6TH CIRCUIT DECISION IN INTERMET: IRS NOT ENTITLED TO DEFERENCE ON TEN-YEAR CARRYBACK ISSUE

by

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Internal Revenue Code ("***IRC***") §172(b)(1)(C) permits an extended ten-year carryback for the portion of a net operating loss attributable to a specified liability loss ("***SLL***"). IRC §172(f) defines a SLL to mean any amount allowable as a deduction with respect to certain liabilities if, among other requirements, the amount is taken into account in computing (and does not exceed the amount of) the net operating loss for the taxable year. The IRS and taxpayers have been engaged in a dispute over the application of the IRC §172(f) net operating loss limitation on SLLs in the context of an affiliated group of corporations filing a consolidated return. Specifically, where an affiliated group has a consolidated net operating loss but the SLL deductions are incurred by a member of the group having positive separate taxable income, the IRS has urged a separate member-by-member approach and argued that the ten-year carryback is unavailable for the SLL deductions, while taxpayers have urged a single consolidated entity approach and argued that the ten-year carryback is available.

The IRS first expressed its position on this issue in Technical Advice Memorandum ("***TAM***") 9715002 (April 11, 1997). There have been two subsequent court cases addressing the issue, one holding in favor of the IRS and the other holding in favor of the taxpayer. On March 24, 2000, in *United Dominion Industries, Inc*. v. *U.S.*, the 4th Circuit Court of Appeals reversed a District Court decision and held in favor of the IRS on the issue. By contrast, on April 20, 2000, in *Intermet Corporation & Subsidiaries* v. *CIR*, the 6th Circuit Court of Appeals reversed a Tax Court decision and held in favor of the taxpayer on the issue.

NO DEFERENCE TO IRS POSITION

Resolution of this issue necessarily involves interpretation of the IRS' consolidated return regulations, which are legislative in character. This in turn raises the question of applicability of the doctrine (sometimes referred to as the *Chevron*[1] doctrine) pursuant to which, under certain circumstances, courts defer to a government agency's reasonable interpretation of a statute which the agency is charged with administering. The contours of the *Chevron* doctrine are not entirely clear but, in the recent *Cigna* case,[2] the 3rd Circuit Court of Appeals rendered a decision and used language arguably indicating that deference is to be accorded to any reasonable IRS interpretation even if first adopted by the IRS in litigation. The prospect, engendered by *Cigna*, that courts are to defer to a mere litigating position of the IRS has sent a shock wave through the

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1 *Chevron, U.S.A., Inc.* v. *National Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

2 *Connecticut General Life Insurance Co.* v. *CIR*, 177 F.3d 136 (3rd Cir. 1999).

taxpayer and taxpayer representative community. Fortunately, however, the 6th Circuit decision in *Intermet* makes it clear that this is not the law.

In *Intermet*, the 6th Circuit rejected the IRS' interpretation, advanced in the case, of how the consolidated return regulations applied to the ten-year SLL carryback. The court stated that its conclusion was fortified by the IRS' history of adopting or applying different and inconsistent interpretations of how the consolidated return regulations applied to the SLL carryback. Specifically, the court noted two inconsistencies between the IRS' rationale for its position as expressed in TAM 9715002 and the IRS' rationale for its position as expressed in the *Intermet* case:

> (i) First, the IRS relied upon Treas. Reg. §1.1502-79(a) in TAM 9715002, but the IRS did not rely upon or even cite this regulation in the briefs it filed or the oral arguments it made in the *Intermet* case; the 6th Circuit noted this inconsistency and concluded that this regulation was inapplicable because it only addressed the allocation and carryback of a consolidated net operating loss to a separate return year of a member of the affiliated group, a situation not present in *Intermet*.
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> (ii) Second, in TAM 9715002 the IRS relied upon Treas. Reg. §1.1502-80 (which provides that the provisions of the IRC apply to an affiliated group to the extent the consolidated return regulations do not exclude such application), but the IRS did not rely upon or even cite the regulation in the briefs it filed or the oral arguments it made in the *Intermet* case; the 6th Circuit noted this inconsistency and concluded that this regulation actually supports the single entity approach espoused by the taxpayer.

Because of the IRS' changing and inconsistent interpretation of the ten-year SLL carryback in the consolidated return context, the 6th Circuit in *Intermet* refused to accord deference to the IRS' interpretation and held that the interpretation was unreasonable. The court essentially held that deference is something that must be earned by an administering agency through unchanging and consistent interpretation. It should be noted that, although sanctioning a very broad application of the *Chevron* doctrine, even the *Cigna* court acknowledged that consistent agency interpretation is a prerequisite to deference by stating that "[o]nce an agency has adopted regulations interpreting the statute, the agency's <u>consistent interpretation</u> of its own regulation will also be accorded substantial deference." (emphasis supplied).[3]

While the arguments made by the IRS in TAM 9715002 to support its separate member-by-member approach differed from the arguments it made in *Intermet*, the IRS' basic position that the separate member-by-member approach was the correct approach did not change;
all pronouncements by and positions taken by the IRS have consistently espoused the member-by-member approach. Nevertheless, the 6th Circuit in *Intermet* held that the IRS position was not entitled to deference and was unreasonable because, although the basic position was consistent and unchanged, the IRS' rationale for the position was changing and inconsistent. Effectively concluding that changing and differing rationales for a position evidence that the position is unreasonable and incorrect, the 6th Circuit in *Intermet* stated the following:

[3] 177 F.3d at 144.

> "We also understand that the IRS's basic position – that a consolidated group cannot invoke the SLL carryback if the SLL expenses are incurred by a member with positive [separate taxable income] – has remained unchanged. However, the IRS's shifting and incongruous reasoning in reaching this result highlights the fundamental flaw: its position does not comport with the current purpose and language of the Code and regulations. <u>It is trying to fit a square peg into a round hole.</u>" (emphasis supplied)

What the 6th Circuit in *Intermet* appears to have been saying is that the IRS is not entitled to deference where arguments made by the IRS are later abandoned by it. More significantly, the message discernable from the decision is that the IRS' development and subsequent abandonment of arguments evidences that it is grasping for straws to come up with any rationale possible to support an incorrect conclusion. If the IRS' conclusion were correct (*e.g.*, if the IRS was trying to fit a round peg into a round hole), the rationales for the IRS' position would not be changing, differing and shifting. Under the standard employed by the 6th Circuit in *Intermet*, deference is to be accorded an agency interpretation only when both the interpretation and the rationale underlying the interpretation are consistent and unchanging.

BROADER IMPLICATIONS FOR TEN-YEAR CARRYBACK

The issue addressed by the 6th Circuit in *Intermet* – the availability of the ten-year SLL carryback in the consolidated return context where the member incurring the SLL deductions has positive separate taxable income – is a relatively narrow issue affecting relatively few taxpayers. The much more significant and common issue is what types of deductions qualify for the ten-year carryback under IRC §172(f)(1)(B) (which defines a SLL to include any amount allowable as a deduction during a taxable year with respect to a liability which arises under a federal or state law if the act or failure to act giving rise to the liability occurs at least three years before the beginning of the taxable year). In this regard, there has been a change, inconsistency and incongruity in the IRS position on what liabilities qualify for SLL treatment that is much more egregious than in the case of the IRS' position on the consolidated return issue. As a result, the prerequisites to deference applied by the 6th Circuit in *Intermet* bode well for taxpayers and poorly for the IRS on the larger threshold issue of what types of liabilities qualify as SLLs. [4]

In the early and mid-1990's, the IRS issued four private letter rulings holding that ten-year SLL carryback treatment was available with respect to various liabilities.[5] The IRS then successfully challenged in court the relatively weak claim by Sealy Corporation for SLL treatment for professional fees incurred in complying with various federal laws.[6] After its

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[4] The taxpayer in *Intermet* claimed SLL treatment for statutory liabilities for state tax deficiencies, interest thereon and interest on federal tax deficiencies which were deducted more than three years after the taxable years to which the tax deficiencies related; having decided against the IRS on the consolidated return issue, the 6th Circuit remanded the *Intermet* case to the Tax Court for a determination of whether these liabilities qualified as SLLs.

[5] PLR 9105022 (November 5, 1990), *revoked*, PLR 199922046 (March 5, 1999); PLR 9409011 (November 24, 1993); PLR 9441020 (July 8, 1984), *revoked*, PLR 199927012 (April 6, 1999); and PLR 9550011 (September 13, 1995). The liabilities at issue in the two private letter rulings which the IRS revoked included the same tax law liabilities for which the taxpayer in *Intermet* claimed SLL treatment.

victory in the *Sealy* case, the IRS did a complete about face and began issuing one written determination after another denying ten-year carryback treatment for virtually all liabilities. This represents a change, inconsistency and incongruity in the overall IRS position, as compared to the consolidated return issue where the IRS' overall position has remained unchanged but there has merely been a change in the rationale for its position. As a result, the IRS' position on the threshold issue of what types of liabilities qualify as SLLs should be entitled to absolutely no deference.

The rationale for the IRS' position (in addition to the position itself) on what types of liabilities qualify as SLLs has also been changing, inconsistent and incongruous. The language of IRC §172(f)(1)(B) is broad, clear and unambiguous, and the four taxpayer-favorable private letter rulings issued by the IRS in the early and mid-1990's were based solely upon a literal interpretation of that language. By contrast, in its post-*Sealy* written determinations denying SLL treatment, the IRS began asserting that various non-statutory requirements or limitations allegedly derived from the legislative history of IRC §172(f)(1)(B) had to be satisfied in order for SLL treatment to be available. One of these alleged non-statutory requirements or limitations is that SLL treatment is only available for a "narrow class" of liabilities. However, what characteristics a liability must possess to be part of this "narrow class" has been a moving target, with the IRS first taking the position in its initial post-*Sealy* written determinations that SLL treatment is available only for non-routine, large and sporadic liabilities, and then the IRS changing course and taking the position in subsequent written determinations that SLL treatment is available only for liabilities as to which there is an inherent delay between the time of occurrence of the act giving rise to the liability and the time when the liability is deductible.[7]

This changing, inconsistent and incongruous rationale for the IRS position on what types of liabilities qualify as SLLs should deprive the IRS of any deference for the same reasons that the 6th Circuit in *Intermet* refused to accord deference to the IRS' position on the consolidated return issue. Deference is available only if earned through consistent and unchanged rationales for a position. The changing and inconsistent rationales underlying the IRS position on what types of liabilities qualify as SLLs highlights the fundamental flaw: The IRS' position does not comport with the language and purpose of IRC §172(f)(1)(B). The IRS has had to manufacture new and different rationales for its position on what liabilities qualify as SLLs, because its position is incorrect. With respect to the threshold issue of what types of liabilities qualify as SLLs, just as in the case of the consolidated return issue, the IRS "is trying to fit a square peg into a round hole."

The IRS has been severely criticized for the fact that it initially ruled favorably on the availability of the ten-year carryback and then, after the *Sealy* case, completely reversed position and began ruling unfavorably. In retort to this criticism, the IRS has pointed out that its initial taxpayer-favorable rulings were private letter rulings which are not binding precedential authority pursuant to IRC §6110(k)(3). However, this fact will not preclude a court from

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6 *Sealy Corporation* v. *CIR*, 107 T.C. 177 (1996), *aff'd*, 171 F.3d 655 (9th Cir. 1999).

7 In addition to the IRS' assertion that a SLL must satisfy the alleged non-statutory prerequisite of being part of a "narrow class" of liabilities, the IRS has also alleged that there is another non-statutory requirement for SLL treatment, namely that deductibility of the liability must be deferred under the economic performance rules of IRC §461(h). While beyond the scope of this paper, a careful review of the relevant legislative history reveals that neither of these alleged non-statutory requirements is in fact a requirement for SLL treatment.

denying deference to the IRS position. Private letter rulings and other IRS written determinations such as TAMs and field service advice, while not binding precedential authority, are looked to by the courts as evidence of IRS administrative practice and are taken into account in determining whether such practice is entitled to deference. This is made clear in *Intermet* where, in denying the IRS deference because of differing and inconsistent interpretations made in TAM 9715002, the 6th Circuit said the following:

> "We recognize that a Technical Advice Memorandum is not binding upon either the IRS or this court. *See* I.R.C. §6110(j)(3) (1994). But the Memorandum illustrates the IRS' application of the SLL carryback in the consolidated return context – history that we may consider in determining whether IRS' current position is reasonable."

Even apart from the shifting and inconsistent position (and rationale for the position) of the IRS on what types of liabilities qualify as SLLs, the clear and unambiguous language of IRC §172(f)(1)(B) precludes the IRS' interpretation of the provision from being accorded any deference. The *Chevron* case and its progeny (including even the *Cigna* case) make it clear that a government agency's interpretation of a statute will be accorded deference only if the statute is ambiguous or silent with respect to the issue being interpreted.[8] In addition to the fact that an agency's interpretation of a clear and unambiguous statute is not entitled to deference, an agency's interpretation of such a statute by reference to the legislative history underlying the statute (as in the case of the IRS' interpretation of IRC §172(f)(1)(B)) is prohibited by the plain meaning rule of statutory construction.

The consolidated return regulations were the primary subject of interpretation in *Intermet*, with the interpretation of IRC §172(f)(1)(B) being a subsidiary issue. In this regard, the courts seem more willing to accord deference to an agency's interpretation of its own regulations than to an agency's interpretation of a statute. Even the *Cigna* court acknowledged this distinction by saying the following, in language indicating that deference may be accorded to an agency's litigating position on interpretation of the agency's regulations but not to an agency's litigating position on interpretation of a statute:

> "CIGNA argues that, under *Bowen* [v. *Georgetown Univ. Hosp.*, 488 U.S. 204, 212 (1988)], the interpretation the Commissioner advances in this case is not

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[8] In the *Cigna* case, the 3rd Circuit quoted the following language from its previous decision in *Sekula* v. *FDIC*, 39 F.3d 448, 451-52 (3d Cir. 1994): "When reviewing an agency's construction of a statute, if the intent of Congress is clear, then we must give effect to that intent. If the statute is silent or ambiguous with respect to a specific issue, then a deference standard applies, and the question for the court becomes whether the agency's answer is based on a reasonable construction of the statute." *See also K Mart Corp.* v. *Cartier, Inc.,* 486 U.S. 281, 291-92 (1988), where the Supreme Court explained the parameters of the *Chevron* doctrine as follows: "In determining whether a challenged regulation is valid, a reviewing court must first determine if the regulation is consistent with the language of the statute. If the statute is clear and unambiguous[,] that is the end of the matter, for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. . . . The traditional deference courts pay to agency interpretation is not to be applied to alter the clearly expressed intent of Congress." (internal citations and quotations omitted). It should be noted that the consolidated return regulations are silent and ambiguous as to their application to the SLL carryback, and a reasonable interpretation by the IRS in *Intermet* would have qualified for deference had the IRS earned deference through consistent and unchanged interpretation.

> entitled to deference because it is a "mere" litigating position. CIGNA's reliance on *Bowen* is misplaced. *Bowen*, which concerned the amount of deference due an administrative agency's informal interpretation of a statute, does not address what deference we should accord an agency's interpretation of its own regulations, such as is at issue here. Indeed, the Supreme Court has deferred to an agency's interpretation of its own regulations, even when that interpretation was proffered for the first time in litigation, see *Gardebring* v. *Jenkins*, 485 U.S. 415, 430 (1988), as have we, see *Elizabeth Blackwell Health Ctr. for Women* v. *Knoll*, 61 F.3d 170, 183 & n.9 (3d Cir. 1995)."[9]

The threshold issue of what types of liabilities qualify as SLLs entails an interpretation of the statutory provision of IRC §172(f)(1)(B); it does not entail interpretation of regulations promulgated by the IRS under that provision and, indeed, the IRS has not promulgated any regulations under the provision, a factor rendering the IRS interpretation of the provision even less worthy of deference.[10]

CONCLUSION

The 6th Circuit Court of Appeals is to be heartily congratulated for its decision in *Intermet* denying deference to the IRS position on the consolidated return SLL issue because, although the IRS' position on the issue was consistent and unchanged, the IRS' reasoning underlying the position was inconsistent and changing. On the threshold issue of what types of liabilities qualify as SLLs, where there has been changing and inconsistency both in the reasoning for the IRS' position and in the position itself, the IRS is even less deserving of deference. The changing and inconsistent IRS positions (and rationales for those positions) reflect the IRS' desperate attempt to find some means of undermining the SLL ten-year carryback benefit enacted by Congress. Hopefully the 6th Circuit decision in *Intermet* will set a precedent for non-deference to and judicial intolerance of this IRS attempt to "fit a square peg into a round hole."

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[9] 177 F.3d at 144. Like the *Intermet* case, the *Cigna* case involved interpretation by the IRS of the consolidated return regulations. Even though they are legislative in character, the above-quoted language indicates that the *Cigna* court would be more inclined to defer to the IRS' interpretation of those regulations than to the IRS' interpretation of a statutory provision.

[10] Even though it ruled in favor of the IRS in the *Sealy* case, the 9th Circuit Court of Appeals in the oral hearing in the case appropriately reprimanded the IRS for failing to issue regulations under IRC §172(f)(1)(B).