

International Tax Controversies

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Swallows Holding: IRS “Interpretive” Regulations Entitled to Chevron Deference; Tax Court Reversed



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Introduction

In *Swallows Holding, Ltd.*,¹ the Third Circuit Court of Appeals reversed the Tax Court with respect to when a foreign taxpayer must file its U.S. tax return in order to avoid a loss of deductions under Code Sec. 882(c)(2).² The court of appeals upheld an IRS regulation requiring the return to be filed within a prescribed time limit. The Tax Court had held the regulation to be an invalid exercise of the Secretary’s general rule-making authority.³

The Tax Court and Court of Appeals opinions focused on an evolving and very important body of law regarding the way in which courts interpret regulations. The *Swallows* cases—and the reasoning within the opinions—could have a direct bearing on a number of high-profile international tax issues, such as the availability of foreign tax credits under the “technical taxpayer” rule⁴ and the treatment of stock options in a qualified cost-sharing arrangement.⁵

Tax Court Opinion

Swallows Holding was a Barbadian corporation engaged in holding real property in the United States. In 1999, the corporation filed its federal income tax returns for tax years 1994, 1995 and 1996. The IRS issued a notice of deficiency for each year, denying the corporation’s claimed deductions under Code Sec. 882(c)(2).

Code Sec. 882(c)(2) states that a foreign corporation shall receive the benefit of otherwise allowable

deductions and credits only if it files a return “in the manner prescribed in subtitle F.” While the statute does not mention a time for filing, Reg. §1.882-4⁶ interprets the statute to require generally that a foreign corporation file a return within 18 months of the due date to claim deductions or credits. At issue in *Swallows* was whether this regulation is a valid construction of the statute.

In a reviewed decision,⁷ the Tax Court held that Code Sec. 882(c)(2) does not include a time element, and that Reg. §1.882-4 is therefore an invalid exercise of the Secretary’s rulemaking authority.⁸ The court held that the Barbadian corporation could not be denied deductions simply because its returns were filed late.

The Tax Court stated that it analyzes interpretive federal tax regulations using the standard set forth by the Supreme Court in *National Muffler Dealers Ass’n*.⁹ Under *National Muffler*, an interpretive regulation¹⁰ is reasonable only if it harmonizes with the plain language of the statute, its origin and its purpose. The court observed that the Supreme Court decided *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*¹¹ after it decided *National Muffler*. Under *Chevron*, if Congress has not spoken to the precise question at issue, a court must defer to an agency’s interpretation if it is based on a permissible construction of the statute.¹² The Tax Court concluded, however, that it need not determine whether the Supreme Court intended *Chevron* to replace *National Muffler* as the standard for reviewing interpretive regulations, because it would reach the same result under either standard.¹³

The court considered the factors cited by the Supreme Court in *National Muffler* and found them to support its conclusion that the regulation was unreasonable. These factors include the length of time the regulation has been in effect, whether it is a contemporaneous construction of the statute, and the consistency of the IRS’s interpretation.¹⁴ The court found that Reg. §1.882-4 was issued 62 years after the statutory provision it interpreted, was a departure from the IRS’s previous regulations and merely adopted the IRS’s unsuccessful litigating position.

Finally, the Tax Court addressed the Supreme Court’s recent decision in *National Cable & Telecommunications Ass’n v. Brand X Internet Services*.¹⁵ *National Cable*, a nontax case, held that under *Chevron*, the Ninth Circuit owed deference to an FCC ruling even though a precedential Ninth Circuit case interpreted the governing statute differently before the FCC issued

the ruling. Thus, the agency in effect was allowed to overrule judicial precedent by issuing the ruling. The Tax Court noted a number of facts distinguishing *National Cable* from *Swallows* (and from tax cases generally) but did not decide whether *National Cable* applies to federal tax regulations.¹⁶

Standard of Review: *National Muffler vs. Chevron*

The Court of Appeals disagreed with the Tax Court’s analysis in several respects. The appellate court stated that the result of the case would not be the same under *National Muffler* and *Chevron*. The court noted that the Tax Court relied on several factors that are relevant to the *National Muffler* standard, but are not mandatory or dispositive under *Chevron*, such as the length of time the regulation has been in effect, whether it is a contemporaneous construction of the statute and the consistency of the IRS’s interpretation. “When *Chevron* deference is owed,” stated the court, “*Chevron*’s demands are clear. If the statutory text is ambiguous, an agency is given the discretion to promulgate rules that interpret the ambiguous provisions.”¹⁷

The court addressed whether *Chevron* deference is owed to interpretive IRS regulations under *Mead Corp.*¹⁸ *Mead* teaches that *Chevron* deference is appropriate “where Congress would expect the agency to be able to speak with the force of law.”¹⁹ Congressional delegation of this authority to an agency may be shown in a variety of ways, as by an agency’s power to engage in adjudication or notice-and-comment rulemaking, or by some other indication of a comparable congressional intent. Here, Congress delegated authority to the Treasury Secretary under Code Sec. 7805(a) to prescribe “all needful rules and regulations” for the enforcement of the Internal Revenue Code. Further, stated the court, the IRS opened the disputed regulation to public comment, a move that is indicative of agency action that carries the force of law. Accordingly, the court held that the regulation is entitled to *Chevron* deference if it survives *Chevron*’s two-prong inquiry.²⁰

Chevron Step One: The Plain Meaning of the Statute

In *Chevron* Step One, a reviewing court determines whether the statutory provision in question is clear and unambiguous. As stated by the Supreme Court,

“If the intent of Congress is clear, 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.”²¹ The inquiry into the ambiguity of a statutory provision begins with the text of the statute.²²

The Court of Appeals stated that previous judicial interpretations of Code Sec. 882(c)(2) do not preempt the court’s analysis in determining if the statute is ambiguous. Under *National Cable*,²³ only a judicial precedent holding that the statute unambiguously forecloses the agency’s interpretation, and therefore contains no gap for the agency to fill, displaces a conflicting agency construction. The court stated that no such opinion exists in this case.²⁴ Thus, the court stated that it was not bound by previous judicial interpretations of Code Sec. 882(c)(2).

An issue such as this could arise if a taxpayer were to challenge the “technical taxpayer” regulations currently proposed under Code Sec. 901, given that there is previous Supreme Court law on point.²⁵

Code Sec. 882(c)(2) states that a foreign corporation, in order to obtain deductions, must file “a true and accurate return, in the *manner* prescribed in subtitle F” of the Code. An issue arose as to the use of the word “manner.” The taxpayer argued that “manner,” by its nature, does not include a timing element, thus indicating that Congress did not intend for a filing deadline to exist.²⁶

The Court of Appeals stated that Congress in other sections of the Code also uses the word “manner” without the word “time,” and that in some of these situations “manner” has been interpreted to include a timing element.²⁷ The court cited in this regard Code Secs. 179(c) and 835(c)(2), each of which permits certain elections to be made in the “manner” the Secretary prescribes by regulations. Regulations interpreting these statutory provisions refer to both the time and manner for making the respective elections.²⁸

The Tax Court’s opinion, on the other hand, cited numerous instances in the 1939, 1954 and 1986 Codes, as well as the earlier Revenue Acts, where Congress deliberately used the words “time and manner” together in order to indicate a timing element. Several of the cited provisions appear in subtitle F of the current Code, relating to the filing of returns.²⁹ The

Tax Court relied on these provisions to conclude that Code Sec. 882(c)(2) is unambiguous in *not* including a time element.³⁰

Finally, the court asserted that the word “manner” as used in Code Sec. 882(c)(2) may be defined as “a characteristic or customary way of acting.” Under this definition, the court stated, the statute is not a clear and unambiguous expression of congressional intent, as one’s customary way of acting may include an element of timeliness.³¹ The court stated that the word “manner” could be read to refer to subtitle F, which includes timing elements, or as indicating that Congress did not intend the timing requirements of subtitle F to apply. Thus, the court held that the word “manner” creates ambiguity, and the Secretary was justified in promulgating a regulation.

The different outcomes reached by the Tax Court and the Court of Appeals illustrate that the “plain meaning” of a statute is sometimes in the eye of the reviewing court.

Chevron **Step Two:** **Reasonableness**

of the Regulation

If the statute is ambiguous, a reviewing court in *Chevron* Step Two must next consider whether the agency’s interpretation is reasonable. The agency’s interpretation need not be the only one it permissibly could have adopted, or even the reading the court would have reached had the question first arisen in a judicial proceeding. Further, the Court of Appeals stated that *Chevron* deference is even more appropriate in cases involving a complex and highly technical regulatory program such as the Internal Revenue Code.³²

The court stated that it is not unreasonable for the Secretary to impose an 18-month filing deadline for foreign corporations in order to benefit from deductions. Drawing this temporal line, stated the court, is a task properly within the powers and expertise of the IRS. The court held that the 18-month filing window of Reg. §1.882-4 is a reasonable exercise of the Secretary’s discretion.³³

The reasonableness of a regulation could be relevant if a taxpayer were to challenge the 2003 cost-sharing regulations with respect to the treatment of stock options. Commentators have questioned the soundness of the IRS’s position on stock options, both before and after the promulgation of the 2003 regulations.³⁴

When Is a Statute's Meaning "Unambiguous"?

The different outcomes reached by the Tax Court and the Court of Appeals illustrate that the "plain meaning" of a statute is sometimes in the eye of the reviewing court. The Tax Court employed traditional tools of statutory construction and also undertook a searching review of the legislative and judicial history of Code Sec. 882(c)(2) in reaching its determination that the statute unambiguously foreclosed the IRS's interpretation. The Court of Appeals, on the other hand, focused primarily on the text of the statute, concluding that the word "manner" created ambiguity regarding the existence of a timing element, thus leaving a gap for the IRS to fill by regulation.

The difference in the Tax Court's and Court of Appeals' approaches cannot be explained merely by the Tax Court's decision to apply *National Muffler* rather than *Chevron*. Courts of appeals applying *Chevron* have at times engaged in thorough analysis of the relevant statutory provision similar to that applied by the Tax Court in *Swallows*. For example, in *Microsoft Corp.*,³⁵ the Ninth Circuit court noted two possible meanings for the term "similar reproductions" in the governing FSC statute,³⁶ then proceeded to determine which meaning Congress intended. "Where the plain language of the statute is

susceptible of more than one interpretation, we are left with the task of determining the more plausible interpretation of the language Congress chose."³⁷

Conclusion

The *Swallows* decisions in the Tax Court and the Court of Appeals are important developments in the law regarding the level of deference to be afforded to a federal tax regulation. It remains to be seen whether and to what extent the Tax Court will conform to the Third Circuit's views regarding the continuing vitality of *National Muffler* and the application of *National Cable*

in tax cases, particularly where regulations purport to overturn a longstanding judicial interpretation of a statute.

To the extent an IRS regulation attracts *Chevron* deference, the *Swallows* decisions reaffirm the continuing importance of the "plain meaning" rule

of statutory interpretation. Even under *Chevron*'s deferential standard of review, the first question a court must address is always whether Congress's intention is clear with respect to the precise question at issue. *Swallows* illustrates that the outcome of a case can turn on whether the court seeks to discern this intention from the language of the statute alone, or instead carefully examines the statutory structure, origin, purpose and history.

Even under *Chevron*'s deferential standard of review, the first question a court must address is always whether Congress's intention is clear with respect to the precise question at issue.

ENDNOTES

¹ *Swallows Holding, Ltd.*, CA-3, 2008-1 USTC ¶50,188, 515 F3d 162 [hereinafter *Swallows II*].

² Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder.

³ *Swallows Holding, Ltd.*, 126 TC 96, Dec. 56,417 (2006) [hereinafter *Swallows I*], vacated, CA-3, 515 F3d 162 (2008).

⁴ Proposed regulations issued in August 2006 would reverse the result in *Guardian Industries Corp.*, FedCl, 2005-1 USTC ¶50,263, 65 FedCl 50, *aff'd*, CA-FC, 2007-1 USTC ¶50,281, 477 F3d 1368. See REG-124152-06, IRB 2006-36, 368. See also Reg. §1.901-2(f); *M.D. Biddle*, SCt, 38-1 USTC ¶9040, 302 US 573, 58 SCt 379.

⁵ Final regulations issued in 2003 would overturn the result in *Xilinx*, 125 TC 37, Dec.

56,129 (2005), *appeal docketed*, CA-9, Nos. 06-74246 and 06-74269 (argued Mar. 12, 2008). See Reg. §1.482-7(d)(2); T.D. 9088, IRB 2003-42, 841.

⁶ Reg. §1.882-4 (1990), T.D. 8322, 1990-2 CB 172.

⁷ Thirteen of the 18 Tax Court judges concurred in the majority opinion; two judges concurred in the judgment only; and three judges dissented.

⁸ *Swallows I*, *supra* note 3.

⁹ *National Muffler Dealers Ass'n*, SCt, 79-1 USTC ¶9264, 440 US 472, 99 SCt 1304.

¹⁰ An "interpretive" federal tax regulation is one issued pursuant to the Treasury's general regulatory authority under Code Sec. 7805(a). By contrast, a "legislative" regulation is issued pursuant to a specific grant of regulatory authority in the statutory provision in question. The Tax Court stated

that it upholds legislative regulations unless they are arbitrary, capricious or manifestly contrary to the statute. See *Swallows I*, *supra* note 3, at 130 n.16.

¹¹ *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, SCt, 467 US 837, 104 SCt 2778 (1984).

¹² See *id.*, at 843.

¹³ See *Swallows I*, *supra* note 3, at 131.

¹⁴ See *id.*, at 129-30 (citing *National Muffler*, 440 US, at 477).

¹⁵ *National Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, SCt, 545 US 967, 125 SCt 2688 (2005).

¹⁶ See *Swallows I*, *supra* note 3, at 143-47.

¹⁷ *Swallows II*, *supra* note 1, at 168.

¹⁸ *Mead Corp.*, SCt, 533 US 218, 121 SCt 2164 (2001).

¹⁹ *Swallows II*, *supra* note 1, at 168 (quoting *Mead*, 533 US, at 229).

²⁰ *Swallows II*, *supra* note 1, at 169.

²¹ *Chevron*, *supra* note 11, at 837–38.

²² *Swallows II*, *supra* note 1, at 170.

²³ *National Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, *supra* note 16.

²⁴ *Swallows II*, *supra* note 1, at 170. In a footnote, the court addressed *Anglo-American Direct Tea Trading Co.*, 38 BTA 711, Dec. 10,446 (1938), *nonacq.*, 1939-1 CB 39. The court stated that the *Anglo-American* court did not purport to apply the unambiguous meaning of the word “manner,” but rather, detailed the interpretive confusion that courts confronted. *Id.*, at 170 note 11. By contrast, the Tax Court held that *Anglo-American* applied the unambiguous meaning of the word “manner.” *Swallows I*, *supra* note 3, at 145.

²⁵ In *Biddle*, *supra* note 4, the Supreme Court held that a foreign tax credit was not available to a shareholder in respect of the tax paid by the corporation. The Court stated that U.S. revenue laws have not treated as taxpayers those upon whom no legal duty to pay the tax is laid.

²⁶ See *Swallows II*, *supra* note 1, at 170.

²⁷ See *id.*, at 171.

²⁸ See Reg. §§1.179-5 and 1.826-1(c). While

Reg. §1.179-5 is entitled, “Time and manner of making election,” the text of the regulation states that the election must be made on the taxpayer’s first income tax return to which the election applies, *whether or not the return is timely*.

²⁹ See *Swallows I*, *supra* note 3, at 132–34 (listing more than 80 statutory provisions).

³⁰ “We believe that Congress acted intentionally and purposely when it included both ‘time’ and ‘manner’ in single sections of the referenced statutes but omitted the word ‘time’ in favor of only the word ‘manner’ in other single sections of those statutes ... as in section 882(c)(2). ...” *Id.*, at 134–35. See also *Russello*, S.Ct., 464 US 16, 104 S.Ct 296 (“Where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.”).

³¹ See *Swallows II*, *supra* note 1, at 171. It would appear that this definition of “manner” is not the one used in the statute. The word “manner” as used in Code Sec. 882(c)(2) refers not to a characteristic of a person, but to “the mode or method in

which something is done or happens.” See WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY (UNABRIDGED), G.& C. Merriam Co., at 1376 (4th ed. 1976) (definitions 2a(1) and 2a(2) of “manner”). Stated another way, the word “manner” addresses *how* something is done. The word “time” is ordinarily used to address *when* something must be done.

³² See *Swallows II*, *supra* note 1, at 171–72. It seems inappropriate in this case to grant any additional deference on account of the complexity of the Code. The question of statutory interpretation involved—whether Congress intended the word “manner” to include a time element—is a relatively simple one that could arise under any federal statute.

³³ See *id.*, at 172.

³⁴ For a detailed discussion of the 2003 regulations, see Ronald B. Schrotenboer, *Arm’s Length in Wonderland*, 2004 TNT 8-29 (Jan. 13, 2004).

³⁵ *Microsoft Corp.*, CA-9, 2002-2 USTC ¶ 50,800, 311 F3d 1178.

³⁶ Code Sec. 927(a)(2)(B), as in effect prior to the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (P.L. 106-519).

³⁷ *Microsoft*, *supra* note 36, 311 F3d, at 1183.

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