To What Extent Can Treasury Abandon or Overrule *INDOPCO*?

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The extent to which Treasury can abandon or overrule the Supreme Court is the subject of significant controversy between the IRS and taxpayers. This article focuses on the subject in the context of *INDOPCO*.

Introduction

In *Santa Fe Pacific Gold*,[1] the Tax Court held that a payment made by a target corporation to terminate a merger agreement (a termination fee) after receiving a superior offer from another suitor was currently deductible under both section 162 and section 165. In its ruling, the court examined both the anticipated benefits and the actual benefits resulting from the second transaction. The court rejected the IRS's position that payment of the termination fee produced the type of future benefit requiring capitalization as contemplated by the Supreme Court in *INDOPCO*.[2] Of significance here, the Tax Court's decision conflicts with a portion of the final regulations effective for years after *Santa Fe Pacific Gold* (the *INDOPCO* regulations), which created an irrefutable presumption of future benefits. Recently issued temporary regulations providing that a basis overstatement can give rise to an omission from gross income for limitations period purposes (the basis overstatement regulations) may also be in conflict with the Supreme Court.

The *Santa Fe Pacific Gold* opinion presents an ideal opportunity to address two questions:

- To what extent can taxpayers and courts consider events occurring after a capital transaction in determining whether to deduct or capitalize costs related to the transaction?
- To what extent can Treasury abandon or overrule Supreme Court and other judicial precedent?

Regarding the first question, *Santa Fe Pacific Gold* and other decisions (including *INDOPCO* itself) have suggested considering post-transaction events in determining whether a particular cost can be immediately deducted or must be capitalized. As to the second question, strong arguments exist that Treasury exceeds its regulatory authority when it promulgates rules inconsistent with Supreme Court precedent.

Statutory Framework

Section 162(a) allows a deduction for ''all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.'' In contrast, section 263(a)(1) provides generally that a deduction is not allowed for amounts ''paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.'' These general rules are long-standing, originating in the first income tax acts during the Civil War era and remaining largely unchanged over the past 150 years. The legislative history on the general rules is sparse, indicating only that Congress was concerned with distinguishing between amounts expended to keep property in its present condition and amounts expended to improve its condition.[3]

The capitalization rules of section 263 trump the deductibility rules of section 162. Neither section distinguishes between anticipated versus actual benefits related to a payment. Further, neither section contains an express grant of authority for Treasury to promulgate regulations interpreting the statute.

The statutes and the interpretations given by courts before *INDOPCO* were not particularly helpful in many cases.[4] Following the Supreme Court's 1971 opinion in *Lincoln Savings*,[5] taxpayers successfully argued in two

[1]*Santa Fe Pacific Gold Co. v. Commissioner*, 132 T.C. No. 12 (2009), *Doc 2009-9470*, *2009 TNT 79-23*. The opinion, written by Judge Goeke, constitutes the opinion of the entire Tax Court and is binding precedent on the court.

[2]*INDOPCO Inc. v. Commissioner*, 503 U.S. 79 (1992).

[3]Section 117 of the Internal Revenue Act of 1864, 13 Stat. 223, 282, permitted a deduction for ''the amount paid out for usual and ordinary repairs'' but not for ''any amount paid out for new buildings, permanent improvements, or betterments made to increase the value of any property or estate.'' The current ''ordinary and necessary expenses'' language in section 162 first surfaced in the 1909 act. J.S. Seidman, *Seidman's Legislative History of Federal Income Tax Laws, 1938-1861*, p. 1011-1012.

[4]*See, e.g., INDOPCO*, 503 U.S. at 86; *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874, 882-883 (8th Cir. 2000), *Doc 2000-22578*, *2000 TNT 169-18*.

[5]*Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1971).

circuits[6] that the decision meant a current deduction had to be allowed in the absence of a separate and distinct asset to which the cost could be capitalized. The Supreme Court rejected this reasoning in *INDOPCO*, explaining that its decision in *Lincoln Savings* stood for the simple proposition that when an expenditure serves to create or enhance a separate and distinct asset, the expenditure should be capitalized under section 263. However, the Court's statement in *Lincoln Savings* that ''the presence of an ensuing benefit that may have some future aspect is not controlling'' did not mean that the creation or enhancement of a separate and distinct asset was a prerequisite to capitalization.[7]

The Supreme Court, acknowledging that ''each case 'turns on its special facts,''' clarified that ''although the mere presence of an incidental benefit — '*some* future aspect' — may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important'' in the determination of whether to immediately deduct or capitalize.[8] Relying on the ''permanent improvements or betterments'' language in section 263(a)(1), the Court emphasized that the analysis ''envisions an inquiry into the duration and extent of the benefits *realized* by the taxpayer.''[9] Thus, the future benefits test was born, seemingly agreeing with the analysis in *Santa Fe Pacific Gold*, because a court cannot determine if there is a realized benefit unless it examines the future.[10]

The reaction to *INDOPCO* has been mixed. Both taxpayers and the IRS have struggled to distinguish between future benefits that are ''incidental'' versus those that are ''significant.''[11] The IRS has been characterized as ''aggressive'' in not allowing deductions,[12] and courts have struggled to reach a uniform understanding and interpretation of the future benefits test, as reflected by several disagreements among the Tax Court and the appellate courts.[13]

Treasury's Response to *INDOPCO*

Ten years after *INDOPCO*, Treasury issued proposed regulations designed to provide bright-line rules on whether specified costs must be capitalized or can be immediately deducted. In doing so, it criticized the Supreme Court's future benefits analysis as not providing ''the certainty and clarity necessary for compliance with, and sound administration of, the law.''[14] Although Treasury indicated that it was seeking to retain a future benefits analysis in many of the categories covered by the regulations, some of the rules were more policy based and aimed at establishing bright-line distinctions while irrefutably assuming significant future benefits.

After receiving comments on the proposed regs, Treasury promulgated the *INDOPCO* rules,[15] effective for amounts paid or incurred after December 31, 2003. Termination fees are dealt with under a broad section requiring the capitalization of amounts paid to ''facilitate'' an ''acquisition or a trade or business, a change to the capital structure of a business entity, and certain other transactions.''[16] Termination fees generally fall under this rule — ''an amount paid to terminate (or facilitate the termination of) an agreement . . . constitutes an amount paid to facilitate a second transaction.''[17]

In Example 13,[18] a target corporation (Y) is the subject of a hostile takeover attempt by another party (Z) and, in defense of the takeover, incurs legal fees defending against the takeover and locating a white knight (W). Y and W enter into a letter of intent with a $10 million termination fee provision. Z thereafter increases its offer, and Y decides to accept the increased offer instead of merging with W. Under the example, the $10 million termination fee that Y must pay to W is capitalized as facilitating the merger agreement with Z. The rationale is

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[6]*See Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2d Cir. 1973); *NCNB Corp. v. United States*, 684 F.2d 285 (4th Cir. 1982).

[7]*INDOPCO*, 503 U.S. at 86.

[8]*Id.* at 86-88.

[9]*Id.* at 88 (emphasis added).

[10]Although the Supreme Court referenced appellate cases analyzing the ''purpose for which the expenditure'' was made, it long ago rejected a ''primary purpose'' test for determining whether costs are currently deductible or must be capitalized. *See Woodward v. Commissioner*, 397 U.S. 572 (1972).

[11]*See Lychuk v. Commissioner*, 116 T.C. 374 (2001), *Doc 2001-15494*, *2001 TNT 106-4*; *Metrocorp Inc. v. Commissioner*, 116 T.C. 211 (2001), *Doc 2001-10873*, *2001 TNT 73-11*.

[12]*See, e.g.*, *PNC Bancorp Inc. v. Commissioner*, 212 F.3d 822, 825 (3d Cir. 2000), *Doc 2000-14529*, *2000 TNT 100-4*. (''*INDOPCO* ushered in the era of generally more aggressive IRS pursuit of capitalization.'')

[13]*Id*. (reversing Tax Court and holding that the costs were ''ordinary and necessary'' business expenses geared toward income production and other current needs, not to ''the corporation's operations and betterment into the indefinite future''); *Wells Fargo*, 224 F.3d 874 (partially reversing Tax Court and holding that the proper inquiry under *INDOPCO* is whether the costs were directly related — and therefore had to be capitalized

(Footnote continued in next column.)

— or indirectly or incidentally related — and therefore deductible — to the capital transaction; also focusing on whether costs were usual or recurrent as a factor in favor of immediate deduction); *U.S. Freightways Corp. v. Commissioner*, 270 F.3d 1137 (7th Cir. 2001), *Doc 2001-27961*, *2001 TNT 217-14* (reversing Tax Court and holding that the administrative costs and conceptual rigor of achieving a perfect match were too great in allocating one-year expenses to two tax years, year in and year out, and allowing an immediate deduction); *Metrocorp*, 116 T.C. 211 (divided, fully reviewed opinion allowing fees paid to the FDIC in connection with taxpayer's acquisition of assets and assumption of liabilities of another bank were deductible); *Lychuk*, 116 T.C. 374 (costs for salaries and benefits capitalized as directly related to acquisition of installment contracts, but divided opinion that overhead expenses related to the same assets that were deductible on the grounds that any future benefits related to these costs were incidental and ''routine and recurring expenses'').

[14]67 *Fed. Reg*. 7,701 (Dec. 19, 2002). Rather than providing certainty, *INDOPCO* requires that courts look at the ''special facts'' of each case.

[15]T.D. 9107, 69 *Fed. Reg*. 436 (Jan. 5, 2004).

[16]Reg. section 1.263(a)-5(a).

[17]Reg. section 1.263(a)-5(c)(8).

[18]Reg. section 1.263(a)-5(l), Example 13.

that, because W could not merge with both W and Z, the termination fee facilitates the transaction with Z.[19]

This portion of the *INDOPCO* regulations makes no reference to a future benefits analysis, either anticipated or actual, in determining whether to capitalize or deduct termination fees. Moreover, it creates a bright-line rule that obviates the need to examine the special facts of each case.

Santa Fe Pacific Gold

In *Santa Fe Pacific Gold* the Tax Court addressed a situation similar to that contained in Example 13 of the *INDOPCO* regulations. Although the court issued its opinion six years after the *INDOPCO* regulations were published, it did not apply them because the year at issue was 1999. As explained below, had the year at issue postdated the effective date of the *INDOPCO* regulations, the result likely would have been different, assuming the regulations are valid and afforded deference.

In *Santa Fe Pacific Gold* the taxpayer was approached by a larger mining company about a business combination. The taxpayer initially rejected the offer, expressing its belief that a combination with the acquiring company would not be beneficial. When the larger company did not relent, the taxpayer sought a white knight to pursue a different business combination involving a merger of equals. The taxpayer and the white knight entered into a merger agreement that, among other provisions, obligated the taxpayer to pay a $65 million termination fee if it received a superior offer from a third party and later terminated the agreement. On learning of the merger agreement, the larger mining company initiated a hostile takeover of the taxpayer. The taxpayer determined that its fiduciary duties under Delaware law required it to obtain the highest value for its shareholders, and it ultimately decided that the larger company's offer was superior in value and that it had to accept and terminate the existing merger agreement. After consummating the transaction, the larger mining company, as the taxpayer had originally feared, aggressively cut duplicative costs by eliminating the taxpayer's staff or putting them under control of the larger company and by closing all of its offices. The taxpayer deducted the termination fee in the year paid, and the IRS challenged on the grounds that the fee resulted in future benefits to the taxpayer in the form of the consummated capital transaction.

The Tax Court sided with the taxpayer and allowed a deduction for the termination fee because it found that the payment did not lead to significant long-term benefits for the taxpayer.[20] The court focused on the hostile nature of the transaction and found that any synergies from the merger benefited only the larger mining company, not the taxpayer, and that the taxpayer did not pay the termination fee in hope of some future benefit. Consistent with *INDOPCO*'s requirement that the taxpayer obtain a realization of benefits, the court also looked at what actually occurred after the merger, finding that the taxpayer did not reap the type of future benefits that require capitalization, such as operating in an improved manner, gaining access to wider services, and operating more competitively after the merger. The court cautioned that not every benefit received after payment of a fee should be treated as caused by or related to that fee, and that all facts and circumstances must be considered. The court also emphasized the purpose of the termination fee and the effect of state law fiduciary duties, concluding that the purpose of the fee was to compensate the unsuccessful bidder and that the taxpayer's board essentially had no choice but to accept the larger mining company's offer.[21] The court determined that payment of the termination fee did not lead to significant benefits for the taxpayer extending beyond the year at issue.

The court's approach of looking at the actual future benefits is consistent with its approach in *Victory Markets*,[22] the Tax Court's first post-*INDOPCO* opinion. In requiring that costs related to a merger agreement be capitalized, the court stated that ''while as a general rule we do not consider after-the-fact occurrences, these factors in this case corroborate that the board's representations to its shareholders were substantially realized.''[23] In the only other termination fee case resulting in a published opinion, the District Court for the Southern District of Ohio similarly tested its conclusion that the deduction was appropriate by looking at actual future benefits: ''While the benefit of hindsight should not be used to determine the classification of an expenditure, it

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[19]Examples 13 and 14 in the *INDOPCO* regulations treat parties differently depending on whether they occupy the position of the target corporation or the acquiring corporation. An acquiring corporation can deduct a termination fee made for the express purpose of abandoning one transaction to enter into a second transaction as long as the acquirer could have acquired both targets, while a target company with the same or even greater resources would have to capitalize its termination fee under the same circumstances merely because of its position as a target instead of an acquirer. No rationale is provided for treating taxpayers differently depending on their status as a target or as an acquirer.

[20]The Tax Court also allowed a deduction under section 165 as a cost of an abandoned transaction. The court's opinion is consistent with *United States v. Federated Department Stores*, 171 B.R. 603 (S.D. Ohio 1994), *aff'g* 135 Bankr. 950 (Bankr. S.D. Ohio 1992), which also permitted a target corporation to deduct a termination fee under sections 162 and 165 under similar circumstances. *See also BJ Servs. Co. Canada v. the Queen*, 2003 TCC 900 (similar conclusion by the Supreme Court of Canada). The Tax Court's allowance of a loss deduction under section 165 raises the separate question of whether the *INDOPCO* regulations are even relevant in situations when a termination fee provision is triggered for calling off a merger agreement because, in those situations, the transaction in which the termination fee originates is always being abandoned.

[21]In *Cox Enterprises v. Commissioner*, T.C. Memo. 2009-134, *Doc 2009-13101*, *2009 TNT 109-16*, the Tax Court, relying on *Santa Fe Pacific Gold*, indicated that the appropriate analysis is whether the future benefits go to the taxpayer rather than the taxpayer's shareholders in the case of a corporation. This issue was also present in *A.E. Staley* (*A.E. Staley Mfg. Co. v. Commissioner*, 119 F.3d 482 (7th Cir. 1997), *Doc 97-19670*, *97 TNT 129-9*) in both the Tax Court and the Seventh Circuit, although it was not definitively resolved in those opinions.

[22]*Victory Markets Inc. v. Commissioner*, 99 T.C. 648 (1992).

[23]*Id.* at 664.

is useful to assess the validity of the Debtor's apprehension.''[24] Thus, while the focus has traditionally been on anticipated future benefits, looking at actual future benefits (that is, realized benefits) reflects a real-world approach that may be significant because there is often a large disparity between anticipated benefits and actual benefits from a merger transaction. It remains to be seen whether future courts will consistently use hindsight as a tool in a future benefits analysis.[25]

Can Treasury Abandon or Overrule *INDOPCO*?

The result in *Santa Fe Pacific Gold* cannot be reconciled with the treatment of termination fees under the *INDOPCO* regulations.[26] The *INDOPCO* regulations require that termination fees paid by a target corporation be capitalized if the target later enters into a second merger transaction, as long as the two transactions are mutually exclusive. The regulations, contrary to *Santa Fe Pacific Gold*, *A.E. Staley*, and *Federated Department Stores*, do not distinguish between termination fees related to hostile or friendly takeovers, nor do they acknowledge that state fiduciary laws may require the board of a target corporation to accept an offer that may be detrimental to that corporation's continued existence. In essence, no attempt is made in the regulations to incorporate *INDOPCO*'s future benefits analysis. Thus, the reasoning that won the day for the taxpayer in *Santa Fe Pacific Gold* is rendered moot.[27]

Santa Fe Pacific Gold therefore raises the question to what extent *INDOPCO* and its future benefits analysis survive in light of the *INDOPCO* regulations. While there is authority for the proposition that the IRS may, under some circumstances, promulgate regulations that change the result in previous cases,[28] the extent to which it may engage in this practice has not been definitively established. Indeed, this issue is the subject of significant controversy under the basis overstatement regulations that overrule several recent decisions, as well as the Supreme Court's 1958 decision in *Colony*,[29] rejecting the Service's position on whether a basis overstatement can give rise to an omission from gross income, thereby triggering the extended six-year limitations period under section 6501(e)(1)(A).[30]

In *Chevron*[31] the Supreme Court set forth a two-prong test for judging whether an agency's interpretation of the law is entitled to deference from the courts.[32] Under the first prong of *Chevron*, if the ''intent of Congress is clear,'' the matter is over; both courts and agencies ''must give effect to'' the ''unambiguously expressed intent of Congress.''[33] The courts, not agencies, are the final authority on issues of statutory construction, and administrative constructions contrary to clear congressional intent must be rejected. Thus, the intent of Congress, as determined by a court using traditional tools of statutory construction, ''is the law and must be given effect.''[34] Under the second prong of *Chevron*, if the intent of Congress is not clear, courts must determine whether the regulation is a reasonable construction of the statute. If so, the agency interpretation is given controlling weight.

Although the Supreme Court has characterized the principle of section 162(a) as ''clear''[35] and its provisions as ''plain,''[36] it has also recognized ''that the 'decisive distinctions' between current expenses and capital expenditures 'are those of degree and not kind,' and that because each case 'turns on its special facts,' the cases sometimes appear difficult to harmonize.''[37] Given the struggles by the courts, taxpayers, and the IRS over the years in applying the general rules of sections 162 and

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[24]*Federated Department Stores*, 171 B.R. at 610.

[25]The use of hindsight is common in legal decisions, and has made its way into other Treasury regulations. *See, e.g.*, reg. section 1.704-1(b)(2)(iii)(b). For a detailed discussion on the use of hindsight in the legal system, see Jeffrey J. Rachlinski, ''A Positive Psychological Theory of Judging in Hindsight,'' 65 *U. Chi. L. Rev*. 571 (1998).

[26]Commentators have noted that other portions of the *INDOPCO* regulations are also inconsistent with *INDOPCO*. *See* Gregg D. Polsky, ''Can Treasury Overrule the Supreme Court?'' 84 *B.U.L. Rev*. 185, 244 (2004); Calvin H. Johnson, ''Destroying Tax Base: The Proposed *INDOPCO* Capitalization Regulations,'' *Tax Notes*, June 2, 2003, p. 1381, *Doc 2003-13382*, or *2003 TNT 106-32*.

[27]Moreover, the requirement in the *INDOPCO* regulations that the two transactions be mutually exclusive — that is, the taxpayer must capitalize if it could not have entered into both transactions — arguably conflicts with long-standing case law allowing immediate deductions under analogous circumstances. *See*, *e.g.*, *Staley*, *supra* note 21; *Lychuk v. Commissioner*, 116 T.C. 374 (2001); *United States v. Federated Dept. Stores, Inc.*, 171 B.R. 603 (S.D. Ohio 1994); *Sibley, Lindsay & Curr Co. v. Commissioner*, 15 T.C. 106 (1950); *Portland Furniture Mfg. Co. v. Commissioner*, 30 B.T.A. 878 (1934); *but see United Dairy Farmers Inc. v. United States*, 267 F.3d 510 (6th Cir. 2001), *Doc 2001-25388*, *2001 TNT 193-5*.

[28]*See Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967 (2005).

[29]*Colony Inc. v. Commissioner*, 357 U.S. 28 (1958).

[30]*See* Roger J. Jones, Kim Marie Boylan, and Andrew R. Roberson, ''IRS Seeks to Overturn Court Losses Through Issuance of Retroactive Regulations,'' 39-22 *The Lawyer's Brief*, Art. VII-IX (2009); *see also* Patrick J. Smith, ''*Brand X* and Omissions From Gross Income,'' *Tax Notes*, Feb. 1, 2010, p. 665, *Doc 2010-604*, or *2010 TNT 22-5*. The government is litigating several cases in the Tax Court, the Court of Federal Claims, and various courts of appeal on this issue.

[31]*Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

[32]*Chevron* deference does not apply to all agency rules. In *United States v. Mead Corp.*, 533 U.S. 218 (2001), the Supreme Court instructed courts to engage in a ''*Chevron* step zero'' inquiry to determine whether *Chevron* applies in the first instance, or whether the less deferential standard set forth in *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944), applies. Cass R. Sunstein, ''*Chevron* Step Zero,'' 92 *Va. L. Rev*. 187, 191 (2006). Given that the *INDOPCO* regulations were issued after a lengthy notice-and-comment process and were plainly intended to be binding and carry the force of law, they would likely be judged under the *Chevron* framework.

[33]*Chevron*, 467 U.S. at 842-843.

[34]*Id.* at 843 n.9.

[35]*Deputy v. du Pont*, 308 U.S. 488, 496 (1940).

[36]*Commissioner v. Tellier*, 383 U.S. 687, 690-691 (1966).

[37]*INDOPCO*, 503 U.S. at 86 (quoting *Welch v. Helvering*, 290 U.S. 111 (1933), and *Deputy v. du Pont*, 308 U.S. 488 (1940)).

263, an argument exists that agency intervention is warranted because Congress left gaps to be filled. Alternatively, can the IRS flatly reject *INDOPCO*'s focus on future benefits (not to mention the special facts of each case)?

Less clear is whether Treasury's construction of section 263 is reasonable. The statute, which requires capitalization of costs "for new improvements or betterments made to increase the value of any property or estate," has been interpreted by Treasury to compel capitalization of termination fees without regard to whether such fees are expected to, or actually do, increase the value of property. As explained above, in *Santa Fe Pacific Gold* the Tax Court found that the taxpayer did not anticipate, nor did it actually realize, any future benefit from the payment of the termination fee and, in fact, the taxpayer suffered as a result of the consummated merger agreement. Rather, the termination fee was paid to compensate the unsuccessful bidder. Put another way, the termination fee constituted liquidated damages, not a payment made to increase the value of any property or estate. Thus, it could be argued that the termination fee provisions in the *INDOPCO* regs are contrary to the statute and therefore not a reasonable construction of it.

Even assuming that the *INDOPCO* regulations pass *Chevron*'s two-prong test, the validity of Treasury's regulatory construction of the tax treatment of termination fees is not necessarily established. Long-standing authority indicates that only the Supreme Court or Congress, not a governmental agency, has the power to overrule Supreme Court precedent.[38] For example, the Supreme Court has repeatedly held: "Once we have determined a statute's meaning, we adhere to our ruling under the doctrine of stare decisis, and we assess an agency's later interpretation of the statute against the settled law."[39] The Supreme Court also opined over 200 years ago that "it is emphatically the province and duty of the judicial department to say what the law is."[40] This authority supports the position that a regulation inconsistent with Supreme Court precedent is invalid.

Examining the Uncertainty Created by *Brand X*

The IRS's position, as contained in the recently issued basis overstatement regulations and court filings defending the validity of those regulations, is that the Supreme Court's 2005 opinion in *Brand X* authorizes a governmental agency to overrule existing precedent, Supreme Court or otherwise, as long as the statutory language at issue is ambiguous and the Service's interpretation is reasonable.[41] In *Brand X* the Supreme Court upheld the validity of a regulation that construed a statute inconsistently with a prior judicial interpretation by the Ninth Circuit. The Court stated:

> A court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the *unambiguous terms of the statute* and thus leaves no room for agency discretion. . . . 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.[42] [Emphasis added.]

However, the Supreme Court did not purport to overrule its earlier decisions in *Neal*, *Lechmere*, and *Maislin*; instead, it characterized those opinions as allowing a court's prior interpretation of a statute to override an agency's interpretation only if the court held that statute unambiguous.[43]

The scope of the Supreme Court's opinion in *Brand X* is unclear. In a concurring opinion, Justice Stevens clarified that the rationale of *Brand X* would not necessarily apply to a Supreme Court decision removing any preexisting ambiguity.[44] In his dissent, Justice Scalia argued not only that judicial decisions should not be subject to reversal by executive officers, but that an agency's overruling of a Supreme Court decision is "probably unconstitutional."[45]

The Supreme Court recently declined to provide *Chevron* deference to a regulation that was inconsistent with Supreme Court precedent, despite a finding that there was ambiguity in the statutory language at issue.[46] The Court explained that "the presence of some uncertainty

[38]For a thorough pre-*Brand X* discussion on this point, see Polsky, *supra* note 26.

[39]*See Neal v. United States*, 516 U.S. 284 (1996); *Lechmere Inc. v. NLRB*, 502 U.S. 527 (1992); *Maislin Indus., U.S. Inc. v. Primary Steel Inc.*, 497 U.S. 116 (1990); *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477 (1989); *see also Brand X*, 545 U.S. 967 (Stevens, J., concurring, and Scalia, J, dissenting); *Raymond B. Yates, M.D., P.C. Profit Sharing Plan v. Hendon*, 541 U.S. 1 (2004) (Scalia, J., concurring).

[40]*Marbury v. Madison*, 5 U.S. (1 Cranch) 137, 176 (1803). The Federal Circuit has held that "the *Chevron* doctrine, properly understood, does not change this basic application of Separation of Powers doctrine." *Bankers Trust N.Y. Corp. v. United States*, 225 F.3d 1368, 1376 (Fed. Cir. 2000), *Doc 2000-24515*, *2000 TNT 185-7*.

[41]2009-43 IRB 552. The government is seeking to vacate or overrule, in the Tax Court and in at least five appellate courts, previous orders or decisions decided under the law as it existed before the basis overstatement regulations were promulgated.

[42]*Brand X*, 545 U.S. at 982-983 (citations omitted). Given that the Court limited its holding to regulations otherwise entitled to *Chevron* deference, presumably an agency could not overrule existing precedent through the issuance of rules subject to a lower form of deference, such as *Skidmore*.

[43]*Id.* at 984. The Supreme Court's interpretation has been described elsewhere as "rather creative" and a "substantial departure" from existing precedent. Kathryn A. Watts, "Adapting to Administrative Law's Erie Doctrine," 101 *Nw. U.L. Rev.* 997, 1016 (2007).

[44]*Brand X*, 545 U.S. at 1003 (Stevens, J., concurring). The Tenth Circuit has stated that *Brand X* applies even when the conflicting opinion is from the Supreme Court. *Hernandez-Carrera v. Carlson*, 547 F.3d 1237, 1248 (10th Cir. 2008). The Fifth Circuit, without referencing *Brand X*, has held that an agency cannot overrule a previous Supreme Court decision. *Tran v. Mukasey*, 515 F.3d 478, 484 (5th Cir. 2008).

[45]*Brand X*, 545 U.S. at 1016-1017.

[46]*Cuomo v. Clearing House Ass'n, LLC*, 129 S.Ct. 2710, 2716-2717 (2009). In a reversal of roles, Justice Scalia delivered the majority opinion, which Justice Stevens joined, and with which Justice Thomas concurred in part and dissented in part.

does not expand *Chevron* deference to cover'' a regulatory construction contrary to Supreme Court jurisprudence and normal principles of construction.[47] Four justices dissented on this point, arguing that the finding of ambiguity meant that *Brand X* provided the framework for deciding the case, and that the agency's construction should be upheld because it was reasonable.[48] The Ninth Circuit recently engaged in a detailed analysis of *Brand X*, explaining that the Supreme Court did not suggest ''that an agency may resurrect a statutory interpretation that a circuit court has foreclosed by rejecting it as unreasonable at *Chevron*'s second step.''[49] It remains to be seen whether other courts that are reluctant to apply *Brand X* broadly will engage in a narrower *Chevron* step two analysis to avoid overruling Supreme Court or appellate court precedent.

Also, it is worth noting that *Brand X* arguably overstates step one of *Chevron* by referring to the ''unambiguous terms of the statute'' instead of the ''unambiguously expressed intent of Congress.''[50] Although the Supreme Court has not been entirely consistent on this point since *Chevron*, it has used statutory tools of construction in step one, such as dictionary definitions, legislative purpose, and legislative history to determine whether the intent of Congress is clear (that is, unambiguous).[51]

Conclusion

Whether *Brand X* authorizes Treasury to overrule or disregard Supreme Court or other judicial precedent is the subject of significant dispute.[52] Not surprisingly, the government is seeking a broad application of *Brand X* which would allow it to abandon or overrule such Supreme Court decisions as *INDOPCO* and *Colony*. This is clearly a controversial issue. Until the Supreme Court revisits the issue, there will continue to be much uncertainty.

The stakes are high — for example, termination fee provisions are found in most merger agreements, are generally calculated as a percentage of transaction value (historically 3 percent), and have exceeded $1 billion in some cases. There are many pending cases tied in part to the validity of the basis adjustment regulations. Taxpayers and their attorneys will need to explore all options when dealing with administrative guidance that may conflict with existing judicial precedent.

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[47]*Id.* at 2715.

[48]*Id.* at 2722-2723 (Thomas, J., concurring in part and dissenting in part).

[49]*Mercado-Zazueta v. Holder*, 580 F.3d 1102, 1114 (9th Cir. 2009); *see also Jean-Louis v. Att'y General*, 582 F.3d 462 (3d Cir. 2009) (rejecting agency construction previously found to be an ''impermissible'' reading of the statutory language). The Ninth Circuit further noted that in *Brand X* the agency promulgating the rule was not a party to the prior litigation. 580 F.3d at 1114; *see also Swallows Holding Ltd. v. Commissioner*, 126 T.C. 6, 144 (2006), *Doc 2006-1541*, *2006 TNT 18-10*.

[50]The Supreme Court applied such an analysis in *Colony*, the case involving the dispute over the basis overstatement regulations. In that opinion, the Supreme Court engaged in a detailed examination of the language of the statute, the dictionary definition of a statutory term, and the legislative history, and determined based on these statutory tools of construction that the intent of Congress was to provide the IRS with a longer limitations period only when a taxpayer actually omitted some income receipt or accrual in the computation of gross income, not when a taxpayer overstated basis. *Colony*, 357 U.S. at 32-36.

[51]*See Coke v. Long Island Care at Home, Ltd.*, 376 F.3d 118, 127 n.2 (2d Cir. 2004) (collecting Supreme Court cases considering legislative history at step one); Irving Salem, ''Third Circuit Ignored the Clear Intention of Congress in *Swallows*,'' *Tax Notes*, July 20, 2009, p. 265, note 3, *Doc 2009-13701*, or *2009 TNT 136-9* (collecting secondary sources identifying different tools of statutory construction used at step one); *cf. Bankers Life & Cas. Co. v. United States*, 142 F.3d 973, 983 (7th Cir. 1998), *Doc 98-12811*, *98 TNT 76-8* (we ''lean toward reserving consideration of legislative history and other appropriate factors until the second *Chevron* step. . . . In the second step, the court determines whether the regulation harmonizes with the language, origins, and purpose of the statute.'').

[52]*See supra* note 30. Moreover, the Tax Court's general position is that the validity of tax regulations issued under section 7805(a) is judged under the standard enunciated by the Supreme Court in *Nat'l Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979). *Swallows Holding*, 126 T.C. at 129. The Tax Court raised but did not answer the issue of whether, because it generally reviews regulations under *Nat'l Muffler*, the Supreme Court's opinion in *Brand X* even applies to tax regulations. *Id.* at 143-144.