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Federal Tax Cases To Watch In 2021

By **Amy Lee Rosen**

Law360 (January 3, 2021, 2:24 PM EST) -- In 2021, courts will examine administrative law challenges to microcaptive and conservation easement tax regulations, what qualifies for a domestic manufacturing deduction and whether partnership disguised sale rules apply to an ownership transaction involving the Chicago Cubs baseball team.

Here, Law360 looks at four federal tax cases to watch in the first half of the year.

CIC Services v. IRS

A case involving a preenforcement challenge to an Internal Revenue Service notice requiring the disclosure of potentially abusive microcaptive insurance arrangements was recently heard by the U.S. Supreme Court. The court's ultimate finding in the case could potentially impact the ability to challenge other types of informal tax guidance.

In December, the Supreme Court heard scheduled arguments on whether an insurance company has the right to argue the IRS had to follow formal rulemaking processes under the Administrative Procedure Act when it issued Notice 2016-66, which characterized certain microcaptive insurance transactions as potentially abusive. Under the 2016 notice, those engaged in such transactions are required to disclose them to the IRS on an information return or potentially face penalties.

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.

During oral arguments Justice Brett Kavanaugh suggested the Supreme Court may need to create an exception to allow insurance company CIC Services LLC to challenge the IRS guidance in court without first violating the informational reporting requirement.

"Shouldn't we carve out an exception … when the penalties for trying to challenge something are so high that it's going to be coercive and effectively deter you from bringing this kind of challenge in the first place?" Justice Kavanaugh asked.

The Supreme Court is reviewing the Sixth Circuit's May 2019 affirmation that CIC Services was barred from continuing its suit under a provision of the APA that allows challenges to agency guidance before it is violated. The court said the action was prohibited by the Anti-Injunction Act, which forbids any lawsuit with the purpose of restraining the collection of taxes.

Michelle Levin, a tax partner at Sirote & Permutt PC, said that the CIC Services case will ultimately clarify whether the AIA bars such preenforcement lawsuits and that hopefully the Supreme Court will provide guidance on whether certain agency actions can be challenged by taxpayers prior to enforcement.

"Congress is using the IRS more and more to implement wide-scale policy decisions," Levin said. "If the IRS can issue regulations without following the procedural safeguards of the APA, the American public could face penalties and fines, or lose access to congressionally intended benefits, based on ambiguous and unexplained regulations."

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

Oakbrook Land Holdings LLC v. Commissioner

Oakbrook Land Holdings v. Commissioner, a case involving the validity of conservation easement regulations that resulted in a divided opinion by the U.S. Tax Court, is worth monitoring on appeal before the Sixth Circuit since it could potentially jeopardize many conservation easement donations and their related tax deductions.

A conservation easement gives a donee a right to permanently limit the development of a piece of land in places such as farms, ranches and forests while giving the donor the benefit of a tax-deductible charitable donation under Section 170 of the tax code.

In May, the Tax Court upheld regulations dating from the 1980s requiring conservation easements to be protected indefinitely to qualify for a tax deduction. The court found investors in a tract of Tennessee land could not claim a $9.5 million charitable deduction because language in the deed's extinguishment clause, which covers how proceeds are distributed if a court nullifies the easement for public reasons, ran afoul of those perpetuity rules.

The court supported the IRS' denial of deductions for Oakbrook's 2008 donation because the deed stipulated if the easement were extinguished, the donee would get a share of proceeds equal to the easement's fair market value when it was donated, reduced by the value of improvements that the donor made. That amounted to a violation of the extinguishment clause regulations, the Tax Court found.

Robert Ramsay, the president of Partnership for Conservation, said extinguishment can happen when a court needs to condemn part of the easement so the public can benefit from it, such as by installing a power line, but such instances are very rare. However, since many conservation easements use similar extinguishment language, they and their associated tax breaks could potentially be in jeopardy depending on how the courts eventually rule in the Oakbrook case, he said.

"Ostensibly whether you donated an easement through a partnership, individual or family trust, if this language is included in your easement, then I would just be nervous because it's certainly something the IRS is pursuing and would like to see go their way," he said.

Many people involved in the conservation field are carefully watching the Oakbrook case, which has been appealed by both the company and the IRS to the Sixth Circuit, said Nicole Elliott, a tax partner at Holland & Knight LLP.

"A taxpayer-favorable decision at the Sixth Circuit could have broad impact [because] the language at issue is found in many easement documents," she said.

For example, in another Tax Court decision, Hewitt v. Commissioner, the court found an Alabama couple could not take a $2.7 million carried-forward tax deduction because their charitable conservation easement deduction also violated the perpetuity clause.

Oakbrook could affect Hewitt as well as other, similar cases involving the extinguishment clause, Elliott said.

The case is Oakbrook Land Holdings LLC, William Duane Horton, Tax Matters Partner v. Commissioner of Internal Revenue, case numbers 20-2117 and 20-2141, in the Sixth Circuit.

Tribune Media Company v. Commissioner

On the line in Tribune Media Co. v. Commissioner is whether partnership disguised sale rules apply to the transfer of ownership interests in the Chicago Cubs baseball team, which could result in the former owners being on the hook for millions in underpaid taxes and penalties.

The owner of the Chicago Tribune newspaper as well as the holding company for the Chicago Cubs used to own the baseball team, but later transferred their ownership interests to the Ricketts family, according to court documents. Tribune and the holding company transferred ownership through a partnership transaction that may or may not have been "cleverly structured" to avoid the partnership disguised sale rules, said Glenn Dance, a tax partner at Holthouse Carlin & Van Trigt LLP.

The Tax Court already granted the IRS a partial win in the case in January 2020 by upholding 40% gross valuation misstatement penalties, saying the government properly followed Section 6751(b)(1) of the Internal Revenue Code in securing managerial approval for the initial determination of that penalty. However, an unresolved issue that went to trial in October gets to the effectiveness of guarantees put in place by Tribune to avoid gain recognition when it pocketed the proceeds of a loan taken out by the partnership that owns the club, Dance said.

"The primary issue is whether a guarantee of partnership debt entered into by the Tribune to monetize its interest in the team will be respected," Dance said. "If the guarantee is not respected, a transaction that was treated as a nontaxable leveraged distribution would instead generate an extremely large tax liability."

The IRS originally asserted a tax deficiency of $181.7 million and a 40% penalty of $72.7 million stemming from the 2009 sale of the Cubs, which resulted in the formation of Chicago Baseball Holdings LLC. The IRS characterized the transaction as a disguised sale, resulting in the deficiency and penalty. Tribune and CBH sued the IRS in Tax Court to dispute the IRS findings.

Dance, who told Law360 he worked on the case when he was with the IRS, said it is important because of the history behind the use of guarantees of leveraged distribution of debt as a strategy to avoid the partnership disguised sale rules.

Several years ago the government issued temporary regulations that were intended to shut down the use of this strategy, but those temporary rules were included in the Trump administration's list of Obama-era regulations that it said should be repealed, he said.

"Once the regs were repealed, it was back to business as usual for practitioners in the partnership tax community," Dance said. "The government seems determined to use cases like this as an alternative way to curtail the use of this technique, by attacking the 'economics bona fides' of the type of guarantee arrangements that aggressive tax planners favor."

The case is Tribune Media Co. et al. v. Commissioner of Internal Revenue, docket numbers 20940-16 and 20941-16, in the U.S. Tax Court.

BATS Global Inc. v. Commissioner

Financial technology company BATS Global Inc. will battle an IRS notice of deficiency in an upcoming Tax Court trial over whether it can take a domestic manufacturing software deduction for electronic trading software that receives, sorts, ranks and matches orders to buy and sell securities.

While the Tax Cuts and Jobs Act repealed the domestic manufacturing deduction the company took under Section 199 of the IRC, the case is important because other businesses that have previously claimed the deduction could face similar IRS scrutiny, said S. Starling Marshall, a tax partner at Crowell & Moring LLP.

Section 199 "by its terms was meant to include computer software, but does not include services, so the fight really has been whether the taxpayer is developing software or selling a service," she said. "Basically the IRS has taken a very, very narrow view on what kind of software would qualify for the credit."

The case was originally scheduled to go to trial in April but was postponed due to the COVID-19 pandemic. Practitioners are eager to see what happens during the new remote trial, which has been scheduled to begin May 24, 2021, Marshall said.

Section 199 was part of the American Jobs Creation Act, which Congress passed in 2004. It provided a phased 3%, then 6% and eventually 9% deduction on either qualified production activity income or the taxpayer's taxable income — whichever was lower. The deduction was available for domestic production gross receipts from the taxpayer's manufacturing, production, growth or extraction of tangible personal property such as computer software and sound recordings, but not land and buildings.

The regulations for Section 199 said the credit could be used for domestic production, and to qualify, companies needed to show that what was being sold was a product and not a service, Marshall said. A party could demonstrate software was a product by either meeting what was called the self-comparable test or a third-party comparable test, but both were difficult to prove and don't reflect how computer software is developed and sold now, she said.

Under the self-comparable test one had to show that software that could be used or downloaded online could also be made in a way that it was affixed to a tangible medium, such as a compact disc, to show it was a product and not just a service, Marshall said. This is less realistic in today's world, in which most laptops don't even come with a CD drive, she said.

The third-party comparable test was also difficult to meet because it required showing that another company made similar computer software affixed to a tangible medium, but a competitor would have been disinclined to share code to help a rival meet the test, Marshall said.

"The fact that we would have to show someone is delivering it through a 'tangible medium' is just not reflective of how we use software now," she said. "There is software in our cars, in our refrigerators, and we think that now we are constantly connected to the internet."

"Maybe in 2004 that might have been the case … but now there are a lot of arguments that the software is a product no matter how it's delivered," she said.

The case is BATS Global Markets Holdings Inc. and Subsidiaries v. Commissioner of Internal Revenue, docket number 1068-17, in the U.S. Tax Court.

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