IN THE COURTS

Wheeler Trigg O'Donnell Gets Millions in Tax Liability Reversed for IBM

Court finds Golden erred in two separate audits

BY **JULIA CARDI**
LAW WEEK COLORADO

Wheeler Trigg O'Donnell recently represented IBM in a Denver bench trial against the City of Golden that resulted in the court invalidating certain tax assessments on IBM from 2006 to 2012 and also nullifying a 50 percent penalty. In the decision, Denver District Court Judge John Madden wrote a judgment from previous litigation in Jefferson County court about a tax assessment from 2003 to 2005 did not preclude IBM from litigating this case's issues, because the Jefferson County court based its previous decision on IBM's failure to provide information.

"This is a recurring issue," said WTO president Hugh Gottschalk, who represented IBM along with Pawan Nelson. "The money that Xcel pays to IBM for its contract services…is a repeating thing, and so if it is ultimately concluded, it has recurring significance. It's about getting the law and the taxability of these payments right, both for this time period and for current and future time periods."

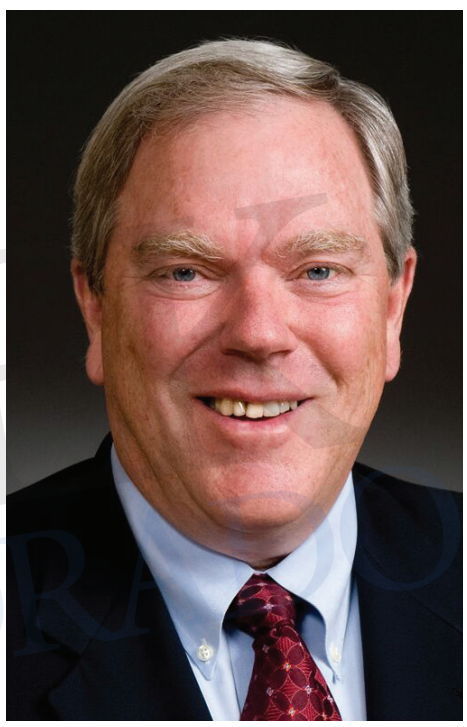
In an email through a city spokesperson, Golden's finance director Jeff Hansen declined comment beyond saying the city is "disappointed with the decision." He confirmed the city will decide in a July 26 executive session with City Council whether to appeal the judgment.

According to the judgment, the case arose from IBM's business relationship with Xcel Energy, in which Xcel and its predecessor companies have outsourced their information technology department to IBM since 1995. IBM provides services to Xcel in multiple states and data centers, in-

CONTINUED ON PAGE 20…

"It's about getting the law and the taxability of these payments right, both for this time period and for current and future time periods."

—Hugh Gottschalk, commercial litigator



HUGH GOTTSCHALK

CONTINUED

10TH CIRCUIT MARIJUANA
CONTINUED FROM PAGE 12 ...

Since the Drug Enforcement Agency still considers marijuana a Schedule 1 controlled substance, no federal tax deductions are available to state-legal cannabis businesses. As a result, pot companies pay an effective tax rate upward of 80 percent.

"It's really simple," said Dean Heizer, an attorney for LiveWell, one of the state's largest marijuana companies, "280e operates exactly the way it was designed to operate; it strips the profit out of businesses selling drugs that the [federal government] has on Schedule 1. What that means from the business perspective is we're a very high volume, low margin business — and that's the only way to make a profit."

The recent 10th Circuit case dealt with a Breckenridge-based medical marijuana company, Alpenglow Botanicals, which is owned and operated by Charles and Justin Williams. The government audited Alpenglow's 2010, 2011 and 2012, tax returns — cannabis companies are audited at a much higher rate than other businesses—and subsequently the IRS issued the company a "Notice of Deficiency concluding that Alpenglow had 'committed the crime of trafficking in a controlled substance in violation of the [Controlled Substances Act]' and denying a variety of Alpenglow's claimed business deductions under 280e."

> *"The 10th Circuit has confirmed what we have known for years, which is that these state-legal, federally-illegal businesses are in a tough tax jam because of the federal illegality of marijuana."*
>
> — Tom Downey, director at Ireland Stapleton Pryor & Pascoe

According to the 10th Circuit opinion, the determination from the audit resulted in Charles Williams owing the IRS an additional $24,133 and Justin Williams owing and additional $28,961. (The owners had attempted to take deductions for things such as rent for their business, labor costs, advertising, business taxes and licenses, and wages and salaries.) Williams and Williams both paid up and then filed for a refund, which was denied; the pair then filed suit in U.S. District Court for the District of Colorado hoping to topple the decision by the IRS.

In the complaint, the plaintiffs argued, among other things, "the IRS' decision to apply 280e was arbitrary because it had no evidence Alpenglow trafficked in a controlled substance." Siding with the IRS, the 10th Circuit affirmed the lower court ruling.

"Practically, it's a fascinating opinion, although it is legally unremarkable" said Tom Downey, a director at Ireland Stapleton Pryor & Pascoe. "The 10th Circuit has confirmed what we have known for years, which is that these state-legal, federally-illegal businesses are in a tough tax jam because of the federal illegality of marijuana." Downey said the only thing that's likely to help state cannabis businesses is either federal legislation declassifying marijuana as a controlled substance or an amendment to the tax code.

Gilmer agreed. "At least as we're seeing it now, this case kind of affirms what most of us have been operating under — it's a known dilemma," he said. "Can we interpret how a different set of facts might play out? No. That's sort of the beauty of the law, right?"

Last month, Sens. Cory Gardner of Colorado and Elizabeth Warren of Massachusetts, two strange political bedfellows, introduced the STATES Act, which would give states the freedom to regulate marijuana without interface from the federal government, including access to banking. Importantly, one aspect of the bill would carve out a new space in the tax code so that marijuana businesses were not impacted by 280e.

Heizer favors the bill's proposed solution to the 280e problem. "I have been a primary advocate of not trying to fight the fundamental questions at issue in Alpenglow in court," he said. "You're not going to win an argument about the application of 280e."

Tax attorney Nick Richards of Dill Dill Carr Stonbraker & Hutchings thinks it's a bit unfortunate cases like Alpenglow have landed in the courts. "It's not good for the industry and doesn't show that the industry wants to be a good citizen taxpayer," Richards said. "[This case] was a losing proposition from the start."

Judicial challenges aside, the STATES Act is not the industry's only hope; according to Richards, there are more bills pending to change 280e now than ever before. They're just all stuck in committee. Problem is, said attorney Pat Oglesby, founder of the Center for New Revenue, a tax policy nonprofit base in North Carolina, fixing the 280e dilemma is a revenue loser; he said the federal government pulls in an estimated $5 billion over a 10-year period in money not lost to these would-be deductions. "The money itself is not huge," Oglesby said. "There's just a reluctance to pass tax cuts for anybody."

Nevertheless, Heizer said he remains hopeful. "We pay our taxes and use a substantial amount of what's left-over, which isn't a lot, to petition our government," he said. "The net margin in this business, if you're paying your taxes, is between 3 and 5 percent. If anyone tells you they're making more money than that they're either lying—or not paying your taxes." He added: "[The STATES Act] is a potentially history making piece of legislation; we just have to get it past Mitch McConnell." •

— Chris Outcalt, COutcalt@circuitmedia.com

LAWYER SELF-ASSESSMENT
CONTINUED FROM PAGE 9 ...

vey information strictly confidential when it's shared with them. The point of the confidentiality requirements is to encourage lawyers to take the survey and have those candid conversations, Yates said. "It's more that because it's confidential, it will encourage people to take the assessments and talk with other attorneys about their assessment answers."

Attorneys can earn free CLE credit for taking the self-assessment survey. They are encouraged to discuss their survey responses with supervisors or mentors, as well, and the PMBP subcommittee is working out an arrangement with the Colorado Attorney Mentoring Program for lawyers to earn additional CLE credit if they do a survey peer review through CAMP.

The subcommittee is presenting an all-day seminar and webcast on the self-assessment program Tuesday at the Colorado Bar Association CLE. Attendees can earn ethics CLE credits at the seminar, which will not only cover the self-assessment itself but also educate on the various lawyering practices the survey addresses.

Yates and White said that the survey, while it is 10 sections long, doesn't have to be completed in one sitting. Survey takers' progress is saved if they choose to fill it out section by section. White said that the self-assessment program is meant to "evolve over time," and survey takers are encouraged to give feedback on the survey through a form that's provided in the online version. •

— Doug Chartier, DChartier@circuitmedia.com

IBM VERDICT
CONTINUED FROM PAGE 11 ...

cluding Golden. Fees paid to IBM by the energy company include "fixed management fees," "variable charges," and "pass through" charges. In exchange for the fixed management fees and variable charges, IBM does not sell any tangible personal property, equipment, hardware or software to Xcel.

By contrast, pass-through transactions fell outside of the regular IT services agreement between Xcel and IBM. In such a situation, the parties would enter into a contractual Statement of Work defining the new project's scope and the associated fees. The fees were treated as pass-through transactions and listed separately from the fixed management fees and variable charges.

In the judgment, the court found Golden city auditor Ken Keeley erred when he classified certain services provided to Xcel by IBM as taxable telecommunications services. Keeley also erred, the court found, when he assessed sales taxes to IBM on some fixed management fees and variable charges when in fact, IBM had not sold any tangible personal property, equipment, hardware or software as part of those transactions and they should not have been taxable.

In the July 1 judgment, the court invalidated tax assessments resulting from two audits Golden conducted of IBM, one spanning tax years 2006 to 2008 and the other 2009 to 2012. IBM had appealed the assessments to the Colorado Department of Revenue, which concluded the challenge was precluded due to the outcome of litigation of a tax assessment from a 2003 to 2005 audit of IBM. The Department of Revenue concluded the IT services agreement at issue in the present case was substantially similar to the one that covered the earlier period.

The Denver District Court disagreed with the department's finding based on the doctrine of issue preclusion. The court also disagreed with Keeley's conclusion during his audit that IBM's sales journal was unreliable because of the inaccurate recordings of a few details about select transactions. The court disagreed with Keeley's decision to subsequently rely on IBM's chargeback database, rather than its sales journal and purchase journal, to estimate the company's tax liability.

According to a news release posted to WTO's website, Golden attempted to recover a total of $6.1 million from IBM, which included a 50 percent penalty assessed by the Department of Revenue for sales and use tax delinquency from the 2006 to 2008 and 2009 to 2012 audit periods.

IBM voluntarily conceded tax liability of $24,307.54 for several pass-through transactions, and the court found an additional liability of $8,588.59. The court vacated the remainder of the assessed taxes spanning from 2006 to 2012, as well as the 50 percent liability.

The court found Golden improperly assessed taxes on IBM from the 2009 to 2012 audit because the audit was not based on any actual audit work. Instead, Golden assessed the taxes based on the 2006 to 2008 audit findings, because Keeley left his position with Golden and Hansen instructed him to issue an assessment rather than assign the audit to another city auditor.

"No audit work was actually conducted during the 2009-2012 Audit," states the court's judgment. "Furthermore, IBM was not given an adequate opportunity to provide information before Golden issued its assessment for the 2009-2012 period."

In a different news release, WTO characterized the case as significant outside Golden as well.

"Golden is not alone among municipalities that take an aggressive approach to taxation," states the release. "The outcome serves as an example for businesses that make good-faith efforts to cooperate with municipalities on taxation issues, yet which will push back hard against the misapplication of tax law when they believe they are being unfairly targeted." •

—Julia Cardi, JCardi@circuitmedia.com