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New Truces And New Battle Lines In Tax Litigation

Law360, New York (February 18, 2014, 2:22 PM ET) -- As the long period of widespread creative tax planning draws to a close for corporate America, state and federal governments are still combatively scrutinizing taxpayer positions.

Long the near-exclusive domain of corporate chief financial officers and tax vice presidents, state and federal tax controversies are increasingly grabbing the attention of general counsel because of the escalating aggressiveness of government tax officials. As the taxpayer pendulum swings away from creativity toward more conservative positions, the government pendulum continues to swing the other way, reflecting a continuing mistrust of the corporate community.

The New Imbalance of Power

The shift is playing out in several ways. Penalties are getting tougher and more fiercely contested. Underscoring that point, the U.S. Supreme Court recently sided with theInternal Revenue Service in a tax-shelter case (U.S. v. Woods) that hit the taxpayer with a 40 percent penalty.

At the state level, California's noneconomic substance transaction penalty can also be as high as 40 percent if the state finds a taxpayer's action was taken merely to reduce taxes; state supreme courts in New Jersey and North Carolina have upheld heavy penalties for actions that were not barred when they took place. Any efforts to reach settlement of taxpayer disputes will be affected by the heavy weight of such significant penalties.

On another front, the IRS has accelerated its audit processes, partly to avoid allowing the statute of limitations to run out and partly to expand its window into evolving taxpayer strategies. The agency recently announced a new enforcement policy for taxpayers who fail to respond promptly to Information Document Requests during an IRS inquiry.

Taxpayers may work with the IRS to set initial response deadlines, but those who miss them will be subject to a new enforcement procedure that may culminate in a summons, which will lead to more litigation. Such matters previously could be handled exclusively within the company's tax department, but they now require closer collaboration with the legal department.

Drawing New Battle Lines

As the pendulum swings, governments and taxpayers alike are working hard to change the tax litigation landscape. For example, many states are applying sales taxes to Internet retailers that do not have a physical presence in the state — the legal threshold for taxation since the U.S. Supreme Court's landmark 1992 Quill ruling.

States are increasingly attempting end runs around U.S. constitutional nexus protections with these laws. Unable to persuade Congress to expand state taxing authority, the states hope to prompt the

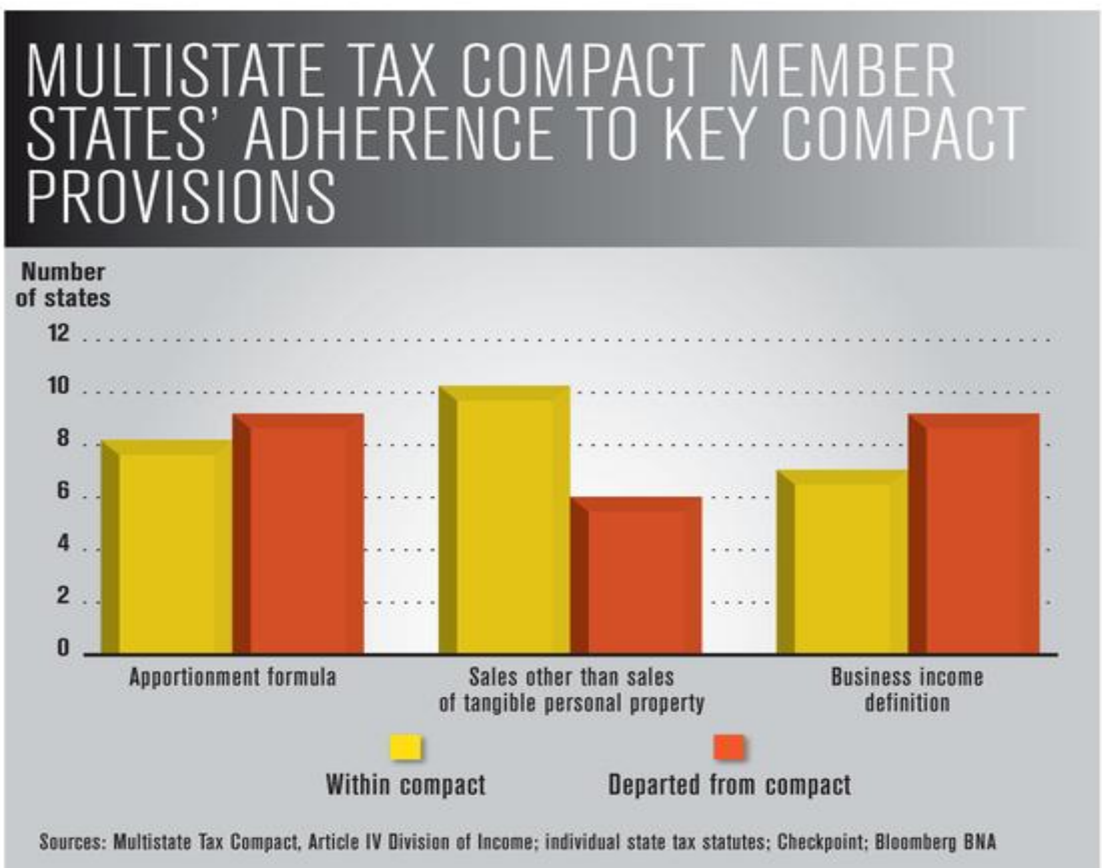
Supreme Court to revisit the issue. The question has led to litigation in a number of states, but the Supreme Court has so far refused to oblige, deciding in December 2013 not to review New York's "click-through" nexus law, despite taxpayers' confidence that it violates the federal Constitution.

For its part, the IRS is increasingly developing regulations based on previous litigating positions. When the IRS loses a case, the agency is basically building its litigating position from that case into the rules. There are now a number of cases out there testing "fighting regulations" that adopt IRS litigating positions, even those that the agency has lost!

For example, in the midst of transfer-pricing litigation the IRS would ultimately lose in the Ninth Circuit, the agency rewrote the regulations. In court, the agency lost its argument that technology company Xilinx must share stock-option costs in a joint venture with an overseas company, but its litigating position lives on in the new regulation, which is now being tested in a case involving Altera Corp.

Meanwhile, taxpayers are pushing back in an evolving area of multistate taxation — apportionment, the process of dividing a company's nationwide income among the states in which it operates. Upward of 20 states agreed many years ago to enter a rare multistate tax compact that allows taxpayers to choose between the compact's apportionment rules and each state's different rules.

Several states, however, now tell taxpayers they have no choice: they must apply the state's formula when that produces a higher tax bill. The resulting litigation has now worked its way to the high courts of California and Michigan in Gillette and IBM. California found the issue troubling enough to drop out of the compact, and a number of states are expected to follow. This a real watershed issue and it's going to be explosive for the next five years — or longer.



A number of states have replaced some of the Multistate Tax Compact's provisions with their own rules and formulas. The resulting discrepancies often create opportunities for taxpayers to seek large refunds.

Restraint — Up To a Point

Despite its aggressive approach to enforcing its interpretation of the tax laws, the IRS has announced the continuation of its “policy of restraint” when it comes to confidentiality of the legal work product that taxpayers generate during the development of their tax positions. However, in those instances where the IRS does want that information, the issue is being hotly contested.

The First Circuit ruled a few years ago that the work-product privilege did not apply to the tax accrual work papers of Textron, a ruling that caused many to wonder if work-product protections were to be severely limited. However, the U.S. Supreme Court declined to hear that case, and the issue continues to reverberate in courtrooms.

On the state side, restraint has been harder to come by. Some states are so aggressive that they hire third-party contractors to audit taxpayers on a contingent fee basis. In a 2012 Microsoft decision, a D.C. administrative law judge invalidated a transfer-pricing assessment based on the contractor’s flawed analysis of the company’s transactions.

While New Jersey has ceased this controversial practice, and top revenue officials in some states have given assurances that they will not take up the practice, other states continue to push the limits, so expect due process challenges in the next several years.

Key Cases

NFIB v. Sebelius — The Supreme Court upheld as a valid exercise of Congress’ taxing power the Affordable Care Act’s individual mandate, which imposes a “shared responsibility payment” on individuals who do not maintain minimum essential health insurance coverage. The court found unconstitutional the act’s Medicaid expansion provision, which threatened states with the loss of all federal Medicaid funds if they failed to increase Medicaid coverage as provided by the act.

U.S. v. Home Concrete & Supply — The Supreme Court rejected IRS attempts to hold the statute of limitations open on a large group of taxpayer transactions. Four justices found certain new IRS regulations were not entitled to Chevron deference because its previous Colony decision had left no room for a contrary statutory interpretation by the IRS. The decision leaves open questions about the IRS’s ability to overturn a prior judicial interpretation by regulation.

U.S. v. Woods — The Supreme Court ruled that a taxpayer was subject to a significant penalty for overstating his basis in a partnership found to be a “sham.” The court also rejected reliance on use of the Joint Committee on Taxation’s “Blue Book,” long considered an authoritative source of legislative history.

—By Donald M. Griswold, Crowell & Moring LLP

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The article was adapted from the firm’s “Litigation Forecast 2014.”