

No. 17-1151

**In The
Supreme Court of the United States**

DUQUESNE LIGHT HOLDINGS, INC. & SUBSIDIARIES
F/K/A DQE, INC. & SUBSIDIARIES, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE.

*ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT*

REPLY BRIEF FOR PETITIONERS

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REPLY BRIEF FOR PETITIONERS

The Third Circuit held that *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934) empowers the IRS to deny deductions it deems duplicative unless the statute or regulation authorizing those deductions *also* expressly states that a double deduction is intended. Thus, even though the applicable regulations authorized Duquesne’s claimed deductions, the Third Circuit concluded the IRS properly deployed *Ilfeld* to override its own regulations and disallow \$199 million worth of deductions. As Judge Hardiman observed in dissent, this holding conflicts with (1) precedent in other federal courts of appeals, (2) this Court’s decisions, and (3) bedrock principles of administrative law—all of which establish that the “judiciary’s policy concern of precluding double deductions must yield to positive law that provides otherwise.” Pet. App. 49a n.3.

The IRS’s opposition does not deny that multiple courts of appeals have refused to read *Ilfeld* as imposing the sort of triple authorization required by the Third Circuit and have instead treated *Ilfeld* as establishing a canon of construction used in interpreting ambiguous statutes and regulations. Nor does the IRS defend the notion that an uncoded anti-duplication principle could override the plain text of its regulations. Rather, the IRS tries to rewrite the Third Circuit’s decision—insisting that the court did not, in fact, hold that *Ilfeld* superseded 26 C.F.R. § 1.337(d)-2T, the regulation expressly authorizing Duquesne’s deductions.

But try as it might, the IRS cannot explain away the Third Circuit’s holding. The court’s reasoning was plain: although § 1.337(d)-2T would have authorized Duquesne’s deductions if “literally” applied, *Ilfeld* disallowed the deductions *because* they were duplicative. Pet. App. 37a-39a. Indeed, the IRS’s specific arguments in support of the Third Circuit’s conclusion only confirm the extent to which the court must have treated *Ilfeld* as a substantive, rather than interpretive, principle. While the IRS couches its assertions in often-vague references to the consolidated return regulations’ “structure and history,” ultimately it insists that because *other* regulations prohibit *other* types of duplicative deductions, *Ilfeld* authorizes the IRS to disregard its own applicable regulations if adherence to their terms would produce a result the IRS disfavors.

As the Cato Institute’s amicus brief emphasizes, the IRS, like all other administrative agencies, is bound by its governing statutes and promulgated regulations. This Court’s review is needed to vindicate that rule-of-law principle and confirm that the IRS cannot administer the tax code through policy preferences imposed by administrative fiat.

ARGUMENT

I. THE THIRD CIRCUIT APPLIED *ILFELD* TO OVERRIDE GOVERNING REGULATIONS

A. The Third Circuit Applied A Triple-Authorization Rule

The linchpin of the IRS’s opposition is its contention that the Third Circuit did not adopt “a ‘triple-authorization’

rule.” Opp. 28. Invoking the court’s occasional use of the word “interpretive,” the IRS insists the decision below accepted Duquesne’s “preferred characterization” of *Ilfeld* as a canon of construction used to construe ambiguous regulations. Opp. 30 (citing Pet. App. 37a-38a).

The Third Circuit did no such thing. Though it used the adjective “interpretive,” the court made clear its view that *Ilfeld*’s so-called “interpretive principle” overrides even *unambiguous* regulations authorizing a deduction if those regulations do not also expressly provide that a duplicative benefit is intended. Pet. App. 37a-39a. The court expressly acknowledged that, if “literally applied,” § 1.337(d)-2T would authorize Duquesne’s challenged deductions. Pet. App. 37a. The court neither identified nor relied on any ambiguity in the regulation’s express terms. Instead, it based its conclusion on its view that this regulatory authorization was purportedly for “one-time only, for there is no mention in the regulation of approval for a loss deduction that duplicates another already taken.” Pet. App. 37a. After citing the IRS Notice indicating the agency intended to promulgate *future* regulations prohibiting duplicative deductions (regulations the court recognized did not apply here), the court then declared: “[T]he blinkered approach of Duquesne does not stand so long as there is *Ilfeld*.” Pet. App. 38a.

Thus, as Judge Hardiman explained in dissent, the “question presented” is whether *Ilfeld* may override a regulation that “authorizes the very actions that *Ilfeld* cautioned against.” Pet. App. 44a. The Third

Circuit majority answered that question with a resounding yes. It held that although § 1.337(d)-2T *would* have authorized Duquesne’s claimed deductions were they not duplicative, the regulation did not supply authorization sufficient to overcome *Ilfeld* where duplicative losses were at issue. Pet. App. 37a-39a; see Pet. App. 43a (“Duquesne and our dissenting colleague believe that the authority for a loss given in this temporary regulation looks forward only, with no accounting for the same loss already taken. We believe *Ilfeld* counsels otherwise * * *.”). That is precisely the “triple-authorization rule” the IRS now denies the Third Circuit adopted.

B. The Regulations Expressly Allowed Duquesne’s Deductions

The Third Circuit needed to adopt this triple-authorization rule because the text of the relevant regulation was plain: the 2002 and 2003 losses Duquesne sustained from Aquasource’s sale of stock were “Allowable Loss[es].” 26 C.F.R. § 1.337(d)-2T(c). Indeed, Duquesne followed the IRS’s regulations and guidance to the letter. Before promulgating § 1.337(d)-2T, the IRS advised taxpayers that it would issue “interim regulations” that would “require consolidated groups to determine the allowable loss on a sale or disposition of subsidiary stock under an amended § 1.337(d)-2.” IRS Announces New Position With Regard to Consolidated Loss Disallowance Rule, IRS Notice 2002-11, 2002-1 C.B. 526 (Jan. 31, 2002). The promised regulation, § 1.337(d)-2T, provided that generally “[n]o deduction is allowed for any loss recognized by a member of a

consolidated group with respect to the disposition of stock of a subsidiary.” 26 C.F.R. § 1.337(d)-2T(a). It also provided that a loss “is not disallowed” (but rather represents an “Allowable Loss”) if “the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain on the disposition of an asset.” *Id.* § 1.337(d)-2T(c). The IRS explained that this provision would “permit certain losses recognized on sales of subsidiary stock by members of a consolidated group.” Loss Limitation Rules, 67 Fed. Reg. 11034-01, 11034 (Mar. 12, 2002).

As the IRS does not now contest, the 2002 and 2003 losses resulted from the disposition of devalued subsidiary stock. The IRS likewise does not dispute that these losses were not attributable to the recognition of built-in gain. Given these predicates, the plain terms of § 1337(d)-2T(c) authorized Duquesne’s 2002 and 2003 deductions.

Faced with this controlling regulation, the IRS makes only a passing attempt to address its actual language. The IRS emphasizes paragraph (c)(2)’s use of the phrase “not disallowed under paragraph (a)(1),” suggesting that paragraph (c)(2) established only that a deduction was not “banned” (rather than that it was permitted). Opp. 24-25. But paragraph (a)(1) expressly encompassed *all* losses incurred in “the disposition of stock of a subsidiary.” Paragraph (c)(2), by providing that certain such losses (those not reflecting built-in gain) were “not disallowed,” thus established that sales of subsidiary stock *did* give rise to allowable losses in those circumstances. The regulation expressly

confirmed as much by characterizing paragraph (c) as governing “Allowable Loss”—textual language the IRS never addresses. The implementing order provides yet further confirmation: “certain losses recognized on sales of subsidiary stock by members of a consolidated group” were “*permit[ted]*.” 67 Fed. Reg. at 11034 (emphasis added).

C. The IRS’s Contentions Depend On *Ilfeld* Overriding Unambiguous Regulations

The IRS’s other arguments serve only to confirm what it attempts to deny—the Third Circuit’s decision hinged on what the court perceived to be *Ilfeld*’s triple-authorization requirement. Implicitly acknowledging the weakness of its fleeting suggestion that § 1.337(d)-2T(c) did not authorize Duquesne’s deductions, the IRS falls back on the assertion that a § 1.337(d)-2T(c)-authorized deduction might nevertheless be overridden by “*other* Code or regulatory provisions.” Opp. 24-25 (emphasis added). The IRS has never identified any such provisions. Instead, the IRS has consistently said these deductions were “disallowed by application of the doctrine of * * * *Ilfeld*” alone. Pet. App. 74a.

The IRS’s emphasis on 26 C.F.R. § 1.1502-35T (2003) is particularly telling. As the IRS ultimately acknowledges, that regulation did not disallow any of Duquesne’s claimed deductions. Opp. 17 n.5, 23. Thus, in repeatedly asserting that § 1.1502-35T “directly addressed the issue of loss duplication” (*e.g.*, Opp. 7), the IRS is referring only to the fact that this regulation was designed to prohibit certain specified double

deductions (but not the ones at issue here).¹ And in repeatedly insisting that § 1.337(d)-2T(c) had “‘nothing to do with loss duplication’” (e.g., Opp. 26), the IRS is merely quoting the Third Circuit’s conclusion that this regulation did not include the special kind of express authorization that the court read *Ilfeld* to require for deductions the IRS deems duplicative of prior claimed losses. Pet. App. 38a. Thus, much like the Third Circuit, the IRS is contending that because the agency generally disfavors duplicative deductions (as § 1.1502-35T illustrates), a regulation *authorizing* a taxpayer’s supposedly duplicative deduction can be set aside under *Ilfeld* even if no regulation prohibits recognition of that loss.

The IRS’s invocations of the supposed “structure and purpose” of the consolidated return regulations are similar. Opp. 25. Echoing the Third Circuit, the IRS emphasizes that these regulations often apply a “single-entity approach,” meaning that members of a consolidated group may be treated as a single taxpayer.

¹ Section 1.1502-35T(c) suspended losses resulting from the sale of a subsidiary’s stock if the subsidiary remained a member of the consolidated group after the sale. That was not the case for AquaSource’s 2002 and 2003 sales of its subsidiaries’ stock, the only transactions to which the regulation might have applied. Pet. App. 36a. The IRS implies that AquaSource structured these sales to evade § 1.1502-35T(c). Opp. 10, 17 n.5. But even had the regulation applied, it would have operated to offset *future* loss deductions, not the 2001 losses the IRS claimed the 2002 and 2003 deductions duplicated. In any event, “one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury.” *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934) (Hand, J.).

Opp. 25 (quoting Pet. App. 33a). But as the Third Circuit recognized, the regulatory regime calculates other aspects of a consolidated group's taxes "as if each member of the group were a separate taxpayer." Pet. App. 3a (citing 13 Mertens Law of Federal Income Taxation § 46:1 (2016 ed.)). One would think that the IRS's regulations would determine which approach governs in any given situation. Instead, however, the IRS bases its contention that the "single-entity approach" dictates the result here on the policy against "duplicative deductions" that the "*Ilfeld* doctrine * * * reflects." Opp. 25-26. In other words, while superficially framing its arguments in interpretive terms, the IRS is again simply arguing that *Ilfeld* authorized it to disregard the plain text of § 1.337(d)-2T(c).

II. THE THIRD CIRCUIT'S DECISION DEEPENS A CIRCUIT CONFLICT

In applying a triple-authorization rule, the Third Circuit deepened an existing division among the federal courts of appeals. As Duquesne detailed (Pet. 17-26), the Third Circuit has now joined both the Eighth and Ninth Circuits in holding that *Ilfeld* may override the plain language of the Internal Revenue Code and its implementing regulations. The First, Fifth, and Tenth Circuits have correctly rejected that proposition.

The IRS's opposition does not dispute Duquesne's characterization of the First, Fifth, and Tenth Circuit precedents. As the IRS acknowledges, these courts have held that *Ilfeld* is an "interpretive principle" that must be disregarded when the text of an applicable

statute or regulation is clear, even if a double benefit results. Opp. 30; see *Transco Exploration Co. v. Commissioner*, 949 F.2d 837, 841 (5th Cir. 1992); *O'Brien v. Commissioner*, 771 F.2d 476, 477 (10th Cir. 1985); *Textron, Inc. v. United States*, 561 F.2d 1023, 1026 & n.5 (1st Cir. 1977). The IRS does not even suggest (as the Third Circuit erroneously did) that these decisions might somehow be distinguished because they did not involve consolidated filers. Pet. 25-26.

Instead, the IRS asserts that the decision below is consistent with these precedents because the Third Circuit “did not conclude that *Ilfeld* permits the Commissioner to disallow double deductions that are unambiguously authorized by statute or regulation merely because in practical effect the deductions reflect the same economic loss.” Opp. 31. But that is exactly what the Third Circuit did. As recounted above, the court determined that, if “literally applied,” § 1.337(d)-2T(c) authorized Duquesne’s deductions; nevertheless, it allowed the IRS to nullify the authorization because the claimed deductions “duplicate[d] another already taken for the underlying economic loss.” Pet. App. 37a-38a.

By contrast, in *Transco* (for example), the Fifth Circuit concluded that *Ilfeld* did not preclude a taxpayer from taking a duplicative lease-bonus deduction where the relevant regulation unambiguously authorized the deduction. 949 F.3d at 841. The court so held even though the regulation included no magic words expressly authorizing a deduction where the taxpayer had already received credit for the same

expenditure. *Ibid.* The IRS cannot reconcile the Third Circuit’s decision here with that holding or credibly claim that Duquesne would not have prevailed had its case arisen in the Fifth Circuit. See W. Sutton, *An Error In Judgment: Revisiting Duquesne Light Holdings*, 44 J. CORP. TAX’N 25, 28 (2017).

Nor can the IRS explain away the Eighth and Ninth Circuit decisions applying *Ifeld* in the same way as the Third Circuit: *Marwais Steel Co. v. Commissioner*, 354 F.2d 997 (9th Cir. 1965) and *Comar Oil Co. v. Helvering*, 107 F.2d 709 (9th Cir. 1939). On *Marwais*, the IRS asserts that the Ninth Circuit “appears to have viewed *Ifeld* and *Pacific Lumber* as controlling on the facts presented.” Opp. 32; see *McLaughlin v. Pacific Lumber Co.*, 293 U.S. 351 (1934). But the Ninth Circuit observed that the “sequence of facts” before it was “reversed” from the circumstances in those cases. *Marwais*, 354 F.2d at 998. Nevertheless, it held that, while the regulations expressly authorized the taxpayer’s claimed deductions, *Ifeld* mandated disallowance “in cases having any similarity at all on double deductions for a single economic loss.” *Id.* at 998-99. Like the Third Circuit here, the Ninth Circuit thus applied *Ifeld* to override the regulatory text. And while the Ninth Circuit may cite *Marwais* infrequently (Opp. 32), the Tax Court has invoked it on multiple occasions—including in this very case. Pet. App. 92a-94a; see *Thrifty Oil Co. v. Commissioner*, 139 T.C. 198, 212 (2012).

As for *Colmar*, the IRS does not deny that the Eighth Circuit invoked *Ifeld* and held that, notwithstanding the applicable statute’s plain text, the

taxpayer could not be allowed “the practical equivalent of double deduction.” *Colmar*, 107 F.2d at 711 (quoting *Ilfeld*, 292 U.S. at 68). Instead, the IRS asserts that *Colmar* was “primarily” based on other decisions involving the “application of equitable principles in the tax context.” Opp. 32. But the Eighth Circuit’s invocation of these decisions merely confirms that it viewed *Ilfeld* as establishing a similar “equitable principle[]” that precludes taxpayers from securing “a second deduction for the same identical loss,” despite what the governing statutes provide. *Colmar*, 107 F.2d at 712. And like *Marwais*, the Tax Court has relied on *Colmar*—forcing taxpayers to attempt to conform to this uncodified common-law doctrine. *Thrifty Oil Co.*, 139 T.C. at 213 n.20, 218.

III. THIS IMPORTANT ISSUE WARRANTS REVIEW

As Duquesne explained (Pet. 27-34), this Court’s intervention is necessary because the Third Circuit’s application of *Ilfeld* is irreconcilable with basic principles of administrative law. Taxpayers, like other regulated entities, are entitled to rely on the plain text of the provisions governing their conduct. *E.g.*, *Gitlitz v. Commissioner*, 531 U.S. 206, 220 (2001). The IRS’s after-the-fact invocation of a judicially created anti-duplication policy to override duly promulgated regulations is anathema to essential principles of fair notice. This Court recently suggested it might consider abandoning deference to agency interpretations of ambiguous statutes and instead embrace the “impressive body of pre-*Chevron* law recognizing that the meaning

of a statutory term is properly a matter for judicial rather than administrative judgment.” *SAS Inst. Inc. v. Iancu*, 138 S. Ct. 1348, 1358 (2018) (internal alterations and quotation marks omitted). Whatever the fate of *Chevron* (and *Auer v. Robbins*, 519 U.S. 452 (1997)), it should be common ground that the judiciary cannot permit agencies to depart from their own unambiguous regulations.

The IRS does not contend otherwise—at least not directly. Rather, the IRS characterizes *Ilfeld* (and follow-on decisions like *United States v. Skelly Oil Co.*, 394 U.S. 578 (1969)) as establishing an “interpretive principle,” and it attempts to demonstrate that the Third Circuit applied *Ilfeld* as such. Opp. 27-28. The latter effort fails, as discussed *supra* pp. 2-4.

And the IRS’s more specific arguments reveal the extent of the authority it hopes to wield. At bottom, the IRS’s contention is that admittedly *inapplicable* regulations that prevent *other* types of duplicative deductions—*e.g.*, § 1.1502-35T—demonstrate that Duquesne’s deductions were unauthorized. Opp. 23-26; *see supra* pp. 6-8. The IRS asserts that because it promulgated *some* regulations intended to disallow *some* deductions, it can also, on an ad hoc basis, disallow other deductions that are entirely consistent with its regulations. As the Cato Institute observes (at 3), this “‘spirit of the regulations’ approach is inconsistent with any legitimate view of the proper role of agencies and this Court’s precedents.” Indeed, if the IRS’s mere desire to prohibit duplicative deductions

sufficed to prohibit them, it is unclear why it needs regulations on the subject at all.

If review is not granted, taxpayers who comply with the statutes and regulations will nevertheless remain in limbo, not knowing whether those rules ultimately will govern. This Court should not allow the IRS to so upset taxpayers' justified reliance. Whatever the IRS's overarching policy preferences, the plain meaning of such provisions must control. If the IRS does not like the result its regulations produce, it should promulgate new ones.

CONCLUSION

The petition should be granted.

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