

5-Hour Energy Founder Cries Foul Over IRS Claims of Sham Deals

by Kristen A. Parillo

The founder of 5-Hour Energy argues that IRS allegations of sham deals should be excluded from his Tax Court case on basis adjustments because they contradict the agency's position in a related case.

The government's assertion that Manoj Bhargava's \$438 million purchase of a partnership interest wasn't a bona fide sale is at odds with the IRS's argument that the foreign seller — Indu Rawat, a Canadian involved in Bhargava's charitable endeavors — has taxable income from the deal, Bhargava claimed in a July 12 filing.

Bhargava is essentially saying that "if the sale never happened for the buyer, how was it 'real' for the seller?" Glenn Dance of Holthouse Carlin & Van Trigt LLP told *Tax Notes* on July 25.

Bhargava's move injects more complexity into a case that has evolved from a seemingly dry dispute over basis adjustments to a tax shelter challenge.

An added wrinkle is that Rawat, who filed a Tax Court petition in 2016 to challenge a deficiency notice stemming from the Bhargava transaction, was originally represented by now-IRS Chief Counsel Michael J. Desmond. That connection may be why Desmond's name was removed from an amended answer in Bhargava's case filed on June 13 and replaced with that of Drita Tonuzi, IRS deputy chief counsel (operations).

Bhargava is essentially saying that 'if the sale never happened for the buyer, how was it "real" for the seller?' Dance said.

Desmond withdrew as Rawat's attorney in May 2018 following his nomination for chief counsel. Rawat is now represented by Christopher S. Rizek of Caplin & Drysdale Chtd.

Tax Shelter Allegations

Bhargava's July 12 filing responds to the IRS's answer (originally filed May 28), which gives a dramatically different take on the parties' dispute and cross-referenced the litigation in Rawat's case.

The answer says that Bhargava entered into a series of purchase and transfer transactions to artificially create hundreds of millions of dollars in inside basis adjustments under sections 754 and 743(b).

The IRS alleges that in 2007 Bhargava sold 200,000 units of Innovation Ventures LLC to Rawat, a nonresident alien for U.S. tax purposes, for \$1. Innovation Ventures is the Michigan-based partnership that owns 5-Hour Energy.

According to Rawat's July 2016 Tax Court petition, she was a non-managing member of Innovation Ventures from December 2000 to January 4, 2008. The petition said Rawat acquired 300,000 units during that period, but it didn't give specific acquisition dates or say how much she paid for the units.

On December 28, 2007, Rawat donated 5,000 units 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. According to RIST's website, the organization was founded by Rawat's family, and she serves as its trustee.

On January 4, 2008, Bhargava purchased — via Acquisition Co., an entity he controlled — Rawat's remaining 295,000 units of Innovation Ventures in exchange for a \$438 million promissory note. A copy of the note was included as an exhibit in the IRS's November 2016 answer to Rawat's petition.

The IRS asserts in its answer in Bhargava's case that the Bhargava-Rawat deal and his 2009 donation of a portion of his ownership stake in Innovation Ventures to RIST — which then sold the partnership units for \$623.64 million to Nevada 5 Inc., an entity Bhargava founded in 2009 — didn't constitute bona fide sales or exchanges of partnership interests.

According to the IRS, because the transactions lacked economic substance, Bhargava wasn't entitled to any of the section 754 amortization deductions that Innovation Ventures reported were attributable to optional section 743(b) basis adjustments on its tax returns for 2009 through 2013.

The IRS had initially allowed \$70 million of the reported \$516 million amortization deductions in the notices of final partnership administrative adjustment issued to Innovation

Ventures in October 2018. The answer asserts that the \$70 million is also disallowed.

That the IRS is now articulating a sham theory and disallowing the entire amount of amortization deductions suggests it has obtained new information after issuing the FPAAAs.

Contradictory Positions

The apparent shift in the IRS's litigation strategy has left an opening for Bhargava to argue that the agency is taking inconsistent positions.

Bhargava's July 12 filing admits that he sold the units to Rawat for \$1 but denies the IRS's other allegations that:

- RIST never became, or intended to become, a member of Innovation Ventures, nor did Bhargava intend for RIST to become a bona fide partner in Innovation Ventures;
- Bhargava continued to exercise total control over Innovation Ventures despite purporting to possess only a minority interest;
- Nevada 5 is completely under Bhargava's control;
- all consideration for the transfers of membership interests in Innovation Ventures was in the form of interest-only promissory notes; and
- the valuations obtained by Innovation Ventures and Bhargava for the membership interests were inflated in order to provide artificial deductions for interest and amortization to shelter Bhargava's net income.

The filing asserts that the IRS's allegations constitute new matters for which the agency bears the burden of proof under Rule 142(a)(1) of the Tax Court's Rules of Practice and Procedure.

The IRS asserts that the Bhargava-Rawat deal and his 2009 donation of a portion of his ownership stake in Innovation Ventures to RIST didn't constitute bona fide sales or exchanges of partnership interests.

Bhargava further argues that the IRS's position that the underlying transactions weren't bona fide sales or exchanges of partnership

interests is contrary to its position in Rawat's case that she has taxable income from the sale of her interests in Innovation Ventures.

The filing alleges that after the IRS audited the partnership's 2008 tax return, the parties entered into an agreement in which they decided that Rawat had sold her interest to Acquisition Co., that Bhargava was entitled to a section 743(b) adjustment, and that the adjustment amount would be changed to reflect the reclassification of a portion of 15-year goodwill property as inventory.

Bhargava asks that the court find under equitable principles that the IRS "is precluded or estopped from asserting the new matters raised in [the IRS's] answer and determine that those new matters are improper."

Not a Problem?

According to Jerald David August of Fox Rothschild LLP, the IRS's contrary positions are unlikely to be fatal to its case.

"There's nothing inconsistent about the government taking alternative positions so that they can't be whipsawed," August told *Tax Notes*. "That's very common in tax litigation. The IRS doesn't want to set itself up to lose twice. In order to get tax on Rawat's gain and deny Bhargava's amortization, the government has to take inconsistent positions."

The IRS also shouldn't have a problem keeping the new allegations in its case against Bhargava, August said. "If there are newly discovered facts, they can easily be admissible," he explained. "There's no doctrine that the IRS is stuck to the theory in the deficiency or partnership notice."

It's possible that one or both parties in the Bhargava dispute — or even the court itself — could seek to have the Bhargava and Rawat cases consolidated under Rule 141(a) of the Tax Court's rules, August said.

"If I were the IRS attorney in Bhargava's case, I'd move to consolidate," August said. "I wouldn't want to risk having the parties feel free to argue whatever they want before a different judge."

Dance had another take.

"The government may like having the ability to make seemingly inconsistent arguments in different cases, so I'm not sure they'd be

motivated to consolidate,” Dance said. “The taxpayers, on the other hand, may seek consolidation to prevent one from throwing the other under the bus.”

Implications for Rawat

It’s not clear what impact, if any, the IRS’s strategy change in Bhargava’s case will have in Rawat’s.

Rawat is disputing a deficiency notice asserting that she owes over \$8 million in taxes and penalties from the 2008 sale of her partnership interest to Bhargava.

According to status reports filed in Rawat’s case, their dispute was put on hold because a key question — whether gain realized by a foreign partner on the disposition of a U.S. partnership interest is U.S.-source income effectively connected with a U.S. trade or business — was being addressed in the IRS’s appeal of a 2017 Tax Court decision in *Grecian Magnesite Mining, Industrial & Shipping Co. SA v. Commissioner*.

The status reports say that Rawat and the IRS agreed to resolve that portion of their dispute (described as the “non-inventory gain issue”) in accordance with the outcome of the appeal in *Grecian Magnesite*.

The D.C. Circuit issued its opinion in *Grecian Magnesite* June 11, agreeing with the Tax Court that the foreign company’s gain from redeeming a U.S. partnership interest isn’t U.S.-source income.

The parties will continue to work toward a settlement of the issue addressed in Grecian Magnesite and are attempting to resolve the remaining issue of whether Rawat is subject to U.S. tax on the portion of gain attributable to inventory, a status report says.

The IRS and Rawat noted the D.C. Circuit’s decision in a joint status report filed July 10. The report says the parties will continue to work toward a settlement of the issue addressed in *Grecian Magnesite* and are attempting to resolve the remaining issue of whether Rawat is subject to U.S. tax on the portion of gain attributable to inventory.

The report also says the parties “wish to notify” the court that the IRS is taking an inconsistent position on the transaction in Bhargava’s case.

Another status report will be filed no later than October. “Should a basis for settlement be reached prior to that date, the parties will promptly inform the Court,” the report says.

August said the IRS could try to argue that it isn’t bound by the parties’ agreement to settle Rawat’s case in line with *Grecian Magnesite*. “The government could possibly find a legitimate hook under U.S. tax law to tax her on the entire gain, even though she wasn’t a U.S. resident,” he said.

However, nothing in the status reports suggests that the IRS plans to change its strategy, August said.

Bhargava’s case is *Innovation Ventures LLC v. Commissioner*, Dkt. No. 5741-19. He is represented by Jennifer Breen, William F. Nelson, and Sheri A. Dillon, all of Morgan, Lewis & Bockius LLP.

Rawat’s case is *Indu Rawat v. Commissioner*, Dkt. No. 15340-16. ■