

## IRS Calls 5-Hour Energy Transactions a Sham

by Kristen A. Parillo

The IRS is doubling down in its Tax Court fight against the founder of 5-Hour Energy, asserting in a new court filing that no basis adjustments should be allowed because the underlying transactions were a sham.

What seemed to be a dispute over whether Manoj Bhargava should have reduced his historical section 743(b) basis adjustments after donating a portion of his ownership stake in Innovation Ventures LLC — the Michigan-based partnership that owns 5-Hour Energy — has evolved into a tax shelter challenge.

In its May 28 answer to Bhargava's Tax Court petition, the IRS contended that Bhargava isn't entitled to any of the \$516 million in section 754 amortization deductions that Innovation Ventures reported was attributable to optional section 743(b) basis adjustments on its tax returns for 2009 through 2013.

In the notices of final partnership administrative adjustment issued to Innovation Ventures in October 2018 — which form the basis of Bhargava's petition — the IRS had disallowed \$446 million in amortization deductions while allowing \$70 million.

The agency now alleges that Bhargava entered into a series of purchase and transfer transactions to artificially create enormous inside basis adjustments under sections 754 and 743(b). It further contends that the values for the purchases, donation, and repurchase from the charity were inflated and pegged to Bhargava's willingness to license the 5-Hour Energy formula.

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The IRS is also now asserting that the 40 percent gross valuation misstatement penalty applies to any underpayment in tax due by a partner of Innovation Ventures that is attributable

to the disallowed basis and the resulting disallowed amortization deductions.

### Shift in Strategy

Glenn Dance, a former IRS attorney, previously speculated to *Tax Notes* that the IRS's position in the FPAs was that Bhargava wasn't entitled to trace the partnership units he retained after the donation, but is instead required to consider a pro rata share of his pre-donation units to have been retained.

Dance said the IRS's explanation in its answer regarding why the FPAs allowed some of the basis adjustments confirmed his hunch.

Given that the IRS position would have "rocked some people's world" and caused problems with software programs that are designed to allow investors to trace the units they've sold and the ones they've retained, the government's apparent shift in litigation strategy "is actually a win for the partnership tax community," said Dance.

Jerald David August of Fox Rothschild LLP said that "based on the degree of detail in the IRS's answer, it is clear that the taxpayer may have a difficult time meeting its required burden of proof in prevailing on the merits."

The government's invocation of the partnership antiabuse rule may not be necessary to strike down the tax benefits claimed by Innovation Ventures and Bhargava, said August.

"Perhaps the antiabuse regulations are helpful in that they allow the IRS to 'recast' a transaction or transactions if necessary," August said. "The sham transaction doctrine generally results in treating the transactions as not having occurred, which in this case could be reflected simply by ignoring the section 743(b) basis adjustments."

August said it's possible that the overvaluation penalties will induce Bhargava to agree to a section 743(b) adjustment of zero in return for the IRS dropping them.

Dance said he thinks the case will ultimately turn on its facts.

"If the taxpayer can substantiate the values applied to the various parts of the transaction, he would presumably win," said Dance. The purpose of the transactions seems to have been for Bhargava to sell partnership units at low values to minimize gain recognition and then buy them

back from tax-indifferent parties at a high price to maximize his section 743 basis adjustments, he said.

"Use of intermediaries to facilitate tax planning is not all that uncommon, but the devil is in the details when you do," Dance said. "Facts, like the applicable valuation assumptions, are often controlling in these cases. I'm not sure this is how the government will want to employ the antiabuse rules, which they've used sparingly to attack transactions where legal interpretations, as opposed to factual integrity, matter."

### Competing Narratives

The tax shelter allegations in the IRS's answer suggest that it obtained new information after issuing the FPAs last fall.

According to Innovation Ventures' March 26 petition, the dispute arose after Bhargava donated 45 percent of his directly held stake (referred to as "founder units" in the petition) in the partnership to the Rural India Supporting Trust (RIST), a section 509(a)(3) supporting organization that provides funds for health, education, and economic support in rural India. The petition said the partnership interest was valued by EY at \$623.64 million.

Shortly after RIST received the gift, it sold the partnership interest to Nevada 5 Inc. in exchange for a promissory note of \$623.64 million. Nevada 5 was founded in April 2009, and Bhargava serves as its president, secretary, treasurer, and director. Nevada 5's sole shareholder is the Knowledge Medical Research Charitable Trust (KMRCT), a medical research charity of which Bhargava was a board member.

Innovation Ventures reported that Nevada 5 was entitled to section 743(b) basis adjustments of \$586 million, \$364 million, and \$394 million in 2009, 2010, and 2011, respectively.

Alluding to the IRS's position that a pro rata approach was needed when disposing of some partnership interests, Innovation Ventures contended that the donation and sale of the "founder units" didn't affect basis adjustments made on the 30 percent partnership interest (referred to as "encumbered units") Bhargava had acquired indirectly via Acquisition Co. (an entity controlled by Bhargava) in 2008 and for which he

claimed basis adjustments of \$431 million and \$2.4 million in 2008 and 2009, respectively.

According to the petition, only founder units were donated to RIST and later sold to Nevada 5. It added that the encumbered units were treated as separately stated items in Innovation Ventures' books.

### 'Artificial' Deductions

The IRS alleged in its answer that two years before the purported 2009 RIST donation, Bhargava sold 200,000 class A units of Innovation Venture to Indu Rawat, a Canadian citizen and nonresident alien for U.S. tax purposes, for \$1. At the end of 2007, Rawat transferred 5,000 units to RIST.

In early January 2008, Bhargava indirectly purchased the 5,000 class A units from RIST in exchange for a \$7.4 million promissory note. That same day, he also indirectly purchased 295,000 class A units from Rawat in exchange for a \$438 million promissory note. Both transactions were made through Acquisition Co.

Rawat didn't file a U.S. tax return in 2008 or report any gain from selling the units to Bhargava. The amount and extent of that gain is the subject of a pending Tax Court case brought by Rawat in 2016 (Dkt. No. 15340-16), according to the IRS's answer.

"Bhargava continued to exercise total control over Innovation Ventures despite purporting to possess only a minority interest" after the 2009 donation of units to RIST and subsequent sale to Nevada 5, the answer says.

The IRS added that the valuations for partnership interests were inflated "to provide artificial deductions for interest and amortization to shelter Bhargava's net income."

Bhargava's 2009 donation to RIST wasn't a gift, according to the IRS. "RIST could not be a partner without violating its representations to [the IRS] and jeopardizing its tax-exempt status," it explained. "RIST's 'ownership' of the Class A units was so transitory it was never allocated even one dollar of income or loss."

The answer further alleges that Bhargava is effectively the only shareholder of Nevada 5 through KMRCT, which the IRS claimed isn't recognized as a charity or foundation by any state or federal authority.

The agency contended that none of the amortization deductions that Innovation Ventures claimed were attributable to basis adjustments should be allowed because "in terms of economic reality, the transactions did not include a transfer to RIST or Rawat, nor was there a bona fide sale or exchange of the interest to Bhargava or Nevada 5."

The adjustments could be challenged under the partnership antiabuse rule or under judicial doctrines, including economic substance and step transactions, the answer says.

The taxpayer in *Innovation Ventures LLC v. Commissioner*, Dkt. No. 5741-19 (2019), is represented by Jennifer Breen, William F. Nelson, and Sheri A. Dillon, all of Morgan, Lewis & Bockius LLP. ■