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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

2014 Federal Tax Litigation In Review

By **Ama Sarfo**

Law360, New York (December 19, 2014, 7:35 PM ET) -- The past year saw a series of high-stakes tax cases, including one that curtailed the Internal Revenue Service's ability to stop tax professionals from accepting contingent fee cases and a U.S. Supreme Court case that could increase the number of court interrogations the service will face after it issues taxpayer summons.

Below, Law360 takes a look at major tax cases that closed in 2014.

U.S. v. Clarke

Last year the Eleventh Circuit issued a surprising ruling when it said taxpayers who get hit by an IRS summons can trigger an evidentiary hearing into the agency's actions simply by alleging the summons was issued in bad faith. The appellate court contradicted every other circuit that has addressed the matter, and the Supreme Court quickly swatted that ruling down in June, likely saving the IRS from a flood of hearing requests.

In a unanimous opinion, the court said taxpayers have a right to examine their IRS agents if they can point to specific facts or circumstances — including circumstantial evidence — that raise an inference of bad faith.

But Rob Kovacev of Steptoe & Johnson LLP and Mary Monahan of Sutherland Asbill & Brennan LLP point out that the court's new, liberal standard may still subject the IRS to more interrogations, particularly since the agency recently rolled out a new information document request procedure that may mean more summonses to recalcitrant taxpayers.

“Tax law is like a pendulum, and right now our pendulum is swinging toward procedural fights because the IRS has changed its summons process and the Supreme Court has changed the litigation standards for looking behind an IRS summons,” said David Fischer, tax partner at Crowell & Moring LLP.

Michael Clarke is represented by Edward A. Marod of Gunster Law Firm.

The case is U.S. v. Michael Clarke, case number 12-13190, in the U.S. Supreme Court.

Gateway Hotel Partners LLC v. Commissioner of Internal Revenue

Historic building tax credit investors have been slowly warming up to the industry since the IRS issued safe harbor guidance last winter, and the U.S. Tax Court extended that strain of guidance in January when it ruled that a rehabilitation partnership wasn't fully liable for taxes on millions it earned transferring historic preservation credits because some transfers happened within the partnership.

Gateway Hotel Partners LLC transferred the credits three times to a real estate developer that obtained $18.4 million in financing for a redevelopment project, which then sold the credits to another company. When Gateway filed its tax returns it didn't mention the $18.4 million, and the IRS issued an administrative judgment. But in a memorandum opinion, the Tax Court said two of the transfers were done within the partnership and weren't taxable.

The industry had considerably slowed down after the Third Circuit in 2013 ruled that an investor in a rehabilitation project could not be allocated a related tax credit because it did not have a meaningful stake in the outcome of the project.

Taxpayers panicked, and the IRS responded with guidance. But questions and uncertainty still remain within the industry, and the Gateway Hotel ruling is a welcome addition to a canon of advice that practitioners will rely on in the months to come.

"Woe is the client who sticks their head in the sand," said Chamberlain Hrdlicka White Williams & Aughtry shareholder Philip Karter, who litigated the case. "There hasn't been a huge groundswell of litigation in this area, but people are worried there could be, they're trying to be proactive and prophylactic."

Gateway Hotel Partners is represented by Herbert Odell, Dustin M. Covello and Philip Karter of Chamberlain Hrdlicka White Williams & Aughtry.

Ridgely v. Lew

The IRS used to bar tax professionals from charging contingency fees for tax filing services, but in June the IRS suffered a significant setback when a District of Columbia federal court said professionals can take on contingent fee cases, driving another nail in the IRS' attempts to regulate tax pros.

The IRS had suffered a notable defeat in February when the D.C. Circuit banned it from imposing a nationwide licensing system on independent tax return preparers. And Ridgely further undercut the agency's dossier of professional service rules called Circular 230 — now, tax attorneys are watching to see what the agency will do next.

"The IRS, good or bad, wants to regulate the behavior of taxpayers by regulating the behavior of their advisers, and their vehicle for regulating behavior of advisers is Circular 230," said tax lawyer Stu Bassin. "If they can't do that, it'll become much more of a problem for them to regulate taxpayers."

And the Ridgely decision could cause taxpayers to take more aggressive filing positions because they won't have to pay their tax professionals up front, Fischer added.

Ridgely is represented by David J. Fioccola and R. Gregory Roberts of Morrison & Foerster LLP and Christopher S. Rizek of Caplin & Drysdale Chtd.

The Treasury defendants are represented by Geoffrey John Klimas, E. Christopher Lambert and Andrew C. Strelka.

The case is Ridgely v. Lew et al., case number 1:12-cv-00565, in the U.S. District Court for the D.C. District.

U.S. v. Quality Stores Inc.

The Supreme Court backed a long-standing IRS policy in March when it ruled that employee severance payments are subject to Federal Insurance Contributions Act taxes, dealing a blow to employers and employees who argued otherwise and filed thousands of pending refund claims.

The government argued that supplemental unemployment compensation benefits, known as SUB payments, are wages because they're only issued to employees and are calculated on an employee's position in his or her company, length of service and salary. The court agreed in an 8-0 decision that was unsurprising to many tax attorneys.

"While there was a good argument to be made that [Internal Revenue Code Section] 3402 didn't specifically include the kind of payments at issue as wages, common sense takes over and if you look at the bulk of the code it's apparent that wages aren't just an amount of money that are paid for a certain amount of work," Reed Smith LLP tax associate Kelley Miller **told Law360 in March**.

Although the ruling was a loss for employers and employees alike, Miller & Chevalier Chtd. tax partner Alan Horowitz said it does lend some certainty to multistate employers who had grappled with a split between the Sixth and Federal circuits.

“You had nationwide employers who were subject to different rules in different states, and they needed to manage their payroll in a way that was efficient,” Horowitz said. “Even though they'll be subject to the tax, they're better off than they were through the uncertainty that persisted.”

Now, employers who conduct mass layoffs will need to be aware of their FICA withholding obligations on their severance payments, Robert Hertzberg, a Pepper Hamilton LLP partner and counsel to Quality Stores, told Law360.

Quality Stores is represented by Robert S. Hertzberg, Michael H. Reed, Deborah Kovsky-Apap and Lesley S. Welwarth of Pepper Hamilton LLP.

The case is U.S. v. Quality Stores Inc. et al., case number 12-1408, before the U.S. Supreme Court.

Dynamo Holdings v. Commissioner of Internal Revenue

In a case of first impression, the Tax Court in September ruled that taxpayers can use predictive coding technology to selectively pick tax information the IRS needs from electronic backup storage tapes that also contained privileged information.

In a consolidated decision involving Dynamo Holdings LP and Beekman Vista Inc., the tax court said the companies had to produce documents that the IRS sought but could limit production using predictive coding, saying that technology provided a “happy medium” between full disclosure and none.

Both companies' cases concerned transfers between Beekman and Dynamo that the IRS cast as disguised gifts while the companies maintained they were loans.

"This will probably change the way in which people respond to IDRs and summonses," Fischer said. "If you look at the evolution of standards in this area, the IRS' IDR update is at the beginning of the line, while this predictive coding ruling falls in the middle and the Supreme Court's ruling in Clarke falls at the end."

The cases are Dynamo Holdings Ltd. Partnership and Dynamo GP Inc., Tax Matters Partner v. Commissioner of Internal Revenue, case number 2685-11, and Beekman Vista Inc. v. Commissioner of Internal Revenue, case number 8393-12, in the U.S. Tax Court.

Dynamo Holdings Limited Partnership, Dynamo GP Inc., Tax Matters Partner and Beekman Vista Inc. are represented by Gunster Yoakley & Stewart PA.

The Commissioner of Internal Revenue is represented by David B. Flassing and Lisa Goldberg.

--Editing by John Quinn and Brian Baresch.
