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Determining the Validity of Tax Regulations— Uncertainties Persist

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With two major Supreme Court cases on regulatory validity in the background, as well as some more recent decisions from the high Court, two recent Tax Court decisions have only served to muddy the waters on when tax Regulations will be vulnerable as either "arbitrary or capricious" or simply "unreasonable."

Two recent Tax Court decisions demonstrate the significant uncertainties courts encounter in determining the validity of tax Regulations.¹ Many of these uncertainties have long existed; others are attributable to relatively recent Supreme Court cases.² Before examining the Tax Court cases, a fresh look at the Supreme Court precedents may suggest a new way of viewing and reconciling them.³

THE SUPREME COURT PRECEDENTS

The Supreme Court long ago held that a tax Regulation is reasonable, and thus valid, if it harmonizes with the plain language of the governing statute, its origin, and its purpose. In *National Muffler Dealers Ass'n, Inc.*, 43 AFTR 2d 79-828, 440 US 472, 59 L Ed 2d 519, 1979-1 CB 198 (1979), an association of Midas muffler franchisees sought to qualify as a tax-exempt business league. It was unable, however, to satisfy regulatory requirements that it exist merely to promote one or more general "lines of business" rather than specific business interests. Before the Supreme Court, the association argued that the Regulation requiring a line of business was invalid. The Court acknowledged that the governing statutory term "business league" did not have a well-defined meaning but concluded the Regulation was nevertheless valid.

The Court began its analysis by recognizing that in Section 7805(a) Congress delegated to the Treasury the authority to prescribe "all needful rules and regulations for the enforcement of [the Code]." Thus, the courts must defer to the Service's "reasonable" exercise of that authority. A Regulation is reasonable, the Court declared, if it "harmonizes with the plain language of the statute, its origin, and its purpose." Among the factors to consider are (1) the extent the Regulation was contemporaneous with enactment of the governing statute, (2) the way the Regulation evolved, (3) its age, (4) reliance placed on it, (5) consistency of the Service's interpretation, and (6) the degree of congressional scrutiny of the Regulation.

The Court did not clearly state whether the governing statutory language in *National Muffler* was ambiguous, saying only that the Service's interpretation "perhaps is not the only possible one." In any event, though, the Court found the Regulation reasonable in

light of the purposes expressed by those originally lobbying for the business league exemption and the consistent interpretation of the IRS and the courts over the Regulation's 50-year history.

The Supreme Court was not bothered that the Regulation had reversed the Service's initial interpretation, stating that contemporaneousness with the original legislation is only one consideration and an agency may change interpretations to accommodate administrative experience. The Court also would not allow the taxpayer's policy arguments to prevail, saying the choice between reasonable interpretations belonged to the IRS and not the courts.

Although the Court conducted its analysis without clearly stating whether it believed the governing statute to be ambiguous, that seems of little concern. It is clear enough that a Regulation "harmoniz[ing] with the plain language of a statute, its origin, and its purpose" is reasonable whether the governing statute is ambiguous or unambiguous.

The *Chevron* Two-Step Analysis

In a different context, the Supreme Court has stated that an agency interpretation is valid if (1) it is consistent with an unambiguous statute or (2) it is a permissible interpretation of an ambiguous statute. In *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 US 837, 81 L Ed 2d 694 (1984), the Environmental Protection Agency (EPA) had issued regulations pursuant to amendments of the Clean Air Act dealing with increases in air pollution due to "new or modified major stationary sources."

In its regulations, the EPA treated plant-wide air pollution emissions as coming from a single source, rather than from separate components of the plant. In effect, the regulations measured increases in total emissions as if they were coming from a single imaginary "bubble" covering an entire plant, thus allowing the offset of increases and decreases in emissions from separate plant components. The Supreme Court held the plant-wide bubble concept to be a reasonable interpretation of the statute's reference to a pollution "source."

Without citing *National Muffler*, the Supreme Court set forth a two-step process for determining the validity of a regulation. First, a regulation will be valid if it is consistent with the clear and unambiguously expressed intent of Congress. Second, if the statute is silent or ambiguous with respect to the issue, the regulation will be valid if based on a "permissible" construction of the statute. Under this standard, regulations expressly authorized by Congress to clarify or implement a specific statutory provision are permissible unless "arbitrary, capricious, or manifestly contrary to the statute."⁴ Regulations implicitly authorized by Congress are permissible if they reflect a "reasonable" administrative view and policy choice. It matters not that the court may prefer a different construction of the statute.

The Court concluded that it could not derive congressional intent from the general terms of the statute (step one) and proceeded to apply to the regulation the reasonableness standard applicable under implicit delegations of regulatory authority (step two). The Court observed that, in addition to environmental concerns, concerns about inhibiting economic growth were evident in the statute's legislative history, the public rulemaking record, and certain private studies.

Furthermore, the Court assumed Congress intended to provide the EPA with administrative flexibility in balancing these two competing policy considerations and concluded that the EPA used that flexibility reasonably in crafting the regulation. The

Court refused to accept contrary policy arguments of the litigants, saying interested parties could more properly address such arguments to Congress or the EPA.

Thus, both *Chevron* and *National Muffler* applied a reasonableness standard to determine the validity of a rule or regulation. *Chevron* stated that "a court may not substitute its own construction ... for a reasonable interpretation made by the administrator of an agency." Very similarly, *National Muffler* stated that the "choice among reasonable interpretations is for the Commissioner, not the courts." *National Muffler* also restated the test as "implement[ing] the congressional mandate in some reasonable manner." This restatement, however, does not appear to conflict with or modify the "reasonable interpretation" standard. Thus, under either *Chevron* or *National Muffler*, a regulation is valid if it is within the bounds of reason.

National Muffler After Chevron

After *Chevron*, the Supreme Court continued to cite and use *National Muffler* in tax cases. For example, in *Cottage Savings Ass'n*, 67 AFTR 2d 91-808, 499 US 554, 113 L Ed 2d 589, 1991-2 CB 34 (1991), the taxpayer claimed taxable losses on interests in a portfolio of mortgages exchanged for interests in other similar mortgage portfolios. The applicable Regulation provided that a taxpayer could treat such losses as sustained only if the exchanged properties "differ[ed] materially either in kind or in extent." Although the governing statute was silent on the point, the Supreme Court found the Regulation to be valid.

The Court first recognized that Section 7805(a) "delegate[s] to the Commissioner the power to promulgate 'all needful rules and regulations' for the enforcement" of the Code. Citing *National Muffler*, the Court again stated that it must defer to such Regulations if they are "reasonable." The Court proceeded to find the disputed Regulation reasonable based on legislative and case history. ⁵

The Court neither mentioned *Chevron* nor acknowledged any possibility that Section 7805(a) might constitute a specific delegation of authority that, under *Chevron*, might require application of the arbitrary and capricious standard. This is a bit surprising since in some nontax cases the Supreme Court has applied the arbitrary or capricious standard to Regulations issued under statutory language similar to Section 7805(a). The explanation might be that Section 7805(a) authorizes Regulations for the entire Code (i.e., all of Title 26), whereas the nontax cases involved authorization of regulations for only specific subchapters or parts of titles. ⁶ Thus, the Court may very well have concluded that, though Section 7805(a) expressly delegates regulatory authority, it does not limit that authority to the mere "elucidat[ion of] a specific provision of the statute...." ⁷

Furthermore, the Court has stated that an agency may derive implicit regulatory authority from "the agency's generally conferred authority and other statutory circumstances." ⁸ In this connection, it would seem that the Service's authority to promulgate all needful rules and Regulations under Section 7805(a) should qualify as a statutory circumstance generally conferring authority. What could be more "generally conferred" than statutory authority commensurate with the entire responsibility of the Service to enforce the revenue laws?

For convenience, this article will hereafter use "interpretive Regulations" for those Regulations issued under Section 7805(a) and will use "legislative Regulations" for those issued under other, more specific Code sections. First, the courts and commentators have traditionally used the terms in this manner in the tax area. Second, based on the

foregoing analysis, the terms line up very nicely with *Chevron's* (1) implicit authority Regulations subject to a reasonableness standard, and (2) specific authority Regulations subject to an arbitrary or capricious standard.

Reconciling *Chevron* and *National Muffler*

In a unanimous decision in *Atlantic Mutual Insurance Co.*, 81 AFTR 2d 98-1566, 523 US 382, 140 L Ed 2d 542, 1998-2 CB 400 (1998), the Supreme Court appeared to merge a *Chevron*-type analysis with a *National Muffler*-type analysis.

The case involved a provision of TRA '86 that mandated the discounting of unpaid loss reserves of property and casualty insurers to account for normally expected delays in payment of the losses. To soften the impact of the change, Congress allowed insurers to exclude from gross income the one-time reduction in reserves required for 1986, the year of the change. To avoid taxpayer manipulation of the exclusion, TRA '86 prohibited "reserve strengthening" for 1986. Subsequent Regulations defined this term to include nearly all net additions to reserves. The taxpayer, however, contended the definition was too broad and should encompass only those reserve additions due to changes in methods or assumptions.

The Supreme Court held the Regulation valid. Citing *Chevron*, the Court first analyzed the disputed term and found it to be ambiguous (the first *Chevron* step) based on its usage in the industry and in prior legislation. The Court then proceeded to apply the reasonableness test (the second *Chevron* step) to the Regulation, but cited instead *Cottage Savings*, which in turn had cited *National Muffler* as authority for the reasonableness test. The Court noted that it was irrelevant whether the Regulation reflected the "best" interpretation of the statute as long as it represented a reasonable interpretation. It concluded that the Regulation was "a reasonable accommodation of the competing interests of fairness, administrability, and avoidance of abuse."

Competing policy interests and other factors. In *Atlantic Mutual*, the Supreme Court for the first time linked *Chevron* and *National Muffler* in a tax case, arguably using the overall analyses in those cases interchangeably. The Court did not expressly distinguish between the basic requirement of each of *National Muffler* and *Chevron* that a Regulation is valid if it is "reasonable." Furthermore, in both *Atlantic Mutual* and *Chevron* the Court focused on the balancing of competing congressional policy interests. This policy focus seems easily reconcilable with *National Muffler's* admonition that a Regulation harmonize with the "origin and purpose" of the governing statute. That is, the "origin" of legislation is primarily in congressional policy concerns, and the "purpose" of legislation is primarily to advance congressional policy interests.

Nevertheless, the specific analytical factors entering into a determination of reasonableness necessarily will differ from case to case depending on the circumstances—particularly when it is necessary to accommodate differing policy interests. For example, in *Chevron* the competing policy interests involved the control of industrial air pollution (an obvious purpose of the statute) without unduly inhibiting economic growth (a purpose found in the legislative history). Balancing of those interests in a technological environment required a high degree of agency flexibility.

By contrast, in *Atlantic Mutual* the Court considered the relevant policy interests in a tax case to include "fairness, administrability, and avoidance of abuse." These policy interests tend to favor stability and certainty more than regulatory flexibility. Thus, in a tax case, analytical factors that are relevant to stability and certainty over time (such as legislative, regulatory, and judicial history) arguably should take on more importance in

the determination of a Regulation's reasonableness. In fact, the factors identified in *National Muffler* as being relevant to reasonableness dovetail nicely with the tax policy interests identified in *Atlantic Mutual*. The Court in *National Muffler* said a court should consider:

- (1) The extent the tax Regulation was contemporaneous with enactment of the governing statute (relevant to the policy interests of fairness, administration, and certainty).
- (2) The way the Regulation evolved (relevant to administration and avoidance of abuse).
- (3) The age of the Regulation (fairness, administration, certainty).
- (4) The reliance placed on the Regulation (fairness, certainty).
- (5) The consistency of the Service's interpretation (fairness, administration, certainty).
- (6) The degree of congressional scrutiny of the Regulation (administration, avoidance of abuse).

Of course, the policy considerations and related factors identified above should not be exclusive. In fact, almost any factor could be relevant to the determination of reasonableness if it is within the bounds of the applicable policy interests. Furthermore, in enacting a particular provision of the Code, Congress often will articulate additional policy interests relating specifically to that provision.⁹

The notion of greater or lesser deference. Some commentators have attributed a higher degree of deference to a *Chevron* analysis than to a *National Muffler* analysis, or a higher degree of deference in nontax cases than in tax cases. The difficulty with those views is that they appear to confuse the end results in the cases with the analytical process used to reach those results. That is, they appear to lump the reasonableness standard together with the differing policies and factors that facilitate application of the standard. Those differing policies and factors may result in outcomes that give the appearance of different degrees of deference.

Yes, the relevant policy interests in *Chevron* made it reasonable to allow a high degree of agency flexibility (and thus the appearance of greater deference). That degree of flexibility, however, is not necessarily reasonable in the context of tax policy interests advancing stability and certainty. On the other hand, it does clarify the argument to acknowledge that some types of tax Regulations also could warrant a high degree of agency flexibility.

For example, when the avoidance-of-abuse policy outweighs the fairness policy in a tax case, it seems reasonable to allow the Service greater flexibility in fashioning a Regulation. In the end, though, what counts is whether a Regulation is reasonable after taking into account the particular policy interests and the other relevant factors.

Decisions of the courts of appeals. The circuit courts generally have avoided considering potential differences between the reasonableness tests of *Chevron* and *National Muffler*. Instead, they generally have made their analyses simply by relying on one or the other of the cases. When relying on *Chevron*, some courts do not cite *National Muffler*¹⁰ or cite it only peripherally on some related point.¹¹ Other courts, when relying on *National Muffler*, cite *Chevron* peripherally.¹² Nevertheless, a few courts cite and rely on both cases, apparently satisfied their respective reasonableness tests are identical.¹³

Only a few courts of appeals have directly discussed potential differences between the two cases. In *Peoples Federal Savings & Loan Ass'n of Sidney*, 68 AFTR 2d 91-5807, 948

F2d 289 (CA-6, 1991), the court applied the *Chevron* reasonableness test to hold a Regulation valid based on substantial legislative and judicial history. The court rejected a *National Muffler* analysis, saying it did not allow for "the deference requirements found in *Chevron*...." Nevertheless, as discussed above, the differences in those cases appear to lie not in the degree of deference afforded but rather in the different underlying policies and factors that support reasonableness.

In any event, the momentum has clearly swung away from reliance on *National Muffler*. For example, the Seventh Circuit in completing its transition to *Chevron* found little difference between the two cases but thought adoption of *Chevron* would promote greater consistency among the circuits.¹⁴ By contrast, the Ninth Circuit appears to have moved from reliance on *National Muffler* to the application of a reasonableness test not directly rooted in either case.¹⁵

The Reach of *Chevron* (and *National Muffler*)

An agency's interpretation of law is entitled to *Chevron*-type deference (and thus *National Muffler* deference) only if issued under congressional authority to make rules carrying the force of law. Interpretations of lesser standing, however, may be entitled to varying degrees of lesser judicial deference.

In *U.S. v. Mead Corp.*, 533 US 218, 150 L Ed 2d 292 (2001), the Supreme Court considered the degree of judicial deference due tariff classifications provided in letter rulings issued by the U.S. Customs Service. The general statutory authorization of customs' "rules and regulations" specifically required promulgation of regulations governing issuance of letter rulings. Customs headquarters and any of 46 subsidiary offices could issue the rulings—without any notice-and-comment requirement. Although the rulings had some limited precedential value and were available for public inspection, only the addressee could rely on a ruling.

The Court held that the letter rulings were not entitled to *Chevron* deference, stating that such deference applies only to agency interpretations under congressional authority to make rules "carrying the force of law." An agency's power to engage in adjudication or notice-and-comment rulemaking will show such authority—as will other comparable indications of congressional intent. But the Customs Service did not issue the letter rulings in question under any such authority. The rulings were not the product of notice-and-comment rulemaking, bound only the parties to the rulings, and were issued in volume by numerous offices. They were more in the nature of "interpretations contained in policy statements, agency manuals, and enforcement guidelines."

Nevertheless, the Court remanded the case to the court of appeals to determine whether the particular letter ruling in question was entitled to some type of non-*Chevron* judicial deference more tailored to the particular facts and circumstances. In explanation of such a non-*Chevron* deference, the Court cited and quoted its decision in *Skidmore v. Swift & Co.*, 323 US 134, 89 L Ed 124 (1944): "The weight [accorded to an administrative] judgment in a particular case will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control."

Tax Regulations Unaffected by *Mead*

After *Mead*, it seems clear enough that interpretive tax Regulations issued under authority of Section 7805(a) continue to be subject to the "reasonableness" standard of *National Muffler* and *Chevron*.

In *Boeing Co.*, 91 AFTR 2d 2003-1088, 537 US 437, 155 L Ed 2d 17, 2003-1 CB 868 (2003), the Supreme Court considered the validity of a Regulation apportioning research and development costs (R&D) to a domestic international sales corporation (DISC) and a foreign sales corporation (FSC). Although the IRS had authority to issue legislative Regulations in this area, the Service followed its frequent practice of ignoring that authority and instead issued the guidance as an interpretive Regulation under Section 7805(a).

Without clearly stating whether it considered the Regulation legislative or interpretive, the Court held the IRS "reasonably" determined the R&D apportionment method. The Court cited *Cottage Savings*, which in turn had cited *National Muffler* as authority for application of the reasonableness test.

The Court said nothing of any reduced level of deference under *Mead*, apparently concluding interpretive tax Regulations carry "the force of law." That conclusion is not surprising since the IRS generally subjects tax Regulations to notice-and-comment rulemaking, and *Mead* stated that such rulemaking normally qualifies Regulations for *Chevron* deference. Although the notice-and-comment rulemaking provided by the IRS for interpretive tax Regulations may be voluntary,¹⁶ *Mead* did not articulate any requirement that notice-and-comment rulemaking be mandatory. In addition, tax Regulations also may carry the force of law in the sense that Regulations generally are binding on the IRS¹⁷ and the Code generally imposes substantial penalties on taxpayers who disregard Regulations.¹⁸

Effect of Judicial Precedents

A normally controlling judicial precedent may preclude a *Chevron*-type analysis of an agency interpretation only if the precedent held the statute unambiguous. *National Cable & Telecommunications Ass'n v. Brand X Internet Services*, 545 US 967, 162 L Ed 2d 820 (2005), involved a ruling under authority delegated by Congress to the Federal Communications Commission (FCC) to prescribe rules and regulations "in the public interest." Using this authority, the FCC issued a ruling that television cable companies providing Internet access were providing "information services" not subject to regulation. The plaintiffs contended, however, that the services offered by the cable companies included "telecommunication services" that were subject to regulation.

The Ninth Circuit held for plaintiffs,¹⁹ stating that it had to follow one of its own cases decided before issuance of the contested FCC ruling. In the prior case, the court had held that, under the best reading of the statute, the Internet access services provided by cable companies were telecommunication services. The Supreme Court reversed and found the FCC ruling valid. The Court held that a judicial precedent interpreting a statute could have stare decisis effect only if the previous case had found the statute unambiguous. Otherwise, the precedent could not "displace" or "trump" a *Chevron*-type analysis—whether or not the precedent reflected the "best" interpretation of the statute.

The Court then found that, although the statute *unambiguously* treated Internet services as information services, the statute was *ambiguous* on the question of whether the cable companies also "offered" telecommunication services as a part of Internet access. Despite that ambiguity, the Court held the FCC ruling a reasonable policy choice under part two of *Chevron*. The Court noted that the statutory term "telecommunication

services" had replaced the prior statutory term "basic service" and the term "information services" had replaced the term "enhanced services." Nevertheless, the FCC had consistently defined the old and new terms by viewing them from the perspective of the customer.

The Supreme Court accepted the FCC's consistent customer viewpoint—invoking the presumption that Congress is aware of settled judicial and administrative interpretations when it amends a statute. The Court then found reasonable the FCC's conclusion that a customer was not likely to perceive Internet access as an "offering" of telecommunication services.

It is important to be very clear about what *National Cable* did *not* hold. It did not hold that all precedents finding a statute unambiguous constitute *controlling* precedents for purposes of determining the validity of an agency's interpretation. The Court did not change the normal principles of stare decisis under which controlling precedents are traditionally limited to prior decisions of the same court or decisions of a higher court to which a direct or indirect appeal lies.²⁰ For example, a decision of one federal circuit is not a controlling precedent in another federal circuit.²¹ Under the *Golsen* rule, decisions of one federal circuit are not controlling precedents in the Tax Court when appeal in the case lies to another circuit.

National Cable also did not hold that a judicial precedent is irrelevant to a *Chevron* analysis merely because the precedent found ambiguity in the statute. Rather it held only that such a precedent does not preclude a *Chevron* analysis. Thus, if a *Chevron* analysis is necessary, *National Cable* should not prevent a court from using the judicial history of an ambiguous statute in its analysis of the reasonableness of a Regulation. Of course, the significance the court should attach to that judicial history will depend on the relevance of the judicial history to the court's effort to balance competing policy considerations. As already noted, judicial history generally should be more significant in a tax case than in other regulatory environments because of the different policy interests involved.

Reconciliation of the Supreme Court Cases

In summary, then, a tax Regulation will be valid if it is consistent with an unambiguous governing statute. It also will be valid if it is consistent with a controlling judicial precedent holding that the statute is unambiguous. For this purpose, a controlling judicial precedent is generally a prior decision of the same court or a decision of a higher court to which a direct or indirect appeal lies. On the other hand, a judicial precedent that is not controlling or that found the governing statute ambiguous does not preclude a *Chevron/National Muffler* analysis (although it may play a significant role in that analysis).

If a tax statute is silent or ambiguous with respect to an issue, a Regulation issued under the statute will be valid only if based on a "permissible" construction of the statute. Under this standard, Regulations expressly authorized by Congress to clarify or implement a specific statutory provision (legislative Regulations) are permissible unless "arbitrary, capricious, or manifestly contrary to the statute." Interpretive tax Regulations authorized by Congress under Section 7805(a) are permissible if they are "reasonable."

Many different factors enter into the determination of the "reasonableness" of a Regulation. These factors and their relative significance necessarily differ from case to case, depending largely on the respective policy considerations involved. In some types of regulatory environments (i.e., pollution control, common carriers, etc.), competing policy interests may involve trade-offs between public protection, economic growth, and

appropriate technological development—policy considerations that invite a great deal of agency flexibility.

By contrast, the competing policy interests in tax cases revolve primarily around considerations of enforcement, administration, fairness, and avoidance of abuse—policy considerations that tend to favor stability and certainty over flexibility. Thus, in a tax case, factors that are relevant to stability and certainty over time (such as legislative, regulatory, and judicial history) should usually take on more importance.

THE RECENT TAX COURT CASES

In two recent cases, the Tax Court reconciled and applied the Supreme Court precedents—with mixed results. Although the Tax Court may have reached the correct results in those cases, its analyses appeared in some ways flawed.

The *Swallows* Case

In *Swallows Holding, Ltd.*, 126 TC 96 (2006), on appeal to the Third Circuit, the issue was whether a foreign corporation owning U.S. real estate could claim deductions on a delinquent tax return. The governing statute provided that deductions were not allowable unless the taxpayer filed a return in the "manner" required by the Code. Regulations interpreted the word "manner" to include a timely filing requirement.

A divided Tax Court held the Regulations invalid on grounds the statute did not require a timely return. Based largely on its analysis of various Code sections containing the words "time" and "manner," the Tax Court concluded that the plain and unambiguous meaning of the word "manner" did not include timeliness.

Alternatively, the court held that, even if the statute were ambiguous, the questioned Regulations were unreasonable under a *National Muffler* analysis. The court noted that the IRS had issued the Regulations more than 60 years after enactment of the governing statute, more than 50 years after the beginning of a long line of contrary court cases, and more than 30 years after issuing previous Regulations that did not mention a timely filing requirement. The court also noted previously expressed congressional interest in allowing deductions to promote foreign investment in U.S. real property.

Furthermore, the court said it would have reached the same conclusion even under a *Chevron*-type analysis (while at the same time hinting at "possible subtle distinctions" between *Chevron* and *National Muffler*).

The Tax Court then distinguished *National Cable* on the grounds the FCC's ruling in that case was entitled to more deference because of the FCC's careful consideration of complex technological issues. In addition, the court found that in *National Cable*, unlike *Swallows Holding*, (1) prior judicial proceedings dealing with the FCC issue were relatively recent, (2) the FCC had not been a party to the prior proceedings, and (3) the FCC ruling did not reverse long-settled law. Finally, the court concluded that in *Swallows Holding* (unlike in *National Cable*) the courts previously dealing with the timely filing issue believed the governing statute to be unambiguous (although those prior courts did not explicitly so state).²²

Analysis. Although likely reaching the correct result, the Tax Court in *Swallows Holding* appeared to (1) continue its mischaracterization of the relationship between *National Muffler* and *Chevron*, (2) unnecessarily attempt to find holdings of unambiguity in the

relevant judicial precedents, and (3) unnecessarily strain to distinguish *National Cable* to avoid misperceived complications related to the reasonableness test.

The court appeared to mischaracterize the connection between *National Muffler* and *Chevron* when it stated there were possible subtle distinctions between the two types of analyses relating to legislative history and the degree of deference required. As discussed above, both cases held that a Regulation issued under an ambiguous statute is valid if it is a "reasonable" interpretation of the statute. *Atlantic Mutual* appears to confirm that the same reasonableness standard applies under each case.

Furthermore, the degree of deference required is the same. That is, deference is absolute if the Regulation is reasonable; deference is nil if the Regulation is unreasonable. But, as previously discussed, the factors considered in determining reasonableness, and the weight assigned them, necessarily will differ (often more than subtly) depending on the respective policy considerations involved.

The Tax Court's conclusion that the relevant judicial precedents *implicitly* found the governing statute to be unambiguous appears unnecessary since the Tax Court had already *directly* held the statute to be unambiguous. Justice Scalia, in his dissent in *National Cable*, anticipated the difficulty of determining the unspoken belief of a prior construing court regarding the unambiguity of a statute. Although courts are generally equipped to make this type of mind-bending determination, it does generally appear easier to determine directly whether a statute is unambiguous than to attempt to fathom a prior court's unspoken beliefs.

The Tax Court also seemed to think it needed to distinguish *National Cable* before it could use judicial precedents in its analysis of the reasonableness of the Regulation. As discussed above, however, *National Cable* does not prevent the consideration of judicial precedents in analyzing the reasonableness of a Regulation. It merely holds that a normally controlling judicial precedent does not *preempt* the *Chevron* reasonableness test unless the precedent held the governing statute unambiguous. The case does not appear to change the factors entering into the analysis of the reasonableness of a Regulation issued under an ambiguous statute.

The Gerson Case

In *Estate of Gerson*, 127 TC 139 (2006), a decedent's husband created a general power of appointment in a trust that became irrevocable at his death (before enactment of the generation-skipping transfer (GST) tax). After enactment of the GST tax, the decedent exercised the power in her will in favor of her grandchildren. Although a grandfather clause stated the GST tax did not apply to any GST "under a trust which was irrevocable," a Regulation provided that the grandfather clause did not protect a post-enactment exercise of a general power of appointment. The decedent's estate contended the Regulation was an invalid interpretation of the grandfather clause.

Before promulgation of the questioned Regulation, four courts had addressed the issue of applying the GST tax to post-enactment exercises or lapses of pre-enactment general powers of appointment. The Tax Court had held that the grandfather clause did not protect the lapse of such a power, and the Second Circuit affirmed.²³ The Eighth and Ninth Circuits, however, each held that the grandfather clause unambiguously protected the exercise of such a power.²⁴ (Any appeal in *Gerson* would be to the Sixth Circuit, which has not spoken on the issue.)

In *Gerson*, a badly divided Tax Court upheld the questioned Regulation. The court avoided *National Cable* by asserting that judicial precedents holding a statute unambiguous should not bind the IRS when those precedents conflict with other judicial precedents. The court then held the grandfather clause ambiguous and proceeded to apply the reasonableness standard of *National Muffler*, stating that its decision would be the same under *Chevron*. Based on legislative and judicial history, the court said the Regulation harmonized with the origin and purpose of the governing statute. That is, it was consistent with the congressional policy interest in applying transfer taxes uniformly, taxing similar transfers in the same way, treating general powers as equivalent to ownership, and grandfathering only clearly inflexible pre-enactment arrangements.

Analysis. Consistent with *National Muffler* and *Chevron*, the Tax Court appropriately used legislative and judicial history to identify and apply the policy considerations bearing on the reasonableness of the Regulation. The court appeared to distinguish *National Cable* for the wrong reasons, however.

National Cable did not speak to conflicting precedents. Rather, it held that an otherwise *controlling* precedent could not override a challenged Regulation unless the precedent found the governing statute unambiguous. *National Cable* did not change the rules for identifying what constitutes a potentially controlling precedent. Thus, under the Tax Court's *Golsen* rule, decisions of the Eighth and Ninth Circuits were not controlling precedents in *Gerson* (for which an appeal would lie to the Sixth Circuit), whether or not those decisions involved findings of unambiguity.

CONCLUSION

The Supreme Court has provided a comprehensive judicial methodology for determining the validity of rules and Regulations. Under this regimen, tax Regulations are valid if consistent with (1) an unambiguous governing statute or (2) a controlling judicial precedent holding the statute unambiguous. Regulations expressly authorized by Congress to clarify or implement a specific statutory provision (legislative Regulations) are permissible unless arbitrary, capricious, or manifestly contrary to the statute.

An interpretive tax Regulation issued under an ambiguous Code section is valid if it is a "reasonable" interpretation, even if a reviewing court would not have chosen it as the best interpretation. Determination of the reasonableness of a Regulation depends on the circumstances in each case. Generally, a court must be cognizant of the Service's need to promulgate Regulations that implement and balance the various policy interests reflected in a governing Code section.

Policy interests relevant to the promulgation of a Regulation may be specific to a particular provision of the Code or generic to the Code as a whole. Not surprisingly, specific policy interests are usually derived from the specific purposes behind enactment of a Code provision. On the other hand, generic policy interests may include such overarching tax policy interests as fairness, administration, and avoidance of abuse. Thus, factors such as legislative, regulatory, and judicial history (that illuminate generic policy considerations) are among the factors that a court should most often consider in determining the reasonableness of a tax Regulation.

Swallows Holding, Ltd., 126 TC 96 (2006), on appeal to the Third Circuit; Estate of Gerson, 127 TC 139 (2006).

[2](#)

National Cable & Telecommunications Ass'n v. Brand X Internet Services, 545 US 967, 162 L Ed 2d 820 (2005); U.S. v. Mead Corp., 533 US 218, 150 L Ed 2d 292 (2001); Atlantic Mutual Ins. Co., 81 AFTR 2d 98-1566, 523 US 382, 140 L Ed 2d 542, 1998-2 CB 400 (1998).

[3](#)

For some prior efforts to analyze and reconcile the Supreme Court cases, see generally Salem et al., "ABA Section of Taxation Report of the Task Force on Judicial Deference," 57 Tax Lawyer 717 (No. 3, Spring 2004); Salem, "Supreme Court Should Clarify Its Deference Standard," 112 Tax Notes 1063 (2006); Salem, "A Chevron/Swallows Update: Time for Congressional Oversight?," 2007 TNT 6-20; Hickman, "The Need for Mead: Rejecting Tax Exceptionalism in Judicial Deference," 90 Minn. L. Rev. 1537 (2006); Schnee and Seago, "Deference Issues in the Tax Law: *Mead* Clarifies the *Chevron* Rule—Or Does It?," 96 JTAX 366 (June 2002); Aprill, "Muffled Chevron: Judicial Review of Tax Regulations," 3 Fla. Tax Rev. 51 (1996); Coverdale, "Court Review of Tax Regulations and Revenue Rulings in the Chevron Era," 64 Geo. Wash. L. Rev. 35 (1995).

[4](#)

The Tax Court and courts of appeals generally have complied with this admonition. Arnett, 126 TC 89 (2006), *aff'd* 99 AFTR 2d 2007-492, 473 F3d 790 (CA-7, 2007); Rite Aid Corp., 88 AFTR 2d 2001-5058, 255 F3d 1357 (CA-F.C., 2001); Cinema '84, 89 AFTR 2d 2002-2598, 294 F3d 432 (CA-2, 2002); E.I. du Pont de Nemours & Co., 74 AFTR 2d 94-7125, 41 F3d 130 (CA-3, 1994); Sidell, 86 AFTR 2d 2000-6229, 225 F3d 103 (CA-1, 2000).

[5](#)

For more on this decision generally, see Sax, "Supreme Court Decides Fundamental Debt Discharge, Loss Realization Issues," 75 JTAX 54 (July 1991).

[6](#)

Sullivan v. Zebley, 493 US 521, 107 L Ed 2d 967 (1990) (regulations authorized for a subchapter and a part of Title 42); Ragsdale v. Wolverine World Wide, Inc., 535 US 81, 152 L Ed 2d 167, 27 EBC 1865 (2002) (regulations authorized for two subchapters of Title 29); Smiley v. Citibank, N.A., 517 US 735, 135 L Ed 2d 25 (1996) (hedged by finding the regulation both reasonable and not arbitrary or capricious).

[7](#)

Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 US 837, 81 L Ed 2d 694 (1984). Also see Rowan Companies, Inc., 48 AFTR 2d 81-5115, 452 US 247, 68 L Ed 2d 814, 1981-2 CB 191 (1981), stating the courts owe a Section 7805(a) interpretive Regulation "less deference than a regulation issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision."

[8](#)

Mead, *supra* note 2.

[9](#)

See for example the discussion in the text, below, of the very specific policy interests related to the governing statute in Gerson, *supra* note 1.

[10](#)

Commonwealth Energy System, 86 AFTR 2d 2000-7327, 235 F3d 11 (CA-1, 2000); Alfaro, 92 AFTR 2d 2003-6914, 349 F3d 225 (CA-5, 2003); Marsh & McLennan Companies, Inc., 90 AFTR 2d 2002-6216, 302 F3d 1369 (CA-F.C., 2002), *cert. den.*; In re Craddock, 82 AFTR 2d 98-5439, 149 F3d 1249 (CA-10, 1998) (but confusing the reasonableness test with the standard applicable to legislative Regulations).

[11](#)

Hospital Corp. of America, 92 AFTR 2d 2003-6705, 348 F3d 136 (CA-6, 2003), *cert. den.* (citing National Muffler in a quotation).

[12](#)

Pacific First Federal Savings Bank, 69 AFTR 2d 92-605, 961 F2d 800 (CA-9, 1992), *cert. den.*; Bell Federal Savings & Loan Ass'n, 74 AFTR 2d 94-6990, 40 F3d 224 (CA-7, 1994).
[13](#)

Snowa, 80 AFTR 2d 97-6127, 123 F3d 190 (CA-4, 1997); Walshire, 89 AFTR 2d 2002-2215, 288 F3d 342 (CA-8, 2002).
[14](#)

Bankers Life and Casualty Co., 81 AFTR 2d 98-1522, 142 F3d 973 (CA-7, 1998), *cert. den.*
[15](#)

Miller, 90 AFTR 2d 2002-7159, 310 F3d 640 (CA-9, 2002).
[16](#)

Internal Revenue Manual section 30(15).
[17](#)

See e.g., Estate of Delaune, 82 AFTR 2d 98-5019, 143 F3d 995 (CA-5, 1998), *cert. den.* ("the Commissioner may not escape the effect" of a bona fide Regulation); Bausch & Lomb Inc., 67 AFTR 2d 91-980, 933 F2d 1084 (CA-2, 1991) (Regulations "are 'binding on the Commissioner'"); Zuckman, 36 AFTR 2d 75-6193, 207 Ct Cl 712, 524 F2d 729 (Ct. Cl., 1975) (Regulations are "binding on the Government"). For unusual situations in which the IRS may not be bound by its own Regulations, see Cohen and Harrington, "Is the Internal Revenue Service Bound by its Own Regulations and Rulings?," 51 Tax Lawyer 675 (No. 4, Summer 1998).
[18](#)

Section 6662(b)(1).
[19](#)

Brand X Internet Services v. F.C.C., 345 F3d 1120 (CA-9, 2003).
[20](#)

See the collection of cases cited in Carroll, 88 AFTR 2d 2001-7029, 198 F Supp 2d 328 (DC N.Y., 2001), *aff'd in part, vac'd and remanded in part* 92 AFTR 2d 2003-5650, 339 F3d 61 (CA-2, 2003). See also In re Osborne, 77 AFTR 2d 96-965, 76 F3d 306 (CA-9, 1996), in which the court said a precedent enjoys stare decisis status "in the same court or a lower court in the judicial hierarchy." See also Riverkeeper, Inc., 475 F3d 83 (CA-2, 2007) (holding that the court's own prior decision finding unambiguity was a controlling precedent under National Cable).
[21](#)

See, e.g., 330 West Hubbard Restaurant Corp., 85 AFTR 2d 2000-869, 203 F3d 990 (CA-7, 2000) ("Although we are not bound by them we 'carefully and respectfully consider' the opinions of our sister circuits").
[22](#)

For more on this case, see Lipton, "A Divided Tax Court Rejects a Regulation—and Struggles With Administrative Law—in *Swallows Holding*," 104 JTAX 260 (May 2006).
[23](#)

E. Norman Peterson Marital Trust, 102 TC 790 (1994), *aff'd* 77 AFTR 2d 96-1184, 78 F3d 795 (CA-2, 1996).
[24](#)

Simpson, 84 AFTR 2d 99-5349, 183 F3d 812 (CA-8, 1999); Bachler, 89 AFTR 2d 2002-1267, 281 F3d 1078 (CA-9, 2002).