THE STATE OF TREASURY REGULATORY AUTHORITY AFTER *MAYO FOUNDATION*: ARGUING FOR AN INTENTIONALIST APPROACH AT *CHEVRON* STEP ONE

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I. INTRODUCTION

On January 11th, 2011, the Supreme Court unanimously held in *Mayo Foundation for Medical Education and Research v. United States*[1] that all agency regulations, including Treasury regulations, should be afforded the standard of deference set out in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc*,[2] a case that prescribed how courts should review agency regulations.[3] Before *Mayo*, *Chevron* did not have very much influence in the tax world—*Chevron* had been cited in only a few Supreme Court tax cases, and the Tax Court continued to cite pre-*Chevron* authority when evaluating whether to defer to the Treasury's construction of the Internal Revenue Code ("Tax Code").[4] Thus, the *Mayo* decision superseded a line of tax cases, including *National Muffler Dealers Ass'n v. United States*,[5] which had established a less deferential, tax-specific standard of

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1. Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704 (2011).
2. Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984).
3. *Mayo*, 131 S. Ct. at 713.
4. Mary L. Heen, *Plain Meaning, the Tax Code, and Doctrinal Incoherence*, 48 HASTINGS L.J. 771, 784–85, 785 n.67 (1997).
5. Nat'l Muffler Dealers Ass'n v. United States, 440 U.S. 472 (1979).

review.[6]

The *Chevron* analysis consists of a two-step inquiry: (1) "[Has] Congress . . . directly spoken to the precise question at issue[?]"; and, (2) "if the statute is silent or ambiguous with respect to the specific issue, . . . [is] the agency's answer . . . based on a permissible construction of the statute[?]"[7] Although the original formulation of *Chevron* clearly intended that outside sources such as legislative history be considered at step one of the inquiry, the Supreme Court has not consistently applied step one in this manner and has in some cases limited the analysis to plain meaning of the text of the statute.[8] As one commentator noted, "*Chevron*'s exhaustive review of legislative history for [the] purposes of . . . step[] one . . . is a somewhat divisive issue in the circuit courts that needs clarification."[9]

In *Mayo*, the Court discussed only the text of the statute at issue, even though both litigants referred to legislative history in their briefs, and the lower court referred to legislative history to support its ruling.[10] After *Mayo*, lower courts relying on it have expressed inconsistent views regarding step one of the test—some relying on legislative history and others stating that *Mayo* suggests that legislative history should not be used.[11] As the Tax Court has noted, "there remain[s] [an] unresolved issue[] that would potentially affect the analysis: . . . [w]hether legislative history should be considered at step one of the two-step *Chevron*

6. *See, e.g.*, *id.* at 477.

7. *Chevron*, 467 U.S. at 842–43. The decision essentially eliminated all other considerations formerly existing under *National Muffler*, including whether the regulation was promulgated in response to an unfavorable court decision or whether the regulation diverges from a prior Treasury position. *See Nat'l Muffler*, 440 U.S. at 477.

8. Irving Salem, Mayo *Dissected: Some Dragons Slain, Some Still Breathing Fire*, 130 TAX NOTES 1327, 1328–29 & n.16 (2011). *See* Linda Jellum, Chevron*'s Demise: A Survey of* Chevron *from Infancy to Senescence*, 59 ADMIN. L. REV. 725, 771 (2007).

9. Salem, *supra* note 8, at 1329. *Compare* Natural Res. Def. Council v. EPA, 526 F.3d 591, 603 (9th Cir. 2008) ("An examination of the statutory language and its legislative history assists us in this [step one] inquiry."), *with* Schneider v. Chertoff, 450 F.3d 944, 955 n.15 (9th Cir. 2006) ("Although we cannot consider legislative history under the first prong of *Chevron*, we note that the Secretary's regulation subverts the very intent of the Nursing Relief Act.") (citation omitted).

10. Salem, *supra* note 8, at 1329.

11. *Compare* Salman Ranch, Ltd. v. Comm'r, 647 F.3d 929, 937–38 (10th Cir. 2011) (looking to legislative intent in applying *Chevron* step one), *vacated*, 132 S. Ct. 2100 (2012), *and* Tigers Eye Trading, LLC v. Comm'r, 138 T.C. 6 (2012) (same), *with* Carpenter Family Invs., LLC v. Comm'r, 136 T.C. 373, 389 (2011) (explaining that in *Mayo* the Supreme Court implied that step one of *Chevron* should be limited to analyzing the plain text of the statute), *and* Kingston Hosp. v. Sebelius, 828 F. Supp. 2d 473, 477 (N.D.N.Y. 2011) (applying step one of *Chevron* only by looking at the statutory text).

analysis."[12] Thus, although the *Mayo* Court made clear that the tax-specific test of *National Muffler* no longer applies when reviewing Treasury regulations, the Court did not address the longstanding uncertainty as to whether outside sources, such as legislative history, should be considered when determining whether Congress has directly addressed the issue subject to the regulation.[13]

In light of *Mayo*'s clear extension of the *Chevron* analysis to Treasury regulations, along with its lack of guidance regarding *Chevron* step one, this Note argues that outside sources such as legislative history must be considered when discerning whether Congress has directly spoken to the precise question at issue. This is especially important in the context of tax regulations because of (1) the high level of complexity and interaction among the provisions of the Tax Code; (2) the specialized nature of tax vocabulary; (3) the established historical practice of creating and relying on extra-statutory glosses on the Tax Code; and (4) the inability of Congress to anticipate every possible contingency when drafting tax provisions. Whether or not reviewing courts consider nonstatutory sources such as legislative history at *Chevron* step one will have a substantial effect on the frequency with which *Chevron* deference is given to Treasury regulations and, as a result, the overall scope of the Treasury's regulatory authority.[14]

The Treasury's need for *Chevron* deference now carries particular importance due to the Tax Code's inability to properly address the changed economic environment resulting from the financial crisis. As a consequence of the financial crisis, an unprecedented amount of debt instruments are under distress. The "original issue discount" and "market discount" rules (which explain how to calculate the amount of tax owed on certain debt instruments), when applied to distressed debt instruments, result in tax outcomes that are unfair to taxpayers and inconsistent with Congress's original design. In order to respond to this inadequacy, the Treasury must be able to utilize the full scope of the authority it received under the original *Chevron* opinion. As explained below, this is not possible unless reviewing courts turn to nonstatutory sources when determining step one of the *Chevron* test.

12. *Carpenter Family*, 136 T.C. at 388.

13. Salem, *supra* note 8, at 1327–29 & n.16. *See generally* Jellum, *supra* note 8 (discussing the tumultuous evolution of the application of *Chevron* step one).

14. *See infra* Part III. In addition to having great importance regarding the scope of Treasury authority, Jeremiah Coder notes that this debate is relevant when deciding whether Treasury regulations can overturn prior court decisions. Jeremiah Coder, Mayo*'s Unanswered Questions*, 130 TAX NOTES 1118, 1118 (2011).

Part II of this Note provides an overview of *National Muffler* and the basic implications of *Mayo*. Part III provides an overview of *Chevron* and the step one intentionalist / textualist debate. Part IV proposes an intentionalist approach to step one, highlighting its particular significance in the tax context. Part V applies the approaches to three examples in order to demonstrate the dangers of a textualist step-one approach, as well as the need for an intentionalist approach. First, these opposing analyses are applied to a past regulation regarding the treatment of hedging assets. Then, they are applied to the "market discount" and "original issue discount" rules, highlighting the current Tax Code's inadequacies regarding recent changes in the economic environment and thereby reemphasizing the Treasury's need for *Chevron* deference in the current era. Part VI concludes.

II. OVERVIEW OF *NATIONAL MUFFLER* AND *MAYO*

An agency regulation comes under review when a challenging party claims that it is inconsistent with the text of the congressional enactment that the regulation is meant to administer. Before *Chevron*, a line of tax-specific cases, including *National Muffler*, set out the standard of review for evaluating Treasury regulations that were challenged for being inconsistent with the Tax Code.[15] After *Chevron* set out a general test for all agency regulations, many judges did not acknowledge that *Chevron* applied to tax regulations and continued to cite the pre-*Chevron* line of tax-specific cases.[16] The Supreme Court provided no help, sometimes citing *National Muffler*, other times citing *Chevron*.[17] Thus, before *Mayo*, it was unclear whether the level of deference given to Treasury regulations should be governed by the line of tax-specific cases including *National Muffler*, or the general principles of *Chevron*.[18]

Under the tax-specific analysis developed by *National Muffler* and its progeny, "a particular regulation carries out the congressional mandate in a proper manner . . . [if it] harmonizes with the plain language of the statute, its origin, and its purpose."[19] An important factor in this determination includes whether the regulation is a "substantially contemporaneous

15. *See, e.g.*, Nat'l Muffler Dealers Ass'n. v. United States, 440 U.S. 472 (1979); Skidmore v. Swift & Co., 323 U.S. 134 (1944).

16. THOMAS GREENAWAY, KPMG, *MAYO FOUNDATION* CURES TAX MYOPIA 2 (2011), *available at* http://taxprof.typepad.com/files/mayo-kpmg.pdf.

17. *Id.*

18. *Id.*

19. *Nat'l Muffler*, 440 U.S. at 477.

construction of the statute by those presumed to have been aware of congressional intent."[20] "If [a] regulation dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations [include] the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent reenactments of the statute."[21]

The effect of the *National Muffler* test is that if a regulation (1) is promulgated long after the enactment of the corresponding statute, (2) is promulgated in response to an unfavorable court decision, or (3) diverges with a prior Treasury position, the reviewing court will suspend deference to the agency interpretation and review such regulation with heightened skepticism.[22] Consideration of these factors hinders the Treasury's ability to efficiently and effectively administer the Tax Code in light of the reality of ever-changing conditions. For example, it reduces the Treasury's ability to fill a statutory gap when, by mere chance, the unanticipated fact pattern that brings such gap to light does not occur until long after the applicable provision's original enactment; a regulation is viewed with heightened skepticism based on the amount of time that happens to pass before taxpayers and the Treasury become aware of the congressional shortcoming. The *Chevron* analysis is not so flawed because, under *Chevron*, the reviewing court defers completely to an agency's reasonable resolution of a statutory gap regardless of the way in which the resolution evolved, or the amount of time that has passed between the provision's enactment and the resolution.[23]

Because of *Chevron*'s high level of deference towards Treasury regulations relative to *National Muffler*, the *Mayo* case turned on whether *National Muffler* or *Chevron* should be used to review a Treasury regulation. In *Mayo*, the Court rejected a challenge to a Treasury regulation defining a medical resident as a worker and not a student for purposes of Federal Insurance Contributions Act ("FICA") taxation.[24] The Mayo Clinic argued that its medical residents were not employees for tax purposes because it did not want to pay the employer's portion of the FICA taxes.[25] The FICA statute, § 3121(b)(10) of the Tax Code, exempts from taxation

20. *Id.*
21. *Id.*
22. *See id.*
23. *See* Jasper L. Cummings, *'Mayo' Decision Does Not Insulate Treasury Regulations from Invalidation*, 21 DAILY TAX REP. (BLOOMBERG BNA) J-1 (Feb. 1, 2011); *infra* Part III.
24. Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 715–16 (2011).
25. Cummings, *supra* note 23.

"service performed in the employ of . . . a school, college, or university . . . if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university."[26] In addition to the statute, Treasury regulations dating back to 1951 had interpreted § 3121(b)(10) to exempt from taxation "students who work for their schools 'as an incident to and for the purpose of pursuing a course of study' there."[27] An individual's work was determined to be "incident to" his studies on a case-by-case basis, primarily considering the number of hours worked and the course load taken.[28]

The Social Security Administration also articulated a case-by-case approach to the corresponding student exception in the Social Security Act—however, the Social Security Administration had always categorically excluded resident physicians from the student exception.[29] In 1998, this practice was declared invalid by the U.S. Court of Appeals for the Eighth Circuit because the regulations provided for a case-by-case approach.[30] As a result, the IRS received more than 7000 claims seeking FICA tax refunds on the ground that medical residents were students under § 3121(b)(10) of the Code.[31] In response, the Treasury adopted an amended rule providing that the services of a full-time employee, which includes any employee normally scheduled to work forty hours or more per week, "are not incident to and for the purpose of pursuing a course of study," and are thus categorically excluded from the § 3121(b)(10) exception, irrespective of whether the services performed have an educational, instructional, or training aspect.[32] The Mayo clinic brought suit challenging the Treasury's full-time employee rule as inconsistent with the text of § 3121(b)(10).[33]

In deciding the case, the Supreme Court addressed the correct standard for deference to Treasury regulations.[34] Under *National Muffler*, the amended Treasury regulation would have been reviewed with heightened skepticism because (1) it was promulgated long after § 3121(b)(10) was enacted; (2) it represented a change in Treasury position regarding the determination of whether an individual's work was "incident to" his studies; and (3) it was promulgated in response to the unfavorable Eighth

26. I.R.C. § 3121(b)(10) (2006).
27. *Mayo*, 131 S. Ct. at 709 (quoting 16 Fed. Reg. 12,453, 12,474 (Dec. 12, 1951)).
28. *Id.*
29. *Id.* (quoting SSR 78-3, 1978 WL 14050 (1978)).
30. *Id.* (citing Minnesota v. Apfel, 151 F.3d 742 (8th Cir. 1998)).
31. *Id.*
32. *Id.* at 710.
33. *Id.*
34. *Id.* at 711.

Circuit decision involving the Social Security Administration.[35] The Supreme Court, however, declined to apply *National Muffler* and thus disregarded the above factors in reaching its decision.

Instead, the Court held that "[t]he principles underlying [its] decision in *Chevron* apply with full force in the tax context."[36] Additionally, the Court struck the historical practice of providing less deference to regulations promulgated under the Treasury's general interpretative authority under 26 U.S.C. § 7805(a), holding that such regulations, like all others, are entitled to the standard of deference set out in *Chevron*.[37]

At *Chevron* step one, the Court found that the FICA statute had an unresolved statutory gap because it did not define "student" and did not otherwise attend to the precise question of whether medical residents are students.[38] The Court then found that the Treasury's construction of the enacted text was reasonable and deferred to the Treasury's full-time employee rule.[39] This demonstrates how the *Chevron* analysis is more deferential to Treasury regulations than *National Muffler*: the application of the *National Muffler* test to the same facts would have likely resulted in the opposite outcome.

Because it extends the principles of *Chevron* to the review of Treasury regulations, the *Mayo* case is an important step toward ensuring that the Treasury can effectively and efficiently administer the provisions of the Tax Code. The *Mayo* Court eliminated the consideration of the *National Muffler* factors, thereby giving the Treasury greater freedom to resolve the problems that may arise in administering the Tax Code, regardless of when or how such problems arise. That said, the application of the *Chevron* test

35. Cummings, *supra* note 23.

36. *Mayo*, 131 S. Ct. at 713.

37. *Id.* at 714. Before *Mayo*, Treasury regulations were classified as either interpretive or legislative and were given different levels of deference depending on which type they were. Bankers Life & Cas. Co. v. United States, 142 F.3d 973, 978 (7th Cir. 1998). Legislative regulations are those promulgated under specific grants from Congress to create detailed rules with respect to certain Code sections. *Id.* at 978–79. Interpretive regulations are those promulgated pursuant to Congress's general grant of authority under § 7805(a) to "prescribe all needful rules and regulations for the enforcement of [the Tax Code], including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue." I.R.C. § 7805(a) (2006). After *Mayo*, the classification no longer matters because the *Mayo* Court held that the *Chevron* analysis applies to all Treasury regulations, whether legislative or interpretive. *Mayo*, 131 S. Ct. at 713–14. However, in extending *Chevron* deference to interpretive regulations, the *Mayo* Court noted that the regulation in question had gone through notice-and-comment procedures. *Id.* at 714. There remains an open question as to whether regulations that did not go through notice-and-comment procedures are entitled to *Chevron* deference. *See infra* Part V.B.

38. *Mayo*, 131 S. Ct. at 711.

39. *Id.* at 714–16.

is anything but clear: an examination of *Chevron*'s history reveals extensive inconsistencies in the way in which it has been applied.[40] In order to fully secure the level of deference that the Treasury needs to administer the Tax Code, further clarification of *Chevron*'s application is needed.

III. OVERVIEW OF *CHEVRON* AND THE INTENTIONALIST / TEXTUALIST DEBATE

Chevron addressed whether judges or administrative agencies should have ultimate authority to interpret congressionally enacted statutes.[41] Before *Chevron*, courts reviewing agency constructions of congressional statutes treated agencies as little more than expert witnesses, deferring to them when they were persuasive and ignoring them when they were not.[42] Thus, the power to fill statutory gaps ultimately belonged to the judiciary. After *Chevron*, the judicial role in statutory construction was greatly reduced because the *Chevron* analysis required reviewing courts to completely defer to any reasonable agency construction if Congress was silent or ambiguous with respect to the precise question at issue.[43] This shift in power is important because "[j]udges are not experts in the field;"[44] administrative agencies are better equipped with the expertise necessary to formulate policies and make rules that further the goals of congressional programs.[45]

In addition, *Chevron* expanded the sphere of legitimate agency lawmaking beyond the arena of explicit congressional delegation. Before *Chevron*, agencies could only promulgate regulations if the text of the statute granted such authority. *Chevron*'s implicit delegation rationale, by contrast, assumes that Congress has granted regulatory authority where there are statutory gaps left to be filled: "'The power of an administrative agency to administer a congressionally created . . . program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress.'"[46] The implicit delegation doctrine is an important product of *Chevron* because it allows agencies to efficiently administer congressional statutes in light of the reality of

40. *See generally* Jellum, *supra* note 8 (discussing the inconsistent way in which the *Chevron* step-one analysis has been applied throughout its existence).

41. *Id.* at 728–29.

42. *Id.* at 738.

43. *Id.* at 741–42.

44. Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 865 (1984).

45. *Id.* at 865–66.

46. *Id.* at 843 (quoting Morton v. Ruiz, 415 U.S. 199, 231 (1974)). *See* Jellum, *supra* note 8, at 741–42.

imperfect congressional drafting. Thus, aside from signifying a great shift of power in favor of administrative agencies and away from the judiciary, *Chevron* resulted in the necessary expansion of legitimate administrative lawmaking.[47]

Determining whether "Congress has spoken directly to the precise question at issue" is the critical point of the *Chevron* test because it acts as a gatekeeper to the highly deferential second step, in which the reviewing court is not to disturb the validity of an agency's construction of a statute on an issue to which Congress has not spoken directly unless that construction is arbitrary in substance, capricious, or manifestly contrary to the statute.[48] If a court decides at *Chevron* step one that congressional intent is clear, then the court and the agency must give effect to the unambiguously expressed intent of Congress, and the agency has no freedom to construct its own interpretation of the statute.[49] However, if the court finds that the statute is silent or ambiguous with respect to the precise question at issue, it must defer completely to the agency's construction so long as it is reasonable, even if the court would have reached a different construction had the question initially originated in a judicial proceeding ("*Chevron* deference").[50] As a result of the significant implications surrounding *Chevron* step one, there has been much debate and confusion about exactly how courts should apply it.[51] The central issue in this debate is whether courts should look broadly to determine congressional intent or more narrowly for merely textual clarity.[52]

Intentionalists assert that legislative intent should guide the interpretation of a statute.[53] Under this approach, legislative history, purpose, and social context are all relevant in determining whether Congress has directly spoken to the precise question at issue.[54] This

47. Jellum, *supra* note 8, at 742.

48. *Chevron*, 467 U.S. at 843–44.

49. *Id.* at 842–43.

50. *Id.* at 843–44 & n.11.

51. *See* Thomas W. Merrill, *Textualism and the Future of the* Chevron *Doctrine*, 72 WASH. U. L.Q. 351, 352–53 (1994) (noting the "outpouring of commentary" regarding textualism and the *Chevron* doctrine). *See, e.g.*, Deborah A. Geier, *Commentary: Textualism and Tax Cases*, 66 TEMP. L. REV. 445, 471–72 (1993) (arguing that application of the textualist approach will decrease the frequency with which *Chevron* deference is granted, thus shifting ultimate interpretive power from the administrative agency to the judiciary); Heen, *supra* note 4, at 776; Jellum, *supra* note 8, at 727; Glen Staszewski, *Textualism and the Executive Branch*, 2009 MICH. ST. L. REV. 143, 147–48; Paul Killebrew, Note, *Where Are All the Left-Wing Textualists?*, 82 N.Y.U. L. REV. 1895, 1916 (2007).

52. Jellum, *supra* note 8, at 727.

53. *Id.* at 727–28.

54. *Id.* at 728.

approach is consistent with the original application of the *Chevron* test. In the *Chevron* opinion, Justice Stevens emphasized that step one was a search for specific congressional "intention," "[b]ased on [an] examination of the legislation *and its history*."[55]At step one, Justice Stevens considered the relevant statute's text, enactment history, and legislative history before concluding that Congress had not addressed the precise question at issue.[56]

In contrast, the textualist approach looks only to statutory language for interpretative guidance.[57] At *Chevron* step one, the entire corpus of legislative intent is gleaned solely from the actual text of the statute. Proponents of the textualist approach argue that allowing judges to use nonstatutory sources enables them to "rewrite the . . . Code to accord with the unenacted purposes of Congresses long since called home."[58]

However, the textualist approach misinterprets the nature of the inquiry as originally formulated in *Chevron* because it confuses the inquiry of whether "Congress has spoken directly to the precise question at issue" with a search for statutory clarity.[59] If Justice Stevens had originally envisioned a textualist approach to step one, he would not have considered the enactment and legislative history of the statute he was interpreting. In addition, the textualist approach is at odds with *Chevron*'s implicit delegation and agency expertise rationales because it shifts the power of statutory construction away from the agencies, which are experts in the field and are vested the power to administer the statutes, and back to the judges. It does so by giving judges the power to withhold *Chevron* deference from agencies by deciding that a statute is clear.[60] This results in

55. *Chevron*, 467 U.S. at 845 (emphasis added).

56. *Id.* at 845–64. *See also* Jellum, *supra* note 8, at 744–45.

57. Jellum, *supra* note 8, at 727.

58. K Mart Corp. v. Cartier, Inc., 486 U.S. 281, 325 (1988).

59. Jellum, *supra* note 8, at 728.

60. Killebrew, *supra* note 51, at 1916–17. It should be noted that an intentionalist approach will not always result in more deference to the Treasury relative to a textualist approach. In some circumstances, allowing judges to look more broadly to legislative history for congressional intent would actually result in the withholding of deference to agency regulations because it provides judges with more material from which to glean congressional intent. Although in these cases the intentionalist approach would appear to give the Treasury less deference than a textualist approach, such withholding of deference is acceptable because it would remain faithful to the fundamental *Chevron* principle that legislative intent should guide statutory interpretation. If the legislative history reveals expressed congressional intent that is not reflected in the statutory text, then that intent should guide the provision's application. On the other hand, a court applying a textualist approach can withhold *Chevron* deference as long as the statutory language is sufficiently clear. This poses the danger of violating the fundamental *Chevron* principle that legislative intent should guide statutory interpretation because, if indicators of congressional intent exist in the legislative history that do not appear in the text, a textualist court will not be able to give effect to that congressional will. For these reasons, the intentionalist approach is preferable, even though in some cases it may withhold deference where a

judges imposing what they believe is the single proper interpretation of a statute's words on an agency, regardless of the agency's interpretation.[61]

Despite *Chevron*'s clear intentionalist design, the Supreme Court has not consistently applied an intentionalist approach in cases following *Chevron*.[62] This trend remained undisturbed in *Mayo*. In determining that Congress had not spoken directly to whether medical residents were students under § 3121, the *Mayo* Court referred only to the statutory text of the section, noting that the text does not define the term "student."[63] Although the Court declined to explicitly rely on § 3121's legislative history or purpose at *Chevron* step one, the Court made no comment whatsoever regarding the uncertainty as to whether the nonstatutory sources could also be considered at *Chevron* step one.[64] As one commentator has noted, "*Mayo* should not be read as the last word on the use of legislative history . . . no one knows if or when the trend of not using legislative history in step one . . . will be modified."[65]

Since *Mayo*, lower courts reviewing Treasury regulations have expressed inconsistent views regarding whether to use legislative history at *Chevron* step one. For example, while one post-*Mayo* opinion notes that *Mayo* "appears to frown upon the use of legislative history at step one of a *Chevron* analysis,"[66] other opinions state that when analyzing step one, "traditional tools of statutory construction, including the statutory language *and* legislative history" should be used.[67]

Mayo's recent extension of the *Chevron* analysis to Treasury regulations, as well as its lack of guidance regarding how to apply step one, highlights the need to clarify that the *Chevron* test must be applied in an intentionalist manner, as it was originally envisioned. As explained below, this clarification carries particular importance in the tax context because of

textualist approach would not.

61. *Id.* at 1915; Geier, *supra* note 51, at 471. *See also* Merrill, *supra* note 51, at 353 (noting that *Chevron* is based on a model of courts as being faithful agents of administrative decisionmakers when no instruction from the legislature can be discerned, and that the judicial autonomy inherent in the textualist approach is at odds with the judiciary assuming the posture of agencies' faithful agents).

62. Jellum, *supra* note 8, at 728, 761; Merrill, *supra* note 51, at 354.

63. Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 711 (2011).

64. Salem, *supra* note 8, at 1329.

65. *Id.*

66. Carpenter Family Invs., LLC v. Comm'r, 136 T.C. 373, 389 (2011). *See also* Kingston Hosp. v. Sebelius, 828 F. Supp. 2d 473, 477 (N.D.N.Y. 2011) (finding that Congress was silent as to the precise question at issue without reviewing legislative history or sources outside of the statutory text).

67. Salman Ranch, Ltd. v. Comm'r, 647 F.3d 929, 937 (10th Cir. 2011) (emphasis added) (quoting Anderson v. U.S. Dep't of Labor, 422 F.3d 1155, 1180 (10th Cir. 2005)) (internal quotation marks omitted), *vacated*, 132 S. Ct. 2100 (2012).

the peculiarities of tax law that make the textualist approach especially dangerous.

IV. THE NATURE OF TAX LAW AND THE NEED FOR AN INTENTIONALIST APPROACH AT *CHEVRON* STEP ONE

The Court's implementation of the *Chevron* test effectuated a great increase in lawmaking and interpretive power for administrative agencies. Indeed, the *Chevron* Court established the principle that agencies should be able to utilize their expertise in order to efficiently "resolv[e] . . . competing interests which Congress itself either inadvertently did not resolve, or intentionally left to be resolved . . . in light of everyday realities."[68] In determining that the *Chevron* test is the correct standard of review for Treasury regulations, the *Mayo* Court reemphasized this basic principle:

> Filling gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation . . . . "[I]n an area as complex as the tax system, the agency Congress vests with administrative responsibility must be able to exercise its authority to meet changing conditions and new problems."[69]

However, because of the particular complexity of the Tax Code, the highly specialized nature of tax vocabulary, the inability of Congress to carry out perfect drafting, and the historical practice of creating and relying on extra-statutory doctrine, the Treasury will not be able to fully exercise its authority under the principles of *Chevron* unless it is applied in an intentionalist manner as it was originally formulated. This means that reviewing courts must consider legislative history and other sources outside of the text of the applicable tax provision when determining whether a Treasury regulation deserves *Chevron* deference—that is, determining whether "Congress has directly spoken to the precise question at issue."[70]

68. Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 865–66 (1984).

69. Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 713 (2011) (quoting Bob Jones Univ. v. United States, 461 U.S. 574, 596 (1983)).

70. *Chevron*, 467 U.S. at 842. There has been much discussion about whether legislative history should be used in traditional statutory construction cases that deal with the struggle of power between the legislature and judiciary. *See, e.g.*, Michael A. Livingston, *Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes*, 69 TEX. L. REV. 819 (1991); Lawrence Zelenak, *Thinking About Nonliteral Interpretations of the Internal Revenue Code*, 64 N.C. L. REV. 623 (1986). This Note discusses this debate in the specific context of the *Chevron* step-one analysis in light of *Mayo*'s extension of the *Chevron* analysis to the review of Treasury regulations, which deals with the struggle of power between administrative agencies and the courts.

A. HIGH LEVEL OF INTERACTION AMONG THE COMPLEX PROVISIONS OF THE CODE

The need to apply an intentionalist approach when reviewing Treasury regulations at *Chevron* step one is particularly important because of the Tax Code's highly detailed and technical nature. Numbering more than 3000 pages, the body of tax law is vast—commonly published in several volumes, along with additional volumes of Treasury regulations.[71] Despite the sheer number of provisions, however, the Tax Code represents a unified system with broad objectives, not a series of unrelated enactments. As a result, there is a high level of interaction between the provisions. Indeed, one commentator has noted that "[w]hat makes tax law so complex . . . is not as much the number of provisions as the maddening way in which the provisions overlap, intersect, and occasionally even contradict each other within a transaction."[72] Nevertheless, the intricate complexity of the Tax Code is necessary to effectuate the overall policy goals of the tax system; each individual tax provision plays a distinct but important role in implementing a sensible tax regime.

Because of the marked interconnection between the many provisions in the Tax Code, it is necessary to view a single provision in light of its role within the body of tax law in order to fully understand the scope of its intended application. Often this will require consideration of sources other than the text of the provision, such as legislative history, as well as consideration of the provision's relation to other provisions. The Supreme Court recognized this necessity in *Commissioner v. Engle*,[73] in which it stated, "We have noted that 'the true meaning of a single section of a statute in a setting as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related sections, or if the mind be isolated from the history of the income tax legislation of which it is an integral part.'"[74] Thus, if a statutory gap left by Congress leaves unresolved questions, the Treasury must look outside the text of the particular tax provision in order to promulgate the necessary gap-filling regulations consistent with the intent of Congress as well as with the general structure and policy goals of the Tax Code.

In the same vein, a court reviewing a Treasury regulation must apply

71. Livingston, *supra* note 70, at 827.

72. *Id.*

73. Comm'r v. Engle, 464 U.S. 206 (1984).

74. *Id.* at 223 (quoting Helvering v. Morgan's Inc., 293 U.S. 121, 126 (1934)). *See also* Zelenak, *supra* note 70, at 638.

an intentionalist approach at step one of the *Chevron* test in order to determine the intended scope of a tax provision's application: the court must look outside the text of a tax provision in order to determine whether Congress has addressed the specific question at issue. While the literal reading of a tax provision, divorced from its context, might suggest a clear congressional intent to apply it in a certain manner, a closer examination of the purpose of the provision and the role it plays in the overall tax regime could bring to light a genuine need for regulatory clarification by the Treasury.[75] "[A] detailed statute may require a more contextual approach to interpretation, because the apparent meaning of one provision may be inconsistent with the overall statutory structure."[76]

B. Highly Specialized Nature of Tax Vocabulary

In addition to the uniquely interconnected nature of the many tax provisions, the Tax Code is largely self-contained with highly specialized vocabulary. "[T]he complexity and technicality of the Code's concepts often make it difficult for Congress to find words that, used in 'ordinary, everyday senses,' clearly convey the intended meaning."[77] As a result, definitions of many terms within the Tax Code often bear little to no resemblance to their definitions in everyday life.[78] For example, while the term "basis" for tax purposes roughly refers to the cost of an asset adjusted for depreciation and other expenses,[79] one dictionary defines "basis" as "the underlying support or foundation for an idea, argument, or process."[80] This definition is essentially useless for tax purposes. Similarly, the terms "realization" and "recognition" have highly specialized meanings for income tax purposes, neither of which is entirely consistent with their nontax definitions. Because the specialized terms are not defined in every provision in which they appear, other code sections or legislative materials must be looked at in order to correctly understand the provisions.

If a reviewing court applies a textualist approach at *Chevron* step one, it will not look to nonstatutory sources and will thus be unable to afford specialized terms their tax-specific meanings. This is likely to result in the court's misunderstanding of congressional intent and inability to discern

75. *See infra* Parts IV.B.1 and IV.B.2.
76. Livingston, *supra* note 70, at 827–28.
77. Zelenak, *supra* note 70, at 639.
78. Livingston, *supra* note 70, at 828.
79. *Id.*
80. *Basis Definition*, OXFORDDICTIONARIES.COM, http://oxforddictionaries.com/definition/english/basis (last visited Oct. 31, 2012).

whether Treasury clarification is appropriate. On the other hand, a reviewing court applying an intentionalist approach may consider all statutory and nonstatutory sources necessary to fully understand any specialized language, and thus will be able to more accurately discern how Congress intended a statute to apply.

C. THE CODE HAS HISTORICALLY BEEN APPLIED AND UNDERSTOOD IN A HIGHLY CONTEXTUAL MANNER

Another especially compelling reason an intentionalist approach needs to be applied at *Chevron* step one in the tax context is the highly contextual manner in which the Tax Code has historically been applied and understood. For most of the Code's century-old existence, federal courts have been willing to at least consider legislative history when interpreting it.[81] As a result, contextual statutory interpretations occur with unusual frequency in tax law.[82] One reason for this is that the incredible complexity and technicality of the Tax Code presents "an unusual number of situations in which the adequacy of language is challenged."[83] In addition, a heavy layer of underlying structure and pervading policy exists behind the Tax Code's statutory text, both of which are helpful when interpreting the Code's difficult provisions.[84] In many cases, courts have relied exclusively on structure and policy to create extra-statutory doctrine that, although have no basis in the statutory text, are relied upon as having the force of law.[85]

One example of this phenomenon is the "continuity of interest" requirement for tax-free corporate reorganizations. Tax-free reorganizations were originally introduced to encourage economically prudent corporate mergers or business combinations that might be impeded by the negative tax consequences that would result for the corporation's shareholders.[86] In a tax-free reorganization, shareholders receive the benefit of nonrecognition under the assumption that the reorganization exchange is merely on paper, and that the shareholders' interests in the reorganized corporation are a continuation of the shareholders' interests in the old corporation.[87]

81. Livingston, *supra* note 70, at 849.

82. John F. Coverdale, *Text as Limit: A Plea for a Decent Respect for the Tax Code*, 71 TUL. L. REV. 1501, 1504 & n.12 (1997). *See* Zelenak, *supra* note 70, at 638–39.

83. Zelenak, *supra* note 70, at 639.

84. *Id.*

85. See *infra* Part VI.A.

86. Meredith R. Conway, *With or Without You: Debt and Equity and Continuity of Interest*, 15 STAN. J.L. BUS. & FIN. 261, 264–65 (2010).

87. *Id.*

Continuity of interest is a judicially created requirement that the shareholders of a target corporation retain a continuing proprietary interest in the resulting corporation in order to obtain the benefit of nonrecognition.[88] Courts developed this requirement in order to ensure that tax-free treatment is limited to exchanges in which the shareholders continue their ownership interest in the resulting corporation.[89] In addition, the courts wanted to prevent taxpayers from converting a cash sale of a corporation into a tax-free transaction by taking advantage of the loopholes in the reorganization provisions.[90]

Since its original inception in 1932, the continuity-of-interest doctrine has been largely developed and expanded by the courts.[91] In its early existence, courts did not provide any clear guidance on how to meet the continuity requirement; however, subsequent decisions have refined the requirement. For example, the courts have established that security instruments received in a reorganization exchange do not count toward meeting the continuity requirement.[92] In addition, the courts have established that if around 40 percent of the consideration received by the shareholders is in the form of an equity interest, the requirement is satisfied.[93] Although Treasury regulations included the requirement initially in 1955, and then in significant detail in 1998, Congress never codified the continuity-of-interest doctrine.[94]

The existence of a judicially created doctrine that carries the force of law even though it has no basis in the statutory text, such as the continuity-of-interest requirement, makes the application of an intentionalist approach at *Chevron* step one especially important in the tax context. If the Treasury regulation containing the continuity-of-interest doctrine were under review today, only a court applying an intentionalist approach would be able to inform itself of the seventy-nine years of federal cases that have explained and developed the requirement. A court applying a textualist approach would be limited to the statutory text and would have to find that, because there is no basis for the continuity-of-interest requirement in the Code, such a requirement does not exist. This result would be in error because it ignores the existence of a well-established doctrine that is necessary to

88. *Id.* at 265.

89. *Id.* at 264–65.

90. *Id.* at 265–66.

91. *Id.* at 272. *See also* Cortland Specialty Co. v. Comm'r, 60 F.2d 937 (1932).

92. Helvering v. Minn. Tea Co., 296 U.S. 378, 384–85 (1935); John A. Nelson Co. v. Helvering, 296 U.S 374, 377 (1935); Pinnellas Ice & Cold Storage Co. v. Comm'r, 287 U.S. 462, 470 (1933).

93. Conway, *supra* note 86, at 298.

94. *Id.* at 265, 272. *See* Treas. Reg. § 1.368-1(e)(i) (1956).

prevent taxpayer arbitrage and has been applied and relied upon by tax professionals for almost eighty years.

D. CONGRESS CANNOT BE EXPECTED TO PREDICT ALL POSSIBLE CONTINGENCIES

The fourth characteristic of tax legislation that highlights the need to apply an intentionalist approach at *Chevron* step one is the inability of Congress to include in the statute every possible contingency, especially those that are improbable or occur infrequently, including an improbable interaction between two seemingly unrelated Tax Code provisions.[95] Because the Tax Code is already immensely long and complex, Congress has an incentive to enact statutes that are as simple and concise as possible. In addition, Congress cannot be expected to anticipate and include in the statutory language a comprehensive list of all possible scenarios to which a statute could apply. If an infrequent or improbable situation should arise, the Treasury needs the authority to fill statutory gaps consistent with the intent of Congress and the underlying purpose of the applicable statute(s). This principle was established almost thirty years ago by the Supreme Court in *Bob Jones University v. United States*,[96] in which the Court stated,

> [S]ince the inception of the Tax Code, Congress has seen fit to vest in those administering the tax laws very broad authority to interpret those laws. . . .
>
> . . . Since Congress cannot be expected to anticipate every conceivable problem that can arise or to carry out day-to-day oversight, it relies on the administrators . . . to implement the legislative will.[97]

In *Chevron* the Supreme Court alluded to this principle as a reason to shift gap-filling power in favor of administrative agencies. The Court noted that the agencies should have the authority to "resolv[e] . . . competing interests which Congress itself . . . inadvertently did not resolve . . . in light of everyday realities."[98] The *Mayo* Court again alluded to this principle in extending the *Chevron* analysis to Treasury regulations, noting that the Treasury must be able to formulate policy and make rules to "exercise its authority to meet changing conditions and new problems."[99]

95. As explained in Part IV.A., Tax Code provisions are highly intertwined. In some cases, new facts may implicate two conflicting Code sections. *See infra* Part VI.B.1.

96. Bob Jones Univ. v. United States, 461 U.S. 574 (1983).

97. *Id.* at 596–97.

98. Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 865–66 (1984).

99. Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 713 (2011) (quoting *Bob Jones*, 461 U.S. at 596) (internal quotation marks omitted).

Proponents of the textualist approach argue that textualist judges are enthusiastic supporters of broad agency authority.[100] They say that "textualism combined with *Chevron* will necessarily result in a 'dramatic increase in the executive's power to make law' at the expense of the . . . judicial branch[],"[101] because prohibiting judges from considering sources outside of the statutory text gives them less material from which to find a clear expression of congressional will, and will thus require judges to defer to the agencies more often than an intentionalist approach would. This evokes a "humble, subservient role for the judiciary."[102] However, the reality is that in many cases, a textualist approach at *Chevron* step one will withhold deference from the Treasury where an intentionalist would correctly find that statutory clarification is needed.[103]

For example, a textualist approach is likely to mistake an inadvertent congressional omission for clear congressional intent, thus barring deference to a Treasury regulation that is in fact necessary to remedy the omission's unintended consequences.[104] In addition, limiting the step one inquiry to the text of a particular provision is unlikely to identify the need for Treasury clarification where the literal application of one provision results in consequences that affect or conflict with another code provision in an unintended manner. Treasury authority is important in these cases because the literal application of a provision to unanticipated facts leads to a result that is inconsistent with general policy and understanding of the Tax Code.[105]

While the textualist approach runs the risk of not adhering to the principle of broad agency authority established in *Bob Jones University*, a court applying an intentionalist approach does not run the risk of inappropriately withholding deference to necessary Treasury regulations. This is because it can perform an exhaustive search of statutory and nonstatutory sources and will be able to identify when a literal reading of statutory language has unintended results. As explained above, a textualist court will likely fail to identify such cases.

100. Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405, 430 n.91, 448 n.151 (1989).

101. Geier, *supra* note 51, at 457 (quoting Sunstein, *supra* note 100, at 430 n.91).

102. *Id.* at 458.

103. *See generally id*.

104. *See infra* Parts V.A, V.B.1, and V.B.2.

105. For examples of this phenomena, see *infra* Parts V.A, V.B.1, and V.B.2.

E. ADDITIONAL FACTORS SUPPORTING THE EXTENSION OF *CHEVRON* DEFERENCE TO TREASURY REGULATIONS

As discussed above, the Tax Code is highly complex and interconnected, has specialized vocabulary, applies to infinitely varied facts that cannot all be anticipated by Congress, and has historically been applied and understood in a largely contextual manner. These characteristics demonstrate the particular necessity of an intentionalist approach at *Chevron* step one in the tax context. This section offers additional reasons showing why the Treasury deserves the authority to fill any statutory gap that Congress has left behind.

1. The External Force of Congressional Budget Constraints

Applying a textualist approach at step one of the *Chevron* test can strip the Treasury of the authority it needs to efficiently administer the complex provisions of the Tax Code consistent with congressional intent in light of imperfect congressional drafting. One commentator has noted that Congress revises the Tax Code on a regular basis, "making tax legislation typically an annual or biennial affair."[106] Given the frequency of congressional revisions, one might wonder why Treasury regulatory authority is so important; why not leave it up to Congress to remedy a statute's unintended results when an unanticipated problem arises? As noted above, it is unrealistic to expect Congress to include a detailed application of a statute to every possible fact pattern within the text of the statute; Congress cannot enact new legislation to correct the unintended results of every individual case. However, even with respect to those unanticipated problems that have widespread consequences among many taxpayers (for which there might appear to be a simple congressional fix), budget constraints can disincentivize congressional action when such action is in taxpayers' favor.

When enacting new tax legislation, Congress is constrained by revenue targets established by the Budget Concurrent Resolutions.[107] For any proposed tax legislation, the Joint Committee on Taxation must provide Congress with an estimated effect on the amount of revenue that the Treasury would bring in if there were no changes to the current tax code.[108] In order to stay within the assigned revenue targets, the internal

106. Livingston, *supra* note 70, at 827.

107. Edward D. Kleinbard, *Tax Expenditure Framework Legislation: America's Looming Fiscal Crisis*, 63 NAT'L TAX J. 353, 359–60 (2010).

108. For details, see JOINT COMM. ON TAXATION, OVERVIEW OF REVENUE ESTIMATING

framework statute of the House and the Senate (called "PAYGO rules") generally requires that any tax legislation estimated to result in a net cost be "paid for" through offsetting revenue increases.[109] In other words, the PAYGO rules require that a proposed tax decrease be offset by a tax increase elsewhere.[110] This amounts to an external force that influences Congress against enacting legislation in taxpayers' favor, because such legislation reduces tax revenue and must be paid for elsewhere by another change in the Tax Code. Unless there is a readily available revenue-increasing tax change to offset the costs of the proposed legislation, Congress cannot freely correct prior legislative shortcomings whenever new and unanticipated facts bring them to light. This highlights the importance of protecting Treasury authority to promulgate statutory clarifications, particularly when such clarifications are in taxpayers' favor; while external pressures disincentivize taxpayer-favorable congressional legislation, the Treasury is not so constrained.

It could be argued that giving the Treasury an excessive leash may undercut the budget process and lead to deficits. However, the application of an intentionalist approach merely gives the Treasury the authority to take action when the baseline figure for tax revenue is unfairly inflated due to the incorrect application of a tax provision caused by new conditions unanticipated by Congress. Any unnecessary external constraints limiting either Congress's or the Treasury's ability to provide the clarification necessary to restore a provision's fidelity to the general policy and structure of the Code is improper; Congress should be allowed more flexibility in deciding how to offset the possible net costs associated with necessary clarifications to mitigate the effect of the PAYGO constraints.[111] Until such a change is made to the internal framework statute, an unnecessary external constraint exists for Congress, but not for the Treasury, and the need for deference to Treasury regulations is heightened.

PROCEDURES AND METHODOLOGIES USED BY THE STAFF OF THE JOINT COMMITTEE ON TAXATION (JCX-1-05) (2005), *available at* http://www.house.gov/jct/x-1-05.pdf; EDWARD D. KLEINBARD, JOINT COMM. ON TAXATION, INSIDE THE JCT REVENUE ESTIMATING PROCESS 3, (2008), *available at* http://www.house.gov/jct/Inside_Revenue_Estimating.pdf.

109. Kleinbard, *supra* note 107, at 361.

110. *Id.* at 362.

111. Even if Treasury regulations were also subject to the PAYGO requirements, my recommendation would be to exempt Treasury clarifications of unfair or unintended applications of tax provisions from the PAYGO requirements, and to amend the internal framework statute of the House and Senate so that the consideration of proposed tax revenue changes are more integrated with the consideration of other programs that could affect the budget. This would allow Congress and the Treasury more flexibility to offset the possible net costs associated with clarifications that are necessary to ensure the fair treatment of taxpayers. *See generally* Kleinbard, *supra* note 107 (suggesting that tax expenditures should be brought more directly into the federal budget-setting process).

2. The Openness of the Regulatory Process

An additional reason why Treasury regulations deserve true *Chevron* deference (which, as explained above, can be realized only by applying an intentionalist step one approach), is the unique openness and added layer of public review of proposed regulations. The Treasury utilizes three main methods of interpreting the Code: regulations, revenue rulings, and private letter rulings.[112] Unlike revenue rulings and private letter rulings, Treasury regulations are subject to the requirements of notice and public comment.[113] This is mainly because, while the revenue rulings and letter rulings do not have broad application, regulations are rules with full legal effect and can create new legal duties which are binding on parties and the courts.[114] While the Administrative Procedure Act ("APA") only requires notice and comment procedures for "legislative" regulations—that is, regulations promulgated pursuant to a specific congressional delegation under a particular Code section (5 U.S.C. § 553(b)(A))—the Treasury follows notice and comment procedures similar to those of the APA when issuing interpretive regulations, which are issued pursuant to the general grant of authority under § 7805(a).[115] Thus, as a general matter, all Treasury Regulations go through the notice and comment procedures before they are finalized.[116]

In order to give the public notice of any proposed rulemaking, Treasury Regulations must be published in the Federal Register at least thirty days before they take effect.[117] After being published in the Federal

112. Bankers Life & Cas. Co. v. United States, 142 F.3d 973, 978 (7th Cir. 1998). For a detailed explanation of all of the different types of guidance issued by the IRS, see Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View from Within*, 46 DUQ. L. REV. 323 (2008).

113. MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶ 3.02[2] (2nd ed. 2009).

114. *Bankers Life*, 142 F.3d at 978–79.

115. *Id.* at 978; First Chi. NBD Corp. v. Comm'r, 135 F.3d 457, 459 (7th Cir. 1998); Korb, *supra* note 112, at 327 n.7.

116. In *Mayo*, the Court noted that the regulation in question had gone though the notice and comment procedures. Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 714 (2011); Steve R. Johnson, Mayo *and the Future of Tax Regulations*, 130 TAX NOTES 1547, 1554 (2011). One commentator has stated that *Mayo* left an open question as to how the APA applies to Treasury rulemaking, and whether APA noncompliance should be considered before the *Chevron* deference analysis. Jeremiah Coder, *The State of Tax Guidance After* Mayo, 130 TAX NOTES 615, 617 (2011). He notes that the Treasury would have a stronger case for deference if interpretive regulations were also subject to APA requirements. *Id.* Because the Treasury generally subjects all regulations, whether legislative or interpretive, to notice and comment procedures according to, or similar to, the APA, the argument for *Chevron* deference still carries weight. *Id.*

117. Saltzman, *supra* note 113, at ¶ 3.02[3]. An additional safeguard of public notice is provided by I.R.C. § 7805(b), which states that no regulation may apply to any taxable period ending before the

Register, interested persons are given the chance to offer any views, data, or arguments with respect to the regulation.[118] If a public hearing is announced, they may also give oral comments at the hearing, provided that they submit an outline of the topics they want to discuss and the time they will devote to each topic within the time limit prescribed in the notice.[119] In addition, the Service solicits comments from the Small Business Administration about the impact of the proposed regulations on small businesses.[120] These procedures add an extra level of public review and scrutiny of proposed regulations that is not required for other types of guidance. Because this added layer of review helps to ensure that the Treasury carefully considers the effects of proposed regulations before applying them to taxpayers, the argument for *Chevron* deference for Treasury regulations in particular is a forceful one.

V. HEDGING, OID, AND MARKET DISCOUNT EXAMPLES

The following section aims to apply the above principles to actual tax provisions in order to provide concrete examples of the potential dangers of a textualist *Chevron* step one approach, as well as to demonstrate the necessity of an intentionalist step one approach. The first example applies the opposing analytical structures to a past scenario where the Treasury promulgated a regulation that was later ratified by Congress. Next, each approach is applied to two current sets of tax rules whose legislative histories indicate a need for Treasury remedying, though such need may not be clear from the face of the statutes.

A. A PAST EXAMPLE: THE HEDGING EXCEPTION TO THE DEFINITION OF CAPITAL ASSETS

Pursuant to its authority under § 7805(a),[121] the Treasury issued a regulation in 1994 that addressed the tax treatment of investment hedges

earliest of (1) the date on which the regulation is filed with the Federal Register, (2) in the case of a final regulation, the date on which a related proposed or temporary regulation was filed in the Federal Register, or (3) the date on which a notice that substantially described the regulation was made public. Where regulations amend existing regulations in a way that adversely affects taxpayers, the Treasury usually delays the effective date of the regulations beyond the thirty-day period. I.R.C. § 7805(b) (2006); Saltzman, *supra* note 113, at ¶ 3.02[3].

118. I.R.C. § 7805(f) (2006).

119. Saltzman, *supra* note 113, at ¶ 3.02[3] n.18 (citing 26 C.F.R. § 601.601(a)(3)(iii) (2012)).

120. I.R.C. § 7805(f) (2006).

121. I.R.C. § 7805(a) gives the Treasury the authority to "prescribe all needful rules and regulations for the enforcement of [the Code], including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue." *Id.* § 7805(a) (2006).

and aimed to resolve confusion about whether gains and losses from certain hedging transactions should be characterized as ordinary or capital.[122] Regulation 1.1221-2 provided that gain or loss from hedging transactions (as defined by the regulation) were to be characterized as ordinary. It aimed to include any hedging transaction entered into in the normal course of a taxpayer's trade or business primarily to insulate the taxpayer from the price fluctuations of ordinary assets used in such trade or business's everyday operation.[123] The regulation amounted to an extra-statutory exception to the Tax Code's definition of capital assets in the 1994 version of I.R.C. § 1221.[124]

The extra-statutory exception that characterized as ordinary those gains or losses resulting from the sale of hedging assets held as an integral part of a taxpayer's business was in fact established in a 1955 case, *Corn Products Refining Co. v. Commissioner*,[125] almost forty years prior to the Treasury regulation. Shortly after, in 1958, the Service formally recognized the *Corn Products* exception by holding that gains or losses from the sale of otherwise capital assets would be ordinary if they arose out of the everyday operation of a taxpayer's business.[126] For more than three decades, the courts, taxpayers, and Service all recognized the *Corn Products* exception: "the overwhelming consensus among tax professionals and the Service was that the scope of [§] 1221's definition of 'capital asset' was limited by an extra-statutory exception for assets used in the everyday operation of a taxpayer's business."[127] Like the continuity-of-interest doctrine explained in Part IV.C., the exception was given the force of law even though it existed nowhere in the language of the Tax Code.

Despite having been relied on by tax professionals for over thirty years, the Supreme Court abandoned the extra-statutory hedging exception in 1988 in *Arkansas Best v. Commissioner*.[128] In an attempt to exclude from

122. Treas. Reg. § 1.1221-2 (1994).

123. *Id.* The regulation defined hedging transactions as one "that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily—(i) To reduce risk of interest rate or price changes or currency fluctuations with respect to ordinary property . . . that is held or to be held by the taxpayer; or (ii) To reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred by the taxpayer." *Id.*

124. *Id*.; I.R.C. § 1221 (1994) (amended 1999).

125. Corn Prods. Ref. Co. v. Comm'r, 350 U.S. 46 (1955), *aff'g* 215 F.2d 513 (2d Cir. 1954). *See also* Edward D. Kleinbard & Suzanne F. Greenberg, *Business Hedges After* Arkansas Best, 43 TAX L. REV. 393, 409–10 (1988).

126. Rev. Rul. 58-40, 1958-1 C.B. 275; Kleinbard & Greenberg, *supra* note 125, at 411.

127. Kleinbard & Greenberg, *supra* note 125, at 411. *See also id*. at 393 (referring to the exception as "30 years of settled administration of the tax consequences of . . . hedging transactions").

128. Ark. Best Corp. v. Comm'r, 485 U.S. 212 (1988); Kleinbard & Greenberg, *supra* note 125, at

ordinary treatment assets that were not true hedging assets used in the ordinary course of business as was envisioned by the Supreme Court in *Corn Products*, such as the corporate-owned stock of a corporation's subsidiary, the *Arkansas Best* Court read the *Corn Products* decision as falling within the literal reading of the statutory inventory exception in § 1221(1), thereby denying that the extra-statutory *Corn Products* doctrine had ever existed.[129] Following *Arkansas Best*, the treatment of hedging transactions involving assets used in the ordinary course of business became unclear. Thus, although there was no statutory basis for Regulation 1.1221-2's hedging exception to the definition of capital assets, the regulation was necessary to bring the application of I.R.C. § 1221 in line with a settled understanding of tax law that had been accepted and relied on for over three decades.

In order to fully appreciate the error of a literal reading of the 1994 version of § 1221, one must understand the nature and purpose of the hedging transactions described in Regulation 1.1221-2. A business taxpayer enters into hedging transactions to reduce its economic exposure to price fluctuations beyond its control, so that the economic results of the taxpayer's business accurately reflect the business's yearly performance, rather than the effect of external price fluctuations.[130] A business taxpayer hedges by taking simultaneous "long" (holding property) and "short" (owing property) positions in the same property in order to create an equal but offsetting risk to its underlying exposure to market fluctuations in the property.[131] The taxpayer is insulated from the effect of market changes on the price of property because a loss due to its underlying exposure will be matched by the gain on its hedge, and vice versa.[132]

For example, a corn producer may wish to protect the profit margins of its product sales by hedging against market fluctuations in the price of corn. If the producer finds itself with surplus corn ("long"), it can protect against an interim corn price decline by entering into a contract to sell the corn on a future date at a predetermined price ("going short"). If the corn's price in fact declines, the producer can close out the contract at a gain that offsets the loss on the actual sale of its surplus corn or, alternatively, it can deliver the corn for the predetermined above-market price. If the price of corn instead rises, the producer can close out the contract at a loss that

393.

129. *Ark. Best*, 485 U.S. at 220; Kleinbard & Greenberg, *supra* note 125, at 415, 417.

130. Kleinbard & Greenberg, *supra* note 125, at 393.

131. *Id.* at 394.

132. *Id.*

reduces its increased profit on the sale of its surplus corn at the higher market price. Thus, the producer can maintain a balanced market position regardless of the inevitable market fluctuations in the price of corn.[133]

If the price of corn increased in the above example, a literal application of § 1221 in 1994 would treat the loss on the futures contract as a capital loss because, at the time, futures contracts related to the hedging of ordinary assets were not listed in any of the exceptions to capital assets.[134] Meanwhile, the gain resulting from the sale of surplus corn would be treated as an ordinary gain because the corn would fall under the § 1221(1) "stock in trade" exception to capital assets.[135] This result was unintended by Congress, since the hedging of assets used in the ordinary course of business is part of the everyday operation of a business,[136] and Congress "intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss."[137] As the Court of Appeals of the Second Circuit noted, the hedging of ordinary assets is "part of the inventory purchase system which is utilized solely for the purpose of stabilizing inventory cost" and is "an integral part of the productive process in which property is held not for investment but for the protection of profit with the intent of disposition when that purpose has been achieved."[138]

In addition, the taxpayer would be subject to an unfair tax "whipsaw" because it would be unable to offset the ordinary income from the sale of surplus corn with the capital loss from the futures contract. The taxpayer is

133. *Id.* at 394–95.

134. *See* I.R.C. § 1221 (1994) (amended 1999). Capital assets are defined as any property that does not fall into one of the listed exceptions. *See id.* Gain or loss from the sale or exchange of property that falls into one of the § 1221 exceptions is ordinary in character because it is gain or loss from property that is not a capital asset. *Id.* §§ 64, 65, 1221.

135. *Id.* § 1221(1).

136. There are considerable tax consequences to characterizing gain or loss as either ordinary or capital. While ordinary gains are taxed on a progressive rate schedule peaking at around 40 percent (or, for corporate taxpayers, at a rate of 35 percent), capital gains (with a few exclusions) are generally taxed a flat rate of 15 percent. *See id.* § 1 (2006). In addition, capital losses can only be used to offset capital gains and cannot be used to offset ordinary income (beyond a three thousand allowance for taxpayers other than a corporation). *Id.* § 1211.

137. Corn Prods. Ref. Co. v. Comm'r, 350 U.S. 46, 52 (1955), *aff'g* 215 F.2d 513 (2d Cir. 1954). The case discusses I.R.C. § 117, which was the precursor to § 1221. The original formulation of the definition of a capital asset was in § 206 of the Revenue Act of 1921. Revenue Act of 1921, ch. 136, 42 Stat. 227 (1921) (codified as amended I.R.C. § 1221 (2006)). *See* H.R. REP. NO. 67-350, at 10–11 (1921) (noting that the purpose of taxing capital gains at lower rates was to relieve taxpayers of excessive tax burdens on gains resulting from the conversion of capital assets, suggesting that gains from the use of futures contracts to stabilize the inventory costs of ordinary assets was not intended to be within the scope of capital gains).

138. *Corn Prods.*, 215 F.2d at 515.

left with taxable ordinary income, and a capital loss which can only be used to offset other capital income—capital income that the taxpayer may or may not have.[139] Even if the taxpayer does have other capital income to make use of its losses from the futures contract, capital gains are taxed at a lower rate than ordinary income;[140] the value of offsetting other capital income is less than that of offsetting the ordinary income from the sale of the surplus corn. Thus, a literal reading of § 1221 in 1994 would defeat the taxpayer's hedging effect to the extent of the unfavorable tax consequences resulting from the nonconforming tax treatment of the taxpayer's long and short positions. Treasury Regulation 1.1221-2 remedied this problem by characterizing losses and gains from hedging transactions as ordinary.

In summary, *Arkansas Best*'s explicit denial of the extra-statutory hedging exception established in *Corn Products* put over thirty years of settled law into question. This caused great uncertainty in the tax treatment of hedging assets among tax professionals, and created a genuine need for Treasury clarification. Also, the pre-1.1221-2 literal application of § 1221 to hedging transactions resulted in an outcome at odds with general tax policy because it subjected taxpayers to an unintended tax whipsaw, and failed to characterize as ordinary the profits and losses from hedging transactions entered into in the ordinary course of business. As a testament to the fact that the *Corn Products* doctrine had indeed existed, Congress later ratified the regulation by amending the text of § 1221 to include a hedging exception to capital assets.[141]

The fact that Congress did not enact corrective legislation until after the Treasury promulgated 1.1221-2 suggests that congressional budget constraints limited its ability to enact a statutory hedging exception on its own. Once the Treasury promulgated Regulation 1.1221-2, it became part of the current law against which new congressional legislation was to be measured; Congress was no longer forced to score the addition of a hedging exception as a revenue loss, and thus no longer needed to offset it with a tax increase. As a result, Congress did not amend § 1221 to include a hedging exception until after the regulation. This demonstrates the importance of Treasury authority to clarify unintended results when such clarification is in taxpayers' favor because once a corrective regulation exists, the influence of congressional budget restraints on amending statutory language is removed.

139. I.R.C. § 1211 (2006).

140. *Id.* § 1(h)(8).

141. Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, § 532, 113 Stat. 1860, 1928–30 (1999) (codified as amended I.R.C. § 1221(a)(7)).

If Treasury Regulation 1.1221-2 were under judicial review today, only a court applying an intentionalist approach at *Chevron* step one would correctly defer to the Treasury's construction of § 1221. A court applying an intentionalist approach at *Chevron* step one would be able to consider the thirty years of hedging rulings—all of which relied on and confirmed the existence of the extra-statutory hedging exception—and find that *Arkansas Best* raised a need for Treasury clarification to restore certainty in the tax treatment of inventory-related hedging transactions.

It would also see from the legislative history of Section 206 of the Revenue Act of 1921, the original formulation of the definition of a capital asset, that that the literal application of § 1221 would be inconsistent with congressional intent.[142] It would thus find that Congress did not address the precise question of whether hedging transactions used solely to stabilize inventory costs as part of the everyday operation of a taxpayer's business and not for investment purposes should be characterized as capital or ordinary. Accordingly, an intentionalist court would have correctly identified the need for Treasury clarification and would have granted the Treasury the deference that it deserved.

On the other hand, a court applying a textualist approach to the 1994 version of § 1221 would not acknowledge the existence of great confusion resulting from *Arkansas Best* and the thirty years of settled law that the case put into question. Instead, it would conclude from the apparent statutory clarity that Congress did not intend for there to be a hedging exception to the definition of capital assets. As explained above, this would be in error, and would inappropriately strip the Treasury of the authority that it needs to remedy a problem that Congress did not anticipate when it created the definition of a capital asset.

B. CURRENT EXAMPLES: THE ORIGINAL ISSUE DISCOUNT AND MARKET DISCOUNT RULES

I now turn to two areas of the Tax Code that are in current need of Treasury remedy: First the taxation of distressed debt under the original issue discount rules. Second, the requirements of the market discount rules when applied to distressed debt instruments. My goal is to again demonstrate the undesirable effects of applying a textualist approach at *Chevron* step one, as well as the necessity of applying an intentionalist approach at *Chevron* step one, particularly in the tax context. In addition,

142. *See Corn Prods.*, 350 U.S. at 52; H.R. REP. NO. 67-350, at 10–11 (1921).

my intention is to reiterate the need for Treasury clarification of these rules, and to show why the Treasury has the authority to take action pursuant to the original principles of *Chevron*. It should be noted that the clarifications explained below are needed to save taxpayers from the unjustified imposition of tax liability and will thus decrease Treasury revenue. As discussed above, in Part IV.A., this highlights the importance of Treasury authority, because budget constraints limit Congress's ability to amend the statutory language.

In addition, these issues are especially relevant in light of the current financial crisis because one of the major resulting changes to the capital markets is "the emergence of distressed debt as a significant investment class. . . . [T]he breadth and variety of distressed debt investments in the current marketplace is unprecedented."[143] As explained below, a court's method of applying step one of the *Chevron* test has great bearing on the ability of the Treasury to fix the unanticipated problems related to the financial crisis, such as the original issue discount and market discount rules as applied to distressed debt instruments.

1. Application of Original Issue Discount Rules to Distressed Debt

The original issue discount ("OID") rules apply to certain bonds whose stated redemption price at maturity is higher than the bond's issue price.[144] Subject to a de minimis exception, the amount of OID on a bond is equal to the excess of the stated redemption price at maturity over the issue price.[145] A holder of a debt instrument with OID must include the OID income on a daily basis, as it accrues, based on a constant interest rate to maturity.[146] To prevent the double taxation of a taxpayer on the amount of OID, the taxpayer's basis in the OID bond is increased by the amount included in gross income under the OID rules.[147] The premise of the OID rules is to treat OID for tax purposes as the equivalent of interest on a nondiscount bond requiring current interest payments—that is, to treat the OID as compensation for the bond issuer's use of the bondholder's money over time.[148]

143. David C. Garlock, *How to Account for Distressed Debt*, 127 TAX NOTES 999, 999 (2010).

144. I.R.C. §§ 1272(a), 1273(a)(1).

145. *Id.* § 1273(a).

146. *Id.* § 1272(a)(3).

147. *Id.* § 1272(d)(2).

148. James N. Calvin & Christopher D. Farias, *When Can Holders of Defaulted Debt Cease Accruing Interest Income?*, 73 J. TAX'N 378, 381 (1990); Martin D. Pollack, Stuart J. Goldring, & Larry J. Gelbfish, *Uncollectible OID: To Accrue or Not to Accrue?*, 84 J. TAX'N 157, 159 & n.10 (1996).

Several passages in the legislative history of the OID rules demonstrate Congress's intent to use the accrual method for OID.[149] The 1982 TEFRA Conference Report, under which the predecessors to the current OID rules were enacted, states that the intended purpose of the OID rules is to provide rules "under which the inclusion and deduction of [OID] correspond to the *actual economic accrual of interest*."[150] The 1985 Senate Report for the most recent amendments to the OID rules contains the following explanation of the OID rules: "The 1984 Act attempted to prevent mismatching of interest income and interest deductions by requiring both [parties] to account for the interest in the transaction on the accrual method of accounting."[151] The Senate Report also states that "the application of the OID rules will require the issuer and the holder of the debt instrument to use the accrual method of accounting for any interest (whether stated or imputed) that is not paid currently."[152] Lastly, the Joint Committee staff has noted that

> a cash-basis taxpayer may be required to use the accrual method of accounting with respect to certain items of income or deduction. For example, if a cash-basis taxpayer acquires an [OID] bond the taxpayer would be required to accrue the daily portions of [OID] during the period the bond is held.[153]

One of the well-established principles of the accrual method of accounting is that a taxpayer using it "should not be required to pay a tax on an accrued income unless it is good or collectible, and, where it is of doubtful collectibility or it is reasonably certain it will not be collected, it would be an injustice to the taxpayer to insist upon taxation" (the "doubtful collectibility exception").[154] This principle was established in the 1930 case, *Corn Exchange Bank v. United States*,[155] and was later recognized by the IRS in Revenue Ruling 80-361.[156] It is meant to address situations involving distressed debt instruments where the questionable health of the debtor makes repayment of the debt sufficiently doubtful.[157] Because the

149. The accrual method is defined in I.R.C. § 446.

150. Pollack, Goldring & Gelbfish, *supra* note 148, at 159 (quoting H.R. REP. NO. 97-760, at 553 (1982)) (internal quotation marks omitted).

151. *Id.* at 159 (quoting S. REP. NO. 99-83, at 14 (1985)) (internal quotation marks omitted).

152. *Id.* (quoting S. REP. NO. 99-83, at 5) (internal quotation marks omitted).

153. *Id.* (quoting STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., BACKGROUND ON TAX SHELTERS 16 n.10 (Comm. Print 1983)) (internal quotation marks omitted).

154. Corn Exch. Bank v. United States, 37 F.2d 34, 34 (1930).

155. *Id.*

156. Rev. Rul. 80-361, 1980-2 C.B. 164.

157. Detailed application of the doubtful collectibility exception is beyond the scope of this Note. For a detailed explanation of how to determine whether there is no longer a reasonable expectation of

legislative history of the OID rules indicates that their intended purpose is to require OID bondholders to use the accrual method of accounting with respect to OID, it follows that the fundamental principles of the accrual method, including the doubtful collectibility exception, should extend to the tax treatment of distressed OID bonds.[158] Despite this, there has been no explicit extension of the doubtful collectibility exception to the OID rules.[159]

In addition to the legislative history supporting the extension of the doubtful collectibility exception to OID bonds, general tax policy also mandates that it be extended. Requiring an OID bondholder to continue recognizing accrued OID despite the existence of doubtful collectibility results in "an injustice to the [bondholder],"[160] and is inconsistent with the general principle that a taxpayer recognize income in a manner that clearly reflects income.[161] This is because without the doubtful collectibility exception, distressed OID bondholders are required to pay tax on income that, due to the poor financial health of the bond issuer, they have no reasonable expectation of actually receiving (and in all likelihood will not receive) in full.

The Treasury could remedy the above problem by extending the doubtful collectibility exception to the tax treatment of OID bonds and by stating explicitly in a regulation that the OID rules should not apply when an OID bond is distressed.[162] Applying the doubtful collectibility exception

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basis recovery under the doubtful collectibility exception, see generally Calvin & Farias, *supra* note 148.

158. "As soon as one accepts the proposition that the OID provisions simply extend the accrual method of accounting, however, the better view is that the doubtful collectibility doctrine is an inherent part of the OID provisions." Pollack, Goldring & Gelbfish, *supra* note 148, at 161 (footnote omitted).

159. I.R.C. §§ 1272–75 (2006). Not only is there no explicit doubtful collectibility exception to the OID rules, the Service incorrectly took the position that the doubtful collectibility exception did not extend to OID in TAM 9538007. *See* I.R.S. Tech. Adv. Mem. 9538007 (June 13, 1995). As several commentators have noted, this decision was in error. *See, e.g.*, John Kaufmann, *The Treatment of Payments on Distressed Debt Instruments*, 26 J. TAX'N INVESTMENTS 13, 18–20 (2008); Pollack, Goldring & Gelbfish, *supra* note 148, at 161; N.Y.C. BAR, COMM. ON TAXATION OF BUS. ENTITIES, REPORT REGARDING PROPOSALS FOR ACCOUNTING TREATMENT OF INTEREST ON NON-PERFORMING LOANS 13–14 (2008), *available at* http://www.nycbar.org/pdf/report/ABCNY%20CityBar_%20Distressed_debt.pdf.

160. Corn Exch. Bank v. United States, 37 F.2d 34, 34 (1930).

161. *See* I.R.C. § 446(b); Pollack, Goldring & Gelbfish, *supra* note 148, at 160 & n.18 (citing S. REP. NO. 97-494, at 212 (1982)). *See generally* United States v. Midland-Ross Corp., 381 U.S. 54 (1965) (holding, under the 1939 Code, that earned OID served the same function as stated interest, and that on a sale of an OID bond, the gain attributable to the OID was ordinary income rather than capital gain).

162. *See generally* Pollack, Goldring & Gelbfish, *supra* note 148 (arguing that Congress's reasons for putting all taxpayers with OID on the accrual method is consistent with the purpose of the doubtful

to OID bonds would solve the injustice to the bondholder because it would enable the bondholder to cease current recognition of accrued OID if the issuer's financial difficulties become so deep that the bondholder no longer has a reasonable expectation of recovering the accrued OID. It is beyond the scope of this Note to explore in depth how the Treasury should implement the exception. The point is that the Treasury (as opposed to the judiciary or Congress) is well equipped with the experience and data needed to answer the highly technical question of at what exact point an OID bond should be deemed to be sufficiently distressed, thus turning off the OID rules. This will then bring the application of the OID rules in line with their intended purpose—to have taxpayers treat OID as if it were interest income under the accrual method.[163]

A court applying an intentionalist approach at *Chevron* step one would see from the legislative history that Congress did not address whether the doubtful collectibility exception should be extended to OID. Congress has clearly expressed that the OID rules are an extension of the accrual method of accounting, but it did not give any guidance as to whether the fundamental principles of the accrual method such as the doubtful collectibility exception should also apply to OID, suggesting that it did not have distressed debt in mind when formulating the OID rules. Thus, an intentionalist court would correctly defer to the Treasury if it were to fill the inadvertent statutory gap in the treatment of distressed OID bonds. On the other hand, a court applying a textualist approach would not defer to the Treasury because it would conclude from the apparent statutory clarity that Congress did not intend for any exclusion to the OID rules. As explained above, this would be inconsistent with the expressed will of Congress to treat OID consistently with the accrual method of accounting. It would also result in an outcome that is at odds with general tax policy and unfair to taxpayers.

2. Application of the Market Discount Rules to Distressed Debt

The market discount rules generally apply to certain bonds that are acquired after their original issue at a discount.[164] If the bond is issued with OID, the market discount rules apply to those bonds acquired after original

collectibility doctrine).

163. For suggestions regarding the detailed application of the doubtful collectibility exception to OID bonds (including how to determine exactly when an OID bond is sufficiently distressed), see N.Y.C. BAR, *supra* note 159, at 15, and Garlock, *supra* note 143, at 1009–10, 1002–03.

164. I.R.C. §§ 1276–78.

issue with a discount that exceeds the unaccrued original issue discount.[165] In general, any gain resulting from the disposition of a bond with market discount will be treated as ordinary income to the extent that the market discount has accrued on the bond.[166] If a bond issuer makes a partial payment of principle on the bond, the payment is first treated as a payment of accrued market discount which is treated first as taxable ordinary gain, and then as nontaxable recovery of principle.[167]

Subject to a de minimis rule, the amount of market discount attached to a bond is equal to the excess of the bond's stated redemption price at maturity (or the revised issue price in the case of a bond issued with OID) over the taxpayer's initial basis for the bond.[168] The amount of accrued market discount at a given time is calculated using either a straight-line, ratable formula, based on the date of acquisition to the maturity date of the bond, or, if so elected, on an economic accrual formula with a constant interest rate over the same period.[169] To prevent the double taxation of the taxpayer on the market discount recognized, appropriate adjustments are made to the taxpayer's basis in the market discount bond to reflect the gain recognized under the market discount rules.[170]

Congress intended that the market discount rules prevent a taxpayer from converting ordinary income (from accrued market discount) into capital gain where the market discount is merely a substitute for stated interest—that is, where the discount is a result of an increase in prevailing interest rates after the issuance of the bond.[171] From the standpoint of the

165. *Id.* §§ 1276, 1278(a)(2).

166. *Id.* § 1276(a)(1).

167. *Id.* § 1276(a)(3).

168. *Id.* § 1278(a)(2).

169. *Id.* § 1276(b). Under the constant yield method, less market discount accrues in the earlier years, and more market discount accrues in the later years, as opposed to the straight-line method.

170. *Id.* § 1276(d)(2). In addition, the current deduction of any interest expense in excess of interest income ("net direct interest expense") in the case of a leveraged purchase of a market discount bond is deferred until the market discount is recognized. *Id.* § 1277(a). Note, however, that this rule does not apply to any tax-exempt market discount debt. *Id.* § 1278(a)(1)(c). With respect to leveraged purchases of market discount bonds, the market discount rules operate so as to prevent a taxpayer from inappropriately deferring its ordinary income; Congress enacted the rules to prevent a taxpayer who finances the purchase of a market discount bond from obtaining a tax benefit by currently deducting the interest expense from unrelated ordinary income, while not recognizing accrued market discount income until the bond's maturity date. H.R. REP. NO. 98-432, at 1170 (1984); STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 93–94 (Comm. Print 1984) [hereinafter JCT BLUEBOOK]. The correct theoretical treatment of market discount would be to tax it as it accrues, however, this would have been too administratively complex. Thus, Congress chose to prevent tax shelter opportunities by deferring the deduction of net direct interest expenses. *Id.* at 98.

171. N.Y.C. BAR, *supra* note 159, at 17 n.63 (citing H.R. REP. NO. 98-432, at 1170 (1984)).

bondholders, the market discount is indistinguishable from OID; holders of a market discount bond are compensated for the bond's lower-than-market interest rate via the discount in a way that places them in the same economic position as holders of a new bond under the current increased market rates; the two bonds are economic equivalents.

For example, assume that a bond is issued with a stated interest rate of 5 percent. After the bond's issuance, the prevailing market rates increase, and comparable bonds are now being issued with a stated interest rate of 8 percent. Assume further that a taxpayer buys one new 8 percent bond at face value, while another buys the old 5 percent bond on the market at a discount of 3 percent. In this situation, the 3 percent market discount on the old bond is clearly a substitute for 3 percent of the stated interest on the newer bond. It would be inconsistent to treat the 3 percent accrued market discount on the old bond as capital gain (upon the disposition of the bond) while treating all 8 percent of the stated interest accrued with respect to the new bond as ordinary income, given that the bonds are designed to be market equivalents.

When the market discount rules are applied to a distressed bond—that is, a bond whose issuer has a weak or rapidly declining credit rating due to its bankruptcy, insolvency, or other serious financial difficulties, the theory that market discount is a mere substitute for stated interest collapses.[172] This is because in cases of distressed debt instruments, the market discount does not place the bondholder in the same economic position as bondholders of newly acquired bonds—the market discount reflects a market recognition that the debt is unlikely to be paid in full due to the issuer's poor financial condition.[173] In these cases, at least a portion of the market discount represents the bondholder's compensation for assuming the increased credit risks more akin to equity investments rather than stated interest on lower-risk debt instruments.[174]

As a result, the application of the current market discount rules to distressed debt instruments is inconsistent with congressional intent. Both the Joint Committee on Taxation's explanation of the market discount rules[175] and the House Ways and Means Committee Report[176] strongly

172. *Id.* at 19; Anne M. Barr, Peter J. Connors, & George C. Howell III, *ABA Members Consider Application of Market Discount Rules to Speculative Bonds*, 91 TAX NOTES TODAY 113-28, 5 (1991).

173. N.Y.C. BAR, *supra* note 159, at 19. It is preposterous to believe that a bond issuer with a severely decreased credit rating would be able to issue new bonds under current market interest rates.

174. Barr, Connors & Howell, *supra* note 172, at 5.

175. JCT BLUEBOOK, *supra* note 170, at 93.

176. H.R. REP. NO. 98-432, at 1170 (1984).

suggest that Congress did not anticipate that the market discount rules would apply to distressed debt instruments because it assumed that all market discount is a substitute for stated interest: "market discount is indistinguishable from OID."[177] In each case the "discount is a substitute for stated interest, and the holder of the obligation receives some of his return in the form of price appreciation when the bond is redeemed at par upon maturity."[178] As explained above, however, market discount attached to distressed debt instruments is not a substitute for stated interest; the market discount reflects the fact that the bond is "unlikely to be redeemed at par upon maturity" because of the issuer's poor financial condition.[179] In addition, the Joint Committee explained that "[c]apital gain treatment should not be afforded to a largely predictable return,"[180] but the return on distressed debt is likely to be unpredictable because of the questionable financial strength of the issuer.[181]

In addition to the legislative history suggesting that Congress did not have distressed debt in mind when creating the market discount rules, the application of the existing market discount rules to distressed debt instruments leads to anomalous results that conflict with general tax policy. First, a secondary purchaser of a market discount bond will likely have to treat a greater portion of each partial payment—if any are made by the issuer—as ordinary interest income than would be the case if the bond purchased was not distressed and was likely to be paid in full.[182] This is because in cases of distressed debt, the amount of market discount attached has an inverse relationship with the financial health of the issuer: the more financially unhealthy the issuer, the more risk associated with the bond, and as a result, the more market discount attached thereto. The more market discount attached to a bond, the greater proportion of income that the purchaser will have to recognize as ordinary income each time a partial payment is made.[183] This result conflicts with the general tax policy of having taxpayers time the recognition of income using an accounting method that clearly reflects their income.[184] Here, the timing of income

177. N.Y.C. BAR, *supra* note 159, at 17.

178. *Id.* at 20 & n.82.

179. *Id.* at 20.

180. JCT BLUEBOOK, *supra* note 170, at 94.

181. N.Y.C. BAR, *supra* note 159, at 20.

182. *Id.* at 19.

183. Barr, Connors & Howell, *supra* note 172, at 5. Recall that for partial payments, the payment is first treated as a payment of accrued market discount which is taxable as ordinary gain, and then as a nontaxable recovery of principle. I.R.C. § 1276(a)(3) (2006).

184. *See* I.R.C. § 446(b); Pollack, Goldring & Gelbfish, *supra* note 148, at 160 ("What Congress was concerned about [when drafting I.R.C. § 1272] was the clear reflection of income.").

recognition imposed on taxpayers by the market discount rules does not clearly reflect income because it requires a holder of a distressed bond to recognize more ordinary income than a holder of a nondistressed bond in the event of a partial payment, even though the very reason for the increased market discount attached to the bond is the unlikelihood that the bondholder will be paid the full amount due at maturity.

Second, any loss recognized by the bondholder upon the subsequent disposition or retirement of the distressed market discount bond will be treated as a capital loss.[185] As explained earlier, capital losses generally cannot be used to offset ordinary income,[186] and, even in the case that the taxpayer has unrelated capital income to utilize such losses, a capital loss is not as valuable as an ordinary loss because ordinary gain is taxed at a higher rate than capital gain.[187] Thus, the application of the market discount rules to a distressed market discount bond is unfair to taxpayers because it risks forcing taxpayers to recognize a considerable amount of ordinary income through partial payments, while later disallowing the taxpayer's ability to offset such income if he or she suffers a loss upon disposition of the same bond.

Because the legislative history shows that Congress did not anticipate that the market discount rules would apply to distressed debt, and because the results of applying the market discount rules to distressed debt instruments are indefensible from a tax policy standpoint, the Treasury has the authority under the principles of *Chevron* to create an exception to the market discount rules for distressed debt instruments.[188] A court applying an intentionalist approach would correctly defer to the Treasury if it were to take such action because it would examine the legislative history of the market discount rules and find that Congress did not address the question of whether the market discount rules should apply to distressed debt. In contrast, a textualist court would incorrectly conclude from the apparent statutory clarity that Congress intended to include distressed debt

185. I.R.C. §§ 165(g)(1), 166(e); N.Y.C. BAR, *supra* note 159, at 19; Barr, Connors & Howell, *supra* note 172, at 5.

186. I.R.C. § 1211. This is aside from a three thousand dollar allowance for noncorporate taxpayers. *Id.*

187. *See id.* § 1.

188. The detailed tax treatment of such bonds is beyond the scope of this Note. For detailed suggestions, see generally N.Y.C. BAR, *supra* note 159, and Barr, Connors & Howell, *supra* note 172. In addition, the Treasury has been granted regulatory authority to "prescribe such regulations as may be necessary to carry out purposes of this subpart [I.R.C. §§ 1276–78], including regulations provided proper adjustments in the case of a bond the principal of which may be paid in 2 or more payments." I.R.C. § 1278(c).

instruments within the market discount rules merely because there is no explicit exception within the statute's text. As explained above, this would be in error and the resulting tax treatment of such instruments would be both unfair to taxpayers and inconsistent with general tax policy.

VI. CONCLUSION

Because *Mayo* replaces the *National Muffler* test with the more deferential *Chevron* analysis, it represents an important step towards giving the Treasury the deference it needs to effectively administer the various provisions of the Code. The *Chevron* case stands for the principle that administrative agencies (as opposed to judges) should have broad rulemaking and policy-formulating authority to clarify and interpret congressional statutes in furtherance of congressional will. In order to uphold this fundamental principle, however, the courts must apply the *Chevron* test as it was originally formulated by employing an intentionalist approach at step one of the analysis. As the hedging, market discount, and original issue discount examples have demonstrated, applying a textualist step one approach poses the danger of mistaking an inadvertent congressional omission for a clear congressional expression of intent. Contrary to the *Chevron* Court's original vision, this shifts the ultimate power to interpret statutes away from the agencies and back to the judiciary, and strips from administrative agencies the deference needed to efficiently administer statutes in light of imperfect congressional drafting.

The dangers of a textualist step one approach are uniquely substantial in the tax context. Because the provisions of the Tax Code are intertwined to further broad objectives, a reviewing court will not be able to accurately determine the intended scope of a statute's application unless it is viewed in context with the overall policy and structure of the Code. Also, the Tax Code is largely self-contained with highly specialized language; a reviewing court will often have to look to nonstatutory sources in order to understand the meaning of tax-specific terms. Furthermore, the Code has never been interpreted in a textualist manner; as the continuity-of-interest doctrine demonstrates, creating and relying on extra-statutory glosses is a common practice of tax law. Lastly, the Code is incredibly complex and applies to infinitely varied facts; Congress cannot be expected to anticipate every possible contingency, so the Treasury needs *Chevron* deference to address the Code's application to improbable or infrequent situations, including the unintended interaction of two seemingly unrelated Code sections. In light of *Mayo*'s clear extension of the *Chevron* analysis to the tax context, the need to apply an intentionalist approach at *Chevron* step one when reviewing Treasury regulations cannot be overstated.