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TREATMENT OF TREAS. REG. §1.752-6 PROVIDES INSIGHT INTO THE APPLICATION OF REVISED I.R.C. §7805(b)

By:

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In Maguire Partners-Master Investments, LLC v. United States, a District court in California joined the Seventh Circuit in Cemco Investors, LLC v. United States in upholding the validity of Treas. Reg. §1.752-6 and the retroactive application of that same regulation. This same regulation was declared invalid by the Court of Federal Claims in Stobie Creek Investments, LLC v. United States and the District court for Colorado in Sala v. United States. In addition, in Klamath Strategic Investment Fund, LLC v. United States a District court in Texas called into question the retroactive effect of the regulation.

These opinions are important because they are the first cases to address the restrictive provisions regarding retroactivity of regulations applicable to statutes enacted after July 30, 1996. Prior to its amendment, section 7805(b) provided that regulations were effective retroactively unless the

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Secretary of the Treasury (hereafter “Secretary”) provided otherwise. Section 7805(b) now provides that regulations are to have prospective effect unless they fit within certain specifically delineated exceptions.

I. CLASSIFICATION OF TREASURY REGULATIONS AND DEFERENCE ACCORDED TO EACH CLASS

Treasury regulations fit within three broad classifications - legislative, interpretative or procedural. Legislative regulations are those issued by the Secretary where Congress “has explicitly left a gap for the agency to fill.” In these instances, Congress can be viewed as having vested in the Secretary the right to “make the law” in a specific area. Interpretative regulations are those promulgated by the Secretary under the general grant of authority contained in section 7805(a). Their scope is more circumscribed as the authority conferred upon the Secretary by section 7805 is to interpret a particular statutory provision.

In Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., the Supreme Court stated that “legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.” The deference accorded properly adopted legislative regulations is, therefore, virtually absolute. In evaluating a legislative regulation the threshold issue is whether, “Congress has directly spoken to the precise question at issue ... [if it has], that is the end of the matter.” If Congress has not directly addressed the precise question at issue, the court does not impose its own construction on the statute ... [r]ather if the statute is silent or ambiguous ... the question for the court is whether the agency’s answer is based upon a permissible construction of the statute.”
The deference accorded an interpretative regulation is not as clear. The threshold question is again whether Congress has directly addressed the issue the regulation seeks to address in a clear and unambiguous manner. If that is the case, there is no room for administrative interpretation.\textsuperscript{14} Where Congress has not addressed an issue, or has done so in an ambiguous fashion, the reasonable interpretation of the administrator of an agency (e.g., the Secretary) should be adhered to even if the reviewing court would have not adopted the same approach.\textsuperscript{15} Stated another way, a court must defer to the administrator’s judgment so long as the administrator’s interpretation is one of a number of possible reasonable interpretations.

In United States v. Mead,\textsuperscript{16} the Supreme Court considered whether a tariff classification ruling issued by the United States Customs Service was entitled to the deference accorded regulations under Chevron. The ruling at issue in Mead was analogous to an Internal Revenue Service (hereafter “Service”) letter ruling.\textsuperscript{17} The Supreme Court refused to accord the classification ruling in Mead the same deference accorded regulations under Chevron.\textsuperscript{18} Mead’s significance lies in the fact that it affirmed the standard of judicial review applicable to interpretative regulations set forth in Chevron.\textsuperscript{19}

Chevron did not specifically address interpretive regulations promulgated by the Secretary under section 7805(a). Two earlier Supreme Court cases that did so were National Muffler Dealers Association, Inc. v. United States\textsuperscript{20} and Vogel Fertilizer Company v. United States.\textsuperscript{21} Neither of these cases was the subject of analysis in Chevron, thus leaving open the question of whether they or Chevron set forth the appropriate level of deference to be accorded interpretative regulations issued pursuant to the general grant of authority conferred upon the Secretary under section 7805(a).

In holding the regulations at issue in National Muffler valid, the Supreme Court stated that “[i]n determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose.”\textsuperscript{22} Applying that same standard in Vogel Fertilizer, the Supreme Court struck down Treas. Reg. §1.1563-1(a)(3) as incompatible with the statute.\textsuperscript{23} The court held in the context of interpretative regulations that the “general principle of deference, while fundamental, only sets the framework for judicial analysis; it does not displace it.”\textsuperscript{24} The majority held that Congress had directly addressed the question that was the subject of Treas. Reg. §1.1563-1(a)(3) in a clear and unambiguous manner, after analyzing the language and the legislative history of the statute. Thus, the regulation was found to be invalid. This conclusion left no room for the Secretary to interpret the statute and is fully consistent with rule articulated in Chevron.\textsuperscript{25}

The Tax Court has continued to apply National Muffler in testing the validity of interpretative regulations. In its view, Chevron merely represents a restatement of the standard articulated in National Muffler.\textsuperscript{26} In Swallows Holding, Ltd. v. Commissioner,\textsuperscript{27} the Third Circuit rejected this view. It held instead that Chevron effectively preempted National Muffler.\textsuperscript{28} In many cases the same result would obtain regardless of which test is applied. The Chevron standard is, however, a more liberal one which affords a greater degree of deference to interpretative regulations promulgated under section 7805.
II. THE RETROACTIVITY OF TREASURY REGULATIONS UNDER SECTION 7805

The retroactive exceptions fall within two categories, those which are temporal and those which are substantive. Under Section 7805(b)(1), a regulation cannot be applied retroactively to any period prior to the filing of final, temporary or proposed regulation with the Federal Register or alternatively the date on which any notice substantially describing their contents is published. The principal substantive exceptions are found in section 7805(b)(3) relating to the prevention of abuse and section 7805(b)(6) relating to a legislative grant allowing for an effective date earlier than that prescribed in section 7805(b)(1).

The threshold question in evaluating the Secretary's authority to invoke the substantive exceptions permitting retroactivity under section 7805(b)(3) is the extent to which prior case law under Old Section 7805 should be imported into the analysis.

Under Old Section 7805(b), the Secretary's decision not to apply a regulation prospectively, was subject to review under an abuse of discretion standard. Judicial review was generally predicated on the need to prevent fundamental unfairness in situations where the Secretary sought to alter settled tax policy upon which a taxpayer justifiably had a right to rely.

In Anderson, Clayton & Company v. United States, the Fifth Circuit set forth some of the relevant factors for determining whether to accord a regulation retroactive effect. These included:

(1) whether or to what extent the taxpayer justifiably relied on settled prior law or policy and whether or to what extent the putatively retroactive regulation alters that law; (2) the extent, if any, to which the prior law or policy has been implicitly approved by Congress, as by legislative reenactment of the pertinent Code provisions; (3) whether retroactivity would advance or frustrate the interest in equality of treatment among similarly situated taxpayers; and (4) whether according retroactive effect would produce an inordinately harsh result.

In Snap-Drape, Inc. v. Commissioner, the Fifth Circuit reaffirmed that "this list of relevant considerations is neither exhaustive nor exclusive" and that it "merely reflects a distillation of prior case law." The court held that the factors listed in Anderson, Clayton were intended only to serve as a guide and that the presence of all four "factors" was not required in order for a court to conclude that the retroactive application of a regulation does or does not constitute an abuse of discretion. The court in Snap-Drape held the regulations before it valid despite finding that "the retroactive application of this regulation has already produced inordinately harsh results." It did so because it found that the Secretary satisfied the requirement that the regulation served a rational legislative purpose.

Under Old Section 7805(b), where there are existing regulations, or a clearly established administrative practice, the Secretary is generally precluded from issuing new regulations having retroactive effect. That limitation, however, is not absolute as the Secretary has the authority to correct erroneous regulations or administrative practices. For example, in Dixon v United States, the Supreme Court stated that the Secretary
"could make retroactive a new regulation increasing tax liability beyond that provided for by the prior regulation where the supersedes regulation corrected an erroneous interpretation of the statute." Moreover, taxpayers relying on non-authoritative administrative pronouncements generally do so at their peril. 42

Where there is no outstanding regulation construing or interpreting a statute when the Secretary chose to issue regulations, those regulations could apply with retroactive effect since the taxpayer's liability was governed by the underlying statute. 43 This rule is applicable even if the regulation is promulgated after litigation has commenced, 44 although the regulation would remain subject to review under the abuse of discretion standard. 45

It is arguable that by eliminating the blanket authority granted the Secretary to allow regulations to have retroactive effect under Old Section 7805(b), Congress obviated the need for a court to apply the traditional standards for determining whether the Secretary abused his discretion. For statutory provisions enacted after July 30, 1996, the sole inquiry in determining retroactivity of regulations should be compliance with the literal language of either section 7805(b)(3) or 7805(b)(6).

Thus, where the Secretary relies on section 7805(b)(3) (relating to the prevention of abuse), the inquiry should be into the potential existence of the type of abuse the retroactive application of a particular regulation is intended to combat. Upon a finding that the potential for such abuse exists, the sole inquiry should be whether the regulation represents a rational or reasonable attempt to prevent that abuse. Similarly, where the reliance is on section 7805(b)(6) (relating to a Congressional grant of authority), the inquiry should be limited to whether Congress has indicated a willingness to permit retroactivity, and whether the retroactive application of a particular regulation serves a rational legislative purpose.

III. TREAS. REG. §1.752-6

(A) Its Origins and Purpose

Section 358(h)(1) was added to the Internal Revenue Code by section 309(a) of the Community Renewal Tax Relief Act of 2000 (hereafter "CRTRA"). 46 It generally requires that a shareholder, who receives stock in an exchange, or series of exchanges, must reduce the basis of that stock to its fair market value by subtracting any liability the corporation assumes.

Section 358(h)(2) provides exceptions to this rule where (1) a trade or business is contributed to the corporation or (2) "substantially all of the assets to which the liability is associated" are transferred to the corporation. The Secretary is, however, permitted to set forth circumstances under which the aforementioned exceptions do not apply.

Section 358(h)(3) provides that "the term 'liability' shall include any fixed or contingent obligation to make payment."

CRTRA §309(c) provides, in pertinent part, that:

The Secretary ... shall prescribe rules ... under subchapter K ... to prevent the acceleration or duplication of losses through the assumption of (or transfer of assets subject to) liabilities described in section 358(h)(3) ... in transactions involving partnerships .... 47
The Secretary relied on this language in promulgating Treas. Reg. §1.752-6. The Service's position is this provision provided it with the authority to prescribe regulations that requires a partner to reduce the basis of his partnership interest by the amount of any liabilities described in section 358(b)(3) that the partnership assumed (or, alternatively took property subject to) in exchange for an interest in the partnership. Those critical of the regulations have ascribed a narrower meaning to the statutory language. They argue that the authority granted to the Secretary was limited to prescribing regulations which give effect to section 358(h) only in cases where a partner or partnership is the transferor shareholder in an exchange involving a corporation.48

(B) Is Treas. Reg. §1.752-6 Legislative or Interpretive in Nature?

The threshold question regarding Treas. Reg. §1.752-6 is whether it is a legislative regulation or an interpretive one. There can be no question the statute explicitly grants the Secretary the authority to issue regulations which give effect to the provisions of section 309(c) of the CRTRA. As such it is a legislative regulation entitled to Chevron deference.49 Thus, the key question is whether Congress in the statute has directly spoken with respect to the issue in a clear and unambiguous fashion, or whether the statute is silent or ambiguous. If it is the latter, the validity of the regulation cannot reasonably be questioned. Stated another way, Treas. Reg. §1.752-6 is invalid only if Congress has unambiguously and directly addressed the issue the regulation purports to address, or the regulation is "arbitrary, capricious, or manifestly contrary to the statute."50 Finally, if Treas. Reg. §1.752-6 is valid, its retroactive application is guaranteed by reason of section 7805(b)(6).

Those courts which have declared Treas. Reg. §1.752-6 not to be legislative in nature have relied on a number of overlapping arguments.51 These are: (1) that section 309(c) of the CRTRA makes no mention of section 752 (Klamath, Stobie Creek), (2) that since section 309 was first proposed on October 19, 1999, before the issuance of Notice 2000-44,52 Congress could not have been aware of the partnership transactions covered by that Notice (Klamath). (3) that the regulation is not a "comparable" rule because it does not address the acceleration or duplication of losses (Sala, Stobie Creek), (4) that Treas. Reg. §1.358-7 represents the only valid exercise of the authority granted to the Secretary (Klamath), and (5) that the regulation does not purport to address liabilities described in section 358(h)(3) (Sala).

With respect to the absence of any specific reference to section 752 in the statutory language or legislative history of CRTRA §309(c), Klamath and Stobie Creek either ignore or give no weight to the fact that the statute specifically refers to Subchapter K, of which section 752 is part. Moreover, the determination of a partner's basis is not governed by section 752, but rather by section 705, although partnership liabilities play an important role in determining a partner's basis under that section.

As to the second point, that because of its timing Congress could not have been aware of the type of transactions covered by Notice 2000-44, this is essentially a statement that in the absence of a direct reference to section 752, Congressional knowledge of "overstated basis" transactions cannot be inferred. This argument has superficial appeal, however, it should be noted that Notice 2000-44 had already been issued when the CRTRA was passed by the House and Senate on December 15, 2000.53
While both Sala and Stobie Creek addressed the issue of “comparable” rules and the “duplication or acceleration of losses,” they did so in a different manner. Sala addressed each of these points separately, while in Stobie Creek the court viewed them as part of the same argument.

The court in Sala acknowledged that the obligation under the contributed short option position would constitute a contingent liability within the meaning of section 358(h)(3). It held, however, that Treas. Reg. §1.752-6 did not provide rules “comparable” to those contained in section 358(h), because it failed to adopt the exception set forth in section 358(h)(2)(B). Assuming that section 358(h)(2) is relevant in determining “comparability,” Sala simply ignores the “[e]xcept as provided by the Secretary” language of that section which allows the Secretary to determine when the section 358(h)(2) exceptions shall not apply. Thus, the Secretary appears to have been well within his rights to provide the “exception to the exception” that the Sala court found objectionable. It would appear that the court in Sala erred by requiring that Treas. Reg. §1.752-6 achieve a result identical to that which it believes would have resulted from the application of section 358(h) to a transaction within the purview of section 351.

The more cogent argument, advanced by both the court in Sala and Stobie Creek, is that Treas. Reg. §1.752-6 does not address the “acceleration or duplication of losses.” Sala held that Notice 2000-44, and consequently Treas. Reg. §1.752-6, instead addressed transactions that “result in a single loss that occurs at a specific time: liquidation of the inflated-basis assets.” The court in Stobie Creek articulated this same argument stating that “[t]he mandate of Congress ... in Section 309(c) ... was not to combat inflation of basis ... [but] to preclude the acceleration and/or duplication of losses.”

According to the court in Stobie Creek Treas. Reg. §1.752-6 cannot be a “comparable” regulation “when it does not speak to transactions involving the possible acceleration and/or duplication of losses.” (Emphasis Added). What appears to have been lost on both courts is the fact that the inflated basis that section 358(h) addresses does not result in a prohibited acceleration or duplication of a loss, rather, it is the disposition of the stock received in a section 351 transfer that caused a loss to be accelerated and/or duplicated. Similarly, something more needed to occur in order for a loss to be accelerated in the transactions before the court in Sala and Stobie Creek. Consequently, section 358(h) and Treas. Reg. §1.752-6 both similarly focus on the “possible” acceleration of a loss because of the existence of an inflated basis. The question is—Whether the recognition of a “real” loss resulting from the disposition of stock having an inflated basis, should be denied; while the recognition of a “created” loss resulting from the disposition of an asset having an inflated basis by reason of it having been passed through a partnership, should be respected?

In Klamath, the court held that Treas. Reg. §1.358-7 was “plainly the type [of regulation] contemplated by [section 309(c) of the CRTRA],” because it addressed “rules applicable to partnerships that were shareholders in corporations that engaged in transactions subject to Section 358(h).” The court thus restricted the ability of the Secretary to issue regulations under the grant of authority contained in CRTRA §309(c) to those situations where partners or partnerships became shareholders of a corporation in a transaction within the scope of section 351. The Klamath court did not cite any authority either within section 309 or its legislative history in support of its position.
There can be no question that Treas. Reg. §1.358-7 addresses the situation described by the court in *Klamath*, nor can it reasonably be asserted that this action was not within the grant of authority conveyed to the Secretary by Congress. However, the possibility of an acceleration or duplication of a loss where a partnership or partner was a transferor in a section 351 transaction is limited in scope. Arguably, the Secretary could have crafted regulations to address these limited circumstances under his authority to issue interpretive regulations pursuant to section 7805(a). The fact that the Secretary was able to issue Treas. Reg. §1.358-7 under the specific grant of authority contained in CRTRA §309(c), does not mandate a finding that this is the only situation the Secretary was authorized to address. Had section 309(c) been drafted in the conjunctive (i.e., "and") that would certainly have favored a finding that the Secretary's authority was limited to situations in which a partner or partnership participates in a transaction within the scope of section 351. Congress, however, drafted section 309(c) in the disjunctive (i.e., "or").

The court in *Sala* held Treas. Reg. §1.752-6 to be overly broad, because it sought to extend section 358(h)(3) outside of the corporate realm. In reaching this conclusion, the court analyzed the language of section 358, but it failed to analyze the language of CRTRA §309(c). The court could have more carefully examined the meaning and interaction of two specific phrases, the first being the "liabilities described in section 358(h)(3)" and the second being "in transactions involving partnerships." Focusing on its limiting language, "[f]or purposes of this subsection," the court concluded that the section 358(h)(3) definition of "liability" was limited in scope to corporate exchanges, such as those described in section 351. Having reached this conclusion it then went onto to hold that since section 358(h)(3) applies only to corporate exchanges, the phrase "in transactions involving partnerships" was a reference to corporate exchanges to which partnership was a party (i.e., the type of transaction covered by Treas. Reg. §1.358-7). This construction is not unreasonable, but it is not the only possible interpretation of the language of section 309(c).

Section 358(h)(3) is definitional in nature, thus, CRTRA §309(c) can be read as follows, "The Secretary ... shall prescribe rules ... under Subchapter K ... to prevent the acceleration or duplication of losses through the assumption ... of [any fixed or contingent obligation to make payment] in transactions involving partnerships." When construed in this manner, the phrase "in transactions involving partnerships" does not carry with it a requirement that the participating partnership be a party to a corporate exchange. This construction is consistent with the rules embodied in Treas. Reg. §1.752-6.

Like the court in *Klamath*, the *Sala* court bottomed its holding on the fact that Congress did not specifically amend section 752 to incorporate the contingent liability language of section 358(h)(3), nor did it specifically reference section 752 in CRTRA §309(c). However, neither did Congress clearly indicate an intention to limit the scope of section 309(c) to only those situations described in Treas. Reg. §1.358-7. Under *Chevron* had Congress done either, that would have ended the matter.

*Chevron* mandates that when Congress does not unambiguously and directly address the precise question at issue, the Secretary may issue regulations filling the gap. Once the Secretary has done so, a court may not construe the statute to its own liking, to the exclusion of another permissible
construction. Rather, the Secretary's interpretation will control unless it is "arbitrary, capricious, or manifestly contrary to the statute."

In Stobie Creek, Sala and Klamath, each court determined that the intent of Congress was clear and unambiguous that the grant of authority to issue regulations pursuant to CRTRA §309(c) extended only to those transactions that involved the acceleration or duplication of losses where a partnership or partner was a party to a corporate exchange, such as, the transferor of property to a controlled corporation pursuant to section 351. Having so held, the decision not to treat Treas. Reg. §1.752-6 as a valid exercise of the Secretary's authority is consistent with Chevron.

As noted above, it is an open question as to whether CRTRA §309(c) provides direct unambiguous direction on this issue. In that case all three courts would have erred, because in effect they would have preferred their construction of the statute over that of the Secretary, an approach specifically rejected in Chevron.

(C) If Treas. Reg. §1.752-6 Is Interpretive In Nature, Does It Represent a Valid Exercise of the Secretary's Authority Under Section 7805?

There can be no doubt that the Secretary had the authority to make a prospective change in the regulations under section 752 to force a reduction of basis for contingent liabilities.66 The only requirement is that the regulation represents a reasonable interpretation of the underlying statute. If the interpretation is a reasonable one, a court may not substitute its judgment for that of the Secretary. 67 The focus, therefore, is on the Secretary's efforts to make the regulation retroactive.

Section 7805(b)(3) can only apply if the regulation was issued to "prevent abuse." There can be no question that Treas. Reg. §1.752-6 satisfies this requirement. The type of transactions at issue in the cases that have addressed the validity of these regulations are clearly abusive in nature.68 In order for a regulation to have retroactive effect under section 7805(b)(3) the regulation must interpret or construe a post July 30, 1996 statute.

The problem is not one of timing, but rather what part of the CRTRA would the regulations purport to interpret. If the regulation was issued pursuant to the lawful exercise of the authority granted the Secretary under section 309(c) of the CRTRA, then it would be a legislative regulation and by virtue of section 309(d) would be retroactive to October 18, 1999.69

If, however, as determined by the courts in Klamath, Sala and Stobie Creek, the regulation was not legislative in nature then the Service could not rely on section 309(c) as the predicate statute. Under Chevron, the opinions of those courts can only stand if section 309(c) represented a clear and unequivocal expression of Congressional intent that only transactions of a type described in Treas. Reg. §1.358-7 were intended to be within its scope. If that is the case, it is difficult to envision how Treas. Reg. §1.752-6 could be found to "harmonize with the plain language of the statute, its origin, and its purpose."70 It would also be unlikely that the regulation could satisfy even the more liberal standard of Chevron – that it simply be a reasonable interpretation of the statute.

Thus, if Treas. Reg. §1.752-6 is interpretive in nature, the only way it can have retroactive effect is to satisfy the requirements of Old Section 7805(b). Under that provision, all regulations are retroactive unless the Secretary provides
otherwise. The Secretary could have, for example, allowed the regulation to be valid back to the date of the enactment of section 752, or he could have, as he did, picked a later point in time. Had Congress not enacted CRTRA §309(c), it is likely that the Secretary would have made the regulations retroactive to the date of the release of Notice 2000-44. Regardless of the earlier date chosen, the Internal Revenue Service would need to establish that the decision not to apply the regulation prospectively did not constitute an abuse of discretion.

As noted in Anderson, Clayton, there are a number of “factors” that shape the consideration of this issue. In Klamath, the court examined each of the “factors” articulated by the Fifth Circuit in a structured fashion. The other courts that have passed on Treas. Reg. §1.752-6 did so by applying a more flexible approach. Regardless of the mechanics applied to the analysis, it is clear that the principal concerns were — (a) whether prior law was settled, (b) the extent that the regulation altered prior law, (c) the taxpayers’ justifiable reliance on that prior law, and (d) whether giving the regulation retroactive effect would produce an inordinately harsh result.

Klamath, Sala and Stobie Creek held that Helmer\(^7\) and its progeny\(^7\) represented a well established body of law which called for contingent liabilities to be excluded from the calculation of basis under section 752. In seeking to establish that the law was not settled, the court in Maguire Partners noted that the Secretary relied on Rev. Rul. 88-77,\(^7\) Rev. Rul. 95-26,\(^7\) and Salina Partnership v. Commissioner\(^7\) in issuing Treas. Reg. §1.752-6.\(^7\)

In Kornman v. Commissioner,\(^7\) the Fifth Circuit adopted the reasoning of Rev. Rul 95-26 in concluding that an obligation to replace borrowed securities and to close a short sale gave rise to a liability. In so doing, the court rejected the taxpayer’s reliance on Helmer. The Kornman court also found that “[t]he initial short sale that generates the cash proceeds and the subsequent covering transaction are inextricably intertwined.”\(^7\) Citing Kornman, the court in Maguire Partners held that applying “the Helmer line of cases to this case would ... ‘[f]ly in the face of reality’ and result in an ‘unwarranted aberration’.”\(^7\) While the Secretary did not follow Helmer line of cases in promulgating Treas. Reg. §1.752-6, even assuming that these cases constituted settled law it is questionable that there was a major alteration to that prior law given the fundamental factual differences between Helmer and cases such as Klamath, Sala and Stobie Creek, Cemco and Maguire Partners.

The question of alteration really comes down to whether the taxpayers/partnerships at issue in the Treas. Reg. §1.752-6 cases justifiably relied on the Helmer line of cases and whether the “change” effectuated by the regulation caused them to suffer an inordinately harsh result. A logical way to pose the first question is — Is a taxpayer justified in relying on a case that excluded from basis consideration an option granted to purchase property owned by a partnership, when the actual transaction they engaged in was the contribution to a partnership of a long option and a short option (the proceeds from which were used to acquire the long position) and the failure to treat the short option as a liability resulted in a multimillion dollar inflation of the basis of the long option position? With respect to the second point, the question is — Does the denial of the claimed tax benefits that flow from such a transaction, constitute an inordinately harsh result? If the answer to both questions is yes, the Secretary was not justified in making the regulation retroactive. If the answer to either is no, the regulation should properly be given retroactive effect.
As the CRTRA is not considered as authority for the issuance of Treas. Reg. §1.752-6, the only remaining question is - How far back can the Secretary go in making the regulation retroactive? Conceivably, there would be no limit on its retroactivity assuming that the law was not “settled.” If the law is considered settled, then the question is - At what point would someone engaging in an “inflated basis” transaction be considered as having notice of the “change?” The question could be posed alternatively as - Was the Secretary’s selection of October 18, 1999 as the limitation on retroactive effect supportable? An argument could clearly be made that given the nature of the transactions (i.e., the creation of losses by inflating basis) that anyone considering entry into this type of transaction should have had pause for concern in light of the Congressional disapproval of “basis inflation” as embodied in section 358(h) and the directive in CRTRA §309(c) that “comparable” regulations be issued in the Subchapter K arena. 81

Failing that, the question is, should retroactivity be permitted back to August 14, 2000, the date the Service issued Notice 2000-44. Arguably, Notice 2000-44 does not satisfy the requirements of section 7805(b)(1)(C) which permits retroactive application of a regulation to the date when the Secretary issues “any notice substantially describing the expected contents of any temporary, proposed, or final regulation.” Query, whether this section is even applicable since the efficacy of Notice 2000-44 must be measured under the abuse of discretion standard attendant in Old Section 7805(b). There can be little question that Notice 2000-44 was intended to put taxpayers on notice that “inflated basis” transactions would not be respected. Since the question under Old Section 7805(b) was one of justifiable reliance, the issue would be whether a taxpayer would be justified in relying on the Helmer line of cases, when the Service has indicated that

“questionable transactions” such as those described in Notice 2000-44 would not be respected.

IV. CONCLUSION

It would appear that the Service has the better of the arguments regarding the validity of Treas. Reg. §1.752-6. Under Chevron, because of the explicit direction to fill a gap in the statute and because section 309(c) of the CRTRA appears to be ambiguous, the regulation is a “permissible construction” of that provision. By virtue of section 309(d) its retroactivity to October 18, 1999 is justified pursuant to section 7805(b)(6). Alternatively, under either Chevron or National Muffler, the Service again has the better argument that it is a valid interpretive regulation. Finally, the Service has the better argument under Old Section 7805(b), that the regulation should be retroactive in effect.

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2 515 F.3d 749 (7th Cir. 2008), cert. denied, 129 S. Ct. 131 (2008)  
3 82 Fed. Cl. 636 (2008). In Murfam Farms, LLC v. United States, 88 Fed. Cl. 516 (2009), the Court of Federal Claims again held that Treas. Reg. §1.752-6 was invalid,  
4 552 F. Supp. 2d 1167 (D. Co. 2008), appeal docketed (10th Cir. 9/12/2008)  
6 See, IRC §7805(b), prior to amendment by Pub. L. No. 104-168 (hereafter “Old Section 7805(b)”)
8 arc to provision 837, bind by lead 1714, The 467 U.S. 467 467 844. Any 1222, at U.S. 467 U.S. at 844. An example of a conflict with the statute that would lead to a legislative regulation being held to be invalid would be an effort by the Secretary to treat an item of income as taxable when another provision of the Internal Revenue Code would provide that the same item was exempt from tax. See, e.g., Joseph Weidenhoff v. Commissioner, 32 T.C. 1222, 1242 (1959), acq., 1960-2 C.B. 7.

11 467 U.S. at 844. An example of a conflict with the statute that would lead to a legislative regulation being held to be invalid would be an effort by the Secretary to treat an item of income as taxable when another provision of the Internal Revenue Code would provide that the same item was exempt from tax. See, e.g., Joseph Weidenhoff v. Commissioner, 32 T.C. 1222, 1242 (1959), acq., 1960-2 C.B. 7.

12 467 U.S. at 842-43

13 467 U.S. at 843

14 Any regulation inconsistent with the clearly expressed intent of Congress is invalid. 467 U.S. at 842-43

15 467 U.S. at 844, wherein the Supreme Court stated, “[s]ometimes the legislative delegation to an agency on a particular question is implicit, rather than explicit. In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.

16 553 U.S. 218 (2001)

17 553 U.S. at 228. Letter rulings are administrative interpretations issued by the Internal Revenue Service without formal review. Pursuant to section 6110(k)(3), they may not be cited as precedent. Furthermore, they can only bind the Service with respect to the taxpayer to whom they are issued. As such, they are at the opposite end of the spectrum from Treasury regulations.

18 Instead, it held that the classification ruling before it might have entitled to some deference under Skidmore v. Swift & Co., 323 U.S. 134 (1944). The Supreme Court, therefore, vacated the decision of the Federal Circuit Court of Appeals and remanded the case to the lower court for further proceedings consistent with its opinion.

19 Writing for the majority in Mead, Justice Souter stated:

This Court in Chevron recognized that Congress not only engages in express delegation of specific interpretive authority, but that “[s]ometimes the legislative delegation to an agency on a particular question is implicit.” Congress, that is, may not have expressly delegated authority or responsibility to implement a particular provision or fill a particular gap. Yet it can still be apparent from the agency’s generally conferred authority and other statutory circumstances that Congress would expect the agency to be able to speak with the force of law when it addresses ambiguity in the statute or fills a space in the enacted law, even one about which “Congress did not actually have an intent” as to a particular result. When circumstances implying such an expectation exist, a reviewing court has no business rejecting an agency’s exercise of its generally conferred authority to resolve a particular statutory ambiguity simply because the agency’s chosen resolution seems unwise, but is obliged to accept the agency’s position if Congress has not previously spoken to the point at issue and the agency’s interpretation is reasonable. (Footnotes omitted). 553 U.S. at 229.

See, also, United States v. Haggar Apparel Co., 526 U.S. 380 (1999), wherein the Supreme Court held that Customs regulations are entitled to Chevron deference. For a diametrically opposed view see the dissent of Judge Vasquez in Estate of Gerson v. Commissioner, 127 T.C. 139, 174-75 (2006), aff’d, 507 F.3d 435 (6th Cir. 2007). Judge Vasquez would hold that Mead changed the landscape with respect to the deference accorded interpretative regulations effectively overruling Chevron. National Muffler
and Vogel Fertilizer by substituting instead a lesser degree of deference more consistent with that articulated in Skidmore.

20 440 U.S. 472 (1979). Some of the factors to be considered include whether the regulation is a substantially contemporaneous construction of the statute, the manner in which it evolved, the length of time the regulation has been in effect, the reliance placed on it, and the consistency of the Secretary’s interpretation, the degree of Congressional scrutiny the regulation received during any subsequent reenactment of the statute.

21 455 U.S. 16 (1982)

22 440 U.S. at 477

23 The court in Vogel Fertilizer stated that “[d]eference is ordinarily owing to the agency construction if we can conclude that the regulation ‘implement[s] the congressional mandate in some reasonable manner.’” (Citations omitted). 455 U.S. at 24

24 455 U.S. at 24

25 In his dissenting opinion, Justice Blackmun found ambiguity to exist both in the language of section 1563 and its legislative history, stating that while the Secretary’s “interpretation is not compelled by the legislative materials … it is not ‘unreasonable or meaningless.’” Consequently he would have held the regulation valid because “[t]he choice among reasonable interpretations is for the Commissioner, not the courts.” (Citations omitted). 455 U.S. at 39


27 515 F.3d 162, 164 (3d Cir. 2008), rev’d, 126 T.C. 96 (2006)

28 See, also, Bankers Life and Casualty Co. v. United States, 142 F.3d 973 (7th Cir. 1998) (“the structure of Chevron encourages a court to defer rather than to interpret. We, therefore, prefer it.”); Peoples Federal Savings & Loan Association of Sidney v. Commissioner, 948 F.2d 289, 304–05 (6th Cir. 1991) (abandoning National Muffler and adopting Chevron). Compare, McNamara v. Department of the Treasury, 488 F.3d 100 (2nd Cir. 2007) (applying Chevron while also citing National Muffler in discussing the deference accorded regulations promulgated under section 7805); Snook v. Commissioner, 123 F.3d 190 (4th Cir. 1997) (applying both Chevron and National Muffler without distinction); Norwest Corp. v. Commissioner, 69 F.3d 1404 (8th Cir. 1995) (applying both Chevron and National Muffler without distinction); Nalle, III v. Commissioner, 997 F.2d 1134 (5th Cir. 1993) (applying National Muffler and limiting Chevron deference to legislative regulations).

29 Section 7805(b)(2) provides an exception to this rule for regulations filed or issued within 18 months of the date the statutory provision to which the regulation relates is enacted.

30 The legislative history is of little help in answering this question as Congress simply repeated the exceptions to retroactivity set forth in the statute. H. Rept. No. 104-506

31 See, e.g., Chock Full O’ Nuts Corp. v United States, 453 F.2d 300, 302-03 (2d Cir. 1971)

32 See, e.g., Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957). See, also, CWT Farms. Inc. v. Commissioner, 755 F.2d 790, 802 (11th Cir. 1985), cert denied, 477 U.S. 903 (1986) (“abuse of discretion may be found where the retroactive regulation alters settled prior law or policy upon which the taxpayer justifiably relied and if the change causes the taxpayer to suffer inordinate harm.”); c.f., International Business Machines Corporations v. United States, 343 F.2d 914 (Ct. Cl. 1965), cert denied, 382 U.S. 1028 (1966) (which, in the context of rulings issued under the authority granted by section 7805(b) emphasized the importance of treating similarly situated taxpayers equally).

33 562 F.2d 972 (5th Cir. 1977)

34 562 F.2d at 981

35 98 F.3d 194 (5th Cir. 1996), cert. denied, 522 U.S. 821 (1997)

36 98 F.3d at 202

37 98 F.3d at 202-03

38 98 F.3d at 203
39 98 F.3d at 203 ("the test for the validity of retroactive effect of statutes and regulations affecting economic policy embodies a search for arbitrariness or irrationality, which turns on the presence or absence of a rational legislative purpose").


42 But compare, CWT Farms, Inc. v. Commissioner, 755 F.2d 790 (11th Cir. 1985), cert. denied, 477 U.S. 903 (1986) (reliance on promise found in Internal Revenue Manual not justified); with Gehl Co. v. Commissioner, 795 F.2d 1324 (7th Cir. 1986); LeCroy Research Systems Corp. v. Commissioner, 751 F.2d 123 (2nd Cir. 1984); Addison International Inc. v. Commissioner, 90 T.C. 1207, aff'd, 887 F.2d 660 (6th Cir. 1989) (reliance on same provision in the Internal Revenue Manual held to be justified).

43 Helvering v. Reynolds, 313 U.S. 428, 433 (1941) ("The fact that the regulation was not promulgated until after the transactions in question had been consummated is immaterial.").

44 Wilson v. United States, 588 F.2d 1168 (6th Cir. 1978)

45 In Anderson, Claydon, the Fifth Circuit observed that "the Commissioner may not take advantage of his power to promulgate retroactive regulations during the course of litigation for the purpose of providing himself with a defense based on the presumption of validity accorded to such regulations." The court went on to note, however, that "[n]o case has held that the Secretary abused his discretion to promulgate retroactive regulations merely because the regulation at issue affected a legal matter pending before a court at the time the regulation was adopted." 562 F.2d at 980. Cf. Check Full O’ Nut wherein the Second Circuit noted that regulations issued to "bootstrap" the Services litigation position may not represent "a valid exercise of the Commissioner’s power to promulgate retroactive regulations." 453 F.2d at 303

46 Pub. L. No. 106-554

47 The conference report discussing section 309(c), H.R. Conf. Rept. No. 106-1033, adds little to the statutory language as it simply states:

The Secretary of the Treasury is directed to prescribe rules providing appropriate adjustments to prevent the acceleration or duplication of losses through the assumption of liabilities (as defined in the provision) in transactions involving partnerships.


49 As such, the Sala court erred by testing the regulation under National Muffler instead of Chevron. The National Muffler standard ("whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose"); to the extent not entirely preempted by Chevron, is only applicable in the case of interpretative regulations.

50 467 U.S. at 844

51 In Klamath, the district court held the regulation to be interpretive in nature. The Klamath court determined that as an interpretive regulation Treas. Reg. §1.752-6 could not be applied retroactively to transactions entered into prior to August 11, 2000 the date Notice 2000-44 was issued. The court, however, declined to rule on the validity of the regulation with respect to transactions entered into after August 14, 2000 as no such transaction was before it. 440 F. Supp. 2d at 625, n.13. The district court in Sala also determined that Treas. Reg. §1.752-6 was not a legislative regulation, but rather, once again, was an interpretive one. The Sala court held that the regulation was "unlawful [and] set it aside" because it found the regulation to be "contrary to the underlying statutes." 552 F. Supp. 2d at 1203. The Court of Federal Claims in Stohic Creek similarly denied legislative regulation status to Treas. Reg. §1.752-6, holding it invalid because the general abuse provision of section 7805(b)(3) was inapplicable and the issuance of Notice 2000-44 was not sufficient to advise taxpayers of the change in position from established legal principles.

52 2000-2 C.B. 255
52 The CRTRA was introduced in the House on December 14, 2000 as H.R. 5662, which was then incorporated by reference into H.R. 4577. H.R. 4577 passed the House and the Senate on December 15, 2000. The conference report on H.R. 4577 (H.R. Conf. Rept. No. 106-1033) was filed in the House on that same day.

53 The Sala court declared the regulation not to be “comparable” because it failed to take into account the fact that the related long option position was also contributed to the partnership. 552 F.3d at 1199-1200

54 The relevance of section 358(h)(2) is questionable in determining whether the regulations ostensibly issued under CRTRA §309(c) are “comparable.”

55 The court’s importation of the section 358(b)(2) exceptions without giving effect to this limiting language denied the Secretary a right specifically granted to him by Congress.

56 552 F. Supp. 2d at 1200

57 82 Fed. Cl. at 670

58 82 Fed. Cl. at 670

60 The legislative history of CRTRA §309 is clear that section 358(h) “does not change the tax treatment with respect to the transferor corporation.” Thus, a corporation continues to utilize its shareholder’s basis in the asset, without reduction for any liability, fixed or contingent.

61 The loss “duplication” that section 358(h) addresses is the result of the “double-tax” regimen of Subchapter C. Anytime a transfer takes place pursuant to section 351, gain, income or loss is potentially duplicated because of the separate taxable entity status of a corporation. Subchapter K, on the other hand, is concerned with flow-through entities (i.e., those that are not tax-paying entities). The possibility of loss duplication does exist in the context of a partner or partnership that acquires stock in a transaction within the scope of section 351, albeit on a smaller scale. See, Section III(B)(4), infra.

62 Prior to the enactment of CRTRA §309(a), the transfer by a partnership of its assets and liabilities was governed by section 351, and the transferor partnership’s basis in the stock received was determined under section 358. This was unchanged by section 309(a). Section 358(h) would cause the basis of the stock a transferor partnership received to be reduced to its fair market value, in the same manner as it would an individual transferor’s stock basis. Thus, a sale by the transferor partnership of the stock would not result in the acceleration or duplication of any loss. Similarly, if the partnership were to distribute the stock to a partner in a non-liquidating distribution, there would be little, if any, potential for the acceleration or duplication of any loss as the distributee partner would take as his basis in the stock the lesser of his basis in the partnership or the partnership’s basis in the stock. See, Section 732(a). The only situation that presents a meaningful possibility for either the acceleration or duplication of a loss is where the partnership itself is liquidated (or the interest of a specific partner is liquidated) and the stock received by the partnership is distributed to the partners or a partner. In that case, the distributee partner will take as his basis in the stock, his basis in his partnership interest. See, Rev. Rul. 84-111, 1984-2 C.B. 88 (Situation 1). Prior to the issuance of Treas. Reg. §1.358-7(b), the partner’s basis in his interest would not have been reduced by a contingent liability. Thus, a partner would have effectively “stepped-up” his basis in the stock received by the partnership and distributed to him in liquidation of his interest in the partnership. This “step-up” would have created the possibility of an acceleration or duplication of a loss by inflating the basis of the stock he received.

63 For example, the Secretary could have addressed this potential for abuse through the exercise of his general authority under section 7805(a) and made any regulation retroactive pursuant to his authority under section 7805(b)(3).

64 The court had earlier addressed the meaning of the phrase “acceleration or duplication of losses.” See, Section III(B)(3), supra. In addition, it also had earlier addressed the absence of a specific reference to section 732. See, Section III(B)(1), supra.

65 See, H.R. Conf. Rept. No. 106-1633 which refers to “the assumption of liabilities (as defined in the provision) in transactions involving partnerships.” (Emphasis added)

66 This action is generally consistent with the Congressional action in attempting to curb efforts to create non-economic losses which would then be deducted for tax purposes by inflating basis. As noted, by the court in
Cemco, the regulation "instantiate[s] the pre-existing norm that transactions with no economic substance don't reduce people's taxes." 515 F.3d at 752

67 467 U.S. at 844

68 We are aware that the court in Sala respected the underlying transactions and sanctioned the created loss in that case. We believe that the Sala court made numerous errors in reaching the result that it did and that Sala will be reversed on appeal. A discussion of the District court's opinion is beyond the scope of this article.

69 See, Section 7805(b)(6)

70 440 U.S. at 477

71 The Secretary's decision to make the regulation retroactive to October 18, 1999 makes sense given his overall reliance on CRTRA §309(c).

72 T.C. Memo 1975-160. The transaction at issue in Helmer was the status of option payments held to have been received by the partnership and then distributed to the partners. The option payments were not refundable by the partnership and the partnership's only obligation was to apply them against the sales price of property owned by the partnership which was the subject of the option. The Internal Revenue Service argued that any liability under the option was "contingent" and could not be used to increase the partner's basis. As a result the partners were required to report a gain under section 731. The property in Helmer was already owned by the partnership when the option was granted. Thus, the option and the property were not contributed to the partnership in the same transaction.

73 Long v. Commissioner, 71 T.C. 1 (1978), aff'd and remanded, 660 F.2d 416 (10th Cir. 1981); LaRue v. Commissioner, 90 T.C. 465 (1988); see, also, Gibson Products Co. v. United States, 637 F.2d 1041 (5th Cir. 1981).

74 1988-2, C.B. 128

75 1995-1 C.B. 131

76 T.C. Memo 2000-352

77 The Seventh Circuit in Cemco made short shrift of the plaintiff's efforts to rely on Helmer, stating "Cemco says that in treating $50,000 of euros as having a $2.6 million basis which turned into a loss ... it was just relying on Helmer .... That may or may not be the right way to understand Helmer; we need not decide, for it is not controlling in this court -- or anywhere else." 515 F.3d at 751

78 527 F.3d 443 (5th Cir. 2008). Kornman involved similar option spread transactions. While the court acknowledged the Service's reliance on Treas. Reg. §1.752-6, it declined to address its validity noting that it had found that the short sale created a liability based upon its reading of section 752 and Treas. Reg. § 1.752-1(a)(4)(i). 527 F.3d at 462

79 527 F.3d at 460-61. See, also, Maguire Partners, 103 AFTR 2d at 773-775 (applying the step-transaction doctrine to establish that the long option, short option and the AIG note were interlocking obligations that created the "bet" the taxpayer claimed he was attempting to take advantage of); Jade Trading v. United States, 80 Fed. Cl. 11 (2007), reh. denied, 81 Fed. Cl. 173 (2007), appeal docket (Fed Cir. 2/26/2008)

80 103 AFTR 2d at 776

81 Cf., CWT Farms, quoting, Wendland v. Commissioner, 739 F.2d 580 (11th Cir. 1972) and citing Helvering v. Reynolds and Chuck Full O' Nuts (proposed regulations should have put taxpayer on notice where he engaged in "questionable transactions") 755 F.2d at 804