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

Federal Tax Cases To Watch In 2015

By **Ama Sarfo**

Law360, New York (January 02, 2015, 5:24 PM ET) -- The U.S. Supreme Court is poised to decide three weighty tax cases in 2015 that could implicate how states assess income taxes, whether taxpayers can challenge state tax reporting requirements in federal court, and how discrimination is defined in federal tax statutes. But tax attorneys should also have a high-profile transfer pricing case and two economic substance cases on their radar.

Here are some of the cases tax attorneys will be following.

Comptroller of Maryland v. Wynne

In 2015, the U.S. Supreme Court is set to decide the constitutionality of a Maryland law that allows residents with out-of-state income to offset their state income taxes but doesn't apply to county taxes, in a case that could significantly narrow states' taxing authority if the high court squashes Maryland's current regime.

The controversy starts with a Maryland couple, Brian and Karen Wynne, who sued the state upon learning that they would have to pay county income taxes on income from the husband's pass-through S corporation, even though that money had been taxed in 39 states and they'd received a credit at the state income-tax level offsetting the other taxes.

A Maryland appeals court declared the scheme unconstitutional, and the state's highest court, the Maryland Court of Appeals, affirmed in a ruling that the state is now trying to overturn.

The litigation has opened an impassioned discussion in the tax world on whether the dormant Commerce Clause — which prohibits states from enacting laws that inhibit interstate commerce — requires states to fully credit their residents for income earned in other areas. The case has also sparked heated debate on whether this issue should be addressed by legislatures instead of courts.

Jeffrey Friedman, a Sutherland Asbill & Brennan LLP partner, says that if the Supreme Court affirms the Maryland Court of Appeals, that would simply uphold the rule of law that many practitioners understand, which is that income taxes are subject to the dormant Commerce Clause. If the high court votes otherwise, we could witness a sea change, he says.

"If Maryland isn't required to provide a credit, that means the credits are optional, and states could

repeal them," Friedman said. "Instances where people live in one state and work in another are not uncommon, and now those taxpayers would be penalized for doing so. That would change people's habits."

"But you never know what the court will say generally about the dormant Commerce Clause," Friedman added.

The high court heard oral arguments Nov. 12

The comptroller is represented by William F. Brockman of the Maryland Office of the Attorney General.

The Wynnes are represented by Dominic F. Perella of Hogan Lovells.

The case is Comptroller of the Treasury of Maryland v. Brian Wynne, case number 13-485, in the Supreme Court of the United States.

Direct Marketing Association v. Brohl

So-called Amazon taxes have sparked litigation across the country, and in Direct Marketing Association v. Brohl the question before the Supreme Court is whether aspects of Colorado's tax law are protected from challenges in federal court. A ruling in favor of Colorado could make it nearly impossible for businesses to challenge state tax administration practices in federal court and get answers that apply uniformly across jurisdictions.

The DMA says Colorado's "Amazon tax" law is particularly egregious because it forces out-of-state retailers that barely have connections to the state and are exempt from collecting state sales tax to report information about their customers' purchases to the state Department of Revenue so Colorado can collect use tax from its residents. Retailers that fail to comply face hefty fines.

The DMA took the case to federal court, but the Tenth Circuit said the case should have stayed in Colorado state court because the federal Tax Injunction Act — which bars federal courts from interfering in cases where taxpayers challenge a state tax assessment or state revenue officials' enforcement of a tax assessment — applies here. But the DMA maintains that this isn't a tax collection case and says it's a case about tax administration and reporting requirements.

"The more broad issue — the interplay between federal mandates and states' right to tax — is very important. There'll always be conflict there, and I think we'll see more of it, particularly in the e-commerce space," Baker Botts LLP partner Renn Neilson said. "So this is one case that's worth paying attention to."

And the ability to take state tax matters to federal court is widely viewed as important among business taxpayers, because those courts are viewed to be more impartial than state courts, which have a natural tendency to vote in favor of their governments because they are part of the same enterprise, according to Friedman.

"Corporate taxpayers just want a fair shake. They want a neutral decision-maker, and it's hard to have that before a state court," Friedman said.

Jones Walker LLP tax chair Bill Backstrom says that a potential ruling against the DMA wouldn't affect

the actual amount of taxes that out-of-state vendors will have to collect for the state.

“It won't change the current law in [Quill Corp. v. North Dakota] regarding when a state can force an out-of-state vendor to remit sales taxes, so businesses that aren’t collecting Colorado sales tax won’t be required to if DMA loses,” Backstrom said.

The high court heard oral arguments Dec. 8.

The DMA is represented by George S. Isaacson and Matthew P. Schaefer of Brann & Isaacson LLP.

Brohl is represented by Melanie Snyder of the Colorado Office of the Attorney General.

The case is Direct Marketing Association v. Brohl et al., case number 13-1032, in the Supreme Court of the United States.

Alabama Department of Revenue v. CSX Transportation Inc.

The federal Railroad Revitalization and Regulatory Reform Act is a highly specific piece of law meant to shield the rail industry from discriminatory sales and use taxes, but an upcoming Supreme Court ruling in a dispute between CSX Corp. and the Alabama Department of Revenue could determine how courts generally define discrimination in tax statutes.

At issue is whether the 4-R Act — which prohibits states from enacting sales or use taxes that discriminate against railroads — bars states from imposing differing taxes on railroads and other taxpayers, even if both sides wind up paying similar tax amounts. But that question also hinges on how the discrimination comparison should run — if railroads should be compared with other commercial and industrial taxpayers, or their direct competitors.

Alabama imposes a 4 percent diesel fuel tax on rail carriers but exempts motor and water carriers from paying it. The state says the exemption is justified because motor and water carriers pay a different but substantially similar 19-cent-per-gallon motor fuel excise tax, but CSX maintains the scheme is discriminatory.

“This will be the first time to my knowledge that the U.S. Supreme Court has construed discrimination in a tax context,” Friedman said.

And the outcome could reverberate widely, as other statutes, like the Internet Tax Freedom Act and the Motor Carrier Act, contain discrimination provisions.

The high court heard oral arguments Dec. 9

CSX is represented by James W. McBride of Baker Donelson Bearman Caldwell & Berkowitz PC and Carter G. Phillips of Sidley Austin LLP.

Alabama is represented by Andrew L. Brasher of the Alabama Office of the Attorney General.

The case is Alabama Department of Revenue et al. v. CSX Transportation Inc., case number 13-553, in the Supreme Court of the United States.

Amazon.com Inc. v. Commissioner of Internal Revenue

Amazon is bitterly locked in a $1.5 billion transfer pricing dispute with the Internal Revenue Service over an arrangement it inked with a European subsidiary, and the outcome of the case, which is sitting in U.S. Tax Court, is being closely watched by multinationals and tax lawyers alike.

Amazon's case against the IRS seeks to resolve notices of proposed adjustments the agency issued for a seven-year period starting in 2005 relating to its transfer pricing with foreign subsidiaries, which the retailer estimates could result in a tax liability of $1.5 billion plus interest.

The dispute centers around a cost-sharing agreement that Amazon inked with Luxembourg affiliate Amazon Europe Holdings Technologies SCS. The IRS disputes the value of so-called buy-in payments that the subsidiary made to Amazon in exchange for intangibles. And the case is particularly important for the IRS after it lost a similar case involving Veritas U.S. in 2009.

“This could be the IRS' second attempt after the Veritas case to win this issue of cost-sharing arrangements and whether a buy-in should be based on a cost-sharing method,” Crowell & Moring LLP tax partner David Blair said. “Veritas was a big loss for the IRS.”

Amazon is represented by John B. Magee, Beth L. Williams, Michael D. Kummer, Saul Mezei, Sanford W. Stark, John G. Ryan, John A. Polito, Carl T. Ussing, Hans D. Gerling-Ritters and Nicholas A. Zemil of Morgan Lewis & Bockius LLP; and Rajiv Madan, Julia M. Kazaks, Christopher P. Murphy and Royce L. Tidwell of Skadden Arps Slate Meagher & Flom LLP.

The IRS is represented by Jill A. Frisch, Melissa D. Lang, Lloyd T. Silberzweig, Anne O'Brian Hintermeister, Mary E. Wynne, Shannon L. Cohen, Melissa L. Hilty and others from the IRS Division Counsel for Large and Mid-Size Business.

The case is Amazon.com Inc. & Subsidiaries v. Commissioner of Internal Revenue, case number 31197-12, in the U.S. Tax Court.

Salem Financial v. U.S. and AIG v. U.S.

BB&T Corp. and American International Group Inc. are currently fighting the IRS in two separate cases, denying that transactions they used for foreign tax credits lack economic substance. And tax attorneys are closely watching the litigation, which is pending before federal circuit courts, to see if the IRS will be able to successfully expand its economic substance doctrine.

"There is arguably some uncertainty as to what is and is not analyzed through the rubric of economic substance, and guidance on that issue could affect transactions going forward," said Baker Botts LLP tax partner Richard Husseini.

In BB&T's case, which is currently before the Federal Circuit, the bank argues that a $1.5 billion U.K.-based loan it was issued by Barclays PLC met a legitimate business need and that it should be entitled to U.S. tax credits for the interest and tax it paid. The U.S. Court of Federal Claims had ruled that the loan was simply an attempt to cover an abusive tax scheme without the necessary “economic substance.”

And AIG's transactions took place between the insurer's financial services arm, AIG Financial Products Corp., and foreign banks and lending institutions in Ireland, Italy and New Zealand. In each transaction,

AIG-FP sold a financial institution preferred stock in one of the company's foreign affiliates and agreed to buy back the shares after a number of years.

AIG-FP invested the money it made selling the shares and paid tax on its investment income to foreign tax authorities. A portion of the money that was generated by the investments was distributed to the lender. The taxes paid by the lender were either relatively minor or entirely exempt because foreign tax collectors treated the stock as an equity investment, despite the fact that AIG-FP had agreed to repurchase the shares.

"Hopefully the right and clear answer is that when genuine business transactions are structured in a tax efficient manner, there should not be a discussion of economic substance," Husseini added.

BB&T is represented by Rajiv Madan, Christopher P. Bowers and Royce L. Tidwell of Skadden Arps Slate Meagher & Flom LLP.

The government is represented by Tamara W. Ashford, Gilbert S. Rothenberg, Richard Farber and Judith A. Hagley of the U.S. Department of Justice's Tax Division.

AIG is represented by David Boies, Robin A. Henry and Edward J. Normand of Boies Schiller & Flexner LLP and Thomas A. Cullinan, Jerome B. Libin and Daniel H. Schlueter of Sutherland Asbill & Brennan LLP.

The U.S. is represented by James N. Boeving, Joseph N. Cordaro and Benjamin H. Torrance, assistant U.S. attorneys for the Southern District of New York.

The cases are American International Group Inc. v. U.S., case number 14-765, in the U.S. Court of Appeals for the Second Circuit; and Salem Financial Inc. v. U.S., case number 14-5027, in the U.S. Court of Appeals for the Federal Circuit.

--Editing by Jeremy Barker and Edrienne Su.
