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Top 5 Tax Cases To Watch In 2017

By **Vidya Kauri**

Law360, New York (January 2, 2017, 1:03 PM EST) -- The new year promises to advance controversial issues currently simmering in courts, such as whether states will get their wish to tax online sales originating outside the states' borders, and to what extent Delaware can shore up its budget with revenue from unclaimed property.

Here, Law360 takes a look at five cases with significant repercussions that courts are expected to weigh in on in 2017.

South Dakota v. Wayfair Inc.

After the U.S. Supreme Court refused to consider petitions concerning a Colorado law requiring out-of-state sellers to file sales information with Colorado, all eyes are now turning toward South Dakota, where a challenge to a common law barring states from collecting transaction taxes from remote retailers is brewing.

State governments, feeling resentful about being unable to cash in on burgeoning online sales, have been seeking to overturn the controversial 1992 Supreme Court ruling in Quill Corp. v. North Dakota, which determined that states may not impose use tax collection obligations on vendors without a physical presence in the state. The states had their hopes dashed last month, when the high court decided not to take up a challenge to Colorado’s reporting requirements.

Delivered before the modern era of online shopping, Quill has been criticized as outdated, and ever since Justice Anthony Kennedy wrote in a 2015 concurrence that it may be time for the high court to revisit its precedent, states have become emboldened to challenge Quill through legislative or regulatory means.

South Dakota enacted legislation in March 2016 requiring large out-of-state sellers to collect sales and use taxes within their borders — regardless of physical presence — then sued Newegg Inc., Wayfair Inc. and Overstock.com Inc. a month later to enforce the new sales tax law.

While the Colorado case had more to do with tax reporting obligations and not tax collection itself, experts say the South Dakota case is a much better vehicle for challenging Quill, as the state carefully crafted its legislation in response to Justice Kennedy’s invitation for an appropriate case to revisit the hot-button ruling.

After South Dakota sued the e-tailers in state court, they removed the case to federal court. The state is currently trying to remand the dispute back to state court.

Marvin Kirsner, a shareholder in Greenberg Traurig LLP's tax practice, said that it "could be a real fast process" in 2017 before the parties get to petition the Supreme Court, but that the U.S. Congress may also weigh in on the issue before the high court gets a chance to do so.

The Legislature has floated a number of bills in recent years to disregard Quill and permit tax on remote sales, but so far no decisive action has been taken on those measures.

Delaware v. Pennsylvania, and Arkansas v. Delaware

The Supreme Court in October 2016 agreed to review a dispute between Delaware and several other states concerning who gets to keep abandoned MoneyGram checks, and experts say a broader ruling on how unclaimed property, including prepaid checks and gift cards, should be distributed could significantly impact states' coffers.

The dispute began with 20 states, including Pennsylvania and Wisconsin, conducting a third-party audit and determining that Delaware had violated a 1974 federal statute by taking custody of funds from unclaimed checks issued in the respective states by MoneyGram Payment Systems Inc.

The states sued Delaware, which filed its own suit to enforce its purported "superior right" to have access to MoneyGram's unclaimed and abandoned official checks. Delaware cited a set of common-law priority rules the Supreme Court had established in 1965 that take advantage of the fact that MoneyGram, like many large businesses, is incorporated in the state. The rules say that unclaimed property should either be possessed by the state in the owner's last known address or the holder's state of incorporation if the owner's address is unknown.

Delaware, which thrives on funds from unclaimed property as its third-largest source of revenue, claims that MoneyGram's official checks are neither money orders nor traveler's checks, because they are not labeled as such, are generally issued by financial institutions and not convenience stores or smaller businesses, are not promoted as being easily negotiable overseas, and can be issued in substantially larger dollar amounts.

Experts say that the Supreme Court, which consolidated the two cases, has historically tried to be as narrow as possible in its rulings and may just focus on the characterization of MoneyGram's checks. However, if the justices determine that the federal statute does not apply, they could either decide Delaware should retain custody of the unclaimed funds based on the high court's own priority rules or choose to revisit those rules, according to Renn Neilson, the chair of Baker Botts LLP's state tax practice.

"Our clients face surprising and large liabilities as a result of these unclaimed property audits, and it's almost always Delaware that causes most of the pain," Neilson said. "The fact that Delaware has become so accustomed to collecting so much of this money, I think it's become sort of an opiate for Delaware. They know it's not a tax, but they rely on it as though it is."

Experts say that the justices may also address due process concerns arising from states' shortening the time during which property must lie dormant before being labeled abandoned, from the use of contingency fees for third-party auditors, and from the amount of notice states provide before escheating unclaimed property.

Altera Corp. v. Commissioner of Internal Revenue

In the Ninth Circuit, the IRS is appealing the U.S. Tax Court's invalidation of the agency's 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. in July 2015 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 in the Ninth Circuit in June 2016 that the Tax Court wrongly concluded 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.

The case had originally 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. The dispute has implications in not only the transfer pricing context but also the broader administrative law context, according to Reed Smith LLP's partner Jeffrey Korenblatt.

"Aside from producing yet another transfer pricing loss for the IRS, Altera stands for the larger proposition that tax regulations must be the product of 'reasoned decision-making,'" Korenblatt said. "Accordingly, such regulations must have a basis in fact, [and] Treasury must demonstrate a rational connection between the facts found and the choice made in the regulations."

The Tax Court's ruling may have caused the IRS and U.S. Department of the Treasury to be more careful and methodical in promulgating other regulations since then, as evidenced by the lengthy preamble to rules under Section 385 of the Internal Revenue Code to recharacterize debt as equity, as well as the scaling back of those regulations in response to a severe public backlash, according to Korenblatt.

Amazon.com Inc. v. Commissioner of Internal Revenue

Amazon.com Inc. is bitterly locked in its own, $1.5 billion transfer pricing dispute with the IRS over an arrangement the online retail giant inked with a European subsidiary. And the case, which is sitting in U.S. Tax Court, is being closely watched by multinational businesses and tax practitioners.

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.

In December 2016, U.S. Tax Court Judge Albert Lauber ordered the release of trial transcripts and more than a dozen documents, either with or without redactions, following a request from Guardian News & Media LLC.

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 currently under advisement after having been tried in 2014, and Amazon and the IRS are currently reviewing transcripts to determine what information should remain sealed, according to court documents.

New York ex rel. Rasmusen v. Citigroup Inc.

A $2.4 billion suit accusing Citigroup Inc. of dodging $800 million in state taxes by illegally deducting losses incurred during the financial crisis is set to pick up steam again, after a New York federal court found it lacked jurisdiction over the case and punted it back to state court in December 2016.

Citi had transferred the suit to federal court in 2015 and sought dismissal of claims that the financial services firm deducted “excessive and improper” net operating losses when Citi paid the New York franchise tax, or corporate tax, from 2010 to 2012. According to the suit, first filed in 2013, the steep losses the bank suffered during the financial crisis couldn't legally be deducted in future tax years, because of huge transfers of bank equity to the federal government.

In remanding the suit to the New York Supreme Court last month, U.S. District Judge Lewis A. Kaplan found that the dispute failed to raise federal issues despite purporting that IRS notices regarding tax code Section 382 were invalid. That section sharply limits a corporation from deducting net operating losses in years after it undergoes an “ownership change,” according to the order.

Indiana University business economics professor Eric Rasmusen, who had filed the suit under New York’s False Claims Act, conceded that he lacks standing to challenge the validity of the IRS notices. Only the Treasury or Citi can do that, Judge Kaplan said.

According to the order, Rasmusen had contended that even if Citi was eligible for the loss deduction on its federal tax filings, New York tax law diverges from federal law on this issue. If the New York statute is viewed that way, then this case could be decided without referencing deductions under Section 382, Judge Kaplan said.

Judge Kaplan's ruling comes after 18 New York Assembly members asked the state Attorney General Eric Schneiderman in March 2016 to explain his decision not to get involved in the dispute. The state representatives, mostly Republicans, said Schneiderman’s not throwing his weight behind the suit was puzzling given he championed the FCA and was willing to fight banks and big businesses.

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