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Top 6 Tax Cases To Watch In The Second Half Of 2016

By **Vidya Kauri**

Law360, New York (July 11, 2016, 9:33 PM ET) -- The second half of this year will be an exciting one in the tax arena, with major battles over online retailers' sales tax obligations, an interstate tax agreement and transfer pricing all coming to a head.

Here, Law360 looks at six tax cases to keep an eye on.

The Gillette Co. et al. v. California Franchise Tax Board et al.

Gillette is one of approximately 40 big-name corporations battling states across the country that have been ditching the Multistate Tax Compact, an interstate tax agreement for calculating corporate franchise taxes, in favor of their own formulas.

Gillette is appealing a decision by the California Supreme Court that the state Legislature is not bound by the agreement, the only such case so far to wind its way to the U.S. Supreme Court for consideration, with Kimberly-Clark Worldwide Inc. and Sigma-Aldrich Inc. joining Gillette in its certiorari petition.

Just last month, the Minnesota Supreme Court also ruled that its state is not contractually bound by the Multistate Tax Compact in a case involving Kimberly-Clark, and a split Michigan Supreme Court came to a similar conclusion when it blocked an appeal from IBM Corp., Sonoco Products Co., Anheuser-Busch LLC, Goodyear Tire and Rubber Co. and Dollar Tree Inc., among others.

A similar case involving Health Net Inc. is scheduled for oral argument before the Oregon Supreme Court in September, and a taxpayer win could demonstrate a split among different states and prompt the high court's review.

Ronson Shamoun, principal attorney and CEO of RJS Law, told Law360 in an email that if the U.S. Supreme Court decides to accept Gillette's petition, the case will bring clarity to the central issue of whether the Multistate Tax Compact is a binding reciprocal agreement among its members.

"There has been quite of bit of uncertainty across the country in the application of the Multistate Tax Compact, which has caused some circuit splits on this issue. With the [Supreme Court] accepting this case, companies that operate in multiple states can finally look forward to having definitive guidance on apportioning their income," Shamoun said.

The case is The Gillette Co. et al. v. California Franchise Tax Board, case number 15-1442, in the Supreme

Court of the United States.

U.S. v. Microsoft Corp. et al.

For about eight years, Microsoft has been embroiled in an IRS audit over its transfer pricing practices that experts say could ultimately lead to a multibillion-dollar income adjustment.

The revenue agency took action in December 2014 to enforce summonses against past and present company executives so it could learn more about two of Microsoft’s cost-sharing agreements with subsidiaries in Puerto Rico and Asia. But the agency's hiring of commercial litigators from Quinn Emanuel Urquhart & Sullivan LLP in a $2.2 million contract to aid with the audit spurred allegations that the IRS had crossed a line.

The case has been closely watched not only because of the underlying transfer pricing questions and the billions of dollars at stake, but also because interested parties have wanted to see to what extent the government can use private lawyers in audits.

In November, U.S. District Judge Ricardo S. Martinez ruled that Microsoft has to comply with the summonses despite the court's concerns about Quinn Emanuel’s level of involvement, and although that particular question has been resolved, the battle is nowhere close to ending.

In May, the software giant agreed to let the IRS take a "quick peek" during meetings at documents over which it has asserted privilege claims. The IRS has said it needs to review them so it can determine if it must demand their production to enforce the summonses.

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.

"This could be the largest transfer pricing issue to date. IRS officials have stated that this is one of the largest audits in IRS history," Larissa Neumann of Fenwick & West 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.

21276-13W v. Commissioner

The IRS whistleblower program and efforts to prosecute illegal offshore accounts will be affected by the outcome of a case that tests whether the laws for whistleblower awards can be interpreted to include collection proceeds from criminal tax cases and penalties under the Report of Foreign Bank and Financial Account, or FBAR, requirements.

The Tax Court ruled last year that the IRS was wrong to have denied informant awards to two whistleblowers who played a key role in securing a $74 million settlement with a foreign business, rejecting the agency’s stance that a tipster must first bring information to its whistleblower office prior to any action.

The key question pending now is whether the award is limited to collection proceeds from the failure to report income under Title 26 of the U.S. Code, or whether it can be based on criminal tax cases and FBAR reporting under Titles 18 and 31, respectively, according to Dean Zerbe of Zerbe Fingeret Frank & Jadav PC, who is the lead counsel on the case.

Zerbe said that the court's language in a separate whistleblower case indicates that 2006 amendments to whistleblower laws intended for a broad reading of "collected proceeds," even though the whistleblower in that case was denied an award based on fines that were paid for failing to file a foreign bank account report.

"A win for whistleblowers will be a huge blow against illegal offshore accounts and tax cheats in general. A loss for whistleblowers will have the bankers and lawyers dancing in the streets in Panama," Zerbe said.

The case is 21276-13W v. Commissioner, case number 21276-13W, in the U.S. Tax Court.

Altera Corp. v. Commissioner

The IRS is appealing, in the Ninth Circuit, a U.S. Tax Court decision invalidating its rule requiring cost-sharing agreements between related parties to include the costs of stock-based compensation.

The Tax Court had sided with chipmaker Altera Corp. last summer after finding that the IRS ignored significant evidence and public comments, and that the agency's final 2003 regulation defied reasonable decision-making and failed the arm's-length standard of ensuring that transactions between related entities developing intangible property are comparable to what unrelated entities might negotiate.

However, the IRS said in a nearly 95-page opening salvo to the Ninth Circuit in June that the Tax Court was wrong in concluding that the analysis for the arm's-length standard must always be based on what unrelated parties do under comparable circumstances, and that such an analysis plays no role in determining the costs that must be shared under a qualified cost-sharing arrangement.

Experts say that the case, which kicked off in 2012 after the IRS issued Altera a deficiency notice saying that cost-sharing payments made by a Cayman Islands subsidiary were short some $80 million for 2004 through 2007, has implications not only in the transfer pricing context, but also in the broader administrative law context.

"[It] establishes a great precedent for attacking the IRS' abuse of discretion in issuing regulations without reasoned decision-making," Neumann said.

Shamoun said that if the Ninth Circuit affirms the Tax Court's holding, there are likely to be "more cases attempting to invalidate Treasury regulations on similar grounds."

The case is Altera Corp. and Subsidiaries v. Commissioner, case numbers 16-70496 and 16-70497, in the U.S. Court of Appeals for the Ninth Circuit.

Amazon.com Inc. v. Commissioner

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

Amazon's suit against the IRS seeks to resolve notices of proposed adjustments the agency issued for a seven-year period, starting in 2005, relating to the company's 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 made with Luxembourg affiliate Amazon Europe Holding 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.

Mayer Brown LLP's Brian Kittle told Law360 that the case remains important even though the relevant regulations were updated after the tax years at issue since the IRS has argued for a perpetual terminal value, which is the value of assets at the end of a projection period, while Amazon has taken the position that no terminal value exists at the end of the seven-year projection period.

"With Amazon, we might get a better perspective into how the court views terminal values in connection with intangibles, which could have a dramatic impact on how taxpayers approach buy-in payments in the future," Kittle said.

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

Crutchfield v. Testa

Crutchfield is just one case in the battle against a 1992 U.S. Supreme Court ruling requiring retailers to have a physical presence in a state for the purpose of collecting sales and use taxes.

The hot-button ruling in Quill Corp. v. North Dakota was handed down before the era of internet sales, and states across the country have become emboldened to challenge it after Supreme Court Justice Anthony Kennedy wrote in a concurrence last year that it may be time for the high court to revisit its precedent.

In Crutchfield, which had consolidated oral arguments in May in the Ohio Supreme Court along with cases involving Newegg Inc. and Mason Cos., is testing out a broad theory by arguing that an internet electronics retailer has a physical presence in the state because of tracking software known as cookies installed on customers' computers.

"This novel theory of establishing virtual physical presence is a new tactic to circumvent Quill that creates no limits on a state's reach of online businesses because presence would be established by merely existing," Stephanie Do of Sutherland Asbill & Brennan LLP said.

Tennessee, Alabama and South Dakota have all introduced similar legislation in recent months to require large out-of-state sellers to collect sales and use taxes within their borders, regardless of physical presence.

Newegg, which sells computer hardware and software, has filed an appeal with the Alabama Tax Tribunal to contest Alabama's recent regulation, and South Dakota sued Newegg, Wayfair Inc. and Overstock.com Inc. in April to enforce the sales tax law it had passed a month earlier.

Experts say that a victory for one state could lead to more states following suit to challenge Quill's physical presence test and impose sales and use tax obligations on out-of-state retailers until either Congress or the Supreme Court weighs in on their power to do so.

The case is Crutchfield Corp. v. Testa, case number 2015-0386, in the Ohio Supreme Court.

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