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Focus on Tax Controversy

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It is with great pleasure that McDermott Will & Emery presents the first quarterly issue of *Focus on Tax Controversy*, which specifically addresses the complex issues surrounding U.S. federal, international, and state and local tax controversies.

We hope that you enjoy these legal news updates and that they will be informative and useful to you as you look to stay abreast of changes and new developments in the law.

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A Decade of Lessons Learned from State Tax False Claims Act Cases

The last decade has witnessed a large upswing of False Claims Act (FCA) cases filed in the state tax arena. New York, particularly in the last few years with Attorney General Eric Schneiderman at the helm, has sharpened its tools and upped its enforcement efforts. The New York False Claims Act was amended in 2010 to allow private citizens acting on behalf of the state to bring a tax claim alleging fraud against taxpayers who met a certain financial threshold. The amendments provide for treble damages, rewards of up to 30 percent of liability and a 10-year statute of limitations, which is years beyond the statute of limitations governing state tax audits. In Illinois, hundreds of state tax FCA cases have been filed by a single plaintiff law firm, triggering a State House Revenue and Finance Committee hearing on the abuse of the Illinois FCA, as well as proposed legislation that would put significant limitations on the filing of such claims. Across the United States, unclaimed property laws also have seen their fair share of FCA litigation.

At present, 29 states, the District of Columbia, New York City, Chicago, and Allegheny County, Pennsylvania, have FCA statutes. Of those jurisdictions, eight (Delaware, Florida, Nevada, New Hampshire, New York, Washington, Wisconsin and Chicago) permit state tax FCA claims involving any type of tax. Three others (Illinois, Indiana and Rhode Island) bar only income tax FCA actions; any other type of state or local tax is fair game. The remaining jurisdictions either bar all tax-related claims or are limited to Medicaid-related claims.

FCA laws, also referred to as *qui tam* or whistleblower laws, allow third-party private citizens ("whistleblowers" or "relators") acting on behalf of a government to sue persons who knowingly make or use a false statement material to an obligation to pay money to the government. In the tax arena, such claims frequently are brought as "reverse" false claims, alleging a knowing concealment or avoidance of a tax obligation. "Knowingly" is broadly defined by the FCA laws as actual knowledge, deliberate ignorance of the truth or falsity of information, or acting in reckless disregard of the truth or falsity of information.

The penalties associated with an FCA violation are severe, and the potential reward to a whistleblower is significant. Persons found to have violated a state FCA may be found liable for three times the amount of unpaid tax, interest and penalties, plus per-occurrence civil penalties (up to $11,000 per false claim in Illinois) and costs. Up to 30 percent of the proceeds of any judgment or settlement may be awarded to the whistleblower, together with its costs, expenses and reasonable attorneys' fees.

The groundswell of such litigation appears to be rising. Although one state (Tennessee) amended its statute to bar the use of FCA cases in the tax arena, proposed legislation to amend the Illinois statute to limit tax-related claims has stalled in committee. Recently, the Multistate Tax Commission Income and Franchise Tax Uniformity Subcommittee formed a working subcommittee to begin drafting a model provision for state false claims acts.

With no universal shutdown of state tax FCA actions on the horizon, this article offers the following practical recommendations to the taxpayer community for defending against third-party FCA claims. A subsequent article will offer practical tips for guarding against FCA claims brought by insiders, including employees.

1. Oppose the enactment of these laws. Be a strong voice against the use of FCA litigation in the tax arena. Emphasize the powerful enforcement mechanisms that already are present and available for use by state tax departments against tax cheats. Explain the risks created when private citizens, with no tax experience, are armed with legislation that gives them the power to drive tax policy by filing whistleblower claims. Do not accept any assurance that a state statute is a copy of the federal FCA, which "has a tax prohibition." Smart whistleblowers recognize that there is ample opportunity to bring tax-related state FCA litigation under such statutes, because they only prohibit income-tax-related claims. *See, e.g.*, the Illinois FCA and related litigation, all of which involve sales and use tax-related claims under a state statute modeled on the federal FCA. The Indiana and Rhode Island statutes are similarly worded.

2. If you are sued, expect a healthy dose of skepticism for your point of view, even if the case filed against you is, from your perspective, completely without merit. Generally speaking, the general public, judges included, believe whistleblower lawsuits serve a useful purpose because they ferret out fraud against the government. Rightly or wrongly, many people view fraud on the government as a rampant problem. In the tax arena, these views are exacerbated by the fact that everyone hates a tax cheat. These ingrained beliefs can present a significant hurdle that must be overcome in order to prevail in the defense of FCA litigation.

3. Be prepared to present your case to the court, and perhaps also the state lawyer assigned to the matter, in a simplistic manner. Because FCA litigation typically arises outside the context of a traditional state tax proceeding, such lawsuits often are assigned to courts and state's lawyers with little or no tax background. In fact, the state taxing authority may not even be named as a party to the litigation.

Individuals without a background in taxation frequently take frivolous claims more seriously than would a more experienced opponent or jurist (see "everyone hates a tax cheat," above). As a result, it is critical for you to explain your tax position clearly and succinctly. It is difficult for a judge to agree to dismiss a case as meritless if he or she does not understand the defect in the whistleblower's tax claim.

If your jurist also lacks experience with FCA litigation, analogize your arguments to other legal concepts that the jurist frequently addresses in other types of litigation. For example, in a motion to dismiss, argue that FCA litigation is like fraud litigation, in that a relator's claims must be pled with specificity.

4. Recognize that the state has competing interests in the litigation. In all likelihood, the state did not initiate the FCA litigation. The state's lawyers may even agree with you, at least privately, that the whistleblower's claim lacks merit. Despite this fact, the state may not have the resources to take an active role in the matter. It may simply decline to intervene, which frees the whistleblower to proceed with the litigation on its own. This is cheaper for the state, but it does not relieve the litigation expense for the taxpayer defendant.

Even more importantly, recognize that a state's interest in helping taxpayer defendants named in unworthy cases is compromised by the fact that the state will benefit if the cases are settled rather than dismissed. At least 70 percent of the dollars paid in any settlement go to the state's coffers. In some states, a portion of the funds collected in FCA litigation go straight to the budget of the state attorney general, rather than to the general revenue funds into which tax payments typically are deposited. As a result, you may find it far easier to persuade a state official to support a nominal settlement of an unworthy FCA case than to publically support your claim that the lawsuit is meritless.

Be aware also that states must analyze their actions in the broader context of all state FCA litigation, not just tax cases. A state's lawyer may be unwilling to publically express a view that a case lacks merit for fear that it may compromise the state's ability to use the FCA in other, more worthy disputes.

5. Be wary of the power of the state. It is the "real party in interest," with strong rights of control over the litigation, even when it does not intervene, including the right to control discovery and a preferential dismissal standard. In addition, the state's approval is essential to the settlement of any FCA matter. Cultivate a strong working relationship with the state's lawyer(s) assigned to your FCA case, even if the state doesn't intervene, so you can call on the state's lawyers for assistance when needed.

6. Use joint defense groups when appropriate. If multiple lawsuits have been filed against a number of defendants on the same issue, consider forming a joint defense group to share ideas and work together on common issues. Be prepared, however, to stand out from the pack in order to emphasize the more favorable aspects of your case.

7. Call the whistleblower's bluff on unworthy cases. If the case filed by the whistleblower is meritless and, from your perspective, is worthy of a fight, aggressively defend your position. Seek to have the case dismissed. Issue discovery requests that require the whistleblower to disclose evidence supporting the required elements of its claim, including that the whistleblower is an original source, that there was no prior public disclosure of the tax issue, and any evidence of deliberate misconduct. Consider filing a counterclaim seeking your attorneys' fees and expenses on the ground that the whistleblower's claim is frivolous. Many whistleblowers file these suits hoping for a quick settlement. If you make it apparent that you intend to aggressively defend your litigation, the whistleblower may back away, focusing instead on less bothersome opponents.

8. Be prepared to settle, but recognize that you may be required to pay the whistleblower's attorneys' fees, costs and expenses. FCA lawsuits can be expensive to defend, even when the underlying tax claims are without merit. When the amount at issue is small and/or the defense to the underlying tax claim is weak, it may be cheaper for a taxpayer defendant named in FCA litigation to negotiate a settlement.

Most FCAs provide that a whistleblower that "prevails" in the litigation is entitled to its reasonable attorneys' fees, costs and expenses. Courts have ruled that a whistleblower is deemed to have "prevailed" when it enters into a court-approved settlement. In the event you decide to settle, be prepared to compensate the whistleblower for its reasonable attorneys' fees, costs and expenses, without regard to the merits of the underlying claim. Fees and expenses also can be awarded to the state.

9. Use state audits for protection. Take steps now to keep yourself from being named in this type of litigation. Disclose your "no tax" positions to state auditors and get their approval, in writing if you can (or preserved in an internal memo if you cannot). Evidence of a state's favorable review of an issue on audit is extraordinarily helpful in defeating a whistleblower's subsequent claim of a deliberate, knowing failure to collect and remit a particular tax.

10. Recognize the inherent limitation of relying upon secondary sources. Secondary sources can provide a good overview of a state's tax structure. Do not assume, however, that such sources are always up to date or accurate, or that your reliance on information contained in such sources can absolve you from any whistleblower claim. Secondary sources do miss new developments, as well as the nuances that may be created by case law.

Make sure that someone in your organization is responsible for following new state tax developments. If your organization prepares a regular survey of state tax obligations, keep the document up to date. Conduct your reviews as frequently as the title (for example "annual survey") of the document suggests.

11. Consider the risk of FCA litigation in your tax planning. When deciding whether to take a particular tax position, consider not just the possible penalties and interest associated with an adverse audit determination, but also the risk of FCA or class action litigation. Risky tax positions can be fodder for such litigation.

12. Lobby for the amendment of bad laws. Speak up in favor of the amendment of existing state FCAs to exclude tax claims, or other modifications designed to limit a whistleblower's right to file tax-related claims. The proposed amendment to the Illinois FCA statute was introduced after the House Revenue and Finance Committee held a public hearing on FCA abuse in the tax arena at which taxpayers testified about the expense and disruption caused by the litigation.

While most would agree that there are contexts in which whistleblower claims are useful in ferreting out government fraud and abuse, the use of such claims in the state tax arena is problematic at best, especially as many of such laws are currently enacted. If you have the misfortune of being named in one of these suits, rely on the above principles to guide you through the litigation.

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Second Circuit Reaffirms Taxpayer's Use of Protective Refund Claims

On September 9, 2013, the U.S. Court of Appeals for the Second Circuit issued a decision in *AmBase Corp. v. United States*, No. 12-3563 (2d Cir. 2013), affirming that the U.S. District Court for the District of Connecticut (District Court) had subject-matter jurisdiction over the taxpayer's case based on the taxpayer's use of a protective refund claim.

Background

A taxpayer must satisfy a number of hurdles before commencing a tax refund action against the United States. Even a small foot fault can deprive the refund forum, such as the district court with subject-matter jurisdiction. Subject-matter jurisdiction in a refund forum is premised on two separate filings by the taxpayer. First the taxpayer must file an administrative claim for refund with the Internal Revenue Service (IRS). Once that claim for refund is denied (or six months has passed after the filing of the claim), then the taxpayer can file a refund suit in the District Court or the U.S. Court of Federal Claims. Under Section 6511 of the Internal Revenue Code the taxpayer has the later of three years from the time the tax return was filed or two years from the time the tax was paid to file the administrative claim. The three-year limitation is increased to seven years if the claim relates to a bad debt deduction. Section 6511(d)(1). The taxpayer then has from six months after the filing of the claim up until two years after the claim's denial to file the refund suit. Section 6532. Section 301.6402-3 of the U.S. Department of the Treasury Regulations sets forth the formal requirements for filing a refund claim; however, as the Second Circuit noted, informal refund claims are also recognized as valid refund claims. See *United States v. Kales*, 314 U.S. 186 (1941). Protective claims are a type of informal claim a taxpayer may file. The Second Circuit cited to Chief Counsel Advisory 200848045, which explains "[p]rotective claims are filed to preserve the taxpayer's right to claim a refund when the taxpayer's right to the refund is contingent on future events and may not be determinable until after the statute of limitations expires."

The specific requirements for filing a proper protective refund claim, are "designed both to prevent surprise and to give adequate notice to the Service of the nature of the claim and the specific facts upon which it is predicated, thereby permitting an administrative investigation and determination." *Alexander Proudfoot Co. v. United States*, 454 F.2d 1379, 1383 (Ct. Cl. 1972) (quoting *Union Pac. R.R. v. United States*, 389 F.2d 437, 442 (Ct. Cl. 1968), cert denied, 395 U.S. 944 (1969)).

As long as the taxpayer timely files the informal protective refund claim, he or she may then file an amendment that relates back to "perfect" to the initial claim out of time. The Treasury Regulations require that the amendment be based on "one or more of the grounds set forth in a claim filed before the expiration" of the statute of limitations. Sec. 301.6402-2(b)(1), Admin. & Proc. Regs. *See also St. Joseph Lead Co. v. United States*, 299 F.2d 348, 350 (2d Cir. 1962) ("[T]he facts upon which the amendment is based would necessarily have been ascertained by the commissioner in determining the merits of the original claim".).

AmBase Corp. v. United States

AmBase Corporation sought a tax refund for its 1989 tax year based on a net operating loss carryback (NOL carryback) from its 1992 tax year. The NOL carryback resulted from an amended calculation of AmBase's affiliate, Carteret Savings Bank FA's, 1992 bad debt deduction.

Toward the end of 1992, Carteret was seized by the Office of Thrift Supervision and put into a conservatorship of the Resolution Trust Corporation (RTC) because it had failed to satisfy capital requirements under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. The receivership was transferred to the Federal Deposit Insurance Company (FDIC) in 1996. AmBase filed its 1992 consolidated federal income tax return on August 30, 1993, reporting Carteret's tax items up until Carteret's seizure; however, RTC did not provide AmBase with Carteret's post-seizure records.

On March 14, 2000, AmBase filed an amended return for the 1992 tax year proposing to increase Carteret's bad debt deduction. Also on March 14, 2000, AmBase filed an amended return for the 1989 tax year seeking to carry the NOL created on the 1992 tax return back to 1989 in order to create a refund. The IRS denied the claim and AmBase filed a complaint in the District Court on April 29, 2008.

During the proceedings, the parties agreed that under the general rules of Section 6511 AmBase had until March 31, 1998, to file the administrative claim for refund. AmBase argued that its March 14, 2000, refund claim was still timely because: (1) the bad debt deduction regulations required an amended return; (2) the March 14, 2000, refund claim related back to four earlier claims (an attachment to its original 1992 return, a note made in 1995 during a separate audit, a 1995 protective claim and a 1996 protective claim filed by the FDIC on Carteret's behalf); and (3) that the seven-year period applied. The District Court initially dismissed all of the arguments, but after AmBase produced the 1996 FDIC protective claim filed on behalf of Carteret, the District Court found that the protective claim filed by the FDIC effectively bestowed subject matter jurisdiction on the District Court.

There are three requirements to an informal protective claim: (1) the informal claim must provide the IRS with notice that the taxpayer is seeking a refund; (2) the informal claim must describe the legal and factual basis for the refund; and (3) the informal claim must have some written element. See *New Eng. Elec. Sys. v. United States*, 32 Fed. Cl. 636, 641(1995) (citing *American Radiator & Standard Sanitary Corp. v. United States*, 162 Ct. Cl. 106, 318 F.2d 915 (1963)). The Internal Revenue Manual adds a further requirement that the informal claim must identify the specific year or years for which the refund is sought. IRM 25.6.1.10.2.6.5(2) (05-17-04).

The government contended that AmBase's March 14, 2000, refund claim did not supplement the 1996 FDIC protective claim because the two claims have different factual bases. The Second Circuit disagreed. It reviewed the 1996 FDIC protective claim and found that it met the three necessary requirements of an informal claim and had put the IRS on notice of a possible future claim. The Second Circuit explained "[t]he 1996 FDIC claim addressed Carteret's bad debts and its method of calculating the bad debt deduction, and it specifically noted potential operating losses and carrybacks." Importantly, the Second Circuit recognized that an informal claim is not limited to the written component, instead "the focus is on the claim as a whole," and under the circumstances, the facts relating to the March 14, 2000, refund claim "would have necessarily been ascertained" upon consideration of the 1996 FDIC protective claim. Therefore the Second Circuit affirmed the District Court's subject-matter jurisdiction over the case.Ad ero conullaore modolessed tionulputet num ipit lummodo cons nonullaore commy nonsendit dolenibh et luptat wis alissi bla conse cor iusto del eliquam quisl ute diam dolobor perat, conum quis alit adit ing el ullan hent vullam, sis nullan henit aciduis molent vel ut alit nullaore vent la augue volor lum.

Future of Protective Claims

Informal protective claims are alive and well. Protective claims fill an important role in protecting a taxpayer's interest when the amount of the refund is unknown or may be contingent on future events. Protective refund claims have been successfully used to gain jurisdiction for many contingent refunds. *Rupert v. United States*, 358 F. Supp. 2d 421 (M.D. Pa. 2004) (taxpayers sought to establish the estate's right to deduct future payments of interest on a loan as they were paid and made certain; the validity of the protective refund was upheld, but the underlying tax refund was denied); *Cooper v. United States*, 84 AFTR 2d 99-6222 (W.D. N.C. 1999) (taxpayer's trustee in bankruptcy filed a protective refund claim due to uncertainty of the outcome of litigation related to income from a stock sale).

More recently, protective refund claims have been filed by employers to preserve their ability to obtain refunds for employment tax paid (by the employer and employee) pending resolution of the question of whether severance payments made by an employer to employees whose employment has been involuntarily terminated because of the closing of the business constitute wages for the purposes of employment tax. The government is seeking certiorari following its loss in the U.S. Court of Appeals for the Sixth Circuit, and Quality Stores opposes it. The bankruptcy court, the U.S. District Court and the Sixth Circuit all held for the taxpayer (*United States v. Quality Stores Inc.*, 693 F.3d 605 (6th Cir. 2012), aff'g 424 B.R. 237 (W.D. Mich. 2010)). However, the government won the same issue on appeal in *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008). In order to preserve refund claims, employers filed protective claims identifying the issue and claiming refunds for an amount to be determined on behalf of themselves and the affected employees.

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Challenging Regulations After *Mayo* and *Home Concrete*

In the wake of the Supreme Court of the United States' recent tax opinions in *Mayo Foundation for Medical Education & Research v. United States*, 131 S.Ct. 1836 (2011), and *United States v. Home Concrete & Supply, LLC*, 132 S.Ct. 1836 (2012) taxpayers have additional arguments at their disposal to challenge U.S. Department of the Treasury regulations. Those arguments are front and center in several pending U.S. Tax Court cases involving challenges to transfer pricing regulations.

Setting the Stage

In *Mayo*, the Supreme Court ended a decades-long debate over whether the standard of review for regulations issued pursuant to the Internal Revenue Service's (IRS's) general grant of authority under § 7805(a) was different from the standard of review for regulations issued pursuant to a specific directive in the pertinent statute. In reaching this holding, the Supreme Court rejected the idea that it should "carve out an approach to administrative review good for tax law only." Although many initially saw this decision as a victory for the IRS, others recognized the significance of the administrative law statement, which provided a clear signal that the IRS, like other federal agencies, is subject to the Administrative Procedure Act (APA) in promulgating its rules and regulations. The IRS, while acknowledging that it is subject to the APA generally, has taken the position that almost all regulations it issues are "interpretative" regulations not subject to various requirements under the APA.

After *Mayo*, appellate courts quickly applied the APA to cases involving challenges to regulations. In *Burks v. United States*, 633 F.3d 347 (5th Cir. 2011), the U.S. Court of Appeals for the Fifth Circuit noted that regulations "are generally subject to notice and comment procedure pursuant to the Administrative Procedure Act" and that the IRS's allowance for such notice and comment after final regulations were enacted was not an acceptable substitute for pre-promulgation notice and comment. In *Cohen v. United States*, 650 F.3d 717 (D.C. Cir. 2011), the U.S. Court of Appeals for the District of Columbia Circuit stated: "The IRS is not special in this regard; no exception exists shielding it—unlike the rest of the Federal Government—from suit under the APA." In *Dominion Resources, Inc., v. United States*, 681 F.3d 1313 (Fed. Cir. 2012), the U.S. Court of Appeals for the Federal Circuit invalidated regulations under § 263A as violating the APA because Treasury did not provide a reasoned explanation for deciding upon a regulation.

In *Home Concrete*, the Supreme Court rejected the IRS's attempt to overrule a prior Supreme Court opinion that had addressed the precise question under an almost identical predecessor statute. The Supreme Court pointedly held that its prior interpretation of a statute meant that "there is no longer any different construction that is consistent with [the prior opinion] and available for adoption by the agency." Because of this approach, the Supreme Court found it unnecessary to address several APA arguments advanced by the parties and amici and addressed in some of the lower court opinions on the issue. In comments reported in the tax press following the Supreme Court's decision, high-ranking government officials at both the IRS and the U.S. Department of Justice's Tax Division indicated that pre-*Chevron* decisions should be generally read as final determinations not subject to change by regulations. As discussed below, these statements are difficult to reconcile with the IRS's litigating position in pending cases involving challenges to transfer pricing regulations issued to ostensibly overrule existing case law.

As noted, the Supreme Court in *Home Concrete* did not address several APA arguments. Additionally, it did not address or clarify other issues raised by the parties, including the precise situations in which an agency can issue regulations to overrule existing judicial precedent, an agency's ability to issue retroactive regulations during litigation, and the proper role of legislative history in determining whether regulations are entitled to deference. However, several lessons can be gleaned from the opinion. Perhaps most importantly, taxpayers and courts should not blindly follow IRS guidance that conflicts with prior judicial precedent. Additionally, a coordinated approach among taxpayers may be helpful in persuading a court to invalidate a regulation. The participation of *amici*, while present in almost all Supreme Court cases, may be gaining traction in the Tax Court, as evidenced by recent filings in some high-profile cases.

Pending Challenges to Transfer Pricing Regulations

It is impossible to know how many pending cases involve challenges to regulations, whether under a general Chevron analysis or on APA grounds (or both). However, three high-profile cases in the transfer pricing arena that have received attention in the tax press are *3M Co. v. Commissioner*, T.C. Dkt. No. 5186-13, *Altera Corp. v. Commissioner*, T.C. Dkt. Nos. 6253-12 and 9963-12, and *Amazon.com, Inc., v. Commissioner*, T.C. Dkt. No. 31197-12. The first deals with Treas. Reg. § 1.482-1(h)(2), and the latter two involve Treas. Reg. § 1.482-7(d).

In *3M*, the IRS determined that Brazilian legal restrictions on the payment of royalties by a Brazilian subsidiary to its U.S. parent should not be taken into account in determining the arm's-length price between 3M and the subsidiary under Treas. Reg. § 1.482-1(h)(2). However, more than 40 years earlier, the Supreme Court in *Commissioner v. First Sec. Bank of Utah*, 405 U.S. 394 (1972), had rejected the IRS's attempt to apply § 482 where federal law prohibited the taxpayer from receiving the income the IRS was seeking to allocate to it. Relying on longstanding and basic principles of taxation, the Supreme Court noted that "[w]e know of no decision of this Court wherein a person has been found to have taxable income that he did not receive and that he was prohibited from receiving." The Supreme Court invoked the "complete dominion" doctrine, first enunciated in 1955 in the seminal case of *Commissioner v. Glenshaw Glass Co*., 348 U.S. 426 (1955), wherein it defined income to include all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." In other words, the Supreme Court held that the taxpayer could not have "income" because of the legal restrictions, and, therefore, the IRS could not use § 482 as a tool to reallocate the restricted amounts to the taxpayer.

Dissatisfied with the Supreme Court's holding, the IRS attempted to limit the scope of the opinion to federal law restrictions; however, courts universally rejected these attempts. *See, e.g., Texaco, Inc. v. Commissioner*, 98 F.3d 825 (5th Cir. 1996); *Procter & Gamble v. Commissioner*, 961 F.2d 1255 (6th Cir. 1992); *Salyersville Nat'l Bank v. United States*, 613 F.3d 650 (6th Cir. 1980). It is worth noting that, in *United States v. Basye*, 410 U.S. 441 (1973), decided shortly after *First Sec. Bank*, the Supreme Court phrased its holding as involving situations where the taxpayer "could not have received that income as a matter of law" without any distinction among federal, state or foreign law.

The *First Sec. Bank* court noted that the IRS's own regulation—Treas. Reg. § 1.482-1(b)(1) (1971)—was consistent with the complete dominion and control concept because it assumed that a group of controlled taxpayers have "complete power" to shift income. The Supreme Court also noted that its holding comported with the statement in the regulations that the "purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer."

The IRS conceded the domestic law application (Rev. Rul. 82-45, 1982-1 C.B. 89; GCM 38545 (Oct. 17, 1980)), but issued regulations in 1994 intended to overrule a foreign law application. Treas. Reg. § 1.482-1(h)(2) provides, in part, that "a foreign legal restriction will be taken into account only to the extent that it is shown that the restriction affected an uncontrolled taxpayer under comparable circumstances for a comparable period of time." Although the regulation also contains a deferred income election that permits the deferred recognition of restricted income, subject to a matching deferral of deductions, it may be difficult in most situations to meet these requirements. In promulgating the new regulation, the IRS relied on the fact that Treas. Reg. § 1.482-1(b)(1) (1971)—the "complete power" regulation cited by the Supreme Court in *First Sec. Bank*—had been repealed. Additionally, it appears that the IRS interpreted the Supreme Court's statement that its holding was consistent with the "parity treatment" provided in the § 482 regulations as meaning that *First Sec. Bank* can properly be applied only where the end result of its application is consistent with the arm's length standard underlying § 482. Finally, the IRS's position relies on an expansive view of the scope of its continuing power to issue regulations clarifying and defining the law in light of the existing judicial landscape.

The validity of Treas. Reg. § 1.482-1(h)(2) has not been challenged in a judicial proceeding in the 20 years since its promulgation. Because *3M* was only recently filed, no summary judgment motions have yet been filed on the issue, but given the legal nature of the regulations issue, it is likely that one will be filed in the near future. The Supreme Court's approach in *First Sec. Bank* of focusing on whether the taxpayer could have "income" instead of jumping straight to § 482, and the subsequent application to foreign law restrictions, provide strong support for 3M's position. Whether 3M succeeds may also depend on how the Tax Court interprets *Home Concrete* and on the Supreme Court's apparent admonition to the government that the Supreme Court has the last word.

In *Altera*, the taxpayer is challenging, under *Mayo* and the APA, the rule including stock-based compensation in the calculation of cost-sharing payments (Treas. Reg. § 1.482-7(d)(1)(iii)). The parties filed cross-motions for summary judgment in May 2013, and final briefs on the issue were filed in September 2013. (Amazon, which filed its petition after Altera, has indicated in filings that it has the same issue and appears to be awaiting the outcome of the summary judgment motions before taking any action on its own.) The crux of the taxpayer's argument is that the APA applies to the regulation at issue and the IRS failed to justify the adoption of its regulations. In *Motor Vehicle Mfrs. Ass'n of the United States Inc. v. State Farm Mutual Auto. Ins. Co*., 463 U.S. 29 (1983), the Supreme Court required that an agency "articulate a satisfactory explanation for its action, including a rational connection between the facts found and the choice made." Absent such a satisfactory explanation, the Supreme Court held, the regulation can be rejected under the APA.

The *Altera* taxpayer's argument was supported by an *amicus* brief submitted by several trade associations that described their members as being U.S. corporations representing more than $1 trillion in market capitalization and encompassing a broad cross-section of industries vital to the U.S. economy. That brief was devoted entirely to why the procedural requirements of the APA apply to IRS informal legislative rulemaking and how courts interpret APA requirements, weigh agency attempts at compliance and remedy failures to satisfy those requirements. Although the Tax Court denied the motion for leave to file the amicus brief, this is just one of several recent cases where *amici* have submitted briefs. Whether to allow *amici* to participate is discretionary, and the Tax Court has recently allowed such participation in some cases while not allowing it in others. In *Advo, Inc., v. Commissioner*, 141 T.C. No. 9 (Oct. 24, 2013), a § 199 case, the Tax Court allowed Limited Brands, Inc., and Meredith Corporation to file an amicus brief supporting the taxpayer's position subject to the IRS's request that it be allowed to file a reply to the brief. The Tax Court subsequently denied the *amici*'s request to file a response to that reply. In *Thrifty Oil Co. v. Commissioner*, T.C. Dkt. No. 1376-10, the Tax Court allowed an amicus brief by another taxpayer with the same or similar issue. After the court decided against the taxpayer in *Thrifty Oil*, it used statements by the other taxpayer in its *amicus* brief against it when its case was decided. In several recent unpublished Orders, the Tax Court has examined whether "the proffered information is timely, useful, or otherwise helpful." The court has also considered whether *amici* are advocates for one of the parties, have an interest in the outcome of the case, and possess unique information or perspective.

Pending Challenges to Transfer Pricing Regulations

Taxpayers that have followed the regulations at issue in the above cases should consider filing protective refund claims in the event the regulations are ultimately invalidated. In general, the statute of limitations for tax refund claims is three years from the filing of the relevant return (or two years from the date of payment, if later). If the IRS issues a notice of claim disallowance, the taxpayer must either bring suit to contest the disallowance within two years after the issuance of this notice or obtain an extension of time to file such a suit with the IRS. The latter process can be initiated by filing IRS Form 907, Agreement to Extend the Time to Bring Suit. For more information, see "Second Circuit Reaffirms Taxpayer's Use of Protective Refund Claims." For future filings, taxpayers should consider whether to file Form 8275-R, Regulation Disclosure Statement, to further protect against penalties for positions contrary to regulations.

Additionally, taxpayers that are aware of pending cases involving the same or similar issues may want to consider coordinating their efforts. This could take the form of engaging in dialogue with other taxpayers on legal arguments and strategy, or seeking to participate in a case as an amicus. The ultimate decision on whether to coordinate, and in what manner, depends on several factors and should be considered as part of an overall strategy in defending one's case against the IRS.

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McDERMOTT TAX CONTROVERSY HIGHLIGHTS

McDermott Named "Tax Litigation Firm of the Year" by U.S. News & Best Lawyers

McDermott Will & Emery has been named "Law Firm of the Year" in the area of Tax Controversy in the 2014 "Best Law Firms" survey published by U.S. News Media Group and Best Lawyers. The Firm was awarded national Tier 1 rankings across 22 practice areas including: Antitrust Law; Biotechnology Law; Commercial Litigation; Corporate Law; Employee Benefits; Energy Law; Environmental Law; Health Care Law; International Trade and Finance Law; Litigation (Antitrust, Environmental, ERISA, Intellectual Property, Patent, Regulatory Enforcement, Securities, and Tax); Patent Law; Securities/Capital Markets Law; Tax Law; Trust & Estates Law and Venture Capital Law.

Questions concerning the information contained in this newsletter may be directed to your regular McDermott Will & Emery lawyer or the editor listed below:

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