IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

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| UNITED STATES OF AMERICA | * | |
| Plaintiff | * | |
| v. | * | Civil Action No. RDB-05-2132 |
| ROBERT L. BERGBAUER et ux. | * | |
| Defendants | * | |

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**MEMORANDUM OPINION**

Pursuant to 26 U.S.C. §7405, the Government has brought this suit against Robert and Marie Bergbauer to reclaim an erroneous tax refund of $276,510, plus statutory interest on that amount, accruing from August 4, 2003. The parties have filed cross motions for summary judgment under Rule 56 of the Federal Rule of Civil Procedure. At a motions hearing held on July 16, 2008, the parties presented legal arguments in support of the pending motions and agreed that no material facts remain in dispute. Under the two-prong, "economic reality" test of the United States Court of Appeals for the Fourth Circuit, this Court finds that the parties intended to treat the underlying transaction as a fully and immediately taxable event. Accordingly, for the reasons set forth below, the Defendants' Cross-Motion for Summary Judgment (Paper No. 33) is DENIED and the Government's Motion for Summary Judgment (Paper No. 28) is GRANTED.

**BACKGROUND**

The material facts governing this case are not in dispute. In autumn 1999, Ernst & Young LLP ("Ernst & Young") and Cap Gemini, S.A. ("Cap Gemini") began discussing the sale of Ernst & Young's consulting business. These discussions materialized when Cap Gemini

acquired Ernst & Young's consulting business on May 23, 2000 ("the transaction"). Under the terms of the transaction, Cap Gemini purchased Ernst & Young's consulting business by issuing shares of its stock, subject to certain restrictions, to Ernst & Young's accredited consulting partners ("Consulting Partners"). There is no dispute that Robert Bergbauer was a Consulting Partner. When the transaction closed, Robert Bergbauer left Ernst & Young and joined the newly-formed Cap Gemini Ernst & Young ("CGE&Y"), the Cap Gemini affiliate established to take over Ernst & Young's consulting division. (Gov't's Mem. Supp. Summ. J. Ex. 1 at 8:19-9:12.)

## I. The Cap Gemini - Ernst & Young Transaction

On March 2, 2000, pursuant to their ongoing negotiations with Cap Gemini, but before the transaction's consummation, Ernst & Young distributed to its Consulting Partners a Partner Information Document and related appendices (collectively, the "PID"), dated March 1, 2000. (*Id.* Exs. 2 and 7.) In pertinent part, the PID indicated that the agreed purchase price for Ernst & Young's consulting business was structured as a fully taxable asset sale (approximately $6.71 billion), allocated as follows:

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| Ernst & Young LLP | $2.145 billion, consisting of € 375 million cash and remainder in Cap Gemini stock |
| Ernst & Young consulting partners | $2.191 billion of Cap Gemini stock |
| Ernst & Young non-consulting (audit and tax) partners | $2.374 billion of Cap Gemini stock |

(*Id.* Ex. 2, at CG000026.) The PID also indicated that the Consulting Partners would receive Cap Gemini stock, recognize gain, and incur federal and state income tax at the 25 percent

capital gains rate. Under the PID, the Consulting Partners' would be permitted to immediately sell 25 percent of Cap Gemini shares received to meet their year 2000 tax burden, but the remainder would be "monetized" for installment sales over the next four years and 300 days. (*Id.* Ex. 2, at CG000034.) The PID stated that the Consulting Partners would vest in their Cap Gemini shares immediately upon the closing of the transaction. It also stated that the shares would "be held in an individual account in an institution such as Merrill Lynch or Citigroup and [would] be subject to resale restrictions imposed by Cap Gemini . . . and under the U.S. securities laws." The PID disclaimed that its contents were "not to be construed as business, legal, or tax advice" and that each Consulting Partner "must rely . . . on the terms of the transaction." (*Id.* at CG000055.)

The PID explained that consent to the transaction was required by a 75 percent super-majority of Consulting Partners. (*Id.* at CG000058.) At a March 7-8, 2000 meeting, the Consulting Partners (including Bergbauer) voted overwhelmingly (approximately 95 percent) to move forward with the transaction. (*Id.* Ex. 6, Arthur Gordon Dep., at 53:19-54:20.) Prior to the meeting, Bergbauer had the opportunity to review the PID, including the portion entitled "Tax Implications." At the meeting, Ernst & Young's management made a presentation to the Consulting Partners, including Bergbauer, and answered questions regarding the proposed transaction and its tax implications. (*Id.* at 26:1-26:19; 46:10-48:11; 49:7-49:16; 144:10-147:22.) One presenter, a former Ernst & Young partner, later offered testimony explaining that he explicitly fielded questions regarding the immediate taxability of the shares. He reported that a vesting schedule was disfavored because the parties viewed the transaction as a sale of assets and not an installment sale. Furthermore, he explained that the transaction was structured for

immediate taxation on shares received by the Consulting Partners to both avoid compensation issues for the newly formed CGE&Y and to ensure favorable tax treatment for the Consulting Partners' future sale of their Cap Gemini shares. (*Id.* at 149:2-151:17.)

Subsequently, on April 7, 2000, the Consulting Partners received a "Partner Transaction Agreement Kit" with copies of legal documents that the Consulting Partners were required to execute pursuant to the transaction. (*Id.* Ex. 1, at 52:20-22.) Upon signing the Consulting Partner Transaction Agreement ("CPTA") on May 1, 2000, Bergbauer became a party to the Master Agreement and all tax related provisions within both the Master Agreement and the CPTA. (*Id.* Ex. 10, at CG4069-4070, 4011, 4068.) Together, the Master Agreement and the CPTA constitute the operative transaction documents to the sale. (*Id.* Ex. 2, at CG000032.)

With respect to the Master Agreement, the relevant tax provisions in this case are sections 7.7(f) and 7.7(h). Section 7.7(f)(i) of the Master Agreement provided that Bergbauer "agreed to determine the value of and allocate" the Cap Gemini stock as consideration for its purchase of Ernst & Young's consulting business. Further, it stated that "the determination and allocation derived . . . shall be binding upon [Ernst & Young, the Consulting Partners and Cap Gemini] for all U.S. federal, state and local Tax reporting purposes." (*Id.* Ex. 3, at CG000541.) Section 7.7(f) also stated that shares "that are not monetized in the Initial Offering will be valued for tax purposes at 95 [percent] of the otherwise-applicable market price." (Defs.' Mem. Supp. Cross Mot. Summ. J. Ex. A.) To supplement section 7.7(f), section 7.7(h) addressed the manner in which the Consulting Partners would report the sale of Ernst & Young's consulting business to Cap Gemini for tax purposes and required that "each Accredited Partner agree not to take any

position in any tax return contrary to the foregoing without the written consent of [Cap Gemini]." (Gov't's Mem. Supp. Summ. J. Ex. 3, at CG000543-CG000544.)

Section 5(b)(xii) of the CPTA provided:

> ***Taxable Transaction; Tax Reporting.*** You understand that your receipt to Cap Gemini shares in the Transaction will be a taxable transaction for U.S. federal income tax purposes . . . . You acknowledge your obligation to treat and report the Transactions for all relevant tax purposes in the manner provided in Sections 7.7(f) and (h) of the Master agreement (as agreed to by Cap Gemini, (Ernst & Young], you and the other Accredited Partners).

(*Id.* Ex. 9, at CG4023.) Under section 5(b)(x), Bergbauer warranted that he had read the PID and transaction agreements, was not relying on any information other than the PID agreements, and was given an opportunity to ask questions about the terms and conditions of the transaction. (*Id.* Ex. 9, at CG4023; Ex. 6, at CG66:8-68:13.) Effectively, Bergbauer's signature bound him to the tax provisions in sections 7.7(f) and 7.7(h) of the Master Agreement.

Section 8 of the CPTA prohibited a Consulting Partner from selling Cap Gemini stock for a period of four years and 300 days from the date of the transaction except in public offerings and certain other "permitted Divestitures." (*Id.* Ex. 9, at CG4026-CG4027, CG4046-CG4050.) Additionally, it provided that all Cap Gemini shares held in the Merrill Lynch Restricted Account were to be voted by Merrill Lynch's French affiliate as instructed by the Consulting Partner. (*Id.* at CG4027, § 8(d).) Finally, under section 8, the Consulting Partners were allowed to accumulate dividend income in their Restricted Accounts.[1]

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[1] Accordingly, dividends were deposited into Bergbauer's Restricted Account and he reported dividend income in the amounts of $8,474 in 2001, $5,740 in 2002, and $762 in 2003. (Gov't's Mem. Supp. Summ. J. Ex. 16 at Interrogs. 18, 19, and 20.) Later, after the requisite tax was paid on each dividend disbursement, the net dividend was moved from the Restricted Account to an accessible, unrestricted account. (*See id.* Exs. 35, 36, 37, 45, 46, 48.)

The "liquidated damages" clause, section 9 of the CPTA, provided that Bergbauer was required to forfeit some or all of his Cap Gemini shares if he was terminated for cause, voluntarily left CGE&Y, or breached the non-competition or confidentiality provisions of his Cap Gemini employment agreement. Specifically, section 9 provided as follows:

| Timing of Event | % of Cap Gemini Stock Forfeited |
|---|---|
| Prior to 12/31/2000 | 100% |
| Prior to first anniversary of Closing | 75.0% |
| After first anniversary and prior to second anniversary of Closing | 56.7% |
| After second anniversary and prior to third anniversary of Closing | 38.4% |
| After third anniversary and prior to fourth anniversary of Closing | 20.0% |
| After fourth anniversary and prior to four years and 300 days after Closing | 10.0% |

(*Id.* at CG4027-CG4028, § 9(a); *see also* Ex. 2 at CG 000036-CG000040.) Additionally, if Bergbauer was terminated for "poor performance," up to 50 percent of these percentages would also be forfeitable at the discretion of CGE&Y officials. (*Id.* at CG4028, § 9(b).)

Finally, under section 10 of the CPTA, Consulting Partners granted power of attorney to the CEO of Cap Gemini or his designee. The power of attorney permitted the CEO to execute transaction documents in connection with the transaction on behalf of Bergbauer, enforce restrictions on transfer and liquidated damages provisions, and implement the resale of Cap Gemini shares. (*Id.* at CG4029-CG4030, § 10 (power of attorney).) Pursuant to section 10, Bergbauer executed a Special Account Instruction with Merrill Lynch agreeing that an

Authorized Signatory would instruct Merrill Lynch as to (1) voting and transfers of Bergbauer's Cap Gemini stock pursuant to section 8 of the CPTA, (2) holding Cap Gemini stock and other assets in Bergbauer's Restricted Account until the restrictions and liquidated damages provisions ended, and (3) transferring Cap Gemini stock and other assets from Bergbauer's Restricted Account to another account when the limitations expired. (*Id.* Ex. 11, Special Account Instruction Agreement; Ex. 9, at CG4026-CG4029.)

**II. The Transaction's Applicability to Bergbauer**

As part of the transaction, Ernst & Young paid Bergbauer the value of his partnership interest. In return, Bergbauer transferred his interest to CGE&Y for 10,740 shares of Cap Gemini stock subject to the restrictions imposed by the transaction. (*Id.* Ex. 1, at 70:6-19.) Around May or June 2000, Bergbauer sold 2,685 shares (25 percent) to pay his year 2000 income taxes. (*Id.* Ex. 15, at Resp. To Interrog. 6.) As of December 31, 2000, 8,055 shares (the remaining 75 percent of the 10,740) resided in Bergbauer's Merrill Lynch Restricted Account and were subject to all restrictions and liquidated damages as per the transaction. (*Id.* Ex. 9, at CG4026-CG4027, § 8.) The shares were valued for tax purposes at 95 percent of their market value. (The market value at the time was $155.30 per share, 95 percent of which was $148.527 per share.)

**III. The Bergbauers' Original and Amended Year 2000 Tax Returns**

The Bergbauers filed a joint return on or about July 13, 2001, consistent with the transaction being a fully taxable event to the Consulting Partners. The initial tax return was prepared by Ernst & Young. This return reported $1,613,379 gross sale proceeds from the transaction in accordance with the Form 1099-B issued to Bergbauer by Cap Gemini, leading to

a total federal tax liability of $676,493. (*Id.* Ex. 13.) Two years later, after Cap Gemini's share value had precipitously dropped to approximately $16 per share, the Bergbauers sought alternative means to profit on the transaction. (*See* Ex. 47.) Heeding the advice that similarly situated Consulting Partners received,[2] the Bergbauers filed an amended federal income tax return for the year 2000 on or about June 3, 2003. (*Id.*, Ex. 14.) The Bergbauers' amended return relied on the proposition that the transaction was not a fully taxable event to the sellers. (*Id.* Ex. 1 at 31:4-17.) Based on this assumption, the Bergbauers reduced the amount of reported taxable income by $1,232,277 (alleging that the 75 percent of Cap Gemini shares, valued at 95 percent, had not yet been taken into income) and claimed a total tax reduction of $253,490. (*Id.* Ex. 14.) Of this, $153,490 was to be refunded and $100,000 was to be applied to their 2001 estimated tax. (*Id.*)

On or about August 4, 2003, the Internal Revenue Service ("IRS") abated $253,490 of tax for 2000, applied a $100,000 credit to the Bergbauers estimated 2001 tax, and cut a refund

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[2] As will be discussed *infra*, Bergbauer was not the only former Consulting Partner that filed an amended return. In *United States v. Culp*, No. 05-0522, 2006 U.S. Dist. LEXIS 95030 (M.D. Tenn., December 29, 2006), the first federal case addressing this issue, the court stated as follows:

> This case is the first of twelve cases involving the Cap Gemini issue that the IRS, to date, has referred to the Tax Division. Presently, there are in excess of two hundred (200) actions related to this action pending in different forums across the country. The different forums involved include the IRS Appeals Office, the United States Tax Court, the United States Court of Federal Claims, and other United States District Courts. These actions are based on virtually the identical substantive tax issue involved with this litigation, the Cap Gemini Issue.

*Id.* at *2 - *3; *see also United States v. Fletcher*, No. 06-6056, 2008 U.S. Dist. LEXIS 3555 (N.D. Ill., January 15, 2008).)

check payable to Robert and Marie Bergbauer in the amount of $176,510, consisting of the $153,490 refund and $23,020 of interest. (Compl. ¶¶ 14, 15, 16.) Later, the IRS alleged error and the Government brought the instant suit against the Bergbauers to recover the refund pursuant to 26 U.S.C. §7405.

The Government filed the initial Complaint on August 4, 2005. Robert Bergbauer is one of over 200 similarly situated individuals throughout the country seeking to resolve the tax implications of the Cap Gemini – Ernst & Young transaction. As such, this Court granted a Motion to Stay on May 29, 2007, lasting approximately 15 months, while other district courts addressed the issue. After the stay was lifted, both the Government and the Bergbauers moved for judgment as a matter of law under Rule 56 of the Federal Rule of Civil Procedure.

## STANDARD OF REVIEW

Rule 56 of the Federal Rules of Civil Procedure provides that summary judgment "shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no *genuine* issue as to any *material* fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c) (emphasis added). In *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242 (1986), the Supreme Court of the United States explained that only "facts that might affect the outcome of the suit under the governing law" are material. *Id.* at 248. Moreover, a dispute over a material fact is *genuine* "if the evidence is such that a reasonable jury could return a verdict for the nonmoving party." *Id.*

The Supreme Court further explained that, in considering a motion for summary judgment, a judge's function is limited to determining whether sufficient evidence supporting a claimed factual dispute exists to warrant submission of the matter to a jury for resolution at trial.

*Id*. at 249. In that context, a court is obligated to consider the facts and all reasonable inferences in the light most favorable to the nonmoving party. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986); *see also E.E.O.C. v. Navy Federal Credit Union*, 424 F.3d 397, 405 (4th Cir. 2005). Rule 56 mandates summary judgment against a party "who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial." *Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986).

When both parties file motions for summary judgment, as here, the court applies the same standards of review. *Taft Broad. Co. v. United States*, 929 F.2d 240, 248 (6th Cir. 1991); *ITCO Corp. v. Michelin Tire Corp.*, 722 F.2d 42, 45 n.3 (4th Cir. 1983) ("The court is not permitted to resolve genuine issues of material fact on a motion for summary judgment – even where . . . both parties have filed cross motions for summary judgment.") (emphasis omitted), *cert. denied*, 469 U.S. 1215 (1985). The role of the court is to "rule on each party's motion on an individual and separate basis, determining, in each case, whether a judgment may be entered in accordance with the Rule 56 standard." *Towne Mgmt. Corp. v. Hartford Acc. & Indem. Co.*, 627 F. Supp. 170, 172 (D. Md. 1985). When cross-motions for summary judgment demonstrate a basic agreement concerning what legal theories and material facts are dispositive, they "may be probative of the non existence of a factual dispute." *Shook v. United States*, 713 F.2d 662, 665 (11th Cir. 1983) (citation omitted).

## DISCUSSION

At the motions hearing conducted on July 16, 2008, the parties agreed that the dispute between them hinges on conflicting interpretations of law, thus making the pending cross

motions ripe for disposition at the summary judgment stage. The disagreement between the parties, in substance, can be summarized as follows. The Government contends that Robert Bergbauer is an asset seller and that the 10,740 shares of Cap Gemini stock were fully taxable on the closing date under 26 U.S.C. § 1001 and in accordance with the contract terms agreed by Ernst & Young and Cap Gemini and to which Bergbauer assented in writing. The Bergbauers contend, however, that Robert Bergbauer received only 2,685 shares of Cap Gemini stock when the transaction closed on May 23, 2000, and that the remaining 8,055 shares were not taxable until the transferability restrictions and liquidated damages provisions of the CPTA lapsed.

The Cap Gemini – Ernst & Young transaction involved a great many Consulting Partners, and Bergbauer is far from the only Consulting Partner seeking to retain a tax refund after filing an amended return with the IRS. Indeed, counsel for the Government indicated at the hearing that, upon resolution of this case, six cases remain pending in federal district courts on the same legal issue, although this estimate has not been confirmed. Additionally, a presently unknown number of cases also remain pending in various other forums across the country, including the IRS Appeals Office, the United States Tax Court, and the United States Court of Federal Claims.

Two cases, *United States v. Culp*, No. 05-0522, 2006 U.S. Dist. LEXIS 95030 (M.D. Tenn., December 29, 2006) and *United States v. Fletcher*, No. 06-6056, 2008 U.S. Dist. LEXIS 3555 (N.D. Ill., January 15, 2008), have already been decided in other federal district courts. In both cases, the court granted summary judgment to the Government, finding that the entire transaction was taxable in 2000.

In *Culp*, the first case involving the Cap Gemini – Ernst &Young transaction, the United States District Court for the Middle District of Tennessee applied traditional contract principles and discussed whether the restrictions contained in the transaction documents were conditions subsequent or conditions precedent. Focusing on the contract language used in the transaction documents, the court found that the restrictions were conditions subsequent to receiving the shares. Therefore, under *Commissioner v. Danielson*, 378 F.2d 771 (3d. Cir. 1967), the defendant could "recharacterize" the terms of the deal only if they were unenforceable due to "mistake, undue influence, fraud or duress." *Id.* at 775. The court concluded that the *Danielson* rule did not apply and granted summary judgment for the Government.

In *Fletcher*, the United States District Court for the Northern District of Illinois found that the transaction documents were ambiguous and susceptible to more than one reasonable interpretation. The court concluded that the PID, viewed as extrinsic evidence, demonstrated the parties' intention to treat the sale as a fully and immediately taxable event. Addressing the defendant's argument that immediate taxation was in contravention of 26 U.S.C. § 451, the court balanced the intention of the parties, on the one hand, with the public policy embodied in the Internal Revenue Code ("the Tax Code"), on the other. The court concluded that under either the *Danielson* rule or the "strong proof" rule, *see Leslie S. Ray Ins. Agency, Inc. v. United States*, 463 F.2d 210, (1st Cir. 1972) (requiring "strong proof" that the parties intended an allocation different than that included in the contract), the result was the same: the sale was an immediately and fully taxable event and the Government was entitled to summary judgment.

The United States Court of Appeals for the Fourth Circuit, however, has neither adopted the *Danielson* rule nor the "strong proof" rule. Instead, the Fourth Circuit, when faced with a tax

recharacterization case, applies a two-pronged test that examines the tax consequences contemplated by the parties and the economic substance of the agreement. *Wrangler Apparel Corp. v. United States*, 931 F. Supp. 420, 424 (M.D.N.C. 1996) (citing *General Ins. Agency Inc. v. Comm'r*, 401 F.2d 324 (4th Cir. 1968).) In short, as outlined by the operative transaction documents and further clarified by the PID, Cap Gemini, Ernst & Young, and Robert Bergbauer all sought immediate taxation on the entire 10,740 shares at the close of the transaction. Furthermore, both sides received bargained-for consideration, thereby supporting the requisite economic substance of the transaction.

**I. The Government Has the Statutory Authority to Seek Refund**

As an initial matter, Defendants argue that the Government's case is not over a refund, but instead involves a mere deficiency in amounts owed. *See* 26 U.S.C. § 6211(a). As such, the appropriate vehicle for recovery under the Tax Code is an assessment and, if necessary, actions to foreclose liens or reduce assessments to judgment. *See* 26 U.S.C. §§ 6321-6326, 7403. Alternatively, Defendants argue that erroneous refund suits are limited to situations in which the IRS makes an erroneous, bona fide error in computation, such as a "clerical misunderstanding, . . . controlling decisions overruled or undermined, . . . [or] a simple change of mind by the [IRS] on the substantive law." *United States v. Russell Mfg. Co.*, 349 F.2d 13, 17 (2d Cir. 1965).

The Tax Code permits the Government to recover an erroneous refund by filing suit under 26 U.S.C. § 7405. Section 7405(b) provides that "[a]ny portion of a tax imposed by this title which has been erroneously refunded (if such refund would not be considered as erroneous under section 6514) may be recovered by civil action brought in the name of the United States." 26 U.S.C. § 7204(b). As the Government notes, there are two categories of erroneous refunds:

rebate and non-rebate. *See O'Bryant v. Commissioner*, 49 F.3d 340, 342 (7th Cir. 1995). A rebate refund is issued on the basis of a substantive recalculation of the tax owed, while a non-rebate refund arises out of clerical or computer errors by the IRS. In the instant case, Defendants undisputedly received a rebate refund because the IRS abated $276,510 worth of tax on the basis of a substantive recalculation pursuant to Defendants' 2003 amended return. Therefore, the Government appropriately filed the instant suit, and this Court has jurisdiction over the matter.

## II. Application Of The Fourth Circuit's Two-Pronged Approach Does Not Alter the Outcome Reached in *Culp* and *Fletcher*

In *Commissioner v. National Alfalfa Dehydrating and Milling Co.*, 417 U.S. 134 (1974), the Supreme Court stated as follows:

> while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice whether contemplated or not [citations omitted], and may not enjoy the benefit of some other route he might have chosen to follow but did not.

*Id.* at 149; *see also Signet Banking Corp. v. Comm'r*, 118 F.3d 239, 241 (4th Cir. 1997). Although the Fourth Circuit has not adopted either the *Danielson* rule (relied upon in *Culp* and *Fletcher*) or the "strong proof" test (cited and discussed in *Fletcher*), the "economic reality" approach used to determine tax consequences in this circuit embraces the principles set forth in *National Alfalfa*. In *Furman v. United States*, 602 F. Supp. 444 (D.S.C. 1984), the court wrote as follows:

> To allow a taxpayer to unilaterally reform one end of a bargain could encourage taxpayers to ignore agreements as written in the hope that the courts will give them more advantageous tax treatment. Both parties to a transaction could enjoy tax benefits due to inconsistent reporting of the same transaction. To allow taxpayers to so

> "whipsaw" the Commissioner would have disastrous effects on our tax system.

*Id.* at 455; *see also Pantry Pride v. Stop & Shop Cos., Inc.*, 630 F. Supp. 637, 640 (E.D. Va. 1986) (holding that allowing a taxpayer to escape an unfavorable outcome would jeopardize the entire transaction—"Here Pantry Pride and Richmond freely agreed to the allocation now complained of. Having made its own bed, Pantry Pride will have to lie in it.").

"[W]hen addressing the tax consequences of a transaction the [Fourth Circuit] applies a two-prong test which examines (1) the intent of the parties; and (2) the economic substance of the transaction." *Wrangler Apparel Corp.*, 931 F. Supp. at 424 (citing *General Ins.*, 401 F.2d at 327). Applying this standard with the principles of *National Alfalfa* in mind, the Government is entitled to judgment as a matter of law.

**A. Intent of the Parties**

This Court looks first within the four corners of the operative transaction documents (namely, the Master Agreement and the CPTA) for the parties' expressed intent regarding the tax implications at the transaction's closing. As in *Fletcher*, this Court finds that the terms within the Master Agreement and the CPTA may be interpreted two different ways.

Both documents contained provisions that strongly demonstrate that Bergbauer's shares were immediately and fully taxable at the transaction's closing. For example, the CPTA provided that the Consulting Partners would receive their shares "[a]t the Closing," and that these shares would "be a taxable transaction for U.S. federal income tax purposes." (Gov't's Mem. Supp. Summ. J. Ex. 9, at 000620-26.) Furthermore, the Master Agreement stated that: (1) Cap Gemini would deliver the shares allotted to each Consulting Partner to the restricted account on his or her behalf and "provide . . . to . . . each [Consulting Partner] a Form 1099-B" with

respect to the transaction; (2) the Consulting Partners would file their tax returns "for the year in which the Closing occurs;" (3) for federal tax purposes, "the transactions undertaken pursuant to [the agreement] will be treated and reported by [all parties] as . . . a sale of the [Consulting Partner's] interests in CGE&Y to Cap Gemini;" and (4) Cap Gemini did not legally own the transferred shares, even if the shares were "held in custodial accounts and/or Trusts" for the Consulting Partners. (*Id.* Ex. 3, at 000046-47, 000121-24, 000143.) The Master Agreement explained further that "neither [Cap Gemini] nor any of its Affiliates will be a legal or beneficial owner of Transaction Shares" in the custodial accounts established for the Consulting Partners. (*Id.* Ex. 3A, at 000560.)

On the other hand, the CPTA also contained provisions that placed limitations and/or restrictions on the Defendant's use of 8,055 shares. Consequently, Defendant argues that, as a matter of law, Bergbauer did not receive the shares subject to the limitations and restrictions, and therefore could not be taxed on them under 26 U.S.C. § 451.[3] Specifically, under the CPTA, Bergbauer could not "directly or indirectly, sell, assign, transfer, pledge, grant any option with respect to or otherwise dispose of any interest in" Cap Gemini Shares, except in periodic offerings organized by Cap Gemini, for a period of four years and 300 days after the closing.

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[3] The Tax Code requires cash method taxpayers, like Defendants here, to report income in the tax year in which they actually or constructively receive it. *See* 26 U.S.C. § 451(a) ("The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer."); 26 C.F.R. § 1.451-1(a) ("Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer."). Under the regulations interpreting section 451, a taxpayer has constructively received income when "it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time." 26 C.F.R. § 1.451-2(a). If the taxpayer's ability to control the account "is subject to substantial limitations or restrictions," then the income is not deemed to have been constructively received. *Id.*

(*Id.* Ex. 9, at 000597-98.) Second, Bergbauer granted Cap Gemini exclusive authority to invest, transfer and release the shares in his Merrill Lynch Restricted Account during that time period. (*Id.* at 000627-31.) Third, under the liquidated damages clause of the CPTA, Bergbauer agreed that he would forfeit some or all of the Cap Gemini shares if he breached provisions of the employment agreement with CGE&Y, voluntarily ended his employment, or was terminated "for cause" or "poor performance."[4] (*Id.* at 000641.)

Because of the conflicting provisions of the transaction documents, this Court is unable to determine with any certainty the parties' intent at the time the transaction closed. Therefore, this Court will look to extrinsic evidence (namely, the PID, testimony of a former Ernst & Young partner, and parties' actions after closing) to examine the parties' intent with respect to taxation.

**1. The PID Explicitly Provided For Immediate Taxation on The Shares in Their Entirety**

As demonstrated by the PID's provisions, the parties plainly intended for Bergbauer to immediately receive and be taxed on all 10,740 Cap Gemini shares. The PID expressly stated that "[e]ven though both [Cap Gemini] and the [Consulting] partners are sellers in this transaction, the [Consulting] partners are treated as though they receive[d] all of the gain and are taxed on it." (*Id.* Ex. 2 at 000726-27.) Moreover, the PID further explained that "[t]he fair market value of the stock received that cannot be sold immediately will be calculated at 95 [percent] of the closing price of Cap Gemini stock *on the day of the exchange* for [CGE&Y] shares." (*Id.* at 000041 (emphasis added).) The PID also stated that "[t]he gain on the sale of the

[4] Both "cause" and "poor performance" were left undefined by the transaction documents.

distributed [CGE&Y] shares is reportable on Schedule D of your U.S. federal income tax return for 2000." (*Id.* at CG000042.) Lastly, it emphasizes the parties' desire to report the transaction consistently, saying that "[i]t also has been agreed that Ernst & Young, its partners, and Cap Gemini will treat valuation and related issues consistently for US federal income tax purposes."[5] (*Id.* at CG000041-42.)

**2. A Former Ernst & Young Partner Explained The Immediate Taxability to The Consulting Partners**

Supplementing the language contained within the PID, a former Ernst & Young partner's testimony regarding his presentation on the transaction's tax consequences at the March 7-8, 2000 meeting affords additional weight to the Government's contention that the parties desired immediate taxation on the received Cap Gemini shares. In pertinent part, the Ernst & Young partner testified that there was a discussion at the meeting concerning immediate vesting upon the transaction's closing and that "people were extraordinarily optimistic that the stock was going to rise at some exponential rate." (*Id.* Ex. 6, at 144:10-145:7.) Moreover, he testified that

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[5] The PID has evidentiary value despite the fact that it was prepared prior to the transaction's closing. The fact that the parties all had the same understanding of the transaction documents *before* signing is persuasive. Moreover, the PID remains persuasive to this Court even though it disclaims that its "contents . . . are not to be construed as legal, business, or tax advice . . . . [Y]ou must rely on your own examination of Cap Gemini and the terms of the transaction." (Gov't's Mem. Supp. Summ. J. Ex. 2 at CG000055 (emphasis supplied).)

Defendants also argue that the PID contains "oblique" language, citing the subsection titled "Subsequent Stock Sales." This subsection was part of a larger, four-page section which addressed the "Tax Implications" of the transaction and that paints a clear picture evidencing the parties' intent to be immediately taxed. (*Id.* at CG000041, CG000044.) Thus, the subsection cited by the Bergbauers does not contradict the parties' expressed desire for immediate taxability on the Consulting partners' received shares, but rather merely established the basis upon which gains and/or losses on future sales of Cap Gemini shares would be measured.

"we all wanted to own the shares outright and all wanted to get the capital gain and, therefore, have this transaction closed" because "creeping vesting" carried too much risk (*Id.* at 149-151.)

Therefore, even if Robert Bergbauer did not immediately appreciate the operative tax language contained within the PID, after attending the March 7-8, 2000 meeting he was well aware that all parties to the agreement intended for the Consulting Partners to be immediately taxed on the entirety of their received Cap Gemini shares.

### 3. The Bergbauers' Actions After Closing Reflect Understanding of Immediate Taxability on The Shares in Their Entirety

Defendants' initial tax return provides very strong evidence that it was mutually understood that the transaction was fully and immediately taxable. As contemplated by the transaction documents, Defendants filed a joint return on or about July 13, 2001. This return reported $1,613,379 gross sale proceeds from the transaction (*i.e.* all 10,740 Cap Gemini shares) in accordance with the Form 1099-B issued to Bergbauer by Cap Gemini, leading to a total federal tax liability of $676,493. (*Id.* Ex. 13.) Notably, it was not until Cap Gemini stock plummeted to approximately $16 per share in 2002 that Defendants filed their amended return and now challenge the transaction's true tax implications. Indeed, prior to the precipitous drop in the share value, the Defendants, much like Cathy Culp and Cynthia Fletcher and others similarly situated, showed no inclination to unilaterally alter the tax consequences of the transaction.

In sum, the extrinsic evidence in this case sheds light on the terms of the transaction documents, and this Court finds that based on the extrinsic evidence the parties' original intent was for the Consulting Partners to be immediately taxed on the entirety of the shares they received at the transaction's closing on May 23, 2000.

**B. Economic Substance**

**"**The second prong of the *General Insurance* test requires that the covenant bargained for have some independent value grounded in economic reality." *Wrangler Apparel Corp.*, 931 F. Supp. at 424 (citing *General Ins.*, 401 F.2d at 330). Thus, the transaction terms must contain some economic substance beyond the parties' subjective intent. The Fourth Circuit explained in *General Insurance* that a contract's terms must "have some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement." *General Ins.*, 401 F.2d at 330 (quoting *Schulz v. C.I.R.*, 294 F.2d 52, 55 (9th Cir. 1961)). In this case, all parties were engaged in arms-length negotiations in which each party bargained for and received real economic benefit. For instance, Cap Gemini ensured that there would not be an immediate sell-off, which would seriously harm share value, by attaching restrictions and limitations preventing the immediate sale of shares given to the Consulting Partners. Likewise, the Consulting Partners believed that their newly acquired Cap Gemini shares would continue to increase in value and therefore sought immediate taxation on their total received shares to capitalize on anticipated future gains. Again, it was only after the stock price plummeted that the Bergbauers and many other similarly situated Consulting Partners sought to unilaterally recharacterize certain aspects of the transaction.[6]

[6] As an additional matter, much like the taxpayers in *Culp* and *Fletcher*, Robert Bergbauer was an accomplished professional at the time of the transaction and "not an unsophisticated school[boy]." *Fletcher*, 2008 U.S. Dist. LEXIS 3555, *11. After agreeing twice (both at the March 7-8 meeting and in signing the CPTA) to the transaction's terms, Bergbauer received the tax consequences he sought.

In sum, full and immediate taxation was consciously chosen by sophisticated parties for real economic purposes. Thus, this Court is satisfied that the Fourth Circuit's two-pronged, "economic reality" test demonstrates that the IRS erroneously issued the Defendants a $276,510 tax refund that the Government may now recover.

**CONCLUSION**

For the foregoing reasons, the Defendants' Cross-Motion for Summary Judgment (Paper No. 33) is DENIED and the Government's Motion for Summary Judgment (Paper No. 28) is GRANTED. A separate Order and Judgment follows.

Dated: August 18, 2008

/s/
Richard D. Bennett
United States District Judge