No. 13-4298

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

BARNES GROUP, INC. AND SUBSIDIARIES
Petitioners-Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee

REPLY BRIEF OF THE APPELLANT

On Appeal From the Judgment of
The United States Tax Court
No. 027211-09
The Honorable Joseph Goeke

Robin L. Greenhouse
McDERMOTT WILL & EMERY LLP
500 North Capitol Street N.W.
Washington, DC 20001
202-756-8204

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

Cases

Internal Revenue Codes

Regulations

Revenue Rulings

Other Authorities

TABLE OF ABBREVIATIONS

A	Joint Appendix
ASA	Associated Spring-Asia PTE Ltd.
Barnes	Barnes Group, Inc.
Bermuda Finance	Barnes Group Finance Company (Bermuda) Limited
Delaware Finance	Barnes Group Finance Company (Delaware)
G.Br	Government-Appellee Response Brief
I.R.C. or Code	Internal Revenue Code (26 U.S.C.)
IRS	Internal Revenue Service
Op.Br.	Barnes' Opening Brief
PwC	PricewaterhouseCoopers
Subpart F	Sections 951 through 956 of the Code
Treas. Reg.	Treasury Regulation (26 C.F.R.)

ARGUMENT

I. INTRODUCTION.

The Tax Court concluded that under the step transaction doctrine the Reinvestment Plan should be recharacterized as a dividend from ASA to Barnes. Simply put ASA made an exchange of foreign currency for another asset, the controlling interest in the common stock of Bermuda Finance. Thus, ASA's asset-for-asset exchange cannot be deemed a dividend because it did not constitute a dividend without expectation of repayment. *Tollefsen v. Comm'r*, 431 F.2d 511, 513 (2d Cir. 1970), *cert. denied*, 401 U.S. 908 (1971).

The government further contends that Bermuda Finance and Delaware Finance are conduits for ASA and thus the Reinvestment Plan is properly characterized as either a dividend from ASA to Barnes or a direct loan from ASA to Barnes. (G.Br. 35-36, 51) Once again, this mischaracterizes the substance of the Plan. Neither corporation is a conduit and when each step of the Reinvestment Plan is considered separately or on an integrated basis, ASA has none of the rights of a creditor, including no right to compel repayment of principal or interest, and no rights vis-à-vis other Barnes creditors.

Finally, the government relies on the congressional policy of Subpart F to ignore the plain language of Section 956 and impermissibly convert Section 956 into an anti-abuse rule. (G.Br. 5-6, 21, 54-55) Even under the government's

expansive interpretation of Subpart F and Section 956, there is no evidence to support the government's claim that the Reinvestment Plan results in a "permanent repatriation."

II. THE REINVESTMENT PLAN IS NOT A DIVIDEND FROM ASA TO BARNES.

As discussed in the opening brief, a dividend is defined as a "distribution of property made by a corporation to its shareholders out of its earnings and profits" and the hallmark of a dividend is a permanent transfer of wealth from a corporation to its shareholders without expectation of repayment. (Op.Br. 26-27) The government defends the Tax Court's mischaracterization of the Reinvestment Plan as a dividend from ASA to Barnes, (G.Br. 23-52), but in so doing, the government fails to acknowledge that ASA made an exchange of foreign currency for another asset, the controlling interest in the common stock of Bermuda Finance. Accordingly, ASA's asset-for-asset exchange cannot be deemed to constitute a dividend because it did not constitute a distribution without expectation of repayment. *Tollefsen*, 431 F.2d at 513.

A. The Step Transaction Doctrine Does Not Apply.

As discussed in the opening brief, the Tax Court misapplied the step transaction doctrine to invent a new step, a permanent distribution from ASA to Barnes which does not take into account all of the commercial aspects of the

Reinvestment Plan. (Op.Br. 22) Moreover, as discussed below, the step transaction doctrine does not apply in this case because (1) there were no transitory steps; (2) the conduit theory is inapplicable; and (3) Barnes' objectives could not have been achieved in a more direct way.

1. There Were No Transitory Steps.

The cases cited in the government's brief do not support the application of the step transaction doctrine to the Reinvestment Plan. The government's cited cases involved fact patterns where a transaction participant acquired and then immediately disposed of an asset without any corresponding claim or right or involved an interim transitory step. Each case involved the elimination of a transitory step. Here there are no transitory steps that may be eliminated to support the proposed adjustment to Barnes' income.

For example, in *True v. United States*, 190 F.3d 1165, 1174 (10th Cir. 1999), the step transaction doctrine was applied to disregard the acquisition and immediate disposition of ranchland and oil and gas leases. In *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1522 (10th Cir. 1991), the step transaction doctrine was applied to disregard the acquisition and immediate disposition of stock. In *Long-Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 191 (D. Conn. 2004), *aff'd*, 150 F. App'x 40 (2d Cir. 2005), the step transaction doctrine (and other judicial doctrines) was applied to disregard

the transfer of stock to a partnership that immediately sold the stock to a related party. Similarly, in *Am. Potash & Chem. Corp. v. United States*, 399 F.2d 194 (Ct. Cl. 1968), the step transaction doctrine was applied to collapse the exchange of a parent company's stock for its subsidiary's stock followed by the liquidation of the subsidiary into the parent. Additionally, in *Wolf v. Comm'r*, 357 F.2d 483, 485-86 (9th Cir. 1966), the court disregarded an alleged Section 351 transaction between a partnership and corporation where the corporation had a very temporary corporate life. Unlike each of these cases, none of the equity or debt investments made by ASA, Bermuda Finance, and Delaware Finance in connection with the Reinvestment Plan included "any intermediate steps which the taxpayer has itself undone with subsequent steps." *See Associated Wholesale Grocers*, 927 F.2d at 1529.

2. The "Conduit-Theory" Does Not Apply to Delaware Finance or Bermuda Finance.

The government also contends that a dividend or loan from ASA to Barnes is appropriate under a conduit theory and cites to *Merck & Co., Inc. v. United States*, 652 F.3d 475 (3d Cir. 2011), as "instructive," and *Enbridge Energy Co. v. United States*, 553 F.Supp. 2d 716, 726 (S.D. Tex. 2008), *aff'd,* 354 F. App'x 15 (5th Cir. 2009). (G.Br. 35, 51) The so-called "conduit theory" allows a court to disregard an entity "if it is a mere conduit for the real transaction at issue" based on substance over form principles. *Enbridge*, 553 F.Supp. 2d at 726. The conduit

theory cannot be used to alter the substance of a transaction. Similar to all iterations of the substance over form doctrine, the conduit theory does not apply unless the form of a transaction does not reflect its true substance. Because the substance of the Reinvestment Plan does not deviate from its form, the conduit theory does not apply in this case.

In any case, neither Bermuda Finance nor Delaware Finance could be disregarded as conduits. The conduit factors identified in *Merck* and *Enbridge* simply do not support a finding that either Delaware Finance or Bermuda Finance is a conduit. The structuring of the Reinvestment Plan always included the participation of Delaware Finance and Bermuda Finance. Barnes had no plan to utilize ASA's excess cash and borrowing capacity prior to the Reinvestment Plan and intentionally structured the transaction to include both entities. Delaware Finance had the risks of a creditor while Bermuda Finance was subject to the risk exposure of an equity investment.

Unlike the conduit found to exist in *Enbridge* whose participation in the transaction was transitory, the participation of Delaware Finance and Bermuda Finance in the Reinvestment Plan has not been transitory. Delaware Finance has consistently accrued interest income from Barnes, has received interest payments, has periodically declared and paid preferred dividends to Bermuda Finance, and has paid to the IRS the U.S. withholding tax computed on the basis of the payment

of a dividend. (A-1948, A-1964, A-2182, A-2198, A-2429, A-2445, A-2854, A-2870, A-3492, A-3509, A-3924, A-3942, A-4350, A-4368, A-4769, A-4786, A-5222, A-5239; A-1389-1404, A-0348-0349) And unlike the conduit found to exist in *Merck*, which immediately entered into side contracts to offset any economic risk associated with the transaction, neither Delaware Finance nor Bermuda Finance have hedged or otherwise mitigated any risk associated with their participation in the Reinvestment Plan.

On every measure, the Reinvestment Plan is distinguishable from the sale transaction at issue in *Merck*. Unlike *Merck*, the Reinvestment Plan does not have the objective economic attributes of a loan from ASA. Also, unlike *Merck*, Barnes and its affiliates (and managers) did not believe they were "crafting" a loan or dividend from ASA, and did not treat the Reinvestment Plan as a loan or dividend from ASA for any purpose. From its inception, through board approval, and through execution and implementation, the Reinvestment Plan was always treated as a series of equity investments in Bermuda Finance and Delaware Finance, followed by a loan from Delaware Finance to Barnes. (A-0847; A-0830-0837)

Finally, the objective economic attributes of the Reinvestment Plan also do not reflect a loan from ASA to Barnes or Delaware Finance. Unlike *Merck*, the evidence in this case does not establish that Barnes has "an unconditional obligation" to make any repayments to ASA. 652 F.3d at 484. Because the true

substance of the Reinvestment Plan is not a loan or dividend from ASA to Barnes, the conduit theory does not permit the recharcterization of any of the transactions at issue in this case.

3. Barnes' Objectives Could Not Have Been Achieved in a More Direct Way.

Under the common-law step transaction doctrine, integrated steps in a single transaction can be amalgamated if the taxpayer could have achieved its **objective** more directly, but instead included the step for no other purpose than to avoid U.S. taxes. *See Long-Term Capital Holdings*, 150 F. App'x at 43 (*citing Del Commercial Props., Inc. v. Comm'r*, 251 F.3d 210, 213 (D.C. Cir. 2001)). The Board of Directors' resolution succinctly states the objectives: (A-0847)

> WHEREAS, the Board of Directors (the "Directors") of Barnes Group Inc. (the "Company") desires to expand the operations of the Company through prudent foreign and domestic acquisitions; and
>
> WHEREAS, the Directors believe that the management of the Company and its subsidiaries should consider global funds management policies that maximize the overall rate of return on temporary cash and borrowing capacity in excess of current needs (cumulatively, the "Excess Cash") in order to enhance shareholder value; and
>
> WHEREAS, the Directors do not desire to permanently repatriate foreign Excess Cash to the United States because they expect that prudent foreign acquisitions will be identified which will require the use of the foreign Excess Cash; and
>
> WHEREAS, Associated Spring-Asia Pte. Limited ("AS-Asia"), an indirect wholly owned subsidiary of the Company formed under the laws of the Republic of Singapore, has foreign Excess Cash; and

> WHEREAS, the Excess Cash of AS-Asia cannot be invested in its business at a rate of return equivalent to the rate of return that can be earned by having the Company manage Excess Cash centrally; and
>
> WHEREAS, it is mutually beneficial to the Company and AS-Asia to provide a structure through which the Company may use the Excess Cash, and thereby allowing AS-Asia to retain an indirect investment in the Excess Cash, to preserve its reserves and to assure its access to the Excess Cash when operational needs or appropriate foreign investment opportunities arise.

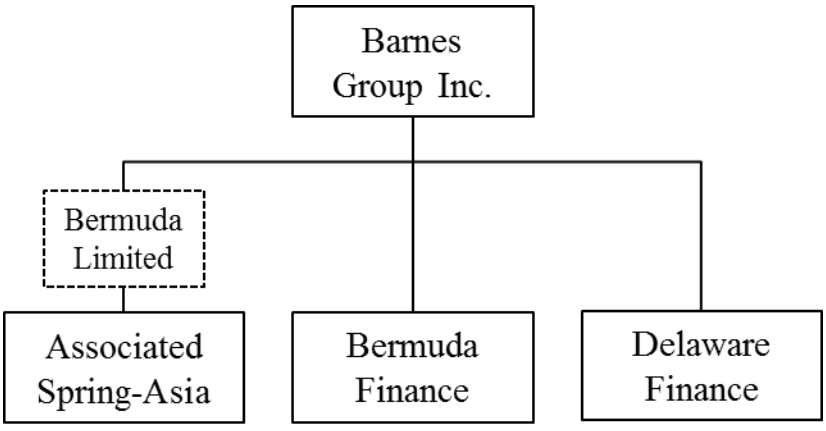
These delineated objectives could not have been achieved, as the government contends, by the repatriation of cash from ASA to Barnes.[1]

---

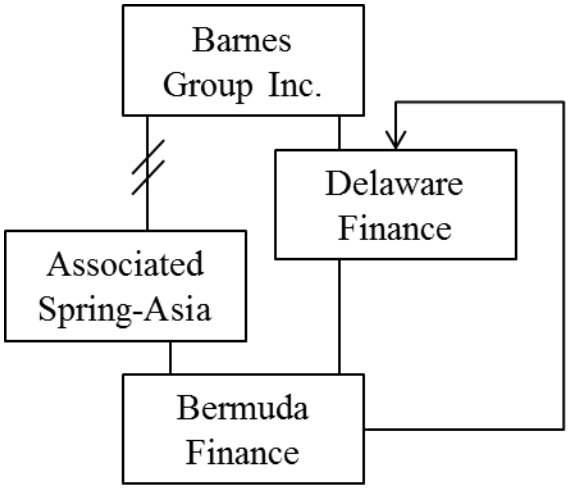
[1] The government's brief cites to Mr. Parent's internal PwC memo to support the government's claim that there was no business purpose for the Reinvestment Plan. (A-3106) Yet, Mr. Parent, (Vice President of cash reporting at Tyco International at the time of his testimony) candidly testified in response to the government's direct examination that he was not on the PwC technical team which analyzed the tax consequences of the Reinvestment Plan and served as a "scrivener" for the technical experts. (A-0457) Notwithstanding, all comments made by Mr. Parent regarding the draft Opinion were addressed by the PwC technical experts, including Mr. Remikis (who was formerly in charge of the IRS National Office Subchapter C group) and resolved these comments to Mr. Parent's and everyone else's satisfaction before the Opinion was finalized and approved. In fact, Mr. Parent testified that Mr. Remikis provided the "ultimate quality review" and concurred that "the rest of us got it right." (A-0171-0173; A-0208; A-0276-0280; A-0295-0297; A-0451-0452; A-0458) The government's brief also attempts to paint PwC as fabricating a business purpose by relying on an email from Mr. Parent about addressing the engagement letter to John Locker, the Treasurer, rather than Joe DeForte, the vice president of Tax, (G.Br. 8) and ignores Mr. Parent's explanation of the email. Mr. Parent testified that he understood that the Reinvestment Plan was a Treasury department motivated transaction and thus, he "absolutely" thought it was appropriate to have the engagement letter addressed to the Treasurer as opposed to the Tax department. (A-0463-0464)

To support its claimed contention that a dividend was the most "direct route," the government's brief cites Barnes' Chief Financial Officer, William Denninger's explanation that a dividend from ASA to Barnes would have been "unacceptable." (G.Br. 33) However, these delineated objectives make clear that Mr. Denninger did not find it "acceptable" to make a taxable distribution from ASA to Barnes because he knew that such action would have been inconsistent with the envisioned need to use ASA's excess cash for offshore acquisitions. (A-0131)

Moreover, the government's "direct route" claim is inconsistent with Mr. Coneys' statement that "[e]very step was needed to accomplish the equity ownership structure" resulting from the implementation of the Reinvestment Plan. (A-0294) Prior to the implementation of the Reinvestment Plan, the Barnes ownership structure appeared as follows (A-2967):



As a result of the Reinvestment Plan, the Barnes ownership structure was changed and ASA holds the controlling interest in Bermuda Finance and Bermuda Finance holds Delaware Finance common and preferred stock (A-2970):



Because (1) there was no alternative path that could have achieved the investment structure above, (2) none of the entities' involvement was transitory, and (3) there were no hedges, puts, derivatives, side agreements or other contractual provisions that undid any of the rights or obligations reflected in this structure, the step transaction doctrine cannot be applied.

B. Bermuda Finance and Delaware Finance Each Had Non-Tax Business Purposes.

In light of the contemporaneous documents and uncontroverted testimony, Barnes has established that the Tax Court committed clear error in failing to find non-tax business purposes for the creation of Bermuda Finance and Delaware Finance.

As described in the opening brief, the non-tax business purposes for creating Delaware Finance and Bermuda Finance were described in several contemporaneous documents. (Op.Br. 31-37) Additionally, the uncontroverted testimony of Barnes and PwC personnel corroborated that Bermuda Finance's and Delaware Finance's participation in the Reinvestment Plan was necessary for reasons other than federal taxes. Based on advice from its Singapore advisors, PwC, in turn, advised Barnes that the creation of Bermuda Finance was necessary because Singapore corporate law did not permit ASA to make the type of equity investment required by the transaction. (A-3119-3120, A-0189-0190, A-0198-0199, A-0293) Additionally, PwC advised Barnes that the creation of Delaware Finance was necessary to provide Barnes with a state tax benefit unrelated to federal income taxes and also to facilitate the more effective control over the funds invested by ASA. (A-0199, A-0264-0265, A-0424, A-2971-2996, A-3035) And it was established that both corporate entities were necessary to enable Barnes to accomplish its overall objective of more efficiently using ASA's excess cash and borrowing capacity to temporarily pay down third party indebtedness while preserving all of ASA's excess cash and borrowing capacity for use in forthcoming acquisitions outside of the United States. (A-0294, A-0131)

To rebut this uncontroverted testimony, the government claims that the Tax Court made adverse credibility determinations but fails to point to a single one.

(G.Br. 37) The Tax Court made factual findings based on the testimony of the witnesses and made no distinction that it may have found some portions of the testimony credible and some not. *See e.g.* A-0097, A-0476 (*Mr. Goodrich's "strategic objective"*); A-0140, A- 0480 (*Mr. Denninger's explanation about using ASA's "borrowing capacity" to finance international "acquisitions"*); A-0254, A-0482 (*Mr. Coneys' explanation that PwC "tax professionals [were] encouraged to" submit their "experiences and ideas" to a "database"*); A-0240-0341, A-0498 (*Mr. DeForte's careful "review" of the factual and legal sections of the PwC Opinion*). The Tax Court has no qualms in making a factual finding that particular testimony is self-serving or not credible; it simply did not find here that any of the witnesses' testimony were lacking in creditability. *See e.g. Am. Valmar Int'l Ltd. v. Comm'r*, T.C. Memo. 1998-419, *aff'd,* 229 F.3d 98 (2d Cir. 2000). It was the government's decision not to cross examine the witnesses as to the Reinvestment Plan's nontax business purpose and thus, absent any credibility determinations, the government cannot simply ignore the uncontroverted testimony.

C. The Reinvestment Plan Was Not Intended to be Permanent.

There is no support for the government's claim that the Reinvestment Plan was intended to be permanent. (G.Br. 49) The government simply ignores the fact that a plan to return the cash to ASA upon the identification of a suitable international acquisition was put in place before the Reinvestment Plan was

implemented, and that Barnes' intent in 2006 to return the cash to ASA to make an offshore acquisition was stymied due to the government's challenge of the Reinvestment Plan. (A-0352) The government's complaint that it does not understand the purported potential for "double taxation" is mystifying. (G.Br. 50 n.9) Mr. DeForte testified that he wanted to return the cash to ASA to fund the Hänggi transaction. However, at that time the Reinvestment Plan was being challenged by the IRS, and he said "I point blank asked Frank Lopane [PwC] could we potentially be double-taxed. If I were to unwind the transaction, pay the tax [resulting from the unwind], use the funds to buy the company and then the IRS assess[es] us, would I be taxed again, and he said possibly yes." (A-0352)

D. Barnes and Delaware Finance Each Respected the Form of the Transaction.

As discussed in Barnes' opening brief, Barnes and Delaware Finance each respected the form of the transaction. (Op.Br. 37-42) The government's assertion that Barnes "backdated the notes" that represented loans from Delaware Finance (G.Br. 14, 41) is factually inaccurate and is a frivolous allegation.[2] The undisputed

---

[2] The government's brief is replete with rhetoric that attempts to characterize Barnes' actions without regard to what the record shows, including: *The repatriation scheme was an integrated scheme that Barnes purchased from PwC . . .* (G.Br. 30); *Barnes and PwC created a series of prearranged steps to*

evidence, which included the testimony corroborated by Barnes' financial statements, demonstrated that the loans between Delaware Finance and Barnes were contemporaneously recorded in the financial statements of both corporations in December 2000 and July 2001, the same months in which the loans were actually made. (A-0396-0398; A-1661-1668) Although written loan agreements were not executed until later in 2001, both loan agreements state they were "dated **as of** December 26, 2001 [sic]" and "dated **as of** July 10, 2001." (A-1111-1118)

The government concedes that "the total loan balance reported on Barnes' tax return had nearly doubled, from $67,605,000 to $127,202,495, an increase that represents accrued but unpaid interest." (G.Br. 42) The fact that Barnes chose to accrue most of the interest and did not make principal payments did not affect the nature of the loan. For example, in the debt/equity case *NA Gen. P'ship, et al. v. Comm'r*, T.C. Memo 2012-172, the Tax Court held that the failure to make timely interest payments did not convert related party debt to equity. The court noted,

> that strict insistence on payment when due is not expected and consistent with business realities in the related-party context. *See Wilshire & W. Sandwiches, Inc. v. Commissioner*, 175 F.2d 718, 720-721 (9th Cir. 1949) (stating no adverse inference should be drawn from a party's failing to demand payment immediately when due from a related party), *rev'g* a Memorandum Opinion of this Court…We do not draw any adverse inference that [the taxpayer] failed to reduce the

---

disguise the intended tax free repatriation of ASA's funds . . . (G.Br. 29); *repatriation scheme was to create a smoke screen . . .* (G.Br. 39).

> principal amount of the intercompany debt during the years at issue as no principal payments were due.").

NA Gen. P'ship, et al., T.C. Memo. 2012-172, at **28-30.

Finally, the government does not dispute that dividend payments were in fact made and that the withholding tax was properly paid to the IRS, but only that Barnes did not put on sufficient proof of payment. (G.Br. 44-47) At trial, the government did not dispute Mr. DeForte's direct testimony that Bermuda Finance made periodic dividend payments on the preferred stock. To the contrary, on cross examination, the government's trial counsel had Mr. DeForte confirm that Barnes intended to pay "one-quarter of the preferred dividends every two years." (A-0364) Mr. DeForte's testimony on this point is corroborated by an email from Mr. Parent. (A-3084) Since the question of whether dividends were paid in the years following the implementation of the Reinvestment Plan was not disputed before or during trial and the government agreed to the introduction of the Forms 1042 as joint exhibits (A-1389-1400) which evidence payment of withholding tax on the dividends paid by Delaware Finance to Bermuda Finance and Mr. DeForte testified that dividends were paid, the government should be barred from disputing the sufficiency of the evidence.

III. BARNES CORRECTLY REPORTED NO INCOME ATTRIBUTABLE TO THE REINVESTMENT PLAN BECAUSE BERMUDA FINANCE HAD AN INVESTMENT IN UNITED STATES PROPERTY WITH AN ADJUSTED BASIS OF ZERO.

The government's references to the Subpart F rules and Section 956 are vague attempts to convert Section 956 into a general anti-abuse rule. (G.Br. 5-6, 51-55) The government's broad statements of congressional intent cannot be used to disregard the plain language of Section 956. Section 956 is a complex statutory provision that determines when the earnings and profits of a CFC must be included in the income of the U.S. shareholders. The government is flatly wrong when it claims that section 956 provides that the income of a CFC "is subject to taxation if it is ever invested in 'United States property.'" (G.Br. 5) Here, the government seeks to ignore the plain statutory provisions in order to obtain its desired result.[3]

Courts have routinely rejected the government's attempt to rewrite the plain language of various Subpart F provisions to prevent tax results that the government deemed inconsistent with the purpose and structure of Subpart F. For example, in

---

[3] Remarkably, this result is inconsistent with the IRS's actual anti-abuse rule in Treas. Reg. § 1.956-1T(b)(4). The anti-abuse regulation provides that when a CFC controls another CFC and the principal purpose for creating, organizing or funding the controlled CFC is to avoid the application of section 956, then the controlling CFC will be considered to hold indirectly the investments in U.S. property of the controlled CFC. While the anti-abuse regulation does not apply to the Reinvestment Plan, if it were to have applied the tax outcome would be the same. ASA would be considered to indirectly hold Bermuda Finance's investment in the Delaware Finance preferred stock, and under the zero basis rule, Bermuda Finance's basis in the preferred stock is zero.

The Limited, Inc. v. Comm'r, 286 F.3d 324, 355 (6th Cir. 2002), the court, in considering whether a CFC which had purchased certificates of deposit from U.S. affiliates qualified for the "banking" exception in former Section 956(b)(2)(A), described the proper interpretation of the statutory provisions in Subpart F as follows:

> In its zeal "to effectuate the intent of Congress," the Tax Court failed to interpret the plain language of §956(b)(2)(A). Before the Tax Court read in the complex business-facilitation requirement, it should have instead relied on another principle of statutory interpretation – statutes imposing a tax should be interpreted liberally in favor of the taxpayer. Thus, rather than force a complex meaning from legislative history, the Tax Court should have instead construed §956(b)(2)(A) in Taxpayer's favor.

In *Brown Grp., Inc. v. Comm'r*, 77 F.3d 217, 222 (8th Cir. 1996), the court strictly applied the definition of "related persons" in Section 954(d)(3) even though it resulted in a tax benefit deemed to be contrary to the purpose of Subpart F. ("Although our holding may result in a tax windfall to the Brown Group…such a tax loophole is not ours to close but must rather be closed or cured by Congress. Indeed, Congress has done just that. It closed the loophole the following year."). Similarly, in *MCA Inc. v. United States*, 685 F.2d 1099, 1104-05 (9th Cir. 1982), the court declined the government's invitation to rewrite the Subpart F statutory provisions explaining that:

> The government asserts that in enacting subpart F Congress was more concerned with the nature of the income than the form of the entity generating the income….
>
> Congress wrote the statute unambiguously to apply to subpart F income received from controlled "corporations" only. If the omission of income received from controlled partnerships has indeed created an unjustified loophole in the tax laws, the remedy lies in new legislation, not in judicial improvisation. (Internal citations omitted.)

The plain language of Section 956 and the other relevant provisions of Subpart F require that the Delaware Finance preferred stock held by Bermuda Finance be treated as an investment in United States property. However, the basis in that property is zero based on the statute as interpreted by the IRS under Rev. Rul. 74-503, 1974-2 C.B. 117. Although the government has issued prospective changes to the applicable basis computation rules under Section 956, the government has not explained what different basis rule should apply to the Reinvestment Plan, nor did the Tax Court address this issue as its holding disregards the preferred stock investment of Bermuda Finance in Delaware Finance.[4]

---

[4] To the extent that the government considered the application of the basis provisions for domestic corporations to result in "an unjustified loophole in the tax laws," the government issued new prospective basis calculation rules under Subpart F that override the basis calculation rules for domestic corporations and prevent the application of the zero basis doctrine in determining the adjusted basis (for purposes of Section 956) of United States property acquired by a CFC. *See*

As discussed in the opening brief (Op.Br. 46), the Tax Court concluded that Barnes could only rely on Rev. Rul. 74-503 and the "will not challenge" provision in Rev. Rul. 2006-2, 2006-1 C.B. 261, if (1) the substance of the Reinvestment Plan was the same as its form, and (2) the Plan was not factually distinguishable from the ruling. Barnes has established that the substance of the Reinvestment Plan did not differ from the form and that the Plan is in all material respects the same as Rev. Rul. 74-503.

Although, the government admits that it does not seek to "disavow" or "argue against" Rev. Rul. 74-503,[5] (G.Br. 54) it instead mistakenly reaches back to its argument that the step transaction rule applies to recharacterize the Reinvestment Plan as a dividend from ASA to Barnes, and thus, contends that the overall substance "was not a § 351 exchange between Bermuda [Finance] and Delaware [Finance]." (G.Br. 54) This contention is patently without merit, since without the step transaction doctrine the government's contention that the Reinvestment Plan was factually dissimilar to Rev. Rul. 74-503 has no underpinnings. For the reasons explained above, the step transaction doctrine may not properly be applied in this case.

Treas. Reg. § 1.956-1(a)(e)(6) applicable to acquisitions of United States property made after June 24, 2009.

[5] It cannot do so in light of *Rauenhorst v. Comm'r,* 119 T.C. 157 (2002) and *Dover Corp. v. Comm'r,* 122 T.C. 324 (2004).

The government and Tax Court cannot ignore the plain statutory provisions of Section 956 in order to effectively convert Section 956 into a general anti-abuse rule simply because they object to the outcome of its application. The Reinvestment Plan met all of the requirements of Section 351 and was not factually dissimilar to Rev. Rul. 74-503. (A-3043-3055) Therefore, the government may not challenge that Barnes correctly reported no income attributable to the Reinvestment Plan because Bermuda Finance had an investment in U.S. property with an adjusted basis of zero.

IV. THE IMPOSITION OF THE ACCURACY-RELATED PENALTY WAS ERRONEOUS.

A. Introduction.

The government's brief essentially rewrites the Tax Court's factual findings with respect to the imposition of the accuracy-related penalties. To this end, the government denigrates PwC in order to overturn the Tax Court's factual holdings that the PwC project team led by Paul Coneys "was a competent professional who had sufficient expertise to justify reliance," and Barnes "provided necessary and accurate information to the advisor." *See Neonatology Assocs., PA v. Comm'r*, 115 T.C. 43, 99 (2000), *aff'd,* 299 F.3d. 221 (3d Cir. 2002); A-0535. The government's brief attempts, contrary to the findings of the Tax Court, to convert PwC's role as a long-standing advisor who responded to Barnes' request for assistance to resolve a treasury problem into the role an advisor with "[a] financial

stake in [the] outcome" that "market[ed]" a "tax shelter." [6] (G.Br. 63-64) The government argues for legal conclusions that the case involves (1) "negligence" under Section 6662(b)(1), and (2) a "tax shelter" under Sections 6662(d)(2)(B)(i) and (d)(2)(C)(ii). (G.Br. 56-57) Although the government devoted numerous pages of its post-trial briefs to these arguments, the government did not offer any proposed findings of fact that would have supported these arguments and the Tax Court appropriately made no factual findings or legal conclusions that would support the imposition of the negligence penalty or the application of the "tax shelter" exception to the substantial authority provision in Sections 6662(d)(2)(B)(i) and (d)(2)(C)(ii).

B. Standard of Review.

This court recently applied a review of a district court's "substantial authority" analysis in *TIFD III-E, Inc. v. United States*, 666 F.3d 836 (2d Cir.

---

[6] The government's brief relies on inflammatory rhetoric that mischaracterizes PwC's role, including:

The repatriation scheme was an integrated scheme that Barnes purchased from PwC . . . (G.Br. 30)*; Barnes and PwC created a series of prearranged steps to disguise the intended tax-free repatriation of ASA's funds.* (G.Br. 29)*; PwC concocted a convoluted scheme . . . to shoehorn* . . . (G.Br. 59)*; and PwC's letter was an 'advocacy piece' to justify a preconceived tax-avoidance scheme that PwC previously marketed to other clients* . . . (G.Br. 67).

2012), strongly suggesting that de novo review is applied to the determination of whether the taxpayer had substantial authority for its tax return position. *See NPR Invs., LLC v. Comm'r*, 740 F.3d 998, 1011 (5th Cir. 2014) ("whether substantial authority exists for a tax treatment is a legal question that this court reviews de novo"); *Cramer v. Comm'r*, 64 F.3d 1406, 1415 (9th Cir. 1995); *Estate of Kluener v. Comm'r*, 154 F.3d 630 (6th Cir. 1998); *but see Antonides v. Comm'r*, 893 F.2d 656 (4th Cir. 1990). Even putting aside the question of review for substantial authority, clearly de novo review should be applied to legal issues pertaining to the imposition of penalties. One such legal issue is whether the Tax Court erred in concluding that it could rely on events that occurred after the tax returns were filed in determining whether Barnes' reliance on the PwC Opinion was reasonable. This hindsight view that penalties may be imposed because of events happening after the fact not only is wrong as a matter of law, but also as a matter of fundamental fairness.

C. Barnes Had Substantial Authority for its Tax Return Position.

As discussed in the opening brief, Barnes correctly reported no income inclusion as a result of the Reinvestment Plan, but in any event, Barnes had substantial authority under Section 6662(d)(2)(B)(i) for its tax return position, and therefore the accuracy-related penalty does not apply. (Op.Br. 56-57) The authorities supporting Barnes' tax return have been briefed extensively by Barnes

and it is Barnes' contention that the proposed adjustments are not proper on the merits. Clearly, in such circumstances the weight of authorities in support of Barnes is substantial in relationship to any authority argued by the government in opposition.

The government contends that the Reinvestment Plan was a "tax shelter" and that Barnes cannot avoid the understatement penalty by having substantial authority. The government raises this argument too late and without supporting factual and legal findings. Indeed the government never proposed any findings of fact that could support a legal conclusion that this case involves a "tax shelter" under Section 6662(d)(2)(C)(ii).[7] More importantly, the Tax Court did not make the requisite factual and legal findings that the Reinvestment Plan was a "tax shelter." *See Icicle Seafoods, Inc. v. Worthington*, 475 U.S. 709, 714 (1986) (The Court of Appeals "should not have made factual findings of its own."). In any event, the Reinvestment Plan was not a "tax shelter" because no purpose, much

---

[7] There is a strong disconnect between the government's label and the IRS's and Treasury Department's response to the Reinvestment Plan. If the Reinvestment Plan was a "marketed tax shelter" as the government alleges, certainly the IRS or the Treasury Department would have issued a Notice, revenue ruling, or some other form of official guidance that would have identified it as an abusive transaction. *See e.g.* Notice 2000-44, 2000-36 I.R.B. (Sep. 5, 2000). The absence of such action, and the decisions to (i) revoke Rev. Rul. 74-503 on a prospective basis only, (ii) include the "will not challenge" clause in Rev. Rul. 2006-02, and (iii) make prospective only the new section 956 basis calculation regulations, collectively demonstrate that the government's rhetoric is misplaced.

less a "significant purpose" was tax evasion or avoidance. *See* Section 6662(d)(2)(C)(ii).

D. The Tax Court's Logic Pertaining to Barnes' Reasonable Cause Relief was Flawed and the Government's Alternative Logic Does Not Cure the Flaw.

Barnes had reasonable cause for its tax return reporting position and acted in good faith. Section 6664(c). The government appears to abandon the Tax Court's reasoning pertaining to Barnes' reasonable cause relief from the accuracy-related penalties, and relegates to the last paragraph of its brief the *Neonatology* test used by the Tax Court.

The Tax Court held that under the first two prongs of *Neonatology* the PwC project team led by Mr. Coneys with Mr. Remikis' quality review "was a competent professional who had sufficient expertise to justify reliance" and Barnes "provided necessary and accurate information to the advisor." In fact the Tax Court held that the government did not "dispute PwC's expertise or whether petitioners provided all necessary and accurate information to PwC." (A-0535) The Tax Court then balances its entire finding that Barnes did not follow the PwC Opinion on the Tax Court's erroneous belief that interest or dividends were not paid. As discussed in the opening brief, the PwC Opinion did not address the payment of interest, the Opinion recognized that dividends on the preferred stock were cumulative, and the Tax Court erroneously relied on events that occurred

after the tax returns were filed. (Op.Br. 60-61) The government, in an attempt to salvage the Tax Court's holding, tries to use Treas. Reg. § 1.6664-4(c) to show that PwC did not consider all the facts and circumstances and that PwC made unreasonable assumptions. This is clearly not the case. There were no unreasonable assumptions reflected in the PwC Opinion or in the representation letter signed by the Barnes CFO. (A-1683-1688, A-3031-3057) None of the statements in either the PwC Opinion letter or the representation letter are false and there were no inaccurate representations in either document as to Barnes' purpose for entering into, or the specific structure of, the Reinvestment Plan. (A-0135, A-0345)

The government's brief directs abusive claims at PwC to show that Barnes' reliance on PwC was unreasonable. The government's brief argues that PwC "was burdened with an inherent conflict of interest," and points to PwC's Ideasource as a nefarious tool with which PwC sought to "market [the Reinvestment Plan] to other corporations." (G.Br. 62-63) With respect to Ideasource, at trial, the Tax Court judge explained: "It's not nefarious. It's just the way the tax world is."[8] (A-0252) Moreover, the government's unfounded assertions that PwC did not

[8] "During the late 1990s all PwC tax professionals were encouraged to submit their experiences and ideas to a database. The information was entered in the database in a way that did not reveal client-identifying information so that the entries were suitable for sharing with other PwC professionals." (A-0482)

provide an adverse opinion in order to sell the transaction to others is ludicrous and without any factual basis. (G.Br. 63)

The government also argues that "PwC even had a financial stake in the outcome," (G.Br. 63) despite the fact that the evidence clearly indicates that the fees were based solely on time. (A-0133; A-0185; A-0187; A-0467) PwC did not market the Reinvestment Plan to Barnes as the government alleges. PwC: (1) was Barnes' longstanding tax advisor; (2) did not give unsolicited advice regarding the Reinvestment Plan; (3) assigned tax specialists to the engagement who provided advice only within their respective realms of expertise; (4) followed their regular course of conduct; and, (5) had no financial stake in the Reinvestment Plan other than receiving 100% of their standard hourly rates. *See 106 Ltd. v. Comm'r,* 136 T.C. 67, 80 (2011) ("a tax adviser is not a 'promoter' of a transaction when he has a long-term and continual relationship with his client; does not give unsolicited advice . . .; advises only within his field of expertise. . . ; follows his regular course of conduct in rendering his advice; and has no stake in the transaction besides what he bills at his regular hourly rate.")

Lastly, contrary to the Tax Court's finding that Barnes provided all of the necessary and accurate factual information to PwC (A-0535), the government's brief argues that the PwC Opinion was not based on "all pertinent facts," and therefore Barnes cannot rely on the PwC Opinion under Treas. Reg. § 1.6664-

4(c)(1)(i). The PwC Opinion addresses the entire transaction, including whether the Reinvestment Plan was in substance a dividend from ASA to Barnes and whether the step transaction doctrine applies. The PwC Opinion carefully reviews each and every step of the Reinvestment Plan explaining that the Opinion "is premised on all steps of the proposed transaction." (A-3057, Emphasis added.)

PwC evaluated and rejected the possibility of a dividend and advised Barnes at the very high "should level" of confidence, that "it is our opinion that the transaction should not result in a deemed repatriation of funds under section 301." (A-3032) PwC also evaluated and rejected the possibility of the application of the step transaction doctrine and advised Barnes that "we believe that our conclusions should not be altered by application of 'step transaction principles.'" (A-3032) Finally, the PwC Opinion concludes at the "should level" of confidence that "the proposed investment in the preferred stock of [Delaware Finance] should result in no income inclusion to Barnes under sections 951(a)(1)(B) and 956." (A-3032)

The government's brief's claims (G.Br. 61-62) that Barnes, as a sophisticated taxpayer, could not rely on the PwC Opinion ignores that Barnes' Tax VP carefully studied each of the Code sections, Treasury Regulations, court opinions, and published guidance cited in the PwC Opinion, and could find no fault with the legal analysis, and similarly, confirmed the accuracy of every factual statement in the Opinion. (A-0339, A-0342, A-1431-1655) Accordingly, based on

Barnes' thorough analysis, Barnes had no reason to believe that the Reinvestment Plan would be recharacterized as a dividend from ASA to Barnes. Accordingly, Barnes reasonably relied on, and acted in good faith in seeking the advice of PwC, its long-time tax advisor, in order to solve a business issue. (A-0321-0322, A-0167-0168)

Finally, the government attempts to support the Tax Court's "reasonable cause" reasoning by claiming that Barnes did not follow the PwC Opinion because Barnes did not implement the transaction properly "when it failed to sign contemporaneous notes" and Barnes "failed to prove that any interest or dividends were paid." (G.Br. 67-68) This ultimate paragraph betrays the disingenuous argument that the government is making. The government's brief argues on the one hand that the PwC Opinion did not address the entire transaction and on the other hand that Barnes did not respect the form of the transaction as required by the PwC Opinion. The facts demonstrate that Barnes complied with the implementation requirements. As discussed above, each step in the Reinvestment Plan was properly and promptly implemented, including the recording of the loans from Delaware Finance and Barnes on their respective financial statements in December 2000 and July 2001. In sum Barnes reasonably relied on the PwC Opinion and as such, met the requirements of Section 6664(c).

CONCLUSION

The Court should reverse the Tax Court's decision and enter judgment for Barnes.

Respectfully submitted,

/s/ Robin L. Greenhouse
Robin L. Greenhouse
McDermott Will & Emery, LLP
500 North Capitol Street, NW
Washington, DC 20001
Tel. (202) 756-8204
Fax. (202) 756-8087

CERTIFICATE OF COMPLIANCE WITH TYPE-VOLUME LIMITATION, TYPEFACE REQUIREMENTS, AND TYPE STYLE REQUIREMENTS

1. This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because:

[X] this brief contains 6,711 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

[] this brief uses a monospaced typeface and contains [state the number of] lines of text, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

2. This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because:

[X] this brief has been prepared in a proportionally spaced typeface using Microsoft Word Version 2003, Times Roman 14 point font.

[] this brief has been prepared in a monospaced typeface using [state name and version of word processing program] with [state number of characters per inch and name of type style].

/s/ Robin L. Greenhouse
ROBIN L. GREENHOUSE
Attorney for Appellant

Dated: May 29, 2014

CERTIFICATE OF SERVICE

IT IS HEREBY CERTIFIED that on May 29, 2014, the foregoing Reply Brief for the Appellant was filed using the Court's ECF system and served on the following attorney for Defendant-Appellee United States of America:

By Electronic Service through the Court's ECF system to this ECF Filer:

Attorney, Appellate Section
Tax Division
Department of Justice
P.O. Box 502
Washington, DC 20044

/s/ Robin L. Greenhouse
ROBIN L. GREENHOUSE
Attorney for Appellant