No. 18-1177

IN THE

Supreme Court of the United States

ESTATE OF ANDREW J. MCKELVEY, DECEASED,
BRADFORD G. PETERS, EXECUTOR,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari
to the United States
Court of Appeals for the Second Circuit

REPLY TO BRIEF IN OPPOSITION

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INTRODUCTION

The Internal Revenue Code contains hundreds of specific commands to the Treasury Secretary to fill statutory gaps with legislative regulations that the Treasury Secretary has chosen to ignore. Pet.15. Rather than seek to implement congressional intent through prospective regulation, Treasury has embraced outsourcing its gap-filling responsibility to courts, encouraging *ad hoc*, retroactive adjudication through "phantom" regulation. Pet.14-21. The Ninth Circuit suggested the Tax Court's myriad "phantom" regulation standards are legitimate. Pet.19. The Fourth Circuit rejected "phantom" regulation—even when it would operate in a taxpayer's favor. Pet.20. And the Seventh Circuit admonished "phantom" regulation in the tax-penalty context. Pet.19. Left ignored is *Dunlap*'s holding that "courts cannot perform executive duties, nor treat them as performed when they have been neglected." *Dunlap v. United States*, 173 U.S. 65, 72 (1899).

The Second Circuit's decision compounds the confusion. Rather than deal with *Dunlap* or the "phantom" regulation debate, the Second Circuit blew past it all. Pet.11-14. It accepted Treasury's request to fill a statutory gap to levy tens-of-millions in taxes *against* a taxpayer. And it did so in the context of an ambiguity-laden statute where Congress explicitly directed the promulgation of prospective regulations that would draw upon regulatory expertise and notice-and-comment accountability. Pet.2-5, 30-32.

The Government defends the Second Circuit decision principally by contending that the court's policy decisions were wise—in other words, *this* "phantom" regulation is okay, so there is nothing to review. Setting aside the problems with the narrow and misguided policy lens the Second Circuit used, the Government's Opposition largely avoids the issue: "phantom" regulation is itself the problem.

When the Government finally contends with whether a court can fill statutory gaps Congress directed the Secretary to fill through regulation, it provides an astonishing defense. It argues that any concern is quelled because, *when the IRS charges a taxpayer with violating the tax laws*, it will provide him a document containing an "administrative interpretation" of the statute that, up to that point, the taxpayer could have never known. Opp.18. This is inconsistent with this Court's precedent and offends fair notice. Pet.33-34.

"Phantom" regulation—here as elsewhere—upends why judicial decisions can have retroactive effect: they are presumed mere interpretations of *pre-exsisting* law. *See De Niz Robles v. Lynch*, 803 F.3d 1165, 1170-73 (10th Cir. 2015) (per Gorsuch, J.). By allowing Treasury to outsource to the Judiciary its congressionally-allocated authority to make prospective legislative rules (Pet.14-21, 29-30), "phantom" regulation permits taxes based on a legal standard the taxpayer *could not know* at the time of his transactions. Allowing this "create[s] a strange incentive for [agencies] to eschew the Court's stated preference for rulemaking," thereby "render[ing]" other precedent of this Court "easily evaded." *De Niz Robles*, 803 F.3d at 1173. The Government's cavalier

response evidences what Petitioner explained: Treasury believes it can shirk its duty to promulgate mandated regulations in favor of invoking statutory gaps against taxpayers. Review is warranted.

ARGUMENT

I. Congress Directed The Promulgation Of Legislative Regulations On The Precise Question At Issue—Meaning Taxes May Not Be Imposed In Their Absence

At no point does the Government dispute that Congress directed the promulgation of regulations on when and how the "amount of property" identified in a "forward contract" should be deemed "substantially fixed." Pet.2-5 (explaining Congress's expectations and the ambiguity inherent to the constructive sale statute's use of "substantially fixed"). But the Government contends that the Second Circuit was free to "construe[] the statute as an original matter" (Opp.11) because Congress did not make the lack of regulations a "precondition" to the constructive sale statute's enforcement here (Opp.19-20). That is incorrect.

a. Regulations Were A Precondition To Enforcing The Constructive Sale Statute Here

The Second Circuit's concession that regulations were "contemplated" (App.26a) here is fatal to the Government's attempt to distinugish *Dunlap*. The Government contends that *Dunlap* is inapposite because, there, regulations were "a precondition to the statute's application." Opp.19. Here, the Government describes the regulatory language in section 1259(f) as "general" (Opp.20),

giving "significant discretion" to the Treasury Secretary. Opp.21. But the Government never explains *why* it believes any distinction in statutory language between the Revenue Act provision at issue in *Dunlap* and the constructive sale statute here makes a difference. In fact, to fill the gaps left in the statutes at issue in both *Dunlap* and Petitioner's case, regulations were required.

Section 1259(f) is a *specific* and *mandatory* delegation provision saying "[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section." App.78a. And the relevant Senate Report expounded on the congressional expectations for prospective legislative rules, both under this section and section 1259(c)(1)(E). App.89a-92a. The Government argues that this regulatory command is meaningless because it is "similar to many other commonplace grants of rulemaking authority," like the general regulatory authority given to Treasury in 26 U.S.C. § 7805(a). Opp.20-21. But when Congress assigns regulatory authority to implement a specific statutory section, it desires legislative (not merely interpretive) rules, which require notice-and-comment, to implement that statutory section. *See* Thomas W. Merrill and Kathryn Tongue Watts, *Agency Rules With The Force Of Law: The Original Convention*, 116 HARV. L. REV. 467, 484 (2002) (drawing this exact distinction between the general regulatory authorization in section 7805(a) and those assigned to specific Internal Revenue Code sections). The Government's argument would render sections 1259(f) and 1259(c)(1)(E) entirely superfluous of the Internal Revenue Code's general authorization for

interpretive rules. That is the opposite of vindicating Congress's intent.

This Court construes delegated authority like that in section 1259 to require agency regulation *before* judicial decisions. Because of its delegation, "Congress . . . understood that the ambiguity" on the precise question at issue in this case "would be resolved, *first and foremost*, by the agency, and desired the agency (*rather than the courts*) to possess whatever degree of discretion the ambiguity allows." *City of Arlington, Tex. v. FCC*, 569 U.S. 290, 296 (2013) (emphasis added) (internal quotation marks omitted) (quoting *Smiley v. Citibank (South Dakokta), N.A.*, 517 U.S. 735, 740-41 (1996)). Then-Professor Kagan put it succicntly when discussing the statutory assignment of certain regulatory power to agencies under this Court's precedent: Congress makes an "institutional choice . . . between agencies and courts in ultimately resolving statutory ambiguities." David J. Barron & Elena Kagan, Chevron*'s Nondelegation Doctrine*, 2001 SUP. CT. REV. 201, 202 (2001). This "institutional choice" is meant to advance "both accountability and discipline in decision making." *Id.* at 204. Accordingly, for an agency to faithfully administer the statute assigned to it, it is "critical" that "*the statutory delegatee*—the officer to whom the agency's organic statute has granted authority over a given administrative action . . . t[a]k[e] the action at issue, rather than subdelegating that action . . . ." *Id.* at 237 (emphasis added).

Here, Congress clearly left the precise question at issue to Treasury regulation: *when* should market uncertanties (and *what* market

uncertainties) justify deeming a forward contract's "amount of property" "substantially fixed"? And, related, *when* does that conclusion justify disregarding a forward contract's broad range in potentially-deliverable property that would otherwise render the property amount *not* "substantially fixed?" Pet.2-5, 23-24. Congress wanted the Treasury Secretary to decide such issues through prospective regulation. Even the Second Circuit conceded this reality. App.26a.

Accordingly, *Dunlap* is squarely on point. *Dunlap* held that "courts cannot perform executive duties, nor treat them as performed when they have been neglected." 173 U.S. at 72. And *Dunlap*'s admonishment that "courts cannot perform executive duties" draws upon separation of powers principles that this Court has long enforced. When "[j]udicial control of federal executive officers was principally exercised through the prerogative writ of mandamus," courts had no power to resolve statutory ambiguities left in the first instance to agencies. *See, e.g.*, *United States v. Mead Corp.*, 533 U.S. 218, 242 (2001) (Scalia, J., dissenting) (discussing, *e.g.*, *Wilbur v. United States ex rel. Kadrie*, 281 U.S. 206, 221-22 (1930)). Post-*Chevron*, the rule is the same. If anything, post-*Chevron*, a judicial finding of "linguistic ambiguity" on the question at issue in a statute administered by an agency is, by itself, enough to conclude "that Congress had delegated gap-filling power to the agency." *United States v. Home Concrete & Supply, LLC*, 566 U.S. 478, 488-89 (2012) (plurality opinion); *see also id.* at 493 (Scalia, J., concurring) ("Indeed, the Court was unaware of even the utility (much less the necessity) of making

the ambiguous/nonambiguous determination in cases decided pre-*Chevron*, ...").

If this Court were to accept the Government's view that legislative rules were not a precondition to enforcing the statute here, the Court would explicitly endorse Treasury's efforts to "administer [an] Act in a manner that is inconsistent with the administrative structure that Congress enacted into law." *ETSI Pipeline Project v. Missouri*, 484 U.S. 495, 517 (1988). Yet in context after context, this is impermissible. An agency cannot re-delegate the authority Congress gave it to another agency. *See id.* An agency cannot act with power Congress never gave it, "[r]egardless of how serious the problem [it] seeks to address . . . ." *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 125 (2000). And an agency cannot administer a statute in a way that "is easier" than the way Congress envisioned. *See Ragsdale v. Wolverine World Wide, Inc.*, 535 U.S. 81, 91 (2002). The logic of these holdings prohibits the premise of the Government's position here—that an agency can simply refuse to promulgate needed regulations, but enforce the statute anyway, because it can ask courts to provide the final say. Opp.17-18.

The only way to vindicate "the administrative structure that Congress enacted into law," *ETSI Pipeline Project*, 484 U.S. at 517, is to give effect to Congress's choice of agent ("[t]he Secretary") and Congress's choice of process ("regulations"). Reading these choices out of the statute for agency convenience has no basis in the separation of powers, statutory construction, or, as will be discussed *infra*, fair notice. *See also* Leon Dalezman and Phillip Lenertz, *When the IRS Prefers Not to: Why*

Disparate Regulatry Approaches to Similar Derivative Transactions Hurts Tax Law, 7 HARV. BUS. L. REV. 81, 89 (2017) ("having a clear line is still better than the uncertainty prevalent in other areas of tax law such as §§ 1259 and 1260 where legitimate tax planners are potentially at risk of being caught up in an ill-defined net cast someday in the future should the IRS decide to change its approach and bring litigation."). If this means that a statute is unenforceable as-applied to a certain case (as the constructive sale statute is to McKelvey's VPFCs) then the Treasury knows what to do: regulate a different result. *See Hillman v. I.R.S.*, 263 F.3d 338, 343 (4th Cir. 2001) ("this is an inequity in the United States Tax Code that only Congress or the Secretary (as the holder of delegated authority from Congress) has the authority to ameliorate.").

b. The Second Circuit's Analysis Reveals Why Regulations Were A Precondition

The Second Circuit's own analysis confirms the prequisite of regulation here. The court did not "construe[] the statute as an original matter." Opp.11. It filled a statutory gap with a policy choice.

A court can construe section 1259's plain language to establish a minimal level of potential variability in an amount of property necessary to avoid constructive sale treatment. Pet.23-24; App.23a (the Second Circuit describing "an amount within a narrow range of limits" as "[a] clear example" of what a "substantially fixed" amount of contractually-specified property variation might be). *But*, the Second Circuit did *not* decide that McKelvey's VPFCs called for the future delivery of

"substantially fixed" property amounts because 5.4 to 6.5 million stock shares was "an amount within a narrow range of limits." Indeed, that precise range was sufficient to *preclude* the IRS from calling his VPFCs constructive sales at their inception. Pet.6-7; App.14a; Opp.4 ("because, by design, the number of shares to be delivered is variable," VPFCs generally are not "substantially fixed"); Opp.9 (the number of deliverable shares in McKelvey's VPFCs "remained unchanged" when he extended the VPFCs).

As the Second Circuit acknowedged, "the amount [of property potentially due under McKelvey's VPFCs] is claimed to be substantially fixed *for a different reason.*" App.23a (emphasis added). Statutory interpretation does not provide the Second Circuit's "different reason" (or "'key step,'" as the Government prefers it (Opp.10) (quoting App.21a)) for finding that McKelvey's VPFCs called for delivery of a "substantially fixed" amount of property. Rather, this "different reason" was made up based on the factors the Second Circuit believes the Treasury Secretary should have taken into account in regulation, and as to which taxpayers could only have speculated. App.26a-29a. McKelvey had no reason to know that extending his VPFCs following a sudden, but hopefully temporary, drop in the underlying stock price would turn transactions that were not constructive sales into transactions that were. Pet.7-8.

The structure of the Second Circuit's analysis is telling. When it conceded the acknowledgement of needed, but missing, regulations "to implement the constructive sale statute" here, App.26a, the Second Circuit did not stop out of a concern for the

congressional scheme. Instead, it accepted Treasury's invitation to take on the role Congress reserved for "[t]he Secretary." The Second Circuit spent the next three—largely citation-free—pages explaining why it was "[n]evertheless" "persuaded to accept probability analysis in this context." App.26a. Nothing about "constru[ing] the statute as an original matter" (Opp.11) produces this outcome. Only "phantom" regulation can. Pet.11-14.

II. The Government's Cavalier Response To "Phantom" Regulation's Fair Notice Problem Confirms Review Is Warranted

"Phantom" regulation has plagued tax law for over 30 years—despite its conflict with *Dunlap*, rejection by the Fourth Circuit, and the Seventh Circuit's admonishment in the tax-penalty context. *See* Pet.14-21. The Second Circuit deepened this divide. Now, Treasury can ask a court of appeals to apply taxes despite having shirked its regulatory responsibilities to establish a pre-existing standard governing the application of the tax at issue. This evidences a disturbing pattern of Treasury preserving strategic tax law uncertainty that it can selectively enforce against taxpayers. *See, e.g.*, Dalezman and Lenertz, *When the IRS Prefers Not to*, 7 HARV. BUS. L. REV. at 82 (explaining how IRS withdrew regulations explaining when interest in a corporation is treated as stock or debt, despite them "provid[ing] a much-needed distinction between debt and equity," so to prevent tax planning).

The Government unconvincingly tries to quell any worries this Court might have about Treasury's nonfeasance by contending that the Second Circuit's

particular policy choice was wise (Opp.14-16); that McKelvey's VPFCs are "uncommon" and "complex" (Opp.3); and the Second Circuit ensured its "phantom" regulation is "factbound" (Opp.15) and "case-specific" (Opp.16). The Government's goal is to evade the question presented: whether, or under what circumstances, a court may enforce an ambiguous provision of the Internal Revenue Code to fill a statutory gap, when Congress delegated gap-filling responsibility to Treasury but Treasury has failed to promulgate required regulations.

When the Government brings itself to address the problem of a court filling gaps in Treasury's place, its argument is astonishing. It contends that there is no issue because "although the Commissioner has not promulgated regulations to implement Section 1259, the court of appeals had before it the administrative interpretation of that provision reflected in the Commissioner's deficiency determination." Opp.18. Overlook for a moment that the "deficiency determination" is a perfunctory document that does not contain anything remotely resembling the transparency or explanation of notice-and-comment rulemaking. On the Government's view, the *first time* a taxpayer may be allowed to know why he is subjected to taxes *is when he is charged with violating the tax laws*.

The Government's position cannot be reconciled with due process, and it highlights why the question presented needs this Court's review. If Treasury can avoid its regulatory obligations because, when a taxpayer is charged with violating the tax laws, he will receive a document that provides the agency's "administrative

interpretation," there is no reason for Treasury ever to regulate. Pet.35-36. This is exactly what "phantom" regulation permits: taxation based on legal standards that did not exist at the time the transaction occurred. And, it is exactly why "phantom" regulation is irreconcilable with the Constitution's presumption that taxes will be enacted *prospectively* to ensure public accountability. Pet.33.

This Court does not allow an agency to supplant needed, missing regulations with "administrative interpretations" made by the agency's prosecutor. *See Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 212 (1988) ("Congress has delegated to the administrative official and not to appellate counsel the responsibility for elaborating and enforcing statutory commands."). That same principle should apply with particular force to the Internal Revenue Code, as it leaves "hundreds" of complicated, tax-policy questions for legislative rulemaking via mandatory delegations to the Treasury Secretary. Pet.15.

As then-Judge Gorsuch, writing for the Tenth Circuit, explained, legislative rules, like legislation, "announce[] a rule of general applicability and regulate[] otherwise private conduct." *De Niz Robles*, 803 F.3d at 1169 (discussing legislation); *see also id.* at 1172 (applied to legislative rules). They are designed to govern prospectively. *See id.* Adjudication is retrospective (Opp.16-17)—*but* that is only consistent with due process because the Constitution "invests judges with none of the legislative power to devise new rules of general applicability, ..." *De Niz Robles*, 803 F.3d at 1171.

"Allowing agencies the benefit of retroactivity always and automatically whenever they choose adjudication over rulemaking would create a strange incentive for them to eschew the Court's stated preference for rulemaking—and render *Bowen* easily evaded." *Id.* at 1173.

Rather than apply these familiar principles, the Government confirms that, without this Court's guidance, "phantom" regulation will persist; Treasury will continue to shirk its regulatory responsibilities in favor of after-fact-adjudication; and taxpayers will continue to suffer from weaponized uncertainty.

CONCLUSION

The Court should grant the Petition.

Respectfully submitted,

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