae in Support of the Petition for Rehearing of Plaintiff-Appellee, *supra* note 84.

87. *Id.* at 6–9.

this year's offering.[88] The distinctive flavor of this year's tax shelter opinion is the very large company, Dow Chemical Company (Dow), several foreign banks, and high-priced legal talent trying to defend this indefensible transaction.[89] In the years 1993–2006, responding to the creativity of Goldman Sachs, who cooked up this brew, Dow engaged in transactions that generated over one billion dollars in tax deductions.[90]

The transactions were basically designed to create an adjusted basis with corresponding amortization of intangible property, pass-through entities, and debt disguised as equity, without anyone incurring any economic or tax risk.[91] There were two sets of transactions—the first in the 1993–1998 time frame and the second in the 1998–2006 period.[92] A series of steps were required:

1. Low basis, high-value assets were selected. Dow selected a group of patents valued at roughly $867 million but with zero tax basis. The patents were not complete in that third parties were still required to obtain necessary licenses from Dow and the partnerships created in the transaction. The second series of transactions did not involve patents but instead a chemical plant in Louisiana valued at $715 million and with a tax basis of $18 million.[93]
2. In the first series, Dow created two special-purpose subsidiaries and used a previously existing foreign subsidiary for the transaction. These subsidiaries formed a partnership having a Swiss location to which Dow assigned the patents. Five foreign banks participated as limited partners, at least in form, and invested $200 million in the partnership. The banks would also be paid a preferential return. Most of the cash was loaned to Dow. The second series was similarly structured.[94]
3. In the first series, the foreign banks and Dow then continued the circuitous process by which Dow licensed the patents so that Dow could continue to use the patents. It paid a royalty to the Swiss partnership. The royalties were the partnership's primary source of income. Similarly, in the second series, the payment from Dow and the cash flows resembled the first series.[95]
4. In the first series, the desired tax benefits required the partnership income to be allocated to the foreign partners, which meant the foreign banks. Dow took amortization deductions of $476 million on the contributed patents. The Dow subsidiary retained sufficient

88. Chemtech Royalty Assocs., L.P. v. United States, 766 F.3d 453 (5th Cir. Sept. 2014).
89. *See id.* at 455.
90. *Id.*
91. *Id.* at 455–56.
92. *Id.* at 457–58.
93. *Id.* at 457.
94. *Id*. at 457–58.
95. *Id.* at 458.

income to pay the priority return to the banks, plus some other smaller distributions.[96]

5. Dow indemnified the banks from all liability and tax risk.[97]
6. Eventually, both series of partnerships were terminated.[98]

After the IRS issued a FPAA for the 1993–2006 tax years, including assertion of accuracy related penalties, the district court conducted a trial over a five-day period at the conclusion of which the district court determined that "(1) [t]he partnerships were shams; (2) the transactions lacked economic substance; and (3) the banks' interests in Chemtech were debt, not equity."[99] Substantial understatement and negligence penalties of 20% were assessed, though the court did not impose gross-valuation penalties.[100]

The Fifth Circuit affirmed on all issues except that it remanded and instructed the lower court to determine whether to impose substantial valuation and gross-valuation misstatement penalties either singularly or both.[101]

The Fifth Circuit applied the classic test for whether to disregard a partnership, as derived from *Tower*, *Culbertson*, and *Southgate*.[102] Based on all facts and circumstances, the partnerships failed.[103] Finding the instant transactions similar to the one seen in *TIFD III-E, Inc. v. United States*,[104] the Fifth Circuit concluded that the banks did not have a meaningful stake in the success or failure of the partnership and thus were not equity partners.[105] The banks faced no meaningful risk of loss.[106] Dow fully indemnified the banks.[107]

96. *Id.* at 457–58.
97. *Id.* at 457.
98. *Id.* at 457–59.
99. *Id.* at 459.
100. *Id.*
101. *Id.* at 465–66.
102. *See id.* at 460 ("In order not to be a sham, or to be a valid partnership for tax purposes, 'persons [must] join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and [ ] there [must be a] community of interest in the profits and losses.'" (alterations in original) (quoting Comm'r v. Tower, 327 U.S. 280, 286 (1946))); *see also* Comm'r v. Culbertson, 337 U.S. 733, 740 (1949) ("[In *Tower*, we] said that a partnership is created 'when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses.'" (quoting *Tower*, 327 U.S. at 286)); Southgate Master Fund, L.L.C. *ex rel.* Montgomery Capital Advisors, LLC v. United States, 659 F.3d 466, 478–79 (5th Cir. 2011) ("The starting point for our analysis is the cardinal principle of income taxation: a transaction's tax consequences depend on its substance, not its form.").
103. *Chemtech*, 766 F.3d at 465.
104. TIFD III-E, Inc. v. United States, 459 F.3d 220 (2d Cir. 2006).
105. *Chemtech*, 766 F.3d at 461.
106. *Id.* at 462.
107. *Id.* at 457.

The court rejected Dow's argument that the debt-or-equity issue must be decided before determining the issue of validity of the partnership.[108] The Fifth Circuit did not find that *Southgate* supported this argument.[109]

Importantly, the Fifth Circuit did not find whether the banks' interests were debt or equity, but rather, whether Dow had the intent to be partners with the foreign banks, and specifically, whether Dow had the intent to share profits and losses with the banks, looking at all relevant facts.[110]

IV. *PILGRIM'S PRIDE CORP. V. COMMISSIONER*

In *Pilgrim's Pride Corp. v. Commissioner*, the Fifth Circuit reversed the Tax Court and held that a taxpayer's abandonment of securities was an ordinary loss, not a capital loss.[111] In so ruling, the court determined that § 1234A does not apply to abandonment of securities.[112] The statute only applies to termination of contractual or derivative rights, not to abandonment of a capital asset.[113]

Pilgrim's Pride purchased securities in 1998 for $98 million, incident to a larger transaction.[114] In 2004, the issuing company offered to redeem its stock held by Pilgrim's Pride for $20 million, but Pilgrim's Pride determined that it would be better off abandoning the securities for no consideration.[115] An influencing consideration was the tax benefits from an ordinary loss of $98 million, which was greater than $20 million in purchase price.[116] Some years later, when Pilgrim's Pride was in bankruptcy, the Service issued a notice of deficiency for $29 million on the basis that the abandonment of the securities should have resulted in a capital loss rather than an ordinary loss.[117] In the Tax Court case, the initial issue was whether abandonment of securities made the securities worthless, thus resulting in a capital loss within the meaning of § 165(g).[118] The Tax Court, on its own motion, introduced the issue of whether § 1234A(1) applied to the abandonment of securities.[119] After briefing, the Tax Court agreed with the Service and held for capital loss treatment.[120]

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108. *Id.* at 462.
109. *Id.* at 463.
110. *Id.*
111. Pilgrim's Pride Corp. v. Comm'r, 779 F.3d 311, 315–17 (5th Cir. Feb. 2015).
112. *Id.*
113. *Id.*
114. *Id.* at 312–13.
115. *Id.* at 313. For ease of discussion, this analysis will ignore the distinction of the abandonment actually occurring by a predecessor to Pilgrim's Pride Corp.
116. *Id.*
117. *Id.*
118. *Id.*
119. *Id.*
120. *Id.*

The bedrock principle at issue in this case is the idea that a capital loss is a loss from the sale or exchange of a capital asset.[121] Statutory provisions have been enacted to treat certain dispositions as sales or exchanges. The primary provision is § 165(g), which characterizes worthless securities as a capital loss even though they are not sold or disposed of.[122] Cases resulting from abandonments of capital assets favor the result of ordinary loss.[123]

Another statute that does not technically treat dispositions as coming within the category of a sale or exchange is § 1234A, enacted in 1981 as part of a larger attack on tax shelters to address tax straddles.[124] A tax straddle involves offsetting contractual positions, in the nature of arbitrage, designed to achieve a tax benefit without any corresponding economic risk.[125] The issue of the case was whether Pilgrim's Pride's abandonment of the securities was within the scope of the forced capital loss treatment of § 1234A.[126]

The Service confronted the challenge of the statutory language of § 1234A, which provides as follows:

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—
>
> (1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
>
> (2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,
>
> shall be treated as gain or loss from the sale of a capital asset. The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation arrangement).[127]

Abandonment is not included in the statutory language. Thus, the Service could not rely on the express statutory language to get the result it

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121. *Id.* at 313–14; I.R.C. § 165(f) (West 2015). Section 165(f) provides: "(f) Capital losses—Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212." I.R.C. § 165(f).

122. I.R.C. § 165(g).

123. The Fifth Circuit cited to *Echols v. Commissioner* and *Citron v. Commissioner* as precedent. *Pilgrim's Pride*, 779 F.3d at 314; *see* Echols v. Comm'r, 935 F.2d 703, 707 (5th Cir. 1991) (approving ordinary loss treatment for abandonment of partnership interest); Citron v. Comm'r, 97 T.C. 200, 215 (1991) ("The touchstone for sale or exchange treatment is consideration." (quoting La Rue v. Comm'r, 90 T.C. 465, 483 (1988))).

124. Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97–34, § 507(a), 95 Stat. 172, 333 (1981) (codified as amended at I.R.C. § 1234A).

125. *Pilgrim's Pride*, 779 F.3d at 314.

126. *Id.*

127. I.R.C. § 1234A.

wanted.[128] So, the Service argued an indirect effect—abandonment of a security involved termination of certain rights and obligations inherent in those assets.[129]

The Fifth Circuit did not seem to have a difficult time swatting away the Service's argument. Approaching the Service's argument logically and quite simply, the court looked at the plain statutory language and refused to be drawn into any logic puzzles or opaque analysis.[130] Further, the Fifth Circuit noted that § 1234A(2) supported its reasoning on § 1234A(1).[131] Section 1234A(2) requires capital gain or loss treatment for termination of a § 1256 contract not described in § 1234A(1), provided the contract is a capital asset in the taxpayer's hands.[132] If the Service's argument was correct, then § 1234A(2) would be superfluous.[133]

The Service attempted to persuade the Fifth Circuit that § 165(g) required the abandonment loss to be capital, but the court was unwilling to deviate from prior precedent by linking worthlessness and abandonment.[134]

V. *BMC SOFTWARE, INC. V. COMMISSIONER*

The Fifth Circuit decision in *BMC Software, Inc. v. Commissioner* is an international tax case that reversed the Tax Court.[135] At issue was § 965, which was enacted to encourage repatriation of foreign earnings by U.S. corporate taxpayers.[136] "Accordingly, § 965 permits a one-time tax deduction in the amount of eighty-five percent of certain dividends paid by a controlled foreign corporation to its United States-based parent corporation."[137] Protections against abuse were also enacted by preventing loans from U.S. affiliates or related taxpayers to pay for the repatriated earnings.[138] The loan exception provides that the amount of repatriated dividends otherwise eligible for a § 965 dividends-received deduction must be reduced by the amount of any increase in related-party indebtedness between October 3, 2004 (the effective date of § 965), and the end of the taxable year in which

128. *Pilgrim's Pride*, 779 F.3d at 315.
129. *Id.*
130. *Id.*
131. *Id.* at 316.
132. *Id.*
133. *Id.*
134. *Id.* at 317–18. The court mentioned that Revenue Ruling 93-80 "held that a taxpayer is allowed an ordinary loss on the abandonment of a partnership interest, even if the abandoned partnership interest is a capital asset," a position contradicting the Service's position in this case. *Id.* at 317 n.8 (citing Rev. Rul. 93-80, 1993-2 C.B. 239). Rev. Rul. 93-80 was published prior to the amendment to § 1234A that made it applicable to nontraded personal property like partnership interests. *Id.* The IRS has never revoked Rev. Rul. 93-80. *Id.*
135. BMC Software, Inc. v. Comm'r, 780 F.3d 669, 671 (5th Cir. Mar. 2015).
136. *Id.*; *see* I.R.C. § 965 (West 2015).
137. *BMC Software*, 780 F.3d at 670.
138. *Id.*; I.R.C. § 965(b)(3).

the dividend was paid.[139] "The window between these two dates is known as the 'testing period.'"[140]

Section 482 is also relevant to the case and prevents a domestic corporation from artificially deflating its profits that are subject to United States income tax by inflating the profits of its foreign subsidiaries, which are not subject to U.S. taxation.[141] The IRS has authority to adjust the prices a company pays for services or products purchased from related foreign companies.[142]

In the 2006 tax year, BMC undertook to repatriate foreign earnings in the form of a cash dividend in the amount of $721 million.[143] No related party loans were involved at the time of the 2006 repatriation.[144] In 2007, a transfer pricing adjustment under § 482 was made to adjust for overstated royalty payments to a foreign subsidiary.[145] To settle the 2007 transfer pricing matter, BMC and the Service made an agreement under which a receivable was created by the amount of the inflated royalties.[146] Since the royalties were in fact paid, the royalties were in possession of the foreign company.[147] The receivable was the mechanism for assuring repayment of the royalties over time.[148] The agreement was in the form of a closing agreement dated effective September 25, 2007.[149] The closing agreement used language indicating that the dates the receivables were deemed to have been established were March 31, 2005, and March 31, 2006.[150]

In 2011, the Service asserted a deficiency against BMC on the ground that the accounts receivable that BMC established to resolve the transfer pricing matter were related-party indebtedness, thus reducing BMC's eligibility for the § 965 dividend-received deduction.[151] The Tax Court upheld the Service and BMC appealed to the Fifth Circuit.[152]

The Fifth Circuit undertook a straightforward approach to statutory interpretation. It looked to the statutory language (§ 965) to answer whether there was any related-party indebtedness at the moment in time when § 965 required testing—March 31, 2006.[153] The court noted:

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139. I.R.C. § 965(b)(3); *BMC Software*, 780 F.3d at 671.
140. *BMC Software*, 780 F.3d at 671.
141. *Id.* at 671–72; I.R.C. § 482.
142. *BMC Software*, 780 F.3d at 672.
143. *Id.*
144. *Id.*
145. *Id.* at 672–73.
146. *Id.* at 673.
147. *Id.*
148. *Id.*
149. *Id.*
150. *Id.*
151. *Id.*
152. *Id.* at 673–74.
153. *Id.* at 674–75.

> The text of § 965(b)(3) specifically requires that the determination of the final amount of indebtedness be made "as of the close of the taxable year for which the election [under § 965] is in effect." Here, the relevant taxable year is 2006, and the close of that taxable year occurred on March 31, 2006. So the relevant testing period ended on March 31, 2006.[154]

On that date, there was no related-party indebtedness.[155] The closing agreement resolving the § 482 transfer pricing issue created related-party indebtedness retroactively, but the Fifth Circuit found this backdating to be a fiction, not a reality.[156] On March 31, 2006, when § 965 required testing, there was not, in fact, any related-party indebtedness.[157]

A secondary issue was present in the Fifth Circuit appeal—namely, whether the closing agreement, as a matter of contract interpretation, treated the related-party indebtedness as indebtedness for § 965 purposes.[158] The closing agreement contained boilerplate language, suggesting that the closing agreement determined all federal income tax issues.[159] The Fifth Circuit summarily rejected the IRS's attempt to extend this introductory phrase in the closing agreement to the earlier resolution of repatriation dividends.[160] It found the plain language of the closing agreement clear that it covered only those tax consequences expressly enumerated in the agreement and no others.[161] Moreover, the court pointed to evidence at trial indicating the intent of the parties in executing the closing agreement, which was to resolve the transfer pricing issue, not to involve the earlier repatriation issue.[162]

All in all, the Fifth Circuit used a traditional and fairly simple analysis of statutory and contractual interpretation to reverse the Tax Court.

VI. *ESTATE OF ELKINS V. COMMISSIONER*

In *Estate of Elkins v. Commissioner*, the Fifth Circuit addressed an estate tax issue involving valuation discounts of fractional interests of artwork.[163] The Service asserted in the Tax Court that no discount was permissible and presented no evidence of any possible discount.[164] The taxpayers, the executors of the estate, presented substantial evidence at trial adducing various fractional-interest discounts for the various works of art.[165] The Tax

154. *Id.*
155. *Id.* at 676.
156. *Id.*
157. *Id.*
158. *Id.*
159. *Id.*
160. *Id.* at 676–77.
161. *Id.* at 677.
162. *Id.*
163. Estate of Elkins v. Comm'r, 767 F.3d 443, 445 (5th Cir. Sept. 2014).
164. *Id.* at 448.
165. *Id.* at 446–48.

Court upheld a ten percent discount, applicable across the board, despite the absence of evidence on which to base its conclusions.[166] The Fifth Circuit disagreed with the Tax Court's ultimate findings, arrived at without any evidence, and thus affirmed in part, reversed in part, and held for the taxpayers.[167]

The case involved only one issue—valuation discounts for fractional interest in sixty-four pieces of art, which the decedent and his three adult children owned jointly at the date of death.[168] The decedent and his wife each created a Grantor Retained Income Trust (GRIT) to hold title to three pieces of the art.[169] The decedent's wife preceded him in death, thus leaving the decedent to own a 50% interest in the three pieces.[170] The children received the wife's 50%, or 16.667% each.[171] For the other sixty-one art pieces, the decedent owned a high percentage (73.055%) on account of a partial disclaimer in favor of his children in the amount of 26.945%, or 8.98167% for each child.[172]

The Fifth Circuit departed from the Tax Court because the Estate's evidence on valuation discounts was uncontradicted or unimpeached.[173] The court could not find any evidence presented to the Tax Court supporting the Tax Court's finding of a ten percent discount.[174] Further, the Fifth Circuit rejected the Tax Court's treatment of the willing-buyer/willing-seller concept.[175] One of the children testified that the children were attached to the art, did not need to sell the art, did not need the money a sale would generate, and therefore would not likely sell the art.[176] Hypothetically, though, the children might purchase the decedent's interest from a hypothetical buyer of the decedent's interest, but only if experts assured the children that the price was fair.[177] The Tax Court concluded that a fictitious buyer and seller would agree on a joint stipulated value at or fairly close to fair market value reduced by a ten percent discount.[178] The Fifth Circuit held the Tax Court erred in this analysis in that a willing buyer would take into account the financial strength of the children, their rejection of the idea of selling their interests, and the time and money required to deal with the legal constraints.[179] This approach minimizes any emotional attachment the children might have to the

166. *Id.* at 449–50.
167. *Id.* at 453.
168. *Id.* at 446.
169. *Id.*
170. *Id.*
171. *Id.*
172. *Id.*
173. *Id.* at 451.
174. *Id.* at 453.
175. *Id.* at 449.
176. *Id.* at 447–48.
177. *Id.* at 448.
178. *Id.* at 449.
179. *Id.* at 452–53.

art.[180] As the daughter testified, the children would consult with experts on a fair and reasonable price for the art.[181]

VII. CONCLUSION

The Fifth Circuit presented a small number of federal tax cases during the review period, but the Fifth Circuit reversed, at least in part, the lower court in each of the five cases. In *BNSF Railway Co.*, the Fifth Circuit reversed the district court based on *Chevron* deference and statutory construction.[182] In *Chemtech Royalty Associates, L.P.*, the court reversed the district court on economic substance and imposition of penalties.[183] In *Pilgrim's Pride Corp.*, the Fifth Circuit reversed on a substantive legal question of whether abandonment generates a capital loss.[184] In *BMC Software, Inc.*, the Fifth Circuit reversed the Tax Court on a question of statutory interpretation.[185] In *Estate of Elkins*, the court reversed the Tax Court on the evidence.[186] Most of the reversals were easy. The lower court was clearly wrong in reaching its result in four of the five cases reviewed. The Fifth Circuit had to work the hardest in its reversal in *BNSF Railway Co.*, in which the court utilized *Chevron* deference and statutory construction as the basis for reversal.[187]

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180. *Id.* at 452.
181. *Id.*
182. *See supra* Part II.
183. *See supra* Part III.
184. *See supra* Part IV.
185. *See supra* Part V.
186. *See supra* Part VI.
187. *See supra* Part II.