Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Top 5 Federal Tax Cases Of 2019: Midyear Report

By **Amy Lee Rosen**

Law360 (July 3, 2019, 5:04 PM EDT) -- In the first half of 2019, federal courts ruled on the deference level for an agency's regulatory interpretation, a clergy housing tax exemption's constitutionality and whether U.S. expatriates can claim foreign tax credits on amounts paid toward social security in France.

Here, Law360 examines five of the most important tax decisions in federal courts from the first half of 2019.

Kisor v. Wilkie

The U.S. Supreme Court, in one of the last decisions of the term, upheld its long-standing precedent requiring judges to defer to how an agency interprets its own regulations, but said the doctrine should be narrowed to apply only when such deference is warranted.

The U.S. Supreme Court's rulings on the taxability of compensation for lost wages and on judicial deference to agencies' interpretations of their own regulations were among the most significant tax decisions in federal courts so far this year. (AP)

In the case, James Kisor, a Vietnam veteran seeking disability benefits for his post-traumatic stress disorder, argued that the U.S. Department of Veterans Affairs based its decision to deny his claims on a flawed interpretation of its own regulation, and that the Auer doctrine compelled the Federal Circuit to accept that interpretation anyway.

Kisor challenged the precedent set in the high court's 1997 decision in Auer v. Robbins, in which the court said judges should defer to an agency's interpretation of its own rule unless that interpretation is plainly erroneous. Auer expands upon the two-step standard of review set under the Supreme Court's 1984 decision in Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc., which said judicial deference is appropriate when an agency's interpretation is not unreasonable and if Congress has not already spoken directly on that issue.

While the court decided to uphold Auer deference, it also outlined the limitations of the doctrine, which means that the Kisor decision will likely have a decades-long effect on how the Internal Revenue Service analyzes and applies ambiguous regulations, according to Jean A. Pawlow, a partner at Latham & Watkins LLP.

The Tax Cuts and Jobs Act "and the complex regulations that were issued (and that still need to be issued) with respect to it are likely to be a fertile ground for dispute" in the wake of Kisor, she told Law360.

Andrew R. Roberson, a partner at McDermott Will & Emery LLP, told Law360 that in Kisor the Supreme Court seemed to suggest that an interpretation raised for the first time in litigation by an agency should not be given deference when the agency is a party to the litigation.

"This would encompass interpretations raised for the first time on brief by the IRS in [the U.S.] Tax Court or the [Department of Justice's] Tax Division in refund courts or Courts of Appeal," Roberson said.

The U.S. Department of the Treasury issued a separate statement in March that said it will not seek Chevron or Auer deference in the U.S. Tax Court for interpretations published as subregulatory guidance, such as revenue rulings and revenue procedures.

The case is Kisor v. Wilkie, case number 18-15, in the U.S. Supreme Court.

BNSF Railway Co. v. Michael D. Loos

The U.S. Supreme Court weighed in on a question of textual interpretation when it decided in March that a railroad company's compensation for an injured employee's lost wages was taxable because the statutory definition of "compensation" for railway workers under the Railroad Retirement Tax Act, or RRTA, is similar to the definition of "wages" under the Social Security system.

Justices overturned an Eighth Circuit decision that personal injury awards for railroad employees cannot be taxed. In the case, BNSF was trying to reduce more than $125,000 in damages that a Minnesota federal court had awarded former employee Michael Loos following a knee injury in a BNSF train yard. The lost wages portion of that award was $30,000, and BNSF argued that it had already paid $3,765 to the Internal Revenue Service as Loos' share of payroll taxes. Loos had also received credit toward his retirement benefits for the time-lost payment, it said in its bid to deduct payroll taxes from Loos' compensation.

Mary B. Hevener, a partner at Morgan Lewis & Bockius LLP, told Law360 that Loos was "a very weird case" because it dealt with an individual who was allowed to get an RRTA wage credit for his payments while trying to be exempted from RRTA taxes, and she noted that even the railroad that had employed him argued the RRTA taxes should apply to those payments.

"I thought he MIGHT win, because technically the payment was not 'income' because it was for a physical injury — but I think the case turned on the fact that the RRTA wage credit regulations allowed him wage credit and the Supreme Court felt it appropriate to impose RRTA taxes on the payment," she said. "I don't know of anything like that in the [Federal Insurance Contributions Act] world."

The case is BNSF Railway Co. v. Michael D. Loos, case number 17-1042, in the U.S. Supreme Court.

CIC Services LLC v. Internal Revenue Service

A split Sixth Circuit panel in May affirmed a court order that dismissed a challenge to IRS guidance branding some small, in-house insurance companies as tax shelters and requiring them to be disclosed. The panel said in a 2-1 decision that the Anti-Injunction Act barred insurance company CIC Services LLC

from challenging IRS Notice 2016-66, which had labeled certain “microcaptive" insurance arrangements as transactions of interest that have a potential for tax avoidance and must be reported to the agency under the threat of penalties.

The court rejected CIC’s argument that the notice violated the Administrative Procedure Act since it did not go through a notice-and-comment period.

Gal N. Kaufman, an attorney at Holland & Knight LLP, told Law360 the case is not very significant within the insurance industry because the IRS notice achieved its desired result of chilling the creation of new microcaptive arrangements. However, if the case is appealed, either en banc to the Sixth Circuit or to the Supreme Court, it could result in a ruling on the reach of the IRS' authority, Kaufman said.

"I think that’s what this case really stands for," he said. "It stands for the belief that federal agencies are overreaching more and more, and taxpayers like CIC are taking a stand against that overreach."

The case is CIC Services LLC et al. v. Internal Revenue Service et al., case number 18-5019, in the U.S. Court of Appeals for the Sixth Circuit.

Gaylor v. Mnuchin

The Seventh Circuit determined in March that a clergy housing tax exemption was constitutional because it was neutral toward religion and did not violate the free exercise or establishment clauses of the U.S. Constitution.

In its decision, a three-judge panel overturned a Wisconsin federal court's decision that Internal Revenue Code Section 107(2), which excludes from taxable income housing allowances paid to a “minister of the Gospel,” was unconstitutional because the plain language of the statute showed a preference for ministers over secular employees.

The atheist group that initiated the lawsuit decided not to appeal the Seventh Circuit's decision because it did not believe the Supreme Court would rule in its favor.

Samuel D. Brunson, a professor at Loyola University Chicago School of Law, said he thought that the decision was not surprising but that the choice by the group, Freedom From Religion Foundation, not to appeal the decision was unexpected. He noted that the litigation had been ongoing since at least 2013, when the district court found the parsonage allowance unconstitutional.

“There may be challenges to it again in the future, but right now, the decision has given certainty to ministers of the Gospel and their employer-churches,” he told Law360.

The case is Annie Laurie Gaylor et al. v. Steven Mnuchin et al., case numbers 18-1277 and 18-1280, in the U.S. Court of Appeals for the Seventh Circuit.

Eshel et al. v. Commissioner of Internal Revenue

The IRS decided in June to drop its litigation against a couple with dual U.S. and French citizenship that the agency had said were not allowed to claim foreign tax credits for payments made in France related to the country’s social security system .

Later that month, the IRS issued a statement saying it will no longer challenge other foreign tax credit claims related to the French social security system. It did so in light of diplomatic communications this year between the U.S. and France, the IRS said.

In the case, the Tax Court ruled in 2014 that because the French taxes “amend or supplement” French social security laws specified in a totalization agreement, they qualify as payments made in accordance with the agreement. Therefore, they can't be credited against U.S. income tax liability, the Tax Court said. But the D.C. Circuit reversed and remanded the Tax Court's decision in August 2016, ruling that “insufficient consideration was given to the text and the official views of the United States and French governments.”

Ryan J. Kelly, a partner at Alston & Bird LLP, said the case is important for many American citizens who live in France because they will be able to claim foreign tax credits.

“Those same American citizens may also be able to claim tax refunds for previous tax years given that the IRS has conceded the issue,” he said. “The tax refund claims could exceed $100 million.”

The case is Eshel et al. v. Commissioner of Internal Revenue, case number 8055-12, in the U.S. Tax Court.

--Additional reporting by Jimmy Hoover, Elise Hansen, Vidya Kauri, Yvonne Juris, Eric Kroh and Natalie Olivo. Editing by Tim Ruel and John Oudens.