News Analysis: Tax Court Flunks the Brand X Test
by Lee A. Sheppard

Tax Notes contributing editor Lee A. Sheppard critiques the Tax Court's January decision in Swallows v. Commissioner, which invalidated a tax return filing regulation.

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Soccer is the key to the Iranian nuclear crisis.

The story thus far: The Americans and Europeans have been dithering with diplomacy for months, while the Iranians have broken the seals on their nuclear installations. Now the Westerners have managed to persuade the Russians and the Chinese to accept a delayed referral of Iran to the United Nations Security Council for sanctions. Even if sanctions were to be imposed, those being considered do not include prohibitions on cultural and sports participation. Meanwhile, the Iranians have threatened to raise the price of oil.

Want to get the Iranians to stop building bombs right now? Tell them they can't play in the 2006 World Cup.

I'm not joking. Most Americans don't remember that in the 1998 World Cup, the Iranian national team beat the American national team. From a footballing standpoint, the match was a contest to see whose team was worse. But the Iranians remember the match fondly. It was a great day when they beat the Great Satan.

Football is ahead of diplomacy in many respects; no country is a pariah. In the world of the Federation Internationale de Football Association, there are no bad countries, only bad teams. Iran finished second in its Asian qualifying group, behind Japan. Its fellow "axis of evil" member, North Korea, finished last in the group. (The Iraqi team was knocked out at an earlier stage.) Given the prestige of qualifying, a World Cup sanction is a no-brainer that probably hasn't even occurred to anyone in Robert Zoellick's office.

The State Department wants to see Iranians in the streets rebelling against their government, whose masters are Shiite clerics out of touch with the younger half of the country's population. Want to foment unstoppable popular demonstrations in the streets? Tell them they can't play in the 2006 World Cup unless they stop building bombs right now. Watch their elected and unelected leaders try to explain why a bomb is more important. What are those leaders going to say -- Mexico and Portugal were going to knock Iran out anyway?

Yes, of course, a nuclear weapon is a symbol that a country has arrived in the big league of nations, which is why countries that can't feed their people squander resources to build bombs. But so is a World Cup qualifying team.

Has this got anything to do with taxes? The State Department has some stiff competition from the Tax Court when it comes to missing the blindingly obvious. The Tax Court, in a reviewed decision, decided not to follow the Supreme Court's latest pronouncement on deference to administrative decisionmaking when it invalidated a practical, reasonable return filing regulation in Swallows Holding Ltd. v. Commissioner, 126 T.C. No. 6 (Jan. 26, 2006), Doc 2006-1541 [PDF] or 2006 TNT 18-10.

The IRS must appeal the Swallows decision. It's that bad. It's so bad that taxpayers' representatives should not be happy about it either, because it would also invalidate rules they like. As it happens, appeal would lie to the Ninth Circuit, which applies a test that is very deferential to the tax administrator. Under the Ninth Circuit reading of Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984), an administrative agency's interpretation of a statute must be arbitrary and capricious for a court to overturn it. (Redlark v. Commissioner, 141 F.3d 936 (1998).)

The Issue

We're in trouble already when it takes Tax Court Judge David Laro, who wrote the majority opinion, some 26 pages of the original text to explain facts that can be summarized in three sentences.

The taxpayer was a Barbados corporation, owned by a Mexican national, that held undeveloped U.S. real property. During the years at issue, the real property taxes on the California property exceeded the income from leasing and options. It therefore behooved the taxpayer to elect to treat this income as effectively connected income to be able to deduct property taxes.

In July 1999 the taxpayer filed returns for fiscal years ending in May 1993, 1994, 1995, and 1996 showing net losses, since attributable expenses exceeded income from the property. In January 2002 the IRS issued a notice of deficiency denying deduction of the expenses claimed on the returns.
Under section 6027, the due date for Form 1120F, the return filed by foreign corporations, is six months after the end of the taxpayer's tax year. A foreign corporation electing to treat income as effectively connected income will not be allowed to claim deductions unless it files a U.S. tax return "in the manner prescribed in subtitle F" under section 882(c)(2). (Subtitle F includes section 6072.)

According to reg. sections 1.882-4(a)(2) and (3)(i), for an electing foreign corporation that filed a return in the immediately preceding year, as the taxpayer had done in this case, or is filing a return for the first time, the due date is 18 months after the regular due date. If the electing foreign corporation was required to file a return for the previous year but did not, then the due date for its return is the earlier of 18 months after the section 6072 due date or the date of a notification from the tax administrator. (The notification is not a notice of deficiency, but a little note reminding the taxpayer of failure to file.) That is the regulation whose validity is disputed in Swallows.

Although code sections reading nearly identically to section 882(c)(2) have existed for the entire life of the income tax, reg. section 1.882-4 was the first administrative interpretation of the rule -- that is, the first attempt to specify the manner in which a return must be filed.

**Timely Filing**

Between 1918 and the 1990 adoption of the regulation, however, a plethora of cases were decided holding, roughly, that the predecessors of section 882(c)(2) did not have a timely filing requirement. So the taxpayer in Swallows argued that according to the case law, which included two Fourth Circuit decisions, the IRS had no right to impose a timely filing requirement.

The Tax Court majority bought the taxpayer's argument, wading through years of ancient case law interpreting the predecessors of section 882(c)(2) while missing the point completely.

In their many years of fussing over the manner in which returns must be filed, the courts had decided that a foreign corporate taxpayer should get around to filing its return before the IRS prepared a substitute return and/or issued a notice of deficiency. That was Taylor Securities, Inc. v. Commissioner, 40 B.T.A. 696 (1939). In that case, the IRS in 1937 sent the taxpayer a notice of deficiency showing substitute returns for tax years 1930 through 1935. At the end of 1938 -- 21 months later, on the eve of its Board of Tax Appeals hearing -- the taxpayer filed the returns.

The Board of Tax Appeals was not amused. The board refused to allow the deductions claimed on the taxpayer's returns on the grounds that the tax administrator had already prepared returns. Basically, the taxpayer should not be allowed to jerk the tax administrator around. The board stated:

> The allowance to foreign corporations of the credits and deductions ordinarily allowable is specifically predicated upon such corporations filing returns. In view of such a specific prerequisite it is inconceivable that Congress contemplated by that section that taxpayers could wait indefinitely to file returns and eventually when the respondent determined deficiencies against them they could then by filing returns obtain all the benefits to which they would have been entitled if their returns had been timely filed. Such a construction would put a premium on evasion, since a taxpayer would have nothing to lose by not filing a return as required by statute.

Courts have repeatedly held that although the predecessors of section 882(c)(2) contained no timely filing requirement, at some point a delay in filing a return becomes unreasonable. The courts settled on the preparation of substitute returns by the tax administrator as the point when delay becomes inexcusable.

Indeed, the most recent appellate decision on the issue, in which the court seemingly held that the IRS had no right to impose a timely filing requirement, had sympathetic facts. In Ardbern Co. v. Commissioner, 120 F.2d 424 (4th Cir. 1941), modifying and remanding on other grounds 41 B.T.A. 910 (1940), an IRS agent refused to accept returns from the taxpayer when offered them, on the grounds that they had to be mailed to the filing center. The agent did not even tell the taxpayer where to file. So the taxpayer waited for a notice of deficiency, and filed returns after petitioning the Board of Tax Appeals.

The majority, however, relied heavily on an earlier decision that had been superseded by later decisions. In Anglo-American Direct Tea Trading Co. v. Commissioner, 38 B.T.A. 711 (1938), the taxpayer managed to file returns just before accepting the tax administrator's substitute returns. The government argued that "in the manner" should be read to include a timely filing requirement, but the Board of Tax Appeals disagreed. The board said that if Congress wanted to deny deductions for a lack of timely filing, it would have said so.

The irrelevance of Anglo-American is evident in the Tax Court's most recent pronouncement on the subject, Espinosa v. Commissioner, 107 T.C. 146 (1996), Doc 96-26161 or 96 TNT 188-4 Ç, which is on all fours with Swallows. Espinosa involved a nonresident alien individual who was twice notified by the tax administrator that he had not filed a return. The IRS then prepared substitute returns. The taxpayer then submitted returns showing net losses from U.S. rental properties.
The Tax Court, applying section 874(a) (the individual analogue of section 882(c)(2)), upheld the IRS denial of deductions on the grounds that the tax administrator's preparation of substitute returns was a reasonable cutoff given that the taxpayer had been warned. The court stated:

While sections 874(a) and 882(c)(2) contain no explicit time limit, the policy behind these provisions, as applied by the case law, dictates that there is a cut-off point or terminal date after which it is too late to submit a tax return and claim the benefit of deductions. If no cut-off point existed, taxpayers would have an indefinite time to file a return, and these provisions would be rendered meaningless.

The Tax Court majority in *Swallows* could not adequately distinguish *Espinosa*. *Swallows* could have been decided on the basis of the law alone, as some of the dissenting judges implied. Dissenting Judge Stephen Swift explained that the majority failed to understand how the disputed regulation implemented the holdings of *Taylor Securities* and other cases.

Dissenting Judge James Halpern summed up the situation when he asked rhetorically: "This case does not involve the question of whether a line can be drawn to enforce section 882(c)(2); that has already been decided in the affirmative. This case involves the question of who gets to draw the line: the courts or the Secretary?"

The majority topped off its weak analysis by holding that the old, superseded case law had been legislatively reenacted with the enactment of section 882. Dissenters pointed out that legislative reenactment requires at least some dim awareness of the existence of the rule being reenacted on the part of Congress, which would have to be shown by some mention in the legislative history. There was no mention of a "file anytime" rule in the legislative history of section 882. Judge Mark Holmes commented on the majority interpretation of legislative reenactment:

If taken seriously, it would freeze existing judicial constructions and IRS regulations in place whenever Congress reenacted a portion of the Code, forcing us to treat them as if they were part of the statutory language and blocking the Secretary from changing regulations without persuading Congress to change the Code. This cannot be right.

**Judicial Deference**

The Supreme Court has reaffirmed *Chevron* after some years of confusion about whether courts had a superior right to interpret statutes meant to be administered by federal agencies. The Court had previously stated in *United States v. Mead Corp.*, 533 U.S. 218 (2001), that the delegation of authority to an administrative agency need not be explicit or a grant of legislative rulemaking authority for the agency's interpretations to be given deference.

In *National Cable & Telecommunications Association v. Brand X Internet Services*, 125 S.Ct. 1288 (2005), the Court upheld the Federal Communications Commission's determination that cable modem service is not a telecommunications service, freeing cable providers to undercut phone providers and reversing the Ninth Circuit's decision to substitute its own judgment for the agency's. This decision may mean that courts will not be free to impose their own interpretations of ambiguous statutes on agencies. The importance of this decision to tax administration cannot be overstated.

In *Brand X*, Justice Clarence Thomas, writing for the majority, explained that *Chevron* does not demand the best, or the court's preferred, interpretation of an ambiguous statute. He wrote:

In *Chevron*, this Court held that ambiguities in statutes within an agency's jurisdiction to administer are delegations of authority to the agency to fill the statutory gap in reasonable fashion. Filling these gaps, the Court explained, involves difficult policy choices that agencies are better equipped to make than courts. If a statute is ambiguous, and if the implementing agency's construction is reasonable, *Chevron* requires a federal court to accept the agency's construction of the statute, even if the agency's reading differs from what the court believes is the best statutory interpretation. (Citations omitted.)

Justice Thomas elaborated on the consequences of a contrary rule allowing courts to second-guess administrative rulemaking:

A contrary rule would produce anomalous results. It would mean that whether an agency's interpretation of an ambiguous statute is entitled to *Chevron* deference would turn on the order in which the interpretations issue: If the court's construction came first, its construction would prevail, whereas if the agency's came first, the agency's construction would command *Chevron* deference.
According to Brand X, the only time a court's interpretation can override an agency's is when the court previously determined that a statute could not be interpreted in the way the agency wants to interpret it. That is a rare and narrowly circumscribed situation. Justice Thomas wrote:

The better rule is to hold judicial interpretations contained in precedents to the same demanding Chevron step one standard that applies if the court is reviewing the agency's construction on a blank slate: 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 foregoing may sound a lot like a reiteration of the Chevron rule to our readers, but Brand X is believed to have worked a sea change in judicial deference, which may explain why Justice Antonin Scalia, dissenting, complained that the decision was "revisionist," even though he had previously acknowledged that adherence to stare decisis would ossify the law. "When a court interprets a statute without Chevron deference to agency views, its interpretation (whether or not asserted to rest upon an unambiguous text) is the law," he wrote. Not anymore.

Brand X is a stunning reversal of the previous Supreme Court interpretation that earlier judicial construction of a statute should always override a later agency interpretation. The Court, like the Tax Court majority in Swallows, had hamstrung itself into accepting all manner of silly, antiquated prior judicial interpretations on the ground that stare decisis should control even in the face of changed circumstances. The Court was criticized for allowing the happenstance of timing to dictate statutory construction. The difference between the Court and the Swallows majority is that the Court had the good sense to put a stop to this unproductive practice.

That is the sea change worked by Brand X. Henceforth, only a previous, unambiguous court decision on the meaning of a particular statute will override a reasonable agency interpretation. As Justice Scalia pointed out in his dissent, however, it is not clear when a court's interpretation of a statute is an unambiguous interpretation that would foreclose agency reinterpretation. And, Justice Scalia asked, if a court affirms an agency interpretation, would the agency be stuck with that interpretation in the future?

"Upholding this regulation should be almost trivially easy," wrote Tax Court Judge Holmes, dissenting in Swallows. "For the Secretary to issue a regulation giving a clear 18-month grace period doesn't contradict anything in the Code, at least anything clearly and unambiguously in the Code."

Judge Holmes argued that the majority had not discovered any unambiguous court decision that there should be no time limit on filing. There was a practical necessity for limiting the time in which returns must be filed, as the tax administrator learned from experience. Judge Holmes pointed out that the IRS notifies foreign nonfilers to encourage them to file if for no other reason than filing. There was a practical necessity for limiting the time in which returns must be filed, as the tax administrator learned from experience. Judge Holmes explained, is a stiff test. He believed that the statute clearly and unambiguously foreclosed the agency's interpretation.

How did the Swallows majority get around Brand X? They missed the point completely. Judge Laro basically ignored it in favor of a pre-Chevron decision that involved the IRS, National Muffler Dealers Association v. United States, 440 U.S. 472 (1979). It was as though the Tax Court believed that Chevron had changed the law for every other administrative agency but the IRS. Judge Laro called the IRS's rationale for adopting the timely filing regulation "at best perfunctory." Brand X can't possibly mean anything, because it was about cable Internet service.

The Tax Court's practice is to apply Chevron deference to legislative regulations (those authorized by the substantive provision itself) and National Muffler scrutiny to general authority regulations (those issued under section 7805(a)). National Muffler, as Judge Holmes explained, is a stiff test. He believed that Chevron had superseded National Muffler, while the majority believed that Chevron had merely distilled it and allowed it to continue.

As dissenting Judge Stephen Swift pointed out, the majority failed to understand that the pre-1990 environment was one of no regulations, so it was left to the courts to determine when a reasonable time for filing a return had elapsed. Once the tax administrator stepped in with its own reasonable time for filing, that determination should have been entitled to judicial deference.

If the majority opinion prevailed, wrote Judge Swift, all of the made-up safe harbors in regulations that taxpayers love would be invalid under National Muffler. Invalid regulations would have to include the beloved hedging rules, which override Arkansas Best v. Commissioner, 485 U.S. 212 (1988), a Supreme Court decision holding that there could be no ordinary treatment of noninventory assets normally considered capital. (Reg. section 1.1221-2.) In his Brand X dissent, Justice Scalia snarled that it would be unconstitutional for executive agencies to reverse federal court decisions.

Judge Holmes accused the majority of an extreme reading of National Muffler that would never allow the tax administrator to change a previous interpretation. National Muffler "makes a regulation that changes existing law more likely to be invalidated," Judge Holmes noted. "Chevron review places substantially less emphasis on justification for regulatory change. It expressly recognizes that there can be a range of permissible alternatives."
Judge Holmes acknowledged that the majority reading and the old court decisions might be more consistent with the literal wording of section 882(c)(2). But the preferred reading of the statute is not the point of *Chevron* deference. "Regulation writers are doing their jobs when they make up safe harbors and lay down deadlines; for judges to do so -- instead of setting up fact-bound tests of 'reasonableness' -- looks like an exercise of legislative or administrative, rather than judicial, power," Judge Holmes wrote.

Where does that leave us? Different circuits have different levels of *Chevron* tests, as Judge Holmes described them. If *Swallows* were to be brought to the Ninth Circuit, as it should be, that court would certainly reverse it, either under *Brand X* or its own permissive interpretation of *Chevron*. In the meantime, the Tax Court majority may have emboldened taxpayers to challenge practical, reasonable rules as inconsistent with obsolete court decisions. And the IRS may have to ask Congress to put a statutory time limit on foreign taxpayers’ returns.