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Disregarding Administrative Tax Guidance Aided the IRS in Two Cases and the Taxpayer in a Third Case

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Three courts—the Supreme Court, the Sixth Circuit, and the Tax Court—recently rejected administrative guidance in tax cases because the guidance was either wrong as applied, unnecessary, or inapplicable.

The takeaway: Administrative guidance issued by the Treasury Department and the Internal Revenue Service is not impervious to attack. Years ago, some thought that "tax exceptionalism" justified less judicial scrutiny of administrative tax guidance than the administrative guidance of other federal agencies. In recent years, that notion has been disabused. Scrutiny will continue not only on the questions of whether the tax guidance is substantively consistent with its enabling statute and whether it plays any interpretative role, but also whether the very act of promulgating the guidance properly followed the procedural rules pursuant to which the guidance was published.[1]

Introduction: Three recent tax cases bear on judicial treatment of Treasury Department and IRS administrative guidance. In *Kellett*,*[2] Whirlpool*,*[3] and Boechler*,[4] the court either rejected or ignored the administrative guidance. In *Kellett*, the Tax Court rejected a revenue procedure favorable to the taxpayer even though the literal terms of the revenue procedure applied. In *Whirlpool*, the Sixth Circuit declined to rely on a regulation arguably favorable to the taxpayer even though the Treasury Department published the regulation pursuant to an express grant of authority in the specific section of the Internal Revenue Code in issue. And in *Boechler*, the Supreme Court did not cite or otherwise discuss a regulation interpreting a statutory section in issue.

Kellett: Revenue Procedure 2000-50[5] provides that "the Service will not disturb a taxpayer's treatment of costs paid or incurred in developing software for any particular project ...." But in *Kellett*, the Commissioner did disturb—and disallowed—the taxpayer's current expense deduction incurred to develop software. In the trial of the case, the Commissioner did not challenge the taxpayer's allegation that it developed software. Nonetheless, the Tax Court, finding for the Commissioner, held that the taxpayer "has not demonstrated that the Code authorizes any such deduction." Thus, in Tax Court, the taxpayer cannot rest on administrative guidance but must also show that the guidance is consistent with its enabling statute.

Admittedly, the Commissioner is not bound by a revenue procedure even though the Commissioner announced that taxpayers generally may rely on revenue procedures published in the Internal Revenue Bulletin in determining the tax treatment of their own transactions.[6] Nonetheless, it is odd that the Commissioner published a procedure for taxpayers to follow and then argued in Tax Court that the procedure it published was invalid as applied to the taxpayer in *Kellett*. In any event, Congress amended the law to provide that any amount paid or incurred to develop any software may be treated as a currently deductible research or experimental expenditure effective for tax years beginning after December 31, 2021.[7] Under current law, *Kellett* now should be decided for the taxpayer.

Whirlpool: If 50% or more of the vote or value of the stock of a foreign corporation is owned by one or more United States shareholders, each of whom owns 10% or more of the stock, the corporation is a controlled foreign corporation ("CFC"). Each United States shareholder is required to include currently in its federal income certain categories of income of the CFC.[8] The inclusion —"Subpart F Inclusion"—is required even if the CFC does not distribute the income to the United States shareholder.

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One category of such income is foreign base company sales income.[9] An example is the purchase by a CFC of property manufactured outside the country of the CFC's organization when the sale of the property by the CFC is to a related person for use, consumption, or disposition outside such country. Without the Subpart F Inclusion, if the foreign country in which the sale to the related person is made is a tax haven that does not tax the sales income, and if the foreign country in which the manufacturing is performed has a territorial system that does not tax income from sales outside its territory, the sales income would not be taxed, if ever, until the foreign sales company distributed its income to its United States parent. Congress was offended by the resulting tax avoidance and consequently enacted the foreign base company sales income provision.

In *Whirlpool*, the taxpayer arranged the legal structure of its foreign operations with the intention of having its manufacturing activities conducted by the same CFC that sold the manufactured property with the hoped-for result that the CFC's sales income would not constitute foreign-based company sales income. To achieve the objective, the taxpayer relied on an income tax regulation determining whether a foreign sales company also conducted manufacturing.[10] The majority opinion in the Sixth Circuit refused, however, to rely on the regulation *even though the relevant statutory provision expressly directed the Treasury Department to publish the regulation*. The majority perceived no gap in the statutory scheme for which any regulation was required even though *Congress* saw such a gap and expressly required the regulation. The dissenting judge saw the gap and would have relied on the regulation to decide the case.

The taxpayer filed a petition for certiorari with the Supreme Court on July 5, 2022.[11] If the Supreme Court grants the petition—and the chances are probably slim—it will be interesting to see how the Court handles the Sixth Circuit's refusal to rely on a regulation that was published to pursuant to an express grant of authority in the specific statute in issue.

Boechler: As we previously reported,[12] the Supreme Court ruled that a taxpayer is entitled to an extension of the thirty-day period – the period is "equitably tolled"—to petition the Tax Court to review an adverse collection due process determination if the taxpayer has a sound reason for filing the petition beyond the thirty-day period. The Court based the ruling on its interpretation of IRC §6330(d)(1).

The Court's ruling contradicts a Treasury Department regulation stating that the taxpayer "must" petition the Tax Court within thirty days to obtain judicial review,[13] but that regulation had no bearing on the issue presented, which was whether the statute, itself, "clearly stated" a jurisdictional requirement. The Supreme Court found that it did not so state and consequently was not jurisdictional. Reference to the Treasury Department regulation for interpretative assistance would have revealed that the statute, itself, did not contain a jurisdictional clear statement. Implicit in *Boechler* is that *Chevron* deference[14] has no place in a question of statutory interpretation when a party arguing for a particular interpretation is confined to the statutory text. If other rules of statutory interpretation require a "clear statement" in the statutory text, further limiting of application of administrative guidance may be expected.[15]

Please contact the authors of this alert should you wish to discuss these issues.

[1] https://www.millercanfield.com/resources.html?results/ Status of the Pending Appeal in *Silver v. Treasury Department*.

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[2] *Kellett v. Commissioner*, T.C. Memo 2022-62 (Jun 14, 2022).

[3] *Whirlpool Financial Corp. v. Commissioner*, 19 F.4th 944 (6th Cir. 2021), cert. filed, _ U.S. _ (July 5, 2022).

[4] *Boechler, P.C. v. Commissioner*, 142 Sup. Ct. 1493 (2022).

[5] §5.01, 2000-2 C.B. at 601.

[6] Rev. Proc. 89-14, 1999-1C.B. 814.

[7] IRC §174(c)(3).

[8] IRC §§951(b), 957(a).

[9] IRC §954(d)(1).

[10] Treas. Reg. §1.954-3(a)(4)(ii) prior to amendment by T.D. 9563 (December 15, 2011).

[11] Petition for Cert. filed, ___ U.S. ___ (July 5, 2022).

[12] https://www.millercanfield.com/resources-Procedural-Actions-Following-Supreme-Court-Boechler-Remand.html.

[13] Treas. Reg. §301.6330-1(f)(2)(A-F1).

[14] *Chevron USA, Inc, v. Natural Resources Defense Council, Inc.*, 468 U.S. 1227 (1984).

[15] *Cf. West Virginia v. Environmental Protection Agency*, 2022 WL 2347278 (2022).