May 4, 2012

Reasserting Its Role as Final Interpreter of the Law, the Supreme Court Rejects IRS "Fighting Regulation" in *United States v. Home Concrete & Supply, LLC, et al.*

By Robert A.N. Cudd, Edward L. Froelich, James E. Merritt and Bernie J. Pistillo

On April 25, 2012, the Supreme Court issued a 5-4 opinion, written by Justice Breyer, concluding that Treasury Regulation § 301.6501(e)-1(a)(iii) was invalid. The regulation required overstatements of basis to be treated as substantial omissions of gross income under Internal Revenue Code § 6501(e)(1)(A) to the extent such overstatements resulted in a reduction of income exceeding 25% of the reported gross income. Under this Code section, a six-year statute of limitations period on assessment of tax would then apply to the return, reflecting the overstated basis instead of the general three-year limitations period.[1] The Court's rejection of the regulation was based on (i) the principle of *stare decisis* in respect of the 1958 Supreme Court opinion on point, *Colony, Inc.* v. *Commissioner*, 357 U.S. 28, and (ii) a clarification of its deference jurisprudence. With last year's high court decision in *Mayo Foundation for Medical Education & Research v. United States* ("*Mayo*"), in which the Court upheld notice and comment regulations in view of ambiguous statutory language, and the 2005 decision in *National Cable & Telecommunications Association v. Brand X Internet Services* ("*Brand X*"), which endorsed agency rules over contrary prior judicial decisions, the Government likely anticipated victory in this case. It came close. The Court issued a 5-4 decision. Justice Scalia provided the fifth vote for the majority, joining all but one subpart of Justice Breyer's opinion, and also wrote a separate concurrence. Justice Kennedy penned the dissent, which reasoned that amendments to the Code since *Colony* indicated that the relevant provision now had a different meaning. As a result of the decision, on April 30, the Court disposed of nine cases, including vacating Government-favorable decisions in the Tenth, D.C., and Federal Circuits.

ISSUANCE OF FINAL REGULATIONS

The Treasury and IRS promulgated the regulation at issue in an attempt to salvage audits involving certain tax shelters that apparently depended upon an overstatement of basis to achieve the desired tax benefit. Faced with a three-year limitations period, the IRS was prevented from assessing a number of taxpayers who had engaged in these shelter transactions. The remedy, which the Treasury found readily at hand, was to promulgate what are commonly called "fighting regulations." The IRS had previously attempted to litigate the position that the statute itself provided for the basis overstatement rule and later issued temporary regulations to support that position. The judiciary was not entirely receptive to either approach. *See Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009) (rejecting IRS's proposed construction of statute) and *Intermountain Insurance Service of Vail v. Commissioner*, 134 T.C. 11 (2010) (holding temporary regulations were invalid). (The Tax Court was later reversed by the D.C. Circuit, 650 F.3d 691 (D.C. Cir. 2011).)

[1] The purpose of this enhanced limitations period is to allow the IRS extra time to discover the omission in the return which is less susceptible to discovery on audit.

The Government enjoyed some success after the issuance of the final regulation in December 2010. *See Beard v. Commissioner*, 633 F.3d 616 (7th Cir. 2011); *Grapevine Imports, Ltd. v. United States*, 636 F.3d 1368 (Fed. Cir. 2011); and *Salman Ranch Ltd. v. Commissioner*, No. 09-9015 (10th Cir. 2011). However, the Fourth and Fifth Circuits prevented a complete sweep of the appellate bench. *See Home Concrete & Supply, LLC v. United States*, 634 F.3d 249 (4th Cir. 2011) (invalidating regulation) and *Burks v. United State*s, 633 F.3d 347 (5th Cir. 2011) (same). Central to the Government losses was the Supreme Court decision in *Colony* in which the Court rejected the Government's interpretation with respect to materially identical statutory language in the predecessor 1939 Internal Revenue Code. In the preamble to the final regulations, the Treasury and IRS explained the basis for their authority despite the *Colony* decision:

> The Supreme Court stated in Colony that the statutory phrase "omits from gross income" is ambiguous, meaning that it is susceptible to more than one reasonable interpretation. The interpretation adopted by the Supreme Court in Colony represented that court's interpretation of the phrase but not the only permissible interpretation of it. Under the authority of Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 982-83 (2005), the Treasury Department and the Internal Revenue Service are permitted to adopt another reasonable interpretation of "omits from gross income," particularly as it is used in a new statutory setting. See Hernandez-Carrera v. Carlson, 547 F.3d 1237 (10th Cir. 2008) (agencies are free to promulgate a reasonable construction of an ambiguous statute that contradicts any court's interpretation, even the Supreme Court's).

T.D. 9511 (December 17, 2010). *Brand X* established a reasonable basis upon which the Government could proceed with its own interpretation despite *Colony*. Moreover, subsequent to the issuance of the final regulation, *Mayo* clearly removed the stigma that once attached to "fighting regulations." *See* 131 S. Ct. 704 (2011) (finding immaterial whether a regulation was "prompted by litigation"). Thus, in view of this modern deference jurisprudence, the Government appeared well-positioned to persuade the bench to set aside *Colony*'s five-decade-old conclusion and validate the regulation.

COLONY IS NOT ABANDONED

Colony was decided well before *Chevron*, in which the Supreme Court determined that a decision regarding whether a statute was ambiguous was the first step to evaluating whether agency action should be respected. The Government was reading *Colony* as if it had been decided under the *Chevron* jurisprudence that was later developed by the Court. The Justices disagreed with that interpretational approach to its 1958 decision. As Justice Breyer explained for four Justices in the plurality portion of the opinion:

> But the Court decided that case nearly 30 years before it decided *Chevron.* There is no reason to believe that the linguistic ambiguity noted by *Colony* reflects a post-*Chevron* conclusion that Congress had delegated gap-filling power to the agency. At the same time, there is every reason to believe that the Court thought that Congress had "directly spoken to the question at hand," and thus left "[no] gap for the agency to fill."

Slip op. at 10 (citations omitted). While not joining that explanation, Justice Scalia noted in his separate concurrence that the Court in *Colony* considered all the factors it needed to resolve any ambiguity about the statutory language and rejected the Government's expansive interpretation of the statute. Scalia, J. Op. at 5. The majority of the Court, through

Justice Breyer, also briefly addressed and rejected the Government's argument that, because Congress had amended section 6501(e), *Colony* was no longer precedential. In short, none of the subsequent amendments to the statute materially affected the structure of the statute, nor the general rule regarding omissions from gross income. Slip. Op. at 5-7. In the Court's view, the only way to accept the Government's position was to overrule *Colony*, which *the Court* decided was "a course of action that basic principles of *stare decisis* wisely counsel us not to take." Id. at 4-5.[2]

Using the analysis of Justice Breyer's plurality, one can view *Colony* in terms of *Chevron* along the following lines. *Colony* involved an initially ambiguous statutory provision which required judicial construction. When analyzed under the ordinary tools of statutory construction, the provision permitted only one reasonable construction. The ambiguity presented was therefore resolved by the Court. The Government's competing regulatory interpretation did not warrant deference because it was not reasonable in light of the words, structure, and legislative history of the statute, and *Chevron* deference exists only where the ambiguity, upon being analyzed, permits more than one reasonable interpretation.

BRAND X: AN ORPHANED OPINION?

Although not relied upon by the dissent, *Brand X* was central to the Government's justification for its basis overstatement rule. That decision stands for the proposition that "a 'court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute . . . .' *National Cable & Telecommunications Assn. v. Brand X Internet Services*, 545 U. S. 967, 982 (2005) (emphasis added)." Slip op. at 8. The Government reasonably argued that *Brand X* mandated deference here because *Colony* itself acknowledged the ambiguous nature of the statutory language (albeit in the predecessor Code). Restating its prior conclusion based on *stare decisis*, the Court announced: "*Colony* has already interpreted the statute, and there is no longer any different construction that is consistent with Colony and available for adoption by the agency." Id.

Were that the end of the Court's analysis, the meaning and vitality of *Brand X* might have been unclear. Accordingly, Justice Breyer provided additional analysis of the decision, in which three other Justices joined. In his analysis, he stated that the Government did not appreciate the rationale for the decision and erroneously interpreted it as an approval for promulgating a rule contrary to *Colony*. Id. *Brand X* involved a dispute over the meaning of "telecommunication service" in the Communications Act of 1934 as amended in 1996. The Federal Communications Commission issued a formal ruling providing that internet service providers did not provide telecommunication services. The ruling was issued under the general rule-making authority granted to the FCC by the statute, similar to the same grant of authority in Internal Revenue Code § 7508(a). The Ninth Circuit had previously issued an opinion as to the meaning of "telecommunication service" which was inconsistent with the FCC ruling. Justice Breyer explained that *Brand X* involved standard *Chevron* analysis which led that court to conclude Congress had delegated statutory gap-filling authority to the FCC.

Thus, *Brand X* shows that in undertaking a *Chevron* analysis of agency action, a court must consider whether "a particular statute in effect delegates to an agency the power to fill a gap, thereby implicitly taking from the court the power to void a reasonable gap-filling interpretation." Id. at. 9. As part of the deference review, a court must decide whether the meaning of the statute can be resolved and whether Congress has delegated gap-filling authority to the agency with respect to the

[2] In our view, it was not immaterial to the Court's rationale that *Colony*'s interpretation of the statute was for decades unchallenged by the Government and that taxpayers had relied upon that interpretation. Cf. Scalia, J. Op. at 1 (citing "justifiable taxpayer reliance" as a basis for rejecting the basis overstatement regulation). Furthermore, in our view Congress would rarely, if ever, grant specific rule-making authority over statutes of limitation.

issue. According to the plurality, unambiguous statutes by their very nature preclude a delegation of gap-filling or rule-making authority, where ambiguous statutes give rise to a presumption, but not a necessity, of such delegation. Id. To decide whether an ambiguous statute delegates rule-making authority a court should employ traditional tools of statutory construction. Id. at 10. A court is not required to defer to the agency views if the meaning of the statute can be resolved into one interpretation using accepted tools of construction. In *Brand X*, the ambiguity was not resolvable into one reasonable interpretation and the Court determined that the FCC had authority to resolve the ambiguity through a formal ruling. With respect to Treasury's basis overstatement rule, the Court, following *Colony*, identified this administrative effort as an invalid exercise of authority because, in view of the Court's prior judicial construction of the statute, the meaning of the statute was clear and Congress did not delegate such authority to the Treasury.

Though Justice Breyer cited *Brand X* as continuing precedent it is possible to argue that the rule it established has been circumscribed by *Home Concrete*. Justice Scalia urged the plurality to simply abandon *Brand X* because he viewed it as needlessly complicating an already "curious" administrative law jurisprudence. Scalia, J. Op. at 5. Of course, Justice Scalia dissented in *Brand X*, and it is not surprising he would take the opportunity to criticize it here. But what of the plurality? It can be argued that complete adherence to *Brand X* would result in a significant limitation on the Court's essential role to speak with finality as to what the law says. The plurality's clarification of *Brand X* thus could be viewed as an attempt to prevent such a restriction on judicial power. The plurality's effort to distinguish the rule of *Brand X* is an effort to persuade the reader that it was simply applying traditional tools of statutory construction in that case and as a result found an ambiguity which indicated congressional delegation of gap-filling authority. But the effect of this distinction is to establish a sacrosanct area of judicial authority irrespective of agency authority: to decide whether a statute is ambiguous. Thus, even if an agency has specific rule-making authority regarding the statutory provision at issue, a court will always have the authority to decide if the statute is ambiguous and resolve that ambiguity into one reasonable interpretation such as was done in *Colony* and *Home Concrete* without deference to the agency's rule.

IMPACT ON *MAYO*?

Aside from a few short citations, the Court did not discuss *Mayo* and one could conclude on that basis that the ruling in *Home Concrete* had no effect on *Mayo.* The IRS presented the high court's decision in *Mayo* as a major endorsement of its inherent authority to provide binding interpretations of the revenue laws. However, the decision in *Home Concrete* is a reminder that the Treasury's authority is limited, notwithstanding a general grant of rule-making authority to it by Congress. Thus, Treasury may not expect deference to its regulations where the statute is clear, where new regulations would be contrary to legislative intent, or where new regulations would undo the terms of a statute (note the high court's citation to *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) slip. op. at 6: "statutes should be read to avoid making any provision superfluous, void, or insignificant").

Furthermore, *Home Concrete* might be read to revive arguments akin to those that were rejected by *Mayo*. In *Mayo* the Court settled a longstanding question regarding the deference owed to "legislative" versus "interpretive" Treasury regulations. Legislative regulations were those in which Congress granted Treasury specific authority to promulgate regulations regarding a specific Code section's terms and provisions and were accorded *Chevron* deference. Interpretive regulations were those based on the general grant of rule-making authority in Code § 7805(a) and were accorded less deference. In *Mayo* the Court discarded that distinction and decided that all notice and comment Treasury regulations should be reviewed under the same *Chevron* deference lens whether or not Congress enacted specific rule-making authority because Congress had delegated general rule-making authority under section 7805(a). This decision was widely viewed as providing a clear rule for courts dealing with final Treasury regulations. However, Justice Breyer noted that one factor to consider in the ambiguity analysis is the degree to which Congress delegated gap-filling authority to the Treasury. Thus practitioners might argue that, when a court is deciding whether there is *Chevron*-ambiguity, the fact that the Treasury regulations at issue do not proceed from a specific grant of authority should weigh in favor of the court construing the statute on its own.[3]

BOTTOM LINE

While we have discussed some of the implications we believe can be reasonably inferred from the decision in *Home Concrete*, it is clear that the decision does not definitively resolve how a court should go about handling future similar situations. Will the test be whether a court's previous construction of a statute was one that ultimately reached the one and only meaning of a statute such that there was no room remaining for agency discretion; or will it be whether the previous judicial interpretation was one choosing among reasonable constructions? As Justice Scalia observed, if *Home Concrete* isn't one of the latter cases, given the Court's statement in *Colony* that the statute was ambiguous, then perhaps the latter category of cases will be few and far between.

To view the Court's opinion, click here.

Contact:

Robert A.N. Cudd	Edward L. Froelich	James E. Merritt	Bernie J. Pistillo
(415) 268-6904	(202) 778-1646	(202) 887-8780	(415) 268-7041
rcudd@mofo.com	efroelich@mofo.com	jmerritt@mofo.com	bpistillo@mofo.com

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[3] Oddly enough, the FCC had general rule-making authority under the communications statutes and in *Brand X* that authority was respected, yet in *Home Concrete* the same authority granted to the Treasury was not respected. Is the difference because of the important role that statutes of limitation play in our society, which prompted the Court to take ownership of the issue? Or is the difference attributable to the Court's general agreement with the agency rule in *Brand X* (and, *Mayo*, for that matter), whereas *Colony* was directly contrary to the agency decision?