LEGAL ALERT

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The 2012 Tax Litigation Year in Review: Important Events

The year 2012 was quite an interesting one for tax controversy. Whereas 2011 brought a win for the Treasury on deference issues in *Mayo Foundation for Medical Ed. v. United States*, 131 S. Ct. 704 (2011), 2012 was the year courts reminded us that deference is limited and but one side of the coin: with deference comes an obligation to abide by the Administrative Procedure Act. It was also a year in which splits among circuits on various tax issues made the news. *See, e.g.*, *United States v. Quality Stores, Inc.*, 693 F.3d 605 (6th Cir. 2012) (FICA taxability of certain payments). And, in a particularly interesting development, 2012 saw a number of cases in which the Internal Revenue Service (IRS) relied more on debt-equity classification arguments to challenge transactions instead of economic substance. On the administrative side, 2012 was one of change for the IRS as it announced a realignment of the Large Business and International (LB&I) Division, terminated its Tiered Issue Process in favor of a new approach, and refined its Quality Examination Process. As we settle into a new year, we take a look back at some of the important tax items that made news in 2012 and that may have continuing importance in the forseeable future.

1. *Home Concrete* – U.S. Supreme Court Puts Limits on Treasury Overreach

On April 25, 2012, a divided five-to-four U.S. Supreme Court held in *U.S. v. Home Concrete & Supply, LLC*, *et., al.*, 132 S.Ct. 1836 (2012), that the extended six-year statute of limitations under IRC Section 6501(e)(1)(A) is not triggered by a taxpayer's overstatement of basis in property, even if the overstatement of basis results in an understatement of gain greater than 25% of the gross income stated on the taxpayer's return. The Court's holding followed an interpretation of the statute announced by the Supreme Court in a prior case, *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958), which the Court held to remain good, controlling law, notwithstanding the Treasury's attempt to produce a different result by adopting a regulation that interpreted the statute differently. Nevertheless, no opinion was able to garner a majority of the Court's justices, indicating that the Supreme Court remains divided on questions of deference to agency interpretations and that the issue of deference will continue to generate controversy in the future.

For a more detailed analysis of the *Home Concrete* opinion, click here.

2. *Dominion Resources* – Federal Circuit Holds That Treasury Regulations Are Subject to the Same Constraints as Other Administrative Pronouncements

In a case that may be a harbinger of future disputes involving regulations, a taxpayer prevailed in a challenge to Treasury regulations as being arbitrary and capricious under the Administrative Procedure Act (APA). *See Dominion Resources, Inc. v. Commissioner*, 681 F.3d 1313 (Fed. Cir. 2012). The Federal Circuit's holding in *Dominion Resources* is particularly noteworthy because it is one of the first cases after *Mayo Foundation for Medical Ed. v. United States*, 131 S. Ct. 704, 713 (2011), to consider how the APA should be applied to tax regulations within the framework set by the Supreme Court in *Chevron*. The Court's holding serves as an important reminder that while courts will accord *Chevron* deference to Treasury regulations under *Mayo*, they will also review Treasury regulations under the same standards as other administrative agency pronouncements to determine whether there is a reasoned explanation for the regulation. Although the Supreme Court has not affirmatively held that Treasury regulations are subject to the APA, its opinion in *Mayo* suggests as much. It will be interesting to watch the Court on this issue since tax regulations may be particularly susceptible to an APA-based challenge because the IRS often does not strictly follow APA notice and comment procedures.

For a more detailed analysis of the *Dominion Resources* opinion, click here.

3. *Quality Stores* – Sixth Circuit Opinion Creates Split in Circuits and Opportunity for Refunds of FICA Taxes Paid on Severance Pay

On September 7, 2012, the Sixth Circuit held that certain types of severance payments (referred to as supplemental unemployment compensation benefits or "SUB payments") are not taxable wages under FICA. *United States v. Quality Stores, Inc.*, 693 F.3d 605 (6th Cir. 2012). In so holding, the court declined to follow IRS revenue rulings and also declined to follow the Federal Circuit's contrary decision in *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008). With the Sixth Circuit's denial of the government's request for rehearing en banc on January 4, 2013, it is reasonably likely that the government will ask the Supreme Court to resolve the issue given the split among the circuits. In the meantime, employers (including employers outside of the Sixth Circuit) that have made severance payments meeting the requirements for SUB payments as set forth in section 3402(o) should consider filing claims for a refund of FICA taxes paid with respect to these payments.

For a more detailed analysis of the *Quality Stores* opinion, click here.

4. *Castle Harbor, Hewlett-Packard, ScottishPower, Historic Boardwalk, PepsiCo,* and *H&M* – Is Debt-Equity the New Economic Substance?

The period from 2000 through 2010 is replete with cases in which the IRS mainly challenged transactions on the basis of economic substance. In an interesting development this past year, the IRS relied less on the economic substance arguments in challenging taxpayers. Instead, 2012 brought several cases in which the IRS principally challenged the classification of a taxpayer's "investment" as debt or equity. *See TIFD III-E, Inc. v. United States*, 666 F.3d 836 (2d Cir. 2012) (*Castle Harbor*); *Hewlett-Packard Co. v. Commissioner*, T.C. Memo. 2012-135, 2012 WL 1673643 (May 14, 2012); *NA General Partnership & Subsidiaries v. Commissioner*, T.C. Memo. 2012-172, 2012 WL 2344719 (June 19, 2012) (*ScottishPower*); *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012); *PepsiCo Puerto Rico, Inc. v. Commissioner*, T.C. Memo. 2012-269, 2012 WL 4207299 (Sept. 20, 2012); and *H&M, Inc. v. Commissioner*, T.C. Memo. 2012-290, 2012 WL 4868198 (Oct. 15, 2012).

- In the long-running *Castle Harbor* litigation, the Second Circuit issued its second decision in the case. The transaction at issue involved a partnership between subsidiaries of General Electric and two foreign banks in which substantially all of the net income of the partnership was allocated to the banks. Reversing the district court for a second time, the Second Circuit concluded that the investment held by the foreign banks was not a "capital interest within the meaning of section 704(e)(1)," *TIFD III-E*, 666 F.3d at 847, and reaffirmed its earlier findings (first made in 2006) that the interest held by the foreign banks "does not qualify as a partnership participation" because the investment was "overwhelmingly in the nature of debt." *Id.* at 842.

- In *Hewlett-Packard*, HP invested in a transaction in which it purchased preferred and priority shares, put and call options, and warrants in a Dutch entity. Treating the investment in the Dutch entity as equity, HP claimed foreign tax credits attributable to the taxes paid to the Dutch government on dividends received from the Dutch entity, which were denied by the IRS. The

Tax Court held that the overall features of the transaction "bear the indicia of a debt investment" and not equity. *Hewlett-Packard,* 2012 WL 1673643, at *30.

- In *NA General Partnership & Subsidiaries* (*ScottishPower*), loan notes were issued by NAGP, a Nevada partnership treated as a corporation for federal tax purposes, to its parent company, ScottishPower, pursuant to a merger transaction. Treating the loan notes as debt, NAGP claimed interest deductions under sections 162 and 163. The IRS denied the deductions arguing that the notes constituted a capital contribution. The court disagreed with the IRS and held that the transaction as a whole reflected a debt arrangement and not equity. *NA General Partnership & Subsidiaries,* 2012 WL 2344719 at * 14.

- In *Historic Boardwalk*, Pitney Bowes invested in a partnership with the New Jersey Sports and Exposition Authority for the purpose of renovating Historic Boardwalk Hall in Atlantic City. The IRS challenged the validity of the partnership, arguing that it was a sham created solely for the purpose of passing on tax credits. The IRS also argued that Pitney Bowes did not have a bona fide partnership interest. The Tax Court rejected both of the IRS's claims. On appeal, however, the Third Circuit agreed with the IRS's second argument and reversed the Tax Court on the basis that Pitney Bowes "lacked a meaningful stake in either the success or failure" of the partnership and was therefore not a bona fide partner. *Historic Boardwalk*, 694 F.3d at 463.

- In *PepsiCo,* advanced agreements were issued by PepsiCo's Netherlands subsidiaries in exchange for notes issued by Frito-Lay, PepsiCo and Metro Bottling to other PepsiCo domestic affiliates. PepsiCo treated the agreements as equity and payments on the agreements as distributions on equity. The IRS denied this treatment, arguing that the agreements constituted debt, but the court disagreed and held that the "advanced agreements exhibited more qualitative and quantitative indicia of equity than debt." *PepsiCo*, 2012 WL 4207299, at *34.

- In *H&M, Inc.*, H&M sold its insurance brokerage business to a local bank in a transaction in which H&M also issued a note to its owner promising to compensate the owner for work performed in years prior to the sale of the business, including interest. H&M claimed deductions for the interest paid on the note but the IRS denied the deductions, arguing that the note did not constitute debt. The court agreed and held that the promissory note "didn't represent a bona fide debt," and the interest payments were not deductible. *H&M, Inc.*, 2012 WL 4868198 at * 11.

The IRS had more success than failure when challenging the debt/equity classification of taxpayers' investments in 2012. That suggests taxpayers can expect to see the IRS continuing to challenge transactions on these grounds in the future.

5. *IRS Restructuring and Procedural Changes* – LB&I Division Realignment, Termination of Tiered Issue Process in Favor of Issue Practice Groups and International Practice Networks, and Revised Quality Examination Process

In 2012, the IRS engaged in a review of its operations and made significant changes for the purpose of creating increased efficiencies from an administrative and taxpayer perspective.

- On May 23, 2012, the LB&I Division announced a realignment, which became effective on October 7, 2012. In realigning its industry groups geographically in groupings of contiguous states, LB&I indicated that it hopes to improve managerial efficiency, make more effective use of the industry knowledge of field specialists, and reduce costs. The realignment also shuffled certain sub-industries and field specialists within the LB&I industry groups. The IRS has indicated that the realignment is not expected to significantly impact taxpayers because examination teams should not change. Some audit teams will begin reporting to different territory managers and directors of field operations, however, so taxpayers may find themselves working with some new IRS personnel, which is something we will be watching in 2013.

For a more detailed analysis of the LB&I realignment, click here.

- On August 17, 2012, the IRS officially terminated the Tiered Issue Process, a program designed in 2006 to ensure consistency in the treatment of challenging corporate tax issues, particularly tax shelter issues. In its place, LB&I created Issue Practice Groups (IPGs) for domestic issues and International Practice Networks for international issues. The stated purpose of the new groups is to more effectively manage knowledge and expertise. LB&I referred to IPGs as “knowledge management networks” designed to provide LB&I examiners with better guidance on issues, to promote LB&I internal collaboration, and to increase transparency in the issue resolution process. In announcing the change, the IRS indicated that the new system was intended to balance the need for consistency with the unique facts and circumstances of particular taxpayers and to provide more flexibility than the Tiered Issue Process. In practice, IPGs consist of two to five full-time technical specialists who focus on their specific issues, with other experts lending their experience to IPGs on a part-time basis.

- In June 2010, the IRS replaced the Joint Audit Planning Process with the Quality Examination Process (QEP), which includes all LB&I examinations. In 2012, LB&I announced several changes to “refocus” QEP principles and guidelines. These included changes in the IDR process by eliminating a standard 30-day response time in favor of individually negotiated response deadlines, planning to issue more focused IDRs, shortening the delinquency period, and having potentially more summons enforcement when responses are not timely. The IRS’s commitment to more focused IDRs and negotiated response deadlines is certainly a promising development for taxpayers often faced with overly broad IDRs. However, whether these changes will actually accomplish the IRS’s purported goals of increased efficiencies and the avoidance of misunderstandings remains to be seen.

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