Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Tax Canon May Ensue If Justices Take $199M Deduction Case

By **Amy Lee Rosen**

Law360 (May 18, 2018, 7:28 PM EDT) -- A Third Circuit ruling on appeal to the U.S. Supreme Court that prevented an electricity supplier from claiming a double deduction on a consolidated tax return has some practitioners worried that, if accepted, the justices could solidify a stand-alone tax doctrine previously used only as a method of statutory interpretation.

At stake is Pittsburgh-based Duquesne Light Holdings Inc.'s attempt to claim $199 million in tax deductions disallowed by the Internal Revenue Service. The energy services holding company tried to take advantage of a gap in regulations when it claimed a capital loss on the transfer of less than 20 percent of its shares in a subsidiary's stock in 2001 but also on the sale of some of the subsidiary's assets at a loss between 2002 and 2003.

The U.S. Tax Court sided with the IRS in 2013 when it granted summary judgment for the agency, finding the IRS met its burden in showing that the 2002-2003 losses duplicated the $199 million deduction taken in 2001 because they reflected the same economic loss. In June 2017 the majority of a three-judge appellate panel on the Third Circuit upheld the Tax Court's decision, concluding that a doctrine stemming from a 1934 Supreme Court case, Charles Ilfeld Co. v. Hernandez, prevents double deductions in consolidated tax returns unless expressly permitted by the U.S. Congress.

Gary B. Wilcox, a Mayer Brown LLP partner involved in the case, said Duquesne is a case where the taxpayer complied with the literal language of the law, yet is now being subjected to a possible stand-alone doctrine that could be used to override the plain meaning of the code and regulations.

“So there is this debate: whether the so-called Ilfeld doctrine should really be used as some sort of interpretive tool in the context of interpreting statutes and regulations, or whether it really is a stand-alone case-law doctrine, like economic substance or step transactions, that courts can just use to effectively override the plain meaning of the rules," Wilcox said.

The transactions in dispute began amid Duquesne's shift in focus from acquiring water and wastewater companies to its core electrical energy interests. On Dec. 31, 2001, the company transferred 50,000 shares of stock in its AquaSource subsidiary to Lehman Brothers, which valued the stock at $4 million. Duquesne determined that these shares accounted for $223 million of its investment, and after various adjustments, it claimed a capital loss of $199 million on the stock transfer.

The company incurred further losses when, from March 2002 through 2003, AquaSource sold its assets, including all of AquaSource's stock interests that it directly and indirectly held in eight of its own subsidiaries. But the IRS concluded that $199 million of those losses between 2002 and 2003 were disallowed under the Ilfeld doctrine.

Wilcox said Duquesne's decision in 2002 and 2003 to sell assets for a loss, which achieved what is known more technically as loss duplication, occurred during a regulatory gap created when the Federal Circuit in 2001 struck down a final loss disallowance regulation, Treas. Reg. § 1.1502-20, in a case called Rite Aid Corp. v. U.S., which had previously prevented the up-front stock loss. The U.S. Department of Treasury had never gone after the deduction of losses when a subsidiary sold assets for a loss following a parent company claiming a loss on the sale of subsidiary stock, he said.

The government said it would not challenge the finding in Rite Aid or submit the case to the U.S. Supreme Court, so taxpayers knew the government would no longer challenge similar stock losses because those regulations that had previously denied it had been invalidated by the Federal Circuit, Wilcox said.

Duquesne likely decided to deduct both the capital loss on the stock transfer and the loss on the sale of the subsidiary's assets because the company was relying on the fact that when the government said it would issue regulations in the future, the IRS and Treasury never indicated they would focus on denying the subsidiary's asset loss, he said.

The government in 2002 and 2003 issued stopgap regulations, Treas. Reg. § 1.337(d)-2T, that applied when Duquesne took the loss duplication, but such regulations did not prohibit the loss, so the company technically acted when there were no regulations that prohibited taking the losses from the stock sale and also from the subsidiary asset sale, Wilcox said.

"In fact, when they actually wrote the replacement regs, they did not attempt to deny the asset loss," Wilcox said. "They even admitted it would be inadministrable to go after the asset loss, yet that's exactly what they asked the court to do."

Wilcox said how one feels about Duquesne depends on one's view about the roles of the court and whether it is within their role to effectively write regulations.

"I'm disturbed by what happened here because taxpayers were told that after Rite Aid, these issues would be dealt with by regulations," he said.

Regulations, which are typically prospective, did not give any notice the government would be challenging taxpayers on the basis of Ilfeld, yet that's what they did in the Third Circuit, he said. That judicial decision can be applied retroactively to other taxpayers, while a regulation would have been subject to full notice and comment and only applied prospectively.

"That's the harsh reality of the government trying to make law through the courts," Wilcox said. "It could be a slippery slope. Certainly the other circuits have not limited Ilfeld to consolidated return cases."

Duquesne submitted a petition for certiorari to the U.S. Supreme Court in February, saying regulatory provisions unambiguously allowed the company to take all of the deductions it claimed. The utilities company said the Third Circuit conducted an incorrect interpretation because the Supreme Court never had held that the IRS has the license to disallow deductions expressly authorized by a common-law no-double-deduction rule.

The Cato Institute argued on behalf of Duquesne in March, saying in an amicus brief the Third Circuit finding created “perverse incentives” for federal agencies to interpret their own law, which violates the separation-of-powers doctrine.

The government responded on May 11, urging the Supreme Court to drop the case because no circuit conflicts existed in how Ilfeld had been interpreted and legal precedent was properly applied. The government called Duquesne's assertion of a "deep conflict" to be mistaken because it "cited no decision that describes the Ilfeld doctrine as a substantive rule of tax law or otherwise rejects the view that it functions as an interpretive principle."

Ruth Mason, a professor at the University of Virginia School of Law, said taking on the case could help resolve a split among the circuits. While Ilfeld held the duplicate deduction was prohibited by the clear language of the applicable regulation, the court also said for public policy reasons that a taxpayer should not be allowed to take two deductions for a single economic loss.

“The question raised by Duquesne, which has gotten different answers in different circuits, is whether the ‘no double deduction rule’ is a rule of statutory interpretation — so that, on balance, where the statute is unclear, courts should not interpret it to provide duplicative deductions — or a mandate, such that no double deductions are allowed unless each deduction plus the duplication of the deduction is authorized," Mason said.

Mason said, based on her reading of Duquesne's brief, her understanding of the circuit split is that some courts say a taxpayer cannot have a double deduction unless it is expressly authorized, such as in the Third, Eighth and Ninth circuits. However, the First, Fifth and Tenth circuits say Ilfeld is a general canon of statutory regulation. If Ilfeld is a general canon of statutory interpretation, then if there are two clear statutes or regulations that each authorize a deduction, then the taxpayer gets both deductions — unless there’s a contrary statement.

Ilfeld is better as a method of statutory interpretation because if it is instead read as a hard-and-fast rule of no double deductions unless expressly authorized, that would lead to a situation in which a taxpayer may have to decide which of two clearly applicable laws apply, which is not an ideal situation, Mason said.

Don Leatherman, professor at the University of Tennessee College of Law, told Law360 Duquesne is important because it addresses the scope of the government’s power to prevent double deductions in consolidated tax returns when there may not be a direct regulation that prohibits it.

“I think the reason why this is an important case has a lot to do with the interpretation of regulations and how much deference a court should give to an administrative agency that hasn’t explicitly stated a rule or standard that it wants to apply,” Leatherman said. “If you follow at least one interpretation of the majority opinion of the third circuit in Duquesne and you follow it to its logical conclusion, it would allow the IRS to deny deductions currently under the regulations in § 1.1502-36, which is the unified loss rule.”

That would allow an aggressive tax administrator to deny almost any deduction, which is bad from both an administrative and taxpayer complaint standpoint because the rules are complicated enough without having to worry about having a further imposition of tax, even though they thought they complied with the tax rules as written.

“That would lead to greater dissatisfaction with the tax system than we have now,” he said.

Leatherman said he thought it was unlikely that the Supreme Court would grant certiorari because Duquesne may already be moot since other regulations have come into place since Duquesne acted during the gap period.

Michael L. Schler, who is of counsel at Cravath Swaine & Moore LLP, supported interpreting Ilfeld as a stand-alone doctrine because that would prevent taxpayers from trying to take advantage of the system.

"I think you really need broader principals from taxpayers from exploiting the tax system from taking advantage of unintended results," he said. "It just costs the government too much revenue."

Schler said interpreting it the other way would only give taxpayers who can afford the best lawyers the chance to get the best tax results.

If the Supreme Court agrees to hear the case, which Schler said he thinks is unlikely, then if Duquesne wins, taxpayers can rely on the literal language of the tax rules and there will be less risk that the IRS can disallow those tax benefits. However if the government wins, taxpayers will be forced to think about general tax principles when they plan transactions.

“It’s just a policy question of how the tax policy system should work and it’s a controversial question that people have thoughts on,” he said.

--Additional reporting by David Hansen and Vidya Kauri. Editing by Tim Ruel and Neil Cohen.

Correction: An error in the date of the Third Circuit's opinion has been corrected.
