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Biggest Federal Tax Cases Of 2015

By **Eric Kroh**

Law360, New York (December 23, 2015, 7:22 PM ET) -- Attorneys were riveted by a showdown between Microsoft and the IRS in 2015 over the agency's hiring of Quinn Emanuel Urquhart & Sullivan LLP to assists with an agency audit and intrigued by the implications of the U.S. Tax Court invalidating IRS cost-sharing regulations. Here, Law360 looks back at some of the biggest federal tax cases of 2015.

Microsoft v. U.S.

Perhaps the case most closely followed by the tax world in 2015 was a dispute between Microsoft Corp. and the IRS over whether the agency crossed a line by hiring commercial litigators from Quinn Emanuel to assist in an examination of the company's transfer pricing practices.

In December, a Washington federal judge ruled that the IRS could enforce summonses it filed last year requesting documents from Microsoft and interviews with several current and former agency executives, saying it would not be an abuse of court process if Quinn Emanuel attorneys sat in on the interviews.

The ruling effectively ended that court battle, but tax practitioners say the dispute was merely a skirmish in a larger war between Microsoft and the IRS that will have profound implications on the extent a private firm can participate in the government's examination of and litigation with taxpayers.

Microsoft alleged in the case that Quinn Emanuel was hired to help out with the audit to prepare for assisting the government in an eventual dispute in the U.S. Tax Court. At a summons enforcement hearing, a government lawyer admitted that the IRS may retain the law firm to help in its litigation with Microsoft, but that its existing contract with Quinn Emanuel did not contemplate it.

Once the IRS carries out its summonses, it should be in a position to give Microsoft its final answer about how much tax it thinks the company owes for 2004 through 2006, the years in question in the examination. Microsoft could then take the case to the Tax Court, and tax professionals will be closely watching to see whether Quinn Emanuel or some other private firm gets involved at that stage as well.

“It'll be interesting to see the differences that arise as a result of having a private firm assisting the IRS in litigation,” David J. Fischer of Crowell & Moring LLP said.

The case is U.S. v. Microsoft Corp. et al., case number 2:15-cv-00102, in the U.S. District Court for the Western District of Washington.

Altera Corp. v. Commissioner

The U.S. Tax Court In July sided with chipmaker Altera Corp. in a challenge to an IRS final rule requiring cost-sharing agreements to include the costs of stock-based compensation, saying the regulation did not reflect reasoned decision-making by the government The ruling could open the agency up to taxpayer challenges of other poorly written rules on procedural grounds.

In a 15-0 opinion, the court said the IRS failed to sufficiently explain its belief that the cost-sharing rules were consistent with the arm's-length standard and ignored significant evidence that it was not. In public comments received by the agency, stakeholders repeatedly asserted that they knew of no cost-sharing agreements between unrelated parties that included stock-based compensation, the court said.

The court's decision was another blow to the government in its longstanding effort to try to require the costs of stock-based compensation to be included in cost-sharing agreements. But the case's lasting significance could be that it may forge an entirely new approach toward the litigation of regulations written by the IRS in which the agency has not provided an adequate explanation for its rule-making.

"That's a really important case," Patricia Sweeney of Miller & Chevalier Chtd. said. "It opened up a defense that I think has been underused on challenging regulations in general."

The case is Altera Corp. et al. v. Commissioner, docket numbers 6253-12 and 9963-12, in the U.S. Tax Court.

STARS Cases

In May, the Federal Circuit upheld the denial of nearly $500 million in foreign tax credits claimed by BB&T Corp. for a so-called structured trust advantaged repackaged securities — or STARS — transaction it entered into with Barclays Bank PLC, finding the transaction lacked economic substance and must be ignored for tax purposes.

In September, the Second Circuit followed suit, denying Bank Of New York Mellon Corp.'s bid for foreign tax credits on its own STARS transaction, and at the same time backing the IRS in a refund suit brought by American International Group Inc., which sought a $306 million refund of foreign tax credits disallowed by the agency for a lack of economic substance.

With the rulings, the courts expanded the economic substance doctrine to apply to the foreign tax credit regime, giving tax practitioners pause. While the IRS had mostly confined the application of the doctrine to tax shelters in the past, courts are now giving the agency a tool that could potentially be used to go after other transactions, they said.

While BB&T, BNY and AIG have appealed the decisions to the U.S. Supreme Court, experts said the issues may not yet be ripe for high court review. In November, though, a Massachusetts federal district court broke with the two circuit courts and said Sovereign Bancorp — now Santander Holdings USA Inc. — can recover some $234 million that it paid in taxes, interest and penalties to the federal government over a STARS transaction.

If the Santander case is upheld on appeal, the government would have a strong incentive to file a writ of certiorari petition to overturn the result, making it more attractive to the high court justices, experts said.

The cases are Salem Financial Inc. v. U.S., case number 15-380, Bank of New York Mellon Corp v. Commissioner of Internal Revenue, case number 15-572, and American International Group Inc. v. United States, case number 15-478, in the U.S. Supreme Court, and Santander Holdings USA Inc. & Subsidiaries v. United States, case number1:09-cv-11043, in the U.S. District Court for the District of Massachusetts.

Schaeffler v. U.S.

The Second Circuit in November ruled that a German auto parts supplier didn't waive attorney-client privilege by sharing tax advice prepared by Ernst & Young with a consortium of banks, overturning a district court decision that the documents weren't privileged.

In the decision, the unanimous three-judge panel rejected the district court's finding that billionaire Georg F.W. Schaeffler and his company waived their privilege rights with respect to certain documents sought by the IRS in connection to the Schaeffler Group's acquisition of Continental AG, including an analysis of the tax consequences of a corporate restructuring undertaken by Schaeffler. The documents had been shared with the banking consortium, which had underwritten a loan to finance the deal.

Though attorney-client privilege is generally waived by the voluntary disclosure of communications to another party, in this case the parties had a common legal interest that preserved the privilege, the Second Circuit said. In the wake of the acquisition, Schaeffler undertook a refinancing of the acquisition debt and a corporate restructuring to avoid insolvency following the economic crisis. The possibility that the IRS would closely scrutinize Schaeffler's refinancing and restructuring would imperil the consortium as well, so the two were engaged in a common legal enterprise such that the privilege was not waived in sharing of the documents, the Second Circuit said.

The panel also rejected the district court's finding that certain documents weren't protected by the work-product doctrine, saying that precedent holds work-product protection can only be withheld for documents prepared in the normal course of business.

Although time will tell whether the Second Circuit's Schaeffler decision represents a wide-reaching pronouncement or a targeted ruling reflecting the unique circumstances of the case, tax practitioners said the court upheld important privacy protections.

"It's a good decision from a taxpayer perspective," Linda Galler, a professor at the Maurice A. Deane School of Law at Hofstra University and senior tax counsel at Curtis Mallet-Prevost Colt & Mosle LLP, said. "I think the court got it absolutely right."

The suit is Schaeffler et al. v. United States of America, case number 14-1965, in the U.S. Court of Appeals for the Second Circuit.

Validus Reinsurance Ltd. v. U.S.

The D.C. Circuit in a May opinion said the IRS may not collect an excise tax on reinsurance policies between two foreign entities, saying there's no indication that Congress intended the tax to apply to completely foreign companies.

The IRS argued that an Internal Revenue Code tax on reinsurers applies to reinsurance known as retrocessions that foreign-owned reinsurers buy from other foreign entities to cover their risks, while foreign reinsurer Validus Reinsurance Ltd. argued the tax applies to only so-called first-level reinsurance policies that a domestic U.S. insurer takes out to cover the risk that it will have to pay claims to policyholders, but not to foreign retrocessions.

The D.C. Circuit said that both parties offered plausible interpretations of the law, and it ultimately found that the text of the reinsurance statute is ambiguous with regard to wholly foreign retrocessions. However, it said that ambiguity is resolved by applying a general presumption against extraterritoriality because there isn't a clear indication that Congress intended the tax to apply to premiums on foreign retrocessions.

Experts saw the IRS' position as a vast overreach and said the decision leaves little room for the IRS to salvage the policy.

The case is Validus Reinsurance Ltd. v. United States of America, case number 14-5081, in the U.S. Court of Appeals for the District of Columbia Circuit.

--Editing by John Quinn and Kelly Duncan.