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Top 4 Federal Tax Cases Of 2021: Midyear Report

By **Dylan Moroses**

Law360 (July 2, 2021, 6:25 PM EDT) -- During the first half of 2021, the U.S. Supreme Court ruled an advisory firm could challenge IRS guidance on microcaptives, while the U.S. Tax Court ruled on the valuation of a pop megastar's estate and the deductibility of legal fees.

Here, Law360 examines a few of the most important tax decisions in federal courts from the past six months.

CIC Services v. IRS

In May, the U.S. Supreme Court revived an advisory firm's challenge to Internal Revenue Service guidance requiring microcaptive insurance transactions to be disclosed on pain of penalties, saying it was not barred by the Anti-Injunction Act.

The challenge by CIC Services to an IRS notice issued in 2016 is not prohibited by the AIA, which bars suits that could restrain the collection of tax, the justices said in a unanimous opinion that reversed a decision by the Sixth Circuit. The target of CIC's suit is the IRS notice, not the potential tax penalty for violating the notice, the court said.

Under microcaptive insurance transactions, companies set up small, in-house insurers that are taxed only on investment income, excluding payments received under the insurance contract from taxable income. IRS Notice 2016-66 labeled microcaptive insurance arrangements as potentially abusive and said they must be reported to the agency under the threat of penalties.

CIC claimed the notice was a violation of the Administrative Procedure Act because it did not go through the notice-and-comment procedures required by that law. The company said the AIA should not apply because it was challenging the IRS notice's reporting requirements, not the collection of tax.

Brian W. Kittle of Mayer Brown LLP said the high court's opinion in the case tackled a complex debate over the scope of the AIA.

"The Supreme Court's analysis takes on what seems to be challenging for courts in a lot of ways, and that is discerning whether the nature of the dispute or complaint by the taxpayer is really about the underlying taxes," Kittle said. "If it were, the Anti-Injunction Act would say you have to pay your taxes

before you can challenge, but in this case, the Supreme Court determined that it was about something else."

CIC filed a complaint in March 2017 challenging the IRS notice. A federal judge dismissed the suit that November on the grounds that it was barred by the AIA. In a 2-1 decision in 2019, a Sixth Circuit panel said the AIA forbade the company from challenging the IRS' notice.

The Supreme Court's opinion in CIC could signal that so-called tax exceptionalism, or the seemingly impervious deference given to the IRS and U.S. Treasury Department in litigation involving tax regulations, may be waning, Steven Dixon of Miller & Chevalier Chtd. told Law360.

"I think the main point is that the Anti-Injunction Act can't be a shield against all actions remotely related to tax," Dixon said.

Allowing CIC's suit to proceed also indicates that Treasury and IRS regulations should be able to be scrutinized in courts similarly to rules issued by other government agencies, especially those that aren't explicitly directed to tax assessment and collection, which would still be protected by the AIA, Dixon said.

"I don't think that this opens the floodgates as the government suggested," Dixon said. "But I do think that it opens a door or window for there to be some pre-enforcement to some kinds of Treasury rulemaking, which is only fair, given that other agencies face the same kinds of challenges."

Nicole Elliott of Holland & Knight LLP told Law360 that the high court's ruling was a significant victory for taxpayers but will pose more questions as the case proceeds in lower courts.

Looking ahead, Elliott said courts will need to determine the merits of CIC's challenge to the IRS notice and "to what extent the APA applies." Judges in general may need to more closely examine whether Treasury and IRS rulemakers are following the law when they issue guidance in light of the Supreme Court's judgment, Elliott said.

"I think it'll be interesting how judges struggle with that tension there: the need for guidance but also the need to make rules that make sense," Elliott said.

The case is CIC Services LLC v. Internal Revenue Service et al., case number 19-930, in the U.S. Supreme Court.

Mylan Inc. v. Commissioner

In April, the U.S. Tax Court ruled pharmaceutical company Mylan Inc. **could deduct legal fees** it incurred defending itself against patent infringement suits from brand-name drug manufacturers as ordinary business expenses.

The legal fees can be deducted as ordinary expenses — rather than capitalized as the IRS had argued — because the patent litigation was separate from the government's generic drug approval process, the court said.

However, other legal fees Mylan paid to prepare notice letters that are required to secure abbreviated new drug application, or ANDA, approval by the U.S. Food and Drug Administration are not ordinary and

necessary expenses and must be capitalized, the opinion said.

Capitalization of costs under Internal Revenue Code Section 263(a) usually results in recovery of the expenditure over a longer time period and is done when the cost creates or enhances a separate and distinct asset or otherwise generates significant benefits for the entity beyond the current tax year, the opinion said.

Mylan makes brand-name and generic drugs, but to be the first to provide a generic version of a drug to the market, it typically prepared formal notice letters to the branded drug manufacturers and patentees, according to court documents.

In analyzing whether fees incurred in preparing those letters should be deducted under Section 162(a) or capitalized under Section 263(a), the Tax Court looked to certain Treasury regulations that require capitalization for amounts to acquire an existing intangible, create or enhance distinct intangibles, or make or enhance some future benefit. Amounts paid to facilitate the acquisition or creation of an intangible must also be capitalized, Judge Patrick Urda said.

From 2012 through 2014, Mylan regularly defended itself against patent infringement suits under Section 271(e)(2), Title 35 of the U.S. Code, brought in response to ANDAs that make paragraph IV certifications, according to court documents. In a paragraph IV certification for an ANDA, a generic drug manufacturer asserts that an existing patent "is invalid or will not be infringed by the manufacture, use or sale of the new drug." This serves to challenge the validity of brand-name manufacturers' patents, and automatically counts as patent infringement, the opinion said.

However, the legal costs in defending against a paragraph IV certification from a generic manufacturer are not capitalized because defending a patent is not a step in the FDA approval process, the opinion said.

The case is Mylan Inc. v. Commissioner, docket numbers 26976-16, 26977-16 and 26978-16, in the U.S. Tax Court.

Estate of Michael Jackson

In May, the U.S. Tax Court said Michael Jackson's image was worth under $4.2 million, much less than a $161 million estimate by the IRS **in its dispute** with the estate of the pop megastar over the valuation of his assets.

Although Jackson reached a peak of fame during his lifetime unlikely to be obtained by many, and though his death led to a surge in sales of his albums and merchandise, the value of Jackson's image will likely fade over time, Judge Mark Holmes wrote for the court.

The Tax Court ruled on the value of three assets at the time of Jackson's death in 2009 that remained in dispute between the estate and the IRS: Jackson's right of publicity, his half interest in the Sony/ATV music publishing company and his interest in his music catalog company, Mijac Music. The IRS had originally adjusted the value of the estate to $1.32 billion from $7 million, demanding $702 million in taxes and penalties, but other disputed valuations were settled before trial.

The estate had asserted the three remaining assets should be valued at about $5.3 million, while the IRS had valued the assets at around $482 million. The Tax Court ruled that the combined value of the assets

was about $111.5 million. While the Tax Court agreed with the estate that the interest in Sony/ATV was worthless, it said the interest in Mijac Music should be valued at $107.3 million, rather than $2.3 million, as the estate had argued.

The estate had initially valued Jackson's image at $2,105, since the appraiser had found when Jackson died he needed income and had earned almost nothing from his likeness, the opinion said. Claims that Jackson sexually abused children also likely weighed on the value of his estate at death, Judge Holmes said.

Meanwhile, the IRS' expert placed a much larger estimate of the value of Jackson's image — $161 million — based on the future revenue that could come through themed attractions and products, branded merchandise, a Cirque du Soleil show, a film and a Broadway musical, the opinion said.

But those future revenue streams were not foreseeable when Jackson died, Judge Holmes said. At the time of his death, Jackson's reputation was dismal, and he had received no revenue related to his likeness in the last 10 years of his life, the judge said. Those factors led the court to conclude that the value of Jackson's image and likeness after death was worth just $4.1 million.

Michael Kosnitzky of Pillsbury Winthrop Shaw Pittman LLP told Law360 that the government overreached in its attempts to collect taxes "based on the benefit of hindsight" in the Jackson estate case. The valuation experts for the IRS weren't as prepared as the estate's witnesses, who provided a more thorough analysis of the value of the different assets in the estate, Kosnitzky said.

"How they might exploit the asset in the future; that's not the law. It was inventing law," Kosnitzky said. "It was a wish list for the government, [but] the law is that it's a snapshot at death."

Kosnitzky said the Jackson case will be a good tool to use as a reminder that the government isn't permitted to overvalue an estate's taxed assets based on the unforeseen increase in value following death.

The disparity in valuations presented during the case is an example of where expert witness testimony could work against the government, and the IRS may have compromised its chances to earn a favorable result in Tax Court when it argued that Jackson's assets were far more expensive, Kittle said.

"Evaluation is very fact-based and fact-interpretation-based for a person who's performing the evaluation, whether it's an economist or some sort of appraiser, and I think that person's credibility is of the utmost importance to the success or failure of that litigation," Kittle said.

The case is Estate of Michael J. Jackson et al. v. Commissioner of Internal Revenue, docket number 17152-13, in the U.S. Tax Court.

California v. Texas

The U.S. Supreme Court ruled 7-2 in June that Republican states led by Texas lacked standing to challenge the Affordable Care Act.

The decision marked the third time the high court has rejected a Republican-backed challenge to the ACA, which has now been in place for a decade.

The GOP states argued that Congress' elimination of the penalty administered through the Internal Revenue Code for individuals failing to comply with the law's mandate to buy insurance rendered that provision invalid, and that because of the provision's importance, the whole law had to be struck down.

In a majority opinion written by Justice Stephen Breyer, the Supreme Court threw out the challenge. Justices Samuel Alito and Neil Gorsuch dissented.

The fatal weakness of the states' case, Justice Breyer said, was that they failed to show how the zeroed-out penalty under the insurance mandate provision would harm states "by leading more individuals to enroll in these programs."

According to Justice Breyer, the existence of a nonenforceable mandate to buy health insurance had "nothing to do" with the government programs that the states said would hurt their pocketbooks, such as Medicaid services for children and pregnant women, emergency services, COVID-19 testing and more.

Justice Clarence Thomas, among the most conservative justices on the court, expressed sympathy with the states' underlying legal arguments but said they nevertheless failed to establish standing.

Where the Supreme Court previously upheld the individual mandate as an exercise of Congress' taxing power in the 2012 case NFIB v. Sebelius, the ACA's defenders now treat the mandate as "just a throwaway sentence," Justice Thomas wrote in a concurrence.

Justice Alito balked at the majority's position that the states lacked standing to challenge the ACA. "Can this be correct? The ACA imposes many burdensome obligations on states in their capacity as employers, and the 18 states in question collectively have more than a million employees. Even $1 in harm is enough to support standing. Yet no state has standing?"

The cases are California et al. v. Texas et al., case number 19-840, and Texas et al. v. California et al., case number 19-1019, in the U.S. Supreme Court.

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Editor's Note: Judge Patrick Urda is the brother of Law360 Editor-in-Chief Anne Urda.
