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United States v. Vogel Fertilizer Co. Harmonizing with Congress: The Court Requires the Treasury to Tune Up, 16 J. Marshall L. Rev. 601 (1983)

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*UNITED STATES v. VOGEL FERTILIZER CO.** HARMONIZING WITH CONGRESS: THE COURT REQUIRES THE TREASURY TO TUNE UP

Congress has granted corporations a limited surtax exemption on initial amounts of income.[1] While intended to ease the tax burden on small businesses, all corporations received this exemption.[2] Business entities, however, often conduct their activities through multiple corporate structures even though they are, in fact, a single enterprise.[3] The result is multiple surtax exemptions, and tax benefits not intended by Congress.[4] To correct the problem, Congress passed section 1561 of the Internal Revenue Code, which limits certain affiliated corporations to one exemption among them.[5] Section 1563(a)(2) of the Internal Revenue Code, as revised by the Tax Reform Act of 1969, enumerates a twofold, mechanical, stock-ownership test that determines whether affiliated corporations belong to a type of group that is allowed only a single surtax exemption.[6] In *United States v. Vogel Fertilizer Co.*,[7] the United States Supreme Court confronted the issue of whether a Treasury Department regulation interpreting the statutory test was valid;[8] the Court held the reg-

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* 455 U.S. 16 (1982).

1. *Hearings on the Subject of Tax Reform Before The House Committee on Ways and Means*, 91st Cong., 1st Sess. 5050, 5385 (1969) [hereinafter cited as *Hearings*].

2. H.R. REP. NO. 749, 88th Cong., 2d Sess. (1964), *reprinted in* 1964 U.S. CODE CONG. & AD. NEWS 1313, 1426.

3. *Id.*

4. *Id.*

5. I.R.C. § 1561 (1982).

6. BROTHER-SISTER CONTROLLED GROUP.—Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing—

(A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and

(B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.

I.R.C. § 1563 (1982).

7. 455 U.S. 16 (1982).

8. *Id.* at 19.

ulation invalid as an unreasonable interpretation of the statute.[9]

In *Vogel*, two closely-held corporations were also interrelated. Vogel Fertilizer Company was owned by Arthur Vogel and Richard Crain; Vogel owned 77.49% of the company stock and Crain owned the remaining 22.51%.[10] Vogel also owned 87.5% of the stock of Vogel Popcorn Company.[11] Crain, however, did not own any stock in Vogel Popcorn.[12] Between 1973 and 1975, the two companies treated themselves as members of an affiliated corporate group, called a "brother-sister controlled group,"[13] in accordance with Treasury Regulation section 1.1563-1(a)(3).[14] In accordance with the regulation, they did not claim a full surtax exemption during this period.[15] In 1976, the regulation was held invalid by the Tax Court.[16] Vogel Fertilizer then

9. *Id.* at 26.

10. *Id.* at 20.

11. *Id.*

12. *Id.*

13. *Id.*

14. Treas. Reg. § 1.1563-1(a)(3) (1973). The regulation used basically the same words as the section it interpreted. It added, however, the key phrase "singly or in combination" when showing how five or fewer persons could own stock in a brother-sister controlled group. The phrase clarified the ambiguity of I.R.C. § 1563(a)(2) by expanding it to allow any number of corporations that were owned by any five persons to be considered for the test. The test could then be applied to the corporations even though there was no mutuality of ownership.

15. United States v. Vogel Fertilizer Co., 455 U.S. 61, 21 (1982).

16. Fairfax Auto Parts, Inc. v. Commissioner, 65 T.C. 798 (1976), *rev'd*, 548 F.2d 501 (4th Cir.), *cert. denied*, 434 U.S. 904 (1977). *Fairfax* involved two Virginia corporations, both located in Fairfax, and both primarily involved in the wholesaling of auto parts. Fairfax Auto Parts of Northern Virginia, Inc. (NOVA), was owned by William Herbert who owned 55% of the stock, and Herbert's brother-in-law, Joseph Ofano, who owned 45% of the stock. Ofano was responsible for the operation of NOVA. Fairfax Auto Parts, Inc. (FAP), was owned totally by William Herbert; Ofano was not involved in the management of FAP. 65 T.C. at 800. The Commissioner contended that the two corporations were a brother-sister controlled group in accordance with I.R.C. § 1563(a)(2) and Treas. Reg. § 1.1563-1(a)(3). 65 T.C. at 801. Applying the test of § 1563(a)(2), as viewed by the government, the relationship of the two corporations looked like this:

	CORPORATIONS		
INDIVIDUALS	FAP	NOVA	IDENTICAL OWNERSHIP
Herbert	100%	55%	55%
Ofano	-0-	45%	-0-
Total	100%	100%	55%

The two corporations were within both steps of § 1563(a)(2)'s test.

The taxpayers argued that the 80% test could only be applied to shareholders who owned stock in both corporations. 65 T.C. at 802. In their view, the relationship of the two corporations appeared to be:

filed for a refund, claiming that it and Vogel Popcorn were not members of a brother-sister controlled group[17] and that each corporation was therefore entitled to a separate surtax exemp-

	CORPORATIONS		
INDIVIDUALS	FAP	NOVA	IDENTICAL OWNERSHIP
Herbert	100%	55%	55%
Ofano	-0-	45%	-0-
Total	100%	55%	55%

In the taxpayer's view, the corporations could not be part of a brother-sister controlled group because, counting the stock owned by shareholders in *both* corporations, the requirements of the 80% test were not met. *Id.* To meet the 80% test, either Ofano would have had to own at least one share in FAP or Herbert would have had to own 80% of the stock in NOVA. If either proved to be the case, the relationships of the corporations would have been:

	CORPORATIONS		
INDIVIDUALS	FAP	NOVA	IDENTICAL OWNERSHIP
Herbert	99%	55%	55%
Ofano	1%	45%	1%
Total	100%	100%	56%
or . . .			
Herbert	100%	80%	80%
Ofano	-0-	20%	-0-
Total	100%	80%	80%

NOVA and FAP appear to have a close relationship. They are in the same business, are located in the same city, and the owner and secretary of FAP were, respectively, the president and secretary of NOVA. 65 T.C. at 800. Herbert controlled both corporations through his majority stock ownership of each. This close relationship gives a subjective appearance of brother-sister corporations, and NOVA and FAP have the "close horizontal relationship *between* two or more corporations" that Justice Brennan considered a statutory requirement in *Vogel*. United States v. Vogel Fertilizer Co., 455 U.S. 16, 25 (1982). The fact that FAP and NOVA looked like a brother-sister controlled group might have been why the Court denied *certiorari* when the taxpayers appealed the circuit court's reversal of the Tax Court ruling. 434 U.S. 904 (1977). The *Vogel* Court did not discuss why it had denied *ceriorari* in *Fairfax*, yet six years later arrived at the same conclusion as the overruled Tax Court, but Justice Brennan did use the Tax Court's reasoning to bolster his own. 455 U.S. at 21, 25, 33.

17. Vogel's interpretation of how the statutory test should be applied to both companies was the following:

tion for each year.[18] The IRS disallowed the claim and Vogel Fertilizer sued for a refund in the Court of Claims.[19] Judgment was rendered in favor of Vogel and the regulation was declared invalid to the extent that it differed with the Court of Claims' interpretation of the statute.[20]

The United States Supreme Court granted *certiorari*[21] in order to resolve a conflict among the circuits on the issue of the regulation's construction.[22] The Court affirmed the decision of

	CORPORATIONS		
INDIVIDUALS	VOGEL FERTILIZER	VOGEL POPCORN	IDENTICAL OWNERSHIP
Vogel	77.49%	87.5%	77.49%
Crain	22.51%	-0-	-0-
Total	77.49%	87.5%	77.49%

This interpretation would not allow a finding of a brother-sister controlled group because the 80% test was not satisfied; less than 80% of the stock of Vogel Fertilizer is owned by shareholders in Vogel Popcorn.

Treasury Regulation § 1.1563-1(a)(3) interpreted and applied the test like this:

	CORPORATIONS		
INDIVIDUALS	VOGEL FERTILIZER	VOGEL POPCORN	IDENTICAL OWNERSHIP
Vogel	77.49%	87.5%	77.49%
Crain	22.51%	-0-	-0-
Total	100.00%	87.5%	77.49%

Both tests as interpreted by the Treasury regulation have been met. Two persons own more than 80% of the stock of both corporations and, counting only those shares held identically, more than 50% of the stock in both corporations is held by one of those two persons.

Vogel Fertilizer and Vogel Popcorn do not appear to have as strong an interrelationship as did the companies in *Fairfax Auto Parts*. *See supra* note 16. Although the Vogel companies were located in the same state and had the same majority shareholder, they were involved in two totally different lines of business. No evidence was presented that indicated they had the same officers, board of directors, or any common elements.

18. United States v. Vogel Fertilizer Co., 455 U.S. 16, 21 (1982).

19. *Id.*

20. Vogel Fertilizer Co. v. United States, 634 F.2d 497 (Ct. Cl. 1980).

21. 450 U.S. 994 (1981).

22. The Second, Fourth, and Eighth Circuits had upheld the regulation. Allen Oil Co. v. Commissioner, 614 F.2d 336 (2d Cir. 1980); T.S. Hunt, Inc. v. Commissioner, 562 F.2d 532 (8th Cir. 1977); Fairfax Auto Parts, Inc., v. Commissioner, 548 F.2d 501 (4th Cir.) (per curiam), *cert. denied*, 434 U.S. 904 (1977). The Fifth Circuit invalidated Treas. Reg. § 1.1563-1(a)(3) in so far as it permitted the 80% requirement to be satisfied without common ownership. Delta Metalforming Co. v. Commissioner, 632 F.2d 442 (5th Cir. 1980). The Tax Court continually adhered to its view that the regulation was invalid.

the Court of Claims in a seven to two vote.[23] Writing for the Court, Justice Brennan first considered the proper standard for determining whether a Treasury regulation is a valid interpretation of the Code.[24] Generally, the Court will defer to an agency regulation if it implements the mandate of Congress in any reasonable manner.[25] This principle, however, was described as merely setting the framework for subsequent analysis; it is refined by whether the type of authority granted to the agency is specific or general.[26] The regulation in question in *Vogel* was written under a general authority[27] and was therefore given less deference by the courts than one issued under a specific authority.[28] Furthermore, when, as here, the statute has defined a term with "considerable specificity", a regulation interpreting that term is less appropriate than if a vague or general[29] term had been used.[30]

Justice Brennan went on to analyze regulation section 1.1563-1(a)(3) and its interpretation of the statute. The regulation used a funnel approach to interpret the two-step statutory test.[31] It first looked for multiple corporations that are owned by up to five persons in the agregate without requiring that each of the five persons own shares in each corporation. The set of shareholders must own 80% of each corporation. Then, for the second step of the test, the regulation counted only those numbers of shares which were owned in identical quantities by each shareholder in each corporation. This second step of the test is a control test.[32] It determines if the corporations can be

23. United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982) (Berger, C.J., Brennan, Marshall, O'Connor, Powell, Rehnquist, and Stevens, JJ. joined in the majority opinion; Blackmun and White, JJ., joined in the dissent).

24. *Id.* at 24.

25. *Id.* (quoting United States v. Correll, 389 U.S. 299, 307 (1967)).

26. 455 U.S. at 24. The Court treated the difference between the two types of agency authority and the deference they are granted by the courts as if it were a new innovation in the law, yet the principle is one that is engrained in case law. *See infra* notes 80-88 and accompanying text.

27. I.R.C. § 7805 (1982).

28. 455 U.S. at 24.

29. The principle that an interpretive regulation is justified when a statute uses a general term stems from Morrissey v. Commissioner, 296 U.S. 344 (1935), in which the Court considered the validity of an interpretive Treasury regulation. The Revenue Act of 1926 provided that the term "corporations" included associations. *Id.* at 349. A Treasury regulation then interpreted "associations" to include certain trusts. *Id.* at 353. The Court concluded that because the term "associations" was not defined in the statute, the Treasury was authorized to provide rules for the enforcement of the section. *Id.* at 354.

30. *See* 455 U.S. at 24.

31. *See supra* note 14.

32. Thomas, *Brother-Sister Multiple Corporations - The Tax Reform Act of 1969 Reformed by Regulation*, 28 TAX. L. REV. 65, 79 (1972).

manipulated as one economic entity by one small group of shareholders.[33] The taxpayer, Vogel, differed with the Treasury over the construction of the test's first step,[34] arguing that each of the shareholders must own stock in each corporation before the first step of the test could be applied.[35] Vogel considered the test's second step a protective device designed to ensure that the corporations identified in the first step were controlled as a single entity.[36] Vogel also considered the control test to be less important than the 80% test.[37] The Court agreed with Vogel.[38]

The Court first considered whether the regulation was in harmony with the statutory language.[39] Noting the ambiguity of the statute, Justice Brennan determined that the language and grammatical structure were in closer harmony with the taxpayer's interpretation that common ownership is required by step one of the test.[40] The Court then faced the issued of whether the regulation conformed with the congressional intent as expressed in the legislative history.[41]

Justice Brennan found that the legislative history of section 1563(a)(2) resolved the ambiguity of the statutory language.[42] The original version of the section was enacted in 1964[43] and consisted of a one-step test that was the equivalent of the first step in the present test.[44] It required that a single person own all the corporations in the group.[45] In 1969, Congress broadened the test by: 1) including corporations owned by up to five per-

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33. *Id.* at 80.

34. *See supra* note 17.

35. *See supra* note 17.

36. Brief for Respondent at 6, United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982).

37. *Id. Cf.* Thomas, *supra* note 32, at 81.

38. United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982).

39. *Id.* at 24. *See also infra* notes 107-09 and accompanying text.

40. 455 U.S. at 25. Justice Brennan determined that the term "five or fewer persons" was the "conjunctive subject" of both tests and that this grammatical structure implied a common-ownership requirement. *Id.* at 25 n.8, 25, 26 (quoting Fairfax Auto Parts, Inc. v. Commissioner, 65 T.C. 798, 803 (1976)). *See supra* note 6.

41. 455 U.S. at 26.

42. *Id.*

43. Revenue Act of 1964, Pub. L. No. 88-272, § 235(a), 78 Stat. 116 (current version at I.R.C. § 1563(a)(2) (1982)). The 1964 version states:

> (a)(2) Brother-Sister Controlled Group.—Two or more corporations if stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations is owned (within the meaning of subsection (d)(2)) by one person who is an individual, estate or trust.

I.R.C. § 1563(a)(2) (1964).

44. 455 U.S. at 28.

45. *See supra* note 43.

sons; and 2) adding the second part of the test.[46] Justice Brennan reasoned that since the present version of the statute was an expansion of the old one, the portion that was common to both must have been intended by Congress to be the primary test.[47] The original test required stock ownership by a single person in all the corporations.[48] The expansion, therefore, must require stock ownership in each corporation by all shareholders now.[49] Furthermore, it was the Treasury Department which had proposed the statutory expansion to Congress, and it had submitted examples to explain the change.[50] In each of the examples, all of the shareholders owned stock in each corporation.[51] The regulation's interpretation of the test was incompatible with the Treasury's representation to Congress.[52] The Court concluded that Vogel's interpretation of section 1563(a)(2) was the one intended by Congress, as indicated by the legislative history.[53]

The immediate importance of *Vogel* to the corporate taxpayer and his attorney are the practical economic consequences of the Court's interpretation of the statute.[54] Perhaps more important to the legal community, however, is the method of analysis employed by the Court in *Vogel* to determine the validity of the regulation. The *Vogel* decision has important implications to all tax disputes because the taxpayer's interpretation of a statute prevailed over the Commissioner's. This note will briefly examine the legislative intent underlying section 1563(a)(2).[55] More importantly, it will compare the *Vogel* Court's method of determining the legislative intent of ambiguous code sections with more traditional statutory analysis.

Determining the legislature's intent is the primary method a court uses when it seeks to determine if an agency regulation

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46. I.R.C. § 1563(a)(2) (1982). *See supra* note 6.

47. 455 U.S. at 29.

48. *Id.* at 28. *See supra* note 43.

49. 455 U.S. at 30.

50. *Id.* at 28. *See Hearings*, *supra* note 1, at 5170, 5395.

51. *See Hearings*, *supra* note 1, at 5170, 5395.

52. 455 U.S. at 31, 32.

53. *Id.*

54. *See* Golub & Weber, *What Supreme Court's Liberal Decision on Controlled Groups Means to Practitioners*, 10 TAXATION FOR LAWYERS 352 (1982). The authors suggest that greater flexibility in corporate planning without forfeiting tax benefits will result. *Id.* They recommend that corporations who are now members of a brother-sister controlled group restructure themselves to escape the test. *Id.* at 355. The authors also predict more surtax exemptions and related benefits. *Id.* at 356.

55. *See supra* note 6.

implementing the statute is valid.[56] The Court correctly concluded that Congress expressed its desire to end with section 1563(a)(2) multiple surtax exemptions granted to corporations controlled by the same small group of people.[57] It is the scope that Congress intended for the test that was in dispute.[58] The primary difficulty in establishing Congress' intent is that the Treasury Department's proposed change was passed without discussion.[59] Only the Treasury's explanation, supplemented with examples, is available for examination in the legislative history.[60] Thus, Justice Brennan's "cheerful"[61] declaration that the legislative history resolves all ambiguity in the statutory language is subject to criticism as a substantial overstatement.[62] The Court either ignored or glossed over several factors which make the legislature's intent less certain.

Both the physical structure and a natural reading of the statute suggest that common ownership is required only for the second part of the test;[63] the common-ownership language is buried within the definition of the second test.[64] A section of the committee hearings also indicates that common ownership is linked only to the control test.[65] The position that common own-

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56. Lane, *Attacking the Regulations*, 52 A.B.A.J. 187, 189 (1966). *See also* Colgate-Palmolive-Peet Co. v. United States, 320 U.S. 422, 429 (1943) (Treasury regulation interpreting ambiguous statutory language concerning domestic oil processing upheld).

57. United States v. Vogel Fertilizer Co., 455 U.S. 16, 26 (1982). *See also id.* at 36 (Blackmun, J., dissenting). *See generally* H.R. REP. NO. 413, 91st Cong., 1st Sess., 98, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 1746-47; Thomas, *supra* note 32; Note, *The Brother-Sister Controlled Group Under I.R.C. § 1563(a)(2)*, 67 VA. L. REV. 751, 762-63 (1981) [hereinafter cited as *Brother-Sister Controlled Group*].

58. Libin & Abromowitz, *Multiple corporations: A surprising interpretation of Sec. 1563(a)(2) in temporary regulations*, 2 TAX ADVISOR 326, 330 (1971).

59. *See generally Hearings*, *supra* note 1.

60. *Id.*

61. United States v. Vogel Fertilizer Co., 455 U.S. 16, 36 (1982) (Blackmun, J., dissenting).

62. *Id.* *See also* Hoffman, *The 80 Percent Ownership Test For Brother-Sister Controlled Groups: The Controversy Continues*, 58 TAXES 329, 332 (1980); Libin & Abramowitz, *supra* note 58. *See generally* White, *The Tax Reform Act of 1969: Demise of Multiple Surtax Exemptions—When Too Much of a Good Thing Proved Its Own Undoing*, 16 WAYNE L. REV. 1353 (1970).

63. United States v. Vogel Fertilizer Co., 455 U.S. 16, 36 (1982) (Blackmun, J., dissenting). *See also* Delta Metalforming Co. v. Commissioner, 632 F.2d 442, 451 (5th Cir. 1980) (Johnson, J., dissenting); Allen Oil Co. v. Commissioner, 614 F.2d 336, 339 (2d Cir. 1980); T.L. Hunt, Inc. v. Commissioner, 562 F.2d 532, 535 (8th Cir. 1977); Fairfax Auto Parts, Inc. v. Commissioner, 65 T.C. 798, 812 (1976) (Simpson, J., dissenting). *See generally* Vogel Fertilizer Co. v. United States, 634 F.2d 497, 514 (Ct. Cl. 1980) (Smith, J., dissenting).

64. *See supra* note 6.

65. *Hearings*, *supra* note 1, at 5394.

However, in order to insure that this expanded definition of brother-sister controlled group applies only to those cases where the five or fewer

ership is required only by the control test seems to follow.[66]

Another factor favoring the Commissioner's interpretation is that Congress must have been aware of the regulation and its consequences. Prior to passage of the Employee Retirement Income Security Act of 1974 (ERISA),[67] the American Bar Association submitted an analysis and criticism of Treasury Regulation section 1.1563-1(a)(3) to Congress and proposed an amendment that would force the same construction that the Court gave it.[68] Additionally, the chairman of the American Bar Association section on taxation personally discussed the proposed changes with the chairman of the House Ways and Means Committee.[69] ERISA specifically referred to section 1563(a)(2) and controlled groups of corporations,[70] so the section was in the congressional mind. Yet Congress did nothing. It also did nothing when it passed the Revenue Act of 1978[71] which amended section 1561 and limited the availability of multiple tax benefits to controlled corporations.[72] The legislative inaction

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individuals hold their 80 percent in a way which allows them to operate the corporations as one economic entity, the proposal would add an additional rule that the ownership of the five or fewer individuals must constitute more than 50 percent of the stock of each corporation considering, in this test of ownership, stock of a particular person only to the extent that it is owned identically with respect to each corporation.

Fairfax Auto Parts, Inc. v. Commissioner, 65 T.C. 798, 809 (Simpson, J., dissenting) (quoting *Hearings*, *supra* note 1, at 5394) (emphasis supplied by the court). See *supra* note 16 for a discussion of *Fairfax*.

66. *Hearings*, *supra* note 1, at 5394. Referring to the hearings, Judge Simpson observed that they clearly showed that different persons may be taken into consideration when applying the 80% and 50% tests. Furthermore, the explanation that there will be common ownership merely "to a large extent" among those corporations considered for the 80% test shows that common ownership is not required. 65 T.C. at 810 (Simpson, J., dissenting).

67. I.R.C. § 1015 (1976).

68. Committee Recommendations, 27 TAX LAWYER 813, 817 (1974). The recommendations added phrasing that required "each of the same 5 or fewer persons" to own stock in "each corporation" being considered as a brother-sister controlled group. *Id.*

69. Worthy, *Chairman's Report*, 27 TAX LAWYER 527, 531 (1974).

70. I.R.C. § 1015 (1976).

71. Pub. L. No. 95-600, § 152(d), 92 Stat. 2799 (1978). The purpose of the Act was to reduce taxes and stimulate investment spending in order to increase economic growth. H.R. REP. NO. 1445, 95th Cong., 2d Sess. 2, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 6761, 6765. If Congress was unhappy with the increased tax burden on corporations which resulted from the Treasury's interpretation of I.R.C. § 1563(a)(2), it could have amended that section when it passed legislation reducing taxes and intended to stimulate economic activity.

72. I.R.C. § 1561(a) (1978).

leads to an inference that Congress approved of the regulation as it stood.

A thorough analytical reading of the legislative history of section 1563(a)(2) offers many possible interpretations,[73] but has only one clear result: the history itself is more ambiguous than the statute.[74] By merely accepting the Treasury's proposal, Congress indicated one of two things; it either expressed confidence in the Treasury's competence to expand the test and administer the section, or it intended to accept the Treasury's solution to the problem. If the former, then it granted the Treasury the equivalent of specific authority to carry out the congressional mandate.[75] If the latter, then to determine the congressional intent, one needs to determine the intent of the Treasury Department. That intent could well be expressed by the contemporaneous construction[76] given the statute in Treasury Regulation section 1.1563-1(a)(3).[77] The courts, however, interpret only statutes and legislative intent, not agency intent, and therefore the natural approach is to resort to the standard rules of statutory construction.[78]

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73. *See generally* Bonovitz, *Brother-Sister Controlled Groups Under Section 1563: The 80 Percent Ownership Test*, 28 TAX LAWYER 511 (1975); Hoffman, *supra* note 62; Thomas, *supra* note 32; White, *supra* note 62; *Brother-Sister Controlled Group*, *supra* note 57.

74. *See* United States v. Vogel Fertilizer Co., 455 U.S. 16, 38 (1982) (Blackmun, J., dissenting); Hoffman, *supra* note 62, at 332; White, *supra* note 62, at 1367.

75. *See infra* text accompanying notes 81-82.

76. The doctrine of special deference to a contemporaneous agency construction of a statute pervades tax law. Rogovin, *The Four R's: Regulations, Rulings, Reliance and Retroactivity*, 43 TAXES 756, 760 (1965). Regulations issued concomitantly with the enactment of a statute are presumed to represent the general understanding of the legislative intent and the statute's meaning. *Id.* The doctrine goes as far back as 1827 when the Court stated: "In the construction of a doubtful and ambiguous law, the contemporaneous construction of those who were called upon to act under the law, and were appointed to carry its provisions into effect, is entitled to very great respect." Edwards's Lessee v. Darby, 25 U.S. (12 Wheat.) 206, 209 (1827). The Court recently reaffirmed the doctrine; in National Muffler Dealers Ass'n v. United States, the Court said that "[a] regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent." 440 U.S. 472, 477 (1979). The mere prompt action of the Treasury in interpreting a statute is given weight by the Court even though a taxpayer's challenge is just as prompt. Colgate-Palmolive-Peet Co. v. United States, 320 U.S. 422, 426 (1943) (Treasury regulation interpreting ambiguous statutory term pertaining to domestic oil processing upheld). In *Vogel*, the Court gave the contemporaneous-construction doctrine a reverse twist and applied it against the Treasury. United States v. Vogel Fertilizer Co., 455 U.S. 16, 31 (1982). For a broad discussion of the doctrine, see 1 MERTENS LAW OF FEDERAL INCOME TAX §§ 3.20-3.26 (Rev. vol. 1981).

77. *See supra* note 14.

78. *See generally* MERTENS, *supra* note 76, at ch. 3.

The courts have developed rules and presumptions as aids in determining legislative intent.[79] An inspection of those rules may set the stage for resolving the ambiguity surrounding section 1563(a)(2). Treasury regulations may be either legislative or interpretive in character.[80] A legislative regulation is one written under a specific authority from Congress to supplement a statute.[81] It has the force of law and is treated as if it was part of the statute.[82] If a legislative regulation is neither *ultra vires*[83] nor capricious,[84] then it is valid.[85] An interpretive regulation, on the other hand, is written under a general power[86] from Congress to administer a statute.[87] The courts treat an interpretive regulation as the mere statement of the Treasury Department's construction of the statute.[88] The rules of construction are applied both to ambiguous statutes[89] and to the interpretive regulations defining the statutory meaning.[90] The regulation challenged in *Vogel*, written under the Treasury's general power to administer the Internal Revenue Code, was interpretive and subject to the rules of construction.

Tax statutes are also subject to their presumptive rules. Should a statute levying a tax be found ambiguous, it will be

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79. *Id.* at § 3.02.

80. Rogovin, *supra* note 76, at 758.

81. *Id.* A legislative regulation derives its authority from a specific delegation of legislative power; it is as if Congress itself had written the regulation. The power to write this type of regulation must be found in the statute. *See* Alvord, *Treasury Regulations and the Wilshire Oil Case*, 40 COLUM. L. REV. 252, 259 (1940).

82. Alvord, *supra* note 81, at 259.

83. Griswold, *A Summary of the Regulations Problem*, 54 HARV. L. REV. 398, 401 (1941). If a regulation is outside the authority delegated by Congress, it is invalid. *Id.*

84. Batterton v. Francis, 432 U.S. 416, 426 (1977) (Department of Health, Education and Welfare regulation determining what constitutes unemployment upheld as reasonable and not arbitrary or capricious).

85. Griswold, *supra* note 83. *See also* Rowan Cos. v. United States, 452 U.S. 247, 253 (1981) (interpretive Treasury regulation held invalid as unreasonable when compared with the manifest congressional design and inconsistent with another Treasury regulation). The Court stated that "where the Commissioner acts under specific authority, our primary inquiry is whether the interpretation or method is within the delegation of authority." *Id.*

86. I.R.C. § 7805 (1982).

87. *See* Alvord, *supra* note 81, at 260. *Cf.* Edwards's Lessee v. Darby, 7 U.S. 126 (12 Wheat. 206) (1827).

88. Alvord, *supra* note 81, at 261. *See also* Rogovin, *supra* note 76, at 759. *Cf.* Burnet v. Chicago Portrait Co., 285 U.S. 1, 16 (1932); Hesselin v. Hoey, 91 F.2d 954 (2d Cir. 1937).

89. Northern Natural Gas Co. v. O'Malley, 277 F.2d 128, 134 (8th Cir. 1960) (Treasury regulation held invalid because it interpreted a statute so that it took away a right clearly granted by Congress).

90. *See* Alvord, *supra* note 81, at 261.

construed in favor of the taxpayer.[91] Deductions, conversely, are granted by legislative grace,[92] do not assess a tax, and are construed against the taxpayer when ambiguous.[93] This second rule[94] favors the Treasury regulation. Because Congress has the constitutional power to tax all income,[95] an exemption is nothing but a limited exclusion from tax liability, similar in effect to a deduction,[96] granted by legislative grace.[97] Therefore, the statute at issue in *Vogel* should be construed against the taxpayer as are deductions.[98]

With the presumptions always in the background, two rules of construction are used to determine if interpretive regulations follow the legislative intent. The reenactment rule applies to an interpretive regulation when the statutory section it implements is reenacted by Congress.[99] The reenactment is often viewed as congressional approval of the agency's interpretation in the regulation.[100] The reenactment rule may also apply when the regulation's effect has been explained to Congress and Congress has

91. Gould v. Gould, 245 U.S. 151, 153 (1917) (alimony is not income for taxation purposes because the statutory section defining net income was obscure and therefore should be interpreted against the government). *See also* United States v. Wigglesworth, 28 F. Cas. 595, 596 (C.C.D. Mass. 1842) (No. 16,690) (duty imposed on imported indigo not allowed because the statute levying it was ambiguous and therefore construed against the government). *Wiggleworth* is apparently the first United States case to articulate this rule of construction.

92. Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943) (disallowal of deduction upheld because taxpayer did not make clear showing of right to the deduction). *See also* New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934) (taxpayer found not entitled to deduction, which is granted by legislative grace).

93. Bingler v. Johnson, 394 U.S. 741, 751 (1969) (regulation delineating "scholarship" upheld; deductions are construed narrowly). *See also* Parker Pen Co. v. O'Day, 234 F.2d 607, 609 (7th Cir. 1956) (regulation limiting deduction upheld; statutes creating deductions are construed against the taxpayer).

94. Bingler v. Johnson, 394 U.S. 741 (1969).

95. U.S. CONST. amend. XVI.

96. This point is best illustrated by comparing the definitions of deduction and exemption. A deduction, as used in the Internal Revenue Code § 1312(2), is "a term of art meaning only those items subtracted, or 'deducted' from gross income in arriving at taxable income. . . ." B.C. Cook & Sons, Inc. v. Commissioner, 584 F.2d 53, 54 (5th Cir. 1978). Similarly, "exempt" merely signifies that a portion of income is excluded from gross income in determining taxable income and that "no tax is payable in the first instance." William Clairmont, Inc. v. State, 261 N.W.2d 780, 784 (N.D. 1977). *See also* Tupelo Garment Co. v. State Tax Commission, 178 Miss. 730, 173 So. 656, 660 (1937) ("deduction [made in determining taxable income] is in fact an 'exemption' ").

97. *Cf. supra* note 92.

98. *See supra* note 93 and accompanying text.

99. Rogovin, *supra* note 76, at 760.

100. Jones v. Goodson, 121 F.2d 176, 180 (10th Cir. 1941) (taxi company sought refund of social security taxes collected by the I.R.S. under a regula-

not acted.[101] The reenactment rule also favors the Treasury regulation because Congress not only let the regulation stand after being appraised of its effect, but also passed legislation referring to the statute.[102] One may safely assume that Congress would have amended section 1563(a)(2) at this time if it disapproved of the agency construction.[103]

The most frequently used rule in modern tax law is the "choice of reasonable interpretations rule." Although interpretive regulations were originally only entitled to polite respect,[104] this respect eventually developed into a rule strongly favoring Treasury regulations.[105] If more than one reasonable interpretation of a statute was possible, the Commissioner could choose any one, and it would stand against all attack.[106] Courts had difficulty with the word "reasonable," and a secondary test of harmony was developed to determine reasonableness.[107] A regulation is in harmony with a statute if it can be read with the statute and does not depart from, or put aside, a statutory definition[108] or conflict with congressional design.[109]

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tion later held to be valid under the reenactment rule). *See also* Alvord, *supra* note 81, at 262.

101. Norwegian Nitrogen Prod. Co. v. United States, 288 U.S. 294, 313 (1933) (duty assessed by United States Tariff Commission upheld; Congress was informed of regulation's effect and did not take action).

102. *See supra* note 67-72 and accompanying text.

103. *See supra* notes 100-01.

104. Hesselin v. Hoey, 91 F.2d 954, 956 (2d Cir.), *cert. denied*, 302 U.S. 756 (1937) (interpretive Treasury regulation imposing a gift tax held invalid). *See also* Burnet v. Chicago Portrait Co., 285 U.S. 1, 16 (1932) (ambiguous Treasury regulation interpreting ambiguous statutory section granted little deference by the Court); Alvord, *supra* note 81, at 260.

105. Northern Natural Gas Co. v. O'Malley, 277 F.2d 128, 130 (8th Cir. 1960).

106. National Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472, 488 (1979). The Court firmly stated that "[t]he choice among reasonable interpretations is for the Commissioner, not the courts." *Id.*

107. Lynch v. Tilden Produce Co., 265 U.S. 315 (1924). *Lynch* involved the statutory definition of adulterated butter and an interpretive regulation which set a standard for it. Congress defined one of the characteristics of adulterated butter as manufacture or manipulation with the intent of causing excessive absorption of water. *Id.* at 319. The Treasury regulation set an arbitrary standard for maximum permissible water content. *Id.* at 320. The Court determined that Congress did not intend for normal amounts of water used in the manufacturing process to be included in its definition of adulterated butter. *Id.* at 321. Intent to cause abnormal absorption was key. *Id.* at 320. Because the regulation made water content the sole criterion of adulteration and did not make allowances for water used in the manufacturing process, it conflicted with the statutory definition. *Id.* at 321. The regulation and the statute could not be read in harmony. *Id.*

108. *Id.*

109. *Cf.* Boske v. Comingore, 177 U.S. 459, 470 (1900) (Treasury regulation concerning control of department records upheld because taxpayer did not clearly show that it was totally inappropriate to the end specified in the statute).

In the area of affiliated corporations, the congressional design was to expand the test for brother-sister controlled groups and further limit the availability of surtax exemptions,[110] but Congress passed an ambiguous statute to obtain this end.[111] The regulation fulfilled its primary function by resolving the ambiguity in accordance with the congressional design.[112] The Court in *Vogel* stated that the taxpayer's interpretation was merely in closer harmony with the statute than the regulation,[113] thus suggesting that the regulation was also a reasonable interpretation.[114] Since the choice of reasonable interpretations is for the Commissioner,[115] the regulation should stand.

Applying the Court's own rules, one can determine how *Vogel* should have been decided. Both the presumptions and the rules of construction applied to tax statutes lead to a result contrary to the *Vogel* decision. The pertinent question, then, is how did the Court come to the opposite conclusion?

Justice Brennan relied heavily on *National Muffler Dealers Association, Inc. v. United States*[116] and *United States v. Correll*.[117] In *National Muffler*, an interpretive Treasury regulation defined the general term "business league" in such a way that it excluded an association of franchised muffler dealers and denied them a tax exemption.[118] The Court reaffirmed both the harmony requirement,[119] as stated in *Lynch v. Tilden Produce Company*,[120] and the policy reasons for allowing any reasonable interpretation of the Treasury to stand.[121] The regulation challenged in *National Muffler* was exactly opposite to the original regulation promulgated by the Treasury.[122] The Court stated

110. *See supra* note 57 and accompanying text.

111. United States v. Vogel Fertilizer Co., 455 U.S. 16, 25 (1982). *See also id.* at 35 (Blackmun, J., dissenting); Hoffman, *supra* note 62; Libin & Abramowitz, *supra* note 58.

112. The congressional design was to expand the test and further limit the number of corporate entities allowed to take a full surtax exemption. *See supra* note 57 and accompanying text.

113. United States v. Vogel Fertilizer Co., 455 U.S. 16, 25 (1982).

114. *Id.* at 38 (Blackmun, J., dissenting).

115. *See supra* note 106.

116. 440 U.S. 472 (1979).

117. 389 U.S. 299 (1967).

118. National Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472 (1979).

119. *Id.* at 477.

120. 265 U.S. 315 (1924).

121. National Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472, 477 (1979). The Court stated that Congress had delegated authority to the Secretary of the Treasury to prescribe regulations to insure that they would be written by "masters of the subject" who would also be responsible for putting them into effect. *Id.*

122. *Id.* at 489 (Stewart, J., dissenting).

that this change of position by the Treasury is permissible because an agency may alter its interpretation of a statute in light of administrative experience.[123] This statement negates Justice Brennan's attempt in *Vogel* to hold the Treasury to the type of examples it submitted to Congress when proposing section 1563(a)(2).[124] *National Muffler*'s principle would allow the Treasury's interpretation in *Vogel* to stand because, even if the original interpretation of the Treasury was the same as the taxpayer's in *Vogel*, an agency is allowed to change its interpretation in light of administrative experience.[125] In *National Muffler*, the Treasury changed its interpretation 180°;[126] in *Vogel*, it merely narrowed and clarified a loophole it did not originally address.

United States v. Correll[127] involved an interpretive Treasury regulation which defined an ambiguous term in a section that granted a deduction.[128] In upholding the regulation,[129] the Court relied on the general rule that deductions will be construed in favor of the government.[130] The Court, however, also included a strong statement that it will not attempt to perfect the administration of tax laws;[131] this is the "province of the Congress and the Commissioner," and any reasonable Treasury interpretation is valid.[132] *Vogel*, like *Correll*, involved an interpretive Treasury regulation[133] that implemented an ambiguous

123. *Id.* at 485.

124. United States v. Vogel Fertilizer Co., 455 U.S. 16, 30 (1982).

125. National Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472, 485 (1979).

126. Id. at 489 (Stewart, J., dissenting).

127. 389 U.S. 299 (1967).

128. *Id.* at 304 (statutory phrase "meals and lodging . . . not self-defining"; interpretive regulation justified). The *Correll* Court also reaffirmed the validity of the reenactment rule. It stated that "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law." *Id.* at 305 (quoting Helvering v. Winmill, 305 U.S. 79, 83 (1938)).

129. 389 U.S. at 307.

130. *Id.* at 304.

131. *Id.* at 306-07. The Court stated that while alternatives to the regulatory view were available,

> we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing all needful rules and regulations for the enforcement of the Internal Revenue Code. 26 U.S.C. sec. 7805(a). In this area of limitless factual variations "it is the province of Congress and the Commissioner, not the courts, to make appropriate adjustments."

Id. (quoting Commissioner v. Stidger, 386 U.S. 287 (1967)).

132. *Id.* at 307.

133. United States v. Vogel Fertilizer Co., 455 U.S. 16, 24 (1982).

section of a statute limiting a tax exemption[134] and, possibly, narrowed the Treasury's construction of the statute.[135] If the principles of *Correll* were applied to the facts of *Vogel*, the Commissioner's interpretation of I.R.C. section 1563(a)(2) would stand because it involves an exemption that should be interpreted in favor of the government, and it is the job of Congress, not the courts, to fine tune the tax laws.[136] Because the rationales of *National Muffler* and *Correll* both dictated that the regulation be upheld, these authorities were either misapplied or not the prime authority for the decision.

Close analysis of the *Vogel* opinion reveals that Justice Brennan relied on the spirit of *United States v. Cartwright*.[137] In *Cartwright*, the Court overturned an interpretive regulation which determined the value of mutual fund shares but which conflicted with the congressional design manifested in other statutes.[138] The *Cartwright* Court stated that the choice-of-reasonable-interpretations rule merely sets the framework for judicial analysis and does not displace it;[139] when the Treasury chooses an interpretation that is consistent with the statute but is unrealistic, the interpretation should not be allowed to stand.[140] The principle of *Cartwright* is that the interpretive regulation must be the most realistic, or reasonable, of the alternatives to retain validity.

When Justice Brennan relied on *National Muffler*[141] and *Correll*,[142] he had to find the regulation totally unreasonable in order to declare it invalid. Yet he had already admitted that the regulation was reasonable,[143] although not as reasonable as the taxpayer's interpretation.[144] In reality, Justice Brennan used the harmony test[145] as a weighing test. Stating that reasonableness is determined by harmony, he then picked the interpretation that was in closer harmony,[146] thereby making the choice-of-reasonable-interpretations rule invalid. A Treasury interpretation must now be the most reasonable one available; when

134. *Id.* at 18.
135. *Id.* at 25.
136. United States v. Correll, 389 U.S. 299, 307 (1967).
137. 411 U.S. 546 (1973).
138. *Id.*
139. *Id.* at 550.
140. *Id.* at 557.
141. National Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472 (1979).
142. United States v. Correll, 389 U.S. 299 (1967).
143. United States v. Vogel Fertilizer Co., 455 U.S. 16, 25 (1982).
144. *Id.*
145. *See supra* notes 104-09 and accompanying text.
146. 455 U.S. at 26.

challenged, the interpretive regulation must be the one that harmonizes most closely with the congressional intent. While it might not be the province of the courts to perfect the tax laws, it is now their province to insure that the Treasury is in harmony with the congressional tune.

This reasoning marks another step in the trend started by *Cartwright*,[147] and is also a return to an older concept.[148] An interpretive rule is once again merely the government's position. It will be given respect, but only respect; if disputed, an interpretive regulation will retain validity only if it is more in harmony with the statute than the interpretation offered by the challenger. The Court's holding in *Vogel* raises implications for the taxpaying community as a whole in addition to the corporate taxpayer.[149] More litigation can be expected as a result of *Vogel*. If a taxpayer believes his view of a statute is more reasonable than the regulatory construction, he is now encouraged to dispute the regulation. In response, Congress may decide to give

147. United States v. Cartwright, 411 U.S. 546 (1973). Rowan Cos. v. United States, 452 U.S. 247 (1981) is the second step in the trend. In *Rowan*, the Court dealt with two interpretive Treasury regulations that defined the statutory term "wages" in totally different ways. *Id.* at 249. One regulation specifically allowed an employer to exclude the value of certain meal and lodging benefits when computing employee wages. *Id.* at 250. The other regulation required the employer to include the same meal and lodging benefits when computing employee wages for purposes of the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA). *Id.* The Court found that the regulations were unreasonable because Congress defined "wages" in substantially the same manner in the different acts and, the term should have been interpreted in only one way. *Id.* at 263. Although the regulations had been in force since 1940, the Court did not apply the reenactment rule because the Treasury did not enforce them in a totally consistent manner until 1957. *Id.* at 260-61. The regulations that included certain meal and lodging benefits in the computation of wages for FICA and FUTA were declared invalid. *Id.* at 263.

In deciding *Rowan*, the Court once again considered what standards to use when determining the validity of a Treasury regulation. *Id.* at 252. It included its normal boiler plate language concerning standards used in previous opinions and paid homage to the choice-of-reasonable-interpretations rule. *Id.* *See* United States v. Vogel Fertilizer Co., 455 U.S. 16, 24 (1982); National Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472 (1979); United States v. Correll, 389 U.S. 299, 305-06 (1967). As in *Vogel*, the *Rowan* Court relied on *National Muffler* and *Correll* and therefore had to find the regulation totally unreasonable in order to declare it invalid. However, the Court also stated that it looks to see "whether the regulation harmonizes" with the statute. 452 U.S. at 253. It then said that regulations written under the Treasury's general authority to promulgate rules are owed less deference than those written under a specific authority. *Id.* The *Rowan* Court essentially took a step away from the choice-of-reasonable-interpretations rule and a step closer to a position where the court would weigh alternative interpretations and choose the most reasonable one.

148. *See supra* notes 104-06 and accompanying text.

149. *See* Golub & Weber, *supra* note 54.

the Treasury Department specific authority[150] in more instances so that it will have greater latitude to administer the tax laws and lesser interference from the courts. The new stricter standard applied to interpretive regulations[151] in *Vogel* may also result in the Treasury using greater care when drafting them.[152] It seems likely,[153] however, that the Treasury, in response to *Vogel*, will submit a new proposal to Congress which will expand the test of section 1563(a)(2)[154] to encompass the funnel approach it used in Treasury Regulation section 1.1563-1(a)(3).[155] When that happens, Congress will have another opportunity to name its tune.

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150. *See supra* note 81.

151. *See supra* notes 86-90 and accompanying text.

152. Other ambiguous sections of the Internal Revenue Code may also be affected by the *Vogel* decision. Welz & Minasian, *Supreme Court in Vogel Voids I.R.S.' 80% Brother-Sister Group Test; Wide Impact Seen*, 56 J. TAX'N 202, 205 (1982).

153. One Treasury official stated that a new proposal is either now on, or should be on, the agenda of changes to the Code that will be submitted to Congress in the future. Conversation with the Honorable John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, at the John Marshall Law School, Chicago, Illinois (October 27, 1982).

154. I.R.C. § 1563(a)(2) (1982). *See supra* note 6.

155. Treas. Reg. § 1.1563-1(a)(3) (1973). *See supra* note 14.