POINT & COUNTERPOINT:
REGULATIONS THAT “FIX” SUPREME COURT OPINIONS: ARROGATION OF ADMINISTRATIVE AUTHORITY OR APPROPRIATE ADMINISTRATIVE RESPONSE?

INTRODUCTION: Although section 702(o)(a) gives Treasury the power to issue regulations to enforce the Code, that power is not unlimited. What are the limits? If Congress fails to change statutory language after the Supreme Court has interpreted a statutory provision, does Treasury have the power to issue regulations that change that interpretation?

In his Point, Gregg Polsky argues that Treasury’s actions in issuing the check-the-box and capitalization of intangibles regulations (T.D. 8697 and T.D. 9107, respectively) improperly overruled Morrissey v. Commissioner, 296 U.S. 344 (1935), and INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992). In his Counterpoint, which focuses on the prescriptive regulations, Jack Cummings argues that Treasury’s actions were an appropriate response to a changing business landscape. Their debate raises important questions regarding separation of powers, inter-branch comity, standing, and administrative exigency. —Gail L. Richmond, Ft. Lauderdale, FL.

POINT: TREASURY SHOULD NOT HAVE PROMULGATED THE CHECK-THE-BOX OR THE INDOPCO REGULATIONS
by Gregg Polsky, Minneapolis, MN

Recently, Treasury has promulgated regulations that purport to “fix” Supreme Court interpretations of the Code that Treasury found unmanageable. In late 1996, Treasury promulgated the check-the-box regulations, which effectively overruled the corporate resemblance test announced long ago in Morrissey v. Commissioner, 296 U.S. 344 (1935), and embodied in the Kintner regulations. Earlier this year, Treasury finalized the so-called INDOPCO regulations, which are inconsistent with the Supreme Court’s conclusions in INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), that “deductions are exceptions to the norm of capitalization” and that expenditures that give rise to significant future benefits must be capitalized.

In both cases, Treasury determined that the standards announced by the Supreme Court were entirely unworkable. To cure this problem, the new regulations set forth bright-line rules that will produce, in many cases, outcomes different from the outcomes that would have resulted under the Supreme Court standards. In addition to creating a more administrable regime, these new regulations are also overwhelmingly taxpayer-favorable.

Because they are inconsistent with existing Supreme Court interpretations, however, these regulations, if challenged, likely would be struck down as invalid. The Court has consistently held that when the Court has previously interpreted a statute, such interpretation is binding on the public and the Executive Branch unless and until Congress amends the underlying statute (or the Supreme Court takes the highly unusual step of overruling its statutory interpretation precedent). Essentially, as far as the Executive Branch is concerned, Supreme Court interpretations of statutory provisions are incorporated into the statute. In other words, once the Court has spoken, the ball is back in Congress’s court—only Congress can change the Court-determined meaning of the underlying statute. (For a complete discussion of this point, see Gregg D. Polsky, Can Treasury Overrule the Supreme Court?, 84 B.U. L. Rev. 185 (2004).) For this reason, Treasury’s promulgation of the check-the-box regulations and the INDOPCO regulations exceeded its legal authority.

Because of the restrictive taxpayer standing rules, however, it may be difficult to find a taxpayer who has both standing and a willingness to challenge these very taxpayer-friendly regulations. If no one ever challenges these regulations, then they will never be struck down, even though they are unlawful. This raises the question—was it wrong for Treasury to promulgate these regulations?

In answering this question, I will assume that both sets of regulations represent better policy than the Supreme Court interpretations they displaced. One may argue that, given this assumption, the ends (the better policy outcomes) justify the means (regulations that are technically without lawful authority). For reasons explained below, I submit that they do not.

First, this strategy of overruling Supreme Court interpretations with invalid, though unchallengeable, regulations undermines rule of law values. With respect to statutory interpretive authority, the rule, clearly announced by the highest court in the land, is simple: Once the Supreme Court interprets a term, that interpretation is binding upon the Executive Branch and can be altered only by an act of the Legislative Branch. Allowing Treasury to disregard this rule of statutory interpretation only because no one has standing to challenge it encourages disrespect for and disobedience to law. The message that is sent—“who cares about law if you’re doing the right thing and you’ll never get caught”—is a dangerous one.

Second, a strategy of ignoring unworkable Supreme Court interpretations would result in a one-way street favoring individual taxpayers over the
entire universe of taxpayers. The strategy may succeed only because the restrictive taxpayer standing rules make challenges unlikely. Because taxpayer-adverse regulations would be quickly challenged and ultimately invalidated, Treasury could successfully fix Supreme Court interpretations only in a taxpayer-friendly manner. As a result, Treasury’s fixing of unworkable Court interpretations would not necessarily result in the best policy choice, but rather in the best rules until Congress decides to fix the problem, it would be unconstrained by this pro-taxpayer force.

Third, if this strategy were acceptable with respect to unworkable Supreme Court interpretations, then it would also appear to be acceptable with respect to clear statutory text that Treasury also deems unworkable. A pro-taxpayer solution to bad statutory text would likewise be, as a practical matter, unchallengeable. Yet I suspect that most lawyers would agree that it is improper for Treasury to disregard clear statutory text.

Fourth, by blithely discarding the Court’s prior interpretation, Treasury fails to afford the Supreme Court an appropriate amount of respect. The Court has the institutional resources to hear relatively few statutory interpretation cases each year (only a very small number of which are tax cases). Taking any particular case involves a significant opportunity cost for the Court. It does not seem overly burdensome for Treasury to abide by Supreme Court interpretations just as it would abide by statutory text.

Finally, it may in fact be incorrect to say that these taxpayer-friendly rules will never get challenged. Professor Marty Ginsburg famously said: “Every stick crafted to beat on the head of a taxpayer will, sooner or later, metamorphose into a large green snake and bite the Commissioner on the hind part.” The inverse is also true. Though pass-through treatment and immediate deductibility are generally preferable, it is not difficult to imagine situations where, in particular taxable years, the opposite results are preferable. Although taxpayers would not plan their affairs on the basis of these regulations’ invalidity, they could raise the invalidity argument in litigation as a defense to a deficiency. If the invalidity argument were made, a court would be put in the unenviable position of either following clearly established law by striking down the regulations or upholding the regulations in the face of this clearly established law. If the court followed the law and struck down these immensely popular and important regulations, chaos would result.

For these reasons, Treasury should not have promulgated these regulations. Instead, it should have appreciated that its hands were effectively tied by the Supreme Court’s prior interpretations and then proposed legislation to Congress.

I understand that stimulating Congress to act may be very difficult. However, that is what current law requires in order to overturn a Supreme Court interpretation. And, in fact, Congress has shown a tendency to respond to Supreme Court decisions, even in highly technical tax cases involving relatively unimportant issues—the congressional overruling of Gitlitz is a classic example. See Gitlitz v. Commissioner, 531 U.S. 206 (2001), and the congressional response in section 108(d)(7)(A).

COUNTERPOINT: TREASURY ACTED PROPERLY IN ISSUING THE CHECK-THE-BOX REGULATIONS

by Jasper L. Cummings, Jr., Raleigh, NC

RECAP

Professor Polsky asserts that Treasury has issued two sets of regulations in recent years that are invalid because they conflict with Supreme Court opinions that should be viewed as establishing the meaning of Code terms until Congress says otherwise; that because the regulations are taxpayer-favorable the Treasury is likely to get away with it; but Treasury should clean up its act anyway, lest the rule of law fall into disrepute.

I focus here on the check-the-box regulations, as to which I agree he has a point, but which I believe were nevertheless a proper response by Treasury to an administrative exigency, at least on the domestic side.

THE SUBTEXT

Not appearing so clearly in Professor Polsky’s written arguments is the view he expressed orally at the ABA Tax Section Winter Meeting, that Treasury and the Service sometimes failed to afford proper respect to Supreme Court precedent, perhaps as a result of some sort of institutional arrogance.

I disagree. Certainly within the Chief Counsel Office, Supreme Court opinions receive perhaps undue attention. The attorneys tend to view Supreme Court dictum as binding, and the guidance process has ground to a halt pending debates over what the Supreme Court meant in several old opinions. These include Charles E. e. Co. v. Hernandez, 292 U.S. 62 (1934) (no double deductions), and Arrowsmith v. Commissioner, 344 U.S. 6 (1952) (a later event takes its character from the earlier event to which it is related).

HOW ABOUT THE LOWER COURTS?

Professor Polsky would do better service to focus on the larger problem of how little regard the lower courts pay to both the holdings and the interpretational rules used by the Supreme Court. See e.g., Jasper L. Cummings, Jr., Statutory Interpretation and Albertson’s, 66 Tax Notes 559 (Jan. 23, 1995). The Tax Court is particularly imbued with the notion that it knows what the Code is supposed to say and how it is to be interpreted, despite considerable contrary guidance from the Supreme Court.

MORRISSEY

But let’s get down to cases. Morrissey involved trustees of a golf club who wanted to avoid association status for 1921–1926. They succeeded for 1921–1923 because the Revenue Act of 1928 retroactively allowed them to...
rely on a regulation making control by shareholders necessary for association status, and the trust’s shareholders had no control. But in 1924 the Treasury dropped that requirement in obedience to a Supreme Court decision. So despite the lack of shareholder control, the golf club was an association for 1924–1926 because the Board of Tax Appeals found many characteristics indicative of corporate organization in its governing instrument. The Ninth Circuit affirmed on the grounds that the trust was “doing business.” The Supreme Court affirmed on the ground that the golf club had every possible indicia of corporateness it could think of, short of a state charter. It appears that its rejection (for the third time) of the importance of shareholder control, and its emphasis on the powers formally possessed, whether exercised or not, were viewed both by it and by commentators as being as important as the identified corporate factors. See Lloyd M. Smith, Associations Classified As Corporations Under the Internal Revenue Code, 34 Cal. L. Rev. 461, 465, 467 (1946).

Subsequent Supreme Court references to the Morrissey opinion show that the Court viewed it as approving the power of the Treasury to change its administrative interpretation in 1924 to eliminate control by the beneficiary as the determinant of association status. See, e.g., Lykes v. United States, 343 U.S. 118, 127 (1952). The Morrissey opinion states that the Treasury has authority to change the regulations to meet “administrative exigencies.” This adds irony to casting Morrissey as a roadblock to the check-the-box regulations.

THE CHECK-THE-BOX REGULATIONS

After a long delay, Treasury built the association definition regulation on those corporate resemblance factors identified in Morrissey. In 1996 it changed that regulation to allow a business entity that is not a de jure corporation, and that is not properly classifiable as a trust, to elect to be treated as an association. Presumably the golf club at issue in Morrissey would be eligible for the election. Therein lies Professor Polsky’s concern. How can Treasury exempt from association status an entity that has 100 percent of the corporate characteristics that the Supreme Court identified in 1935? Notice 95-14, 1995-1 C.B. 297, which forecast the new regulations, explained the Treasury’s reasoning: (1) the existing approach was based on the historical difference between partnerships and corporations; (2) state statutory changes (principally the advent of LLCs allowing limited liability) were enhancing the ability of well-advised taxpayers to get partnership classification for entities that were not meaningfully different from corporations; but (3) those changes were creating a trap for the unwary user of the LLC form for the corner grocery who might get corporate treatment he did not expect.

The Notice did not mention Morrissey. If it had, it might have said: Although the proposed regulations will allow a business trust like the one in the Morrissey case to elect to avoid the corporate treatment that the Supreme Court imposed on it in 1935 (assuming it is not publicly traded), the Treasury does not believe that the Morrissey opinion forbids this election. The facts that underlay the Court’s view of the essence of resemblance to a corporation have changed so that now substantial corporate indicator has changed over time. An early commentator stated that limited liability seemed to be almost irrelevant in 1915. See Lloyd M. Smith, supra, at 534. And so the effort logically to distinguish Morrissey on the facts breaks down. Treasury must rely on the other “leg” of that decision, which recognized Treasury’s power to deal with administrative exigencies.

Treasury thought it had an administrative and taxpayer exigency. The system had been effectively elective for the well advised for many years; but results could be disastrous for the ill advised using the newly created LLC structure in lieu of S corporations. Nothing proximate to 1995 had created the problem qualitatively, but the increased use of LLCs had quantitatively exacerbated it.

DID TREASURY WORRY ABOUT MORRISSEY?

Inquiry indicates they did worry about authority early on and decided...
cases like major issue. Why not?

extraordinary justification, and may viewed as a stunning act requiring indications, however, that the reversal must support the initial view. There are which memo is not public but certainly

of the case law.

interpretation, it cannot be in violation is equally as reasonable as the Court’ s as a new administrative interpretation issues. Treasury may think that so long along with the courts, as to all types of interest in reorganizations (continuity of business enterprise and relations were part of a loose “package” of administrative changes in that era)

Moreover, the check-the-box regula-

were others) that Treasury pursued in order to clear out the underbrush of time consuming issues where it no longer had a dog in the fight. This was a noble effort. Treasury intended to do good, knew it was doing good, and did good in practice. Unfortunately, that is the tale of every sinner: doing good some-
times blinds us to even the possibility that we might be violating some rule. WHO MIGHT CHALLENGE THE CHECK-THE-BOX REGULATIONS?

The professor’s complaint shines a light on one part of a much larger issue in the federal tax law: interpretation of the Internal Revenue Code has gone its own way, somewhat separate and apart from the mainstream of administrative law and judicial interpretation of other federal statutes. We discuss “substance over form” as if it were an idea unique to the federal tax law, when in fact it has been a feature of law since the writing of the Talmud, if not before. Because of our intense specialization, our attorney and our specialty courts are inadvertent to the mainstream of the law.

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WHO MIGHT CHALLENGE THE CHECK-THE-BOX REGULATIONS?

I agree that the check-the-box regula-
tions may be challenged. Here is an example: USLLC needed to check the box to be treated as a corporation before Date 1 because a transaction occurring on that date produced certain tax advantages only if USLLC was then treated as a corporation. The election inadvertently was made as of a later date, and retroactive relief is not available. The Service seeks additional tax attributable to completion of the transaction as a partnership. USLLC contests that treatment on the ground that under the Morrie test it resembled a corporation and should be so treated as of the time of the transaction. Will USLLC win? I doubt it. Should the case ever reach the Supreme Court, it will understand that thousands of taxpayers’ returns for multiple years will be thrown into dispute if it invalidates the regulation. The Court will see that it cannot resurrect the prior regulations; at least the Service had the authority to revoke its own regulations. Therefore, the Court will leave all of these taxpayers and the government to figure out what proper entity characterization is under a 69-year-old opinion that did not even address the partnership corporation distinction. But I would be glad to take the case!

A LARGER ISSUE

The professor’s complaint shines a light on one part of a much larger issue in the federal tax law: interpretation of the Internal Revenue Code has gone its own way, somewhat separate and apart from the mainstream of administrative law and judicial interpretation of other federal statutes. We discuss “substance over form” as if it were an idea unique to the federal tax law, when in fact it has been a feature of law since the writing of the Talmud, if not before. Because of our intense specialization, our attorneys and our specialty courts are inadvertent to the mainstream of the law.

We chafe at Supreme Court intervention in the sacred interpretation of the Code, but we should be grateful to the Court episodically brings us back to the reality that the Code is just one of many federal statutes and must be subject to general interpretational standards. In other words, if ordinary Supreme Court justices can’t understand the Code, what good is it?