OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

January 2, 1999

CC:DOM:FS

UILC: 1502.20-00

Number: **199916007**
Release Date: 4/23/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT:

This is in response to your request for Field Service Advice regarding several procedural issues concerning the loss disallowance rule (LDR) issue (Treas. Reg. § 1.1502-20) in the above-captioned Notice case. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

P =
S =
X =

Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =

Date 1 =
Date 2 =

| | |
|---|---|
| $A | = |
| $B | = |
| $C | = |
| $D | = |
| $E | = |
| | |
| w months | = |
| y months | = |
| | |
| Court A | = |
| Docket No. Z | = |

ISSUES:

1. In the event that respondent wins the X phantom gain issue, what arguments should respondent raise regarding the court's discretion to decide the Treas. Reg. § 1.1502-20 issue.

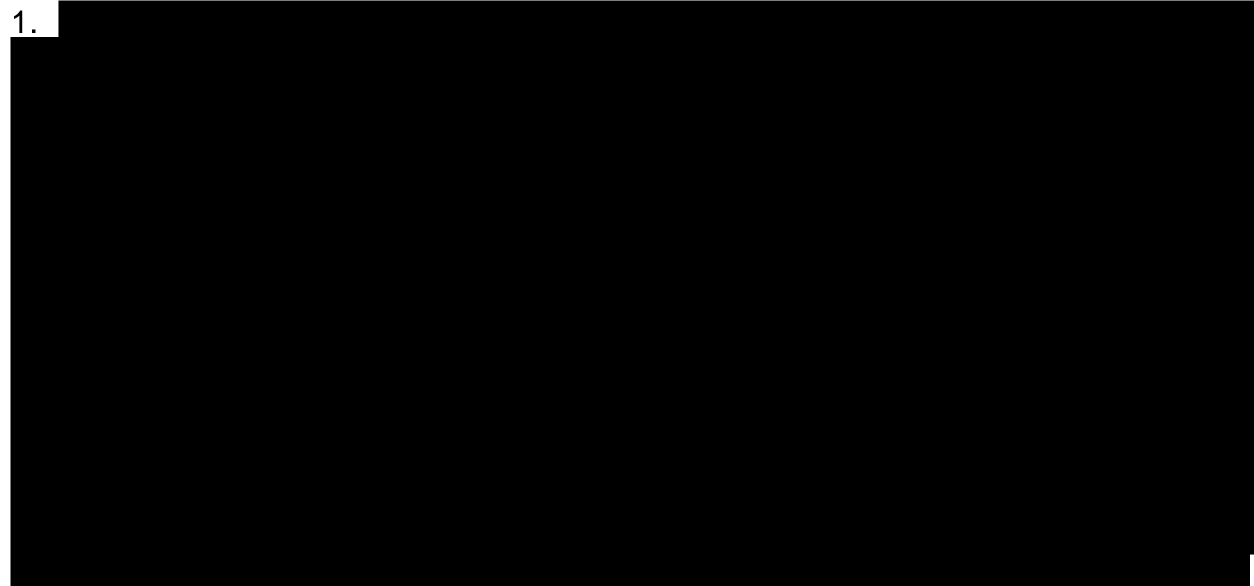
2. Whether the LDRs were promulgated in accordance with the Administrative Procedure Act.

3. What is the authority for applying the LDRs retroactively.

4. Whether Treas. Reg. § 1.1502-20 is a legislative regulation and thus entitled to greater judicial deference.

CONCLUSIONS:

1.



2. The LDRs were the subject of two rounds of notice and comment in connection with the two sets of proposed regulations that were issued. The preambles to those proposed regulations contained lengthy discussions of the issues that needed to be addressed, the possible approaches that were being considered, and with respect to the second set of proposed regulations, the prior comments that were received. Moreover, it is evident that serious consideration was given to the comments and changes to the regulations were made where it was considered appropriate and feasible, consistent with the balancing of competing policy considerations that were involved. Accordingly, interested persons had an opportunity to express their views and meaningfully participate in the development of the final plan, and the resulting changes that were adopted in the final regulations, which were mostly ameliorative, were a logical outgrowth of that process. Consequently, the purpose of the notice and comment requirements of the APA were met in the instant case.

3. In light of section 7805(b), there is a presumption that tax regulations apply retroactively unless expressly made prospective only. Since section 7805(b) is a specific statute concerning regulations relating to the internal revenue laws, it takes precedence over the 30-day rule in 5 U.S.C. § 553(d) of the Administrative Procedure Act, which is a general statute applying to most federal agencies. Nonetheless, the Secretary's decision not to limit the retroactive effect of a regulation is subject to judicial review under an abuse of discretion standard. In our opinion, it was not an abuse of discretion to issue Treas. Reg. § 1.1502-20 with retroactive effect and to apply it in the instant case. Such action is consistent with, and supported by, section 1503(a), which provides that consolidated returns are subject to the section 1502 regulations prescribed before the due date for such return. Alternatively, even if it is determined that the 30-day rule applies to tax regulations in general and the consolidated return regulations in particular, the purpose of the 30-day rule was satisfied in the instant case. Moreover, the exception to the 30-day rule relating to the relief of a restriction as well as the good cause exception apply in the instant case.

4. It is well settled that the consolidated return regulations are legislative in character. Since the LDRs were promulgated not only under the broad grant of authority in section 1502, but also pursuant to a specific grant of authority in section 337(d), Treas. Reg. § 1.1502-20 should be afforded a high degree of deference.

FACTS:

In Year 4 , P sold the stock of S and claimed a loss on the sale. This was reported as a long term capital loss on P's Year 4 consolidated return. A portion of this loss

was carried back to Year 1 and Year 2 and the remainder was carried forward to Year 5. In the statutory notice of deficiency, the Service reduced the amount of the allowable loss by $A to $B based on the application of the loss disallowance rules under Treas. Reg. § 1.1502-20. No deficiency resulted from this adjustment.

In Year 5, P acquired an interest in X. X purportedly engaged in
transactions involving
generating short term capital gains. On its Year 5 consolidated return, P reported approximately $C in net short term capital gain from its interest in X. This net short term capital gain was used to offset the long term capital loss that was carried forward from Year 4. Upon audit, the Service reduced the amount of X's net short term capital gain, which in turn reduced P's distributive share of said gain to $D. As a result, no portion of the long term capital loss that was offset in Year 5 would be attributable to the loss disallowed under Treas. Reg. § 1.1502-20. Consequently, the adjustment based on the application of the loss disallowance rules currently has no effect on P's taxable income for Year 5.

LAW AND ANALYSIS:

1. Discretion Issue

The real question in the instant case is whether the court should refrain from considering the loss disallowance issue notwithstanding its jurisdiction to resolve it. This question more typically arises in the context of a proffered concession of an issue by one party that is objected to by the other party, usually because they want an opinion from the court for various reasons. One of the leading cases addressing this situation is LTV Corp. v. Commissioner, 64 T.C. 589 (1975). In that case, the Service conceded the existence of consolidated net operating losses for 1968 and 1969 sufficient to eliminate the deficiencies determined by the Service for 1965 and 1966, the years before the court. However, the parties continued to disagree about the amount of the pre-carryback deficiencies for 1965 and 1966; the precise amount of the consolidated net operating loss attributable to 1968 and 1969; and the amount of the 1968 and 1969 losses which must be used to eliminate the deficiencies for 1965 and 1966. After concluding that its jurisdiction was unimpaired by the Service's concession of no deficiency for the years before the court, the court indicated that it then had to decide whether to simply enter a decision in favor of the taxpayer or whether it should nevertheless resolve the above-described issues, which remained in dispute. Hence, this opinion makes it clear that the court has discretion regarding how to proceed under these circumstances. See also McGowan v. Commissioner, 67 T.C. 599 (1976) (where the Service filed a notice conceding the substantive issue in the case and requested the court to enter a decision of no deficiency, and the taxpayers opposed

such concession and urged the court to issue an opinion, the court, in the exercise of its discretion and in the interests of justice, may decide the substantive issue).

Moreover, LTV Corp. is instructional regarding the factors that the court considers in determining whether to exercise its discretion. In that case, the taxpayer argued that the 1968 and 1969 losses that were not absorbed by the 1965 and 1966 deficiencies, would be carried to the 1973 and 1974 years, necessitating a determination of all of the issues then before the court at some future date. The taxpayer emphasized the convenience of resolving the issues currently when witnesses were available and memories were fresh, rather than in connection with the later years, which might not reach the litigation stage for quite some time considering the complexity of the returns involved. Thus, the taxpayer argued that the parties had a real stake in a concrete controversy because of the impact that the decision would likely have on future years. Finally, the taxpayer raised the specter of a multiplicity of litigation (e.g., a refund suit) in different forums due to a continuing dispute over restricted interest for the years at issue.

Notwithstanding the taxpayer's arguments, the court determined that it should enter a decision in favor of the taxpayer without resolving the remaining outstanding issues. This conclusion was driven, at least in part, by the court's analysis of section 6214(b). In this regard, the court stated:

> section 6214(b) directs us to look at "the taxes of other years" only to the extent it is "necessary to correctly determine the amount of [the] *deficiency*" (emphasis added by the court) before us. There is no reason for us to look at 1968 to determine the 1965 and 1966 deficiencies before us. These deficiencies are zero in any event.

64 T.C. at 597 (footnote omitted).

The rationale of the court was further explained in Chevron Corp. v. Commissioner, 98 T.C. 590 (1992). In that case, the court denied the taxpayer's motion for leave to file an amended petition under Rule 41(a) in which it sought to raise a new issue. The court relied upon LTV Corp. to support its conclusion. The court described the reasons for its decision not to determine the amount of the losses for the later years in LTV Corp. as follows:

> We stated that "such a determination would in any event relate to a deduction that may be used in some future year, and would provide no assistance in resolving the deficiencies in the years before us." *LTV Corp. v. Commissioner, supra* at 596.
>
> Our decision in *LTV Corp.* was based on judicial administration concepts, including ripeness, mootness, and advisory opinions, which allow a court to decline to render a decision on a matter though not

> precluded by a jurisdictional bar from considering the issue. *LTV Corp. v. Commissioner, supra* at 595. Thus, we concluded that no matter what we might otherwise decide with regard to the amount of net operating losses available for 1968 and 1969, the decision would have "absolutely no impact on the years before the Court, since the decision will be the same in any event - no deficiency." *LTV Corp. v. Commissioner, supra* at 596.

98 T.C. at 592-593.

The court in Chevron Corp. then mentioned some additional factors militating against allowing the taxpayer to raise the new issue. Specifically, it stated:

> As in *LTV Corp.*, resolution of the Indonesian foreign tax credits issue will have no impact on tax liability for 1977 and 1978, the years before the Court. Furthermore, all of the parties as well as the Court would have to expend considerable time and effort on a matter that may never affect petitioners' tax liability for any year.
>
> In addition, res judicata and collateral estoppel will not preclude petitioners from raising the Indonesian foreign tax credits issue in a succeeding year, and this is an additional and significant ground for denying petitioners' motion to amend so as to raise the disputed issue.

Id. at 593.

In contrast, in McGowan v. Commissioner, supra, the court refused to accept the Service's proffered concession of the only issue in the case, which involved whether amounts withheld from wages for contribution to the Rhode Island temporary disability insurance fund were deductible under sections 164, 162 or 212. The basis for the court's action appears to be twofold. First, the court noted that the Service abruptly changed its longstanding position on the issue through the issuance of a revenue ruling in the year before the court, despite the absence of any significant change in the underlying statutory provisions upon which the Service's earlier rulings rested. In this regard, the court acknowledged that this "abrupt shift in position, standing alone, would not necessarily run counter to the interests of justice if it were grounded on sound legal principles and fully explained to the inquiring public." 67 T.C. at 607-608. However, the court observed that the Service did not reverse its position with respect to a series of comparable rulings pertaining to foreign tax credits. Moreover, the court remarked that the Service's position appeared to be invalid. The second ground for the court's decision was that although the Service had indicated that it was reconsidering the revenue ruling in question, the court was "not inclined to believe that such review is being undertaken with the expedience dictated by the circumstances surrounding this case." Id. at 608. The court then went on to explain as follows:

> Many taxpayers in Rhode Island will be affected by the outcome herein and the time for filing another year's return is rapidly approaching for most of them. We continuously have emphasized our desire to reach a speedy determination . . . . * * * [Respondent's] repeated attempts to obtain continuances have run counter to our expressed desire to quickly resolve the issue. We think the interests of justice now demand a more expeditious resolution of the issue than respondent has been willing to provide. Therefore, we conclude that our rejection of respondent's Notice of Concession represents a valid exercise of judicial discretion.

Id.

2. Administrative Procedure Act Issue

P challenges the validity of Treas. Reg. § 1.1502-20 on several grounds. P's attacks on the merits of the LDRs were addressed in a prior FSA that was issued in this case. This FSA focuses on the procedural issues raised by P. One of P's arguments is that Treas. Reg. § 1.1502-20 is invalid because the notice and comment requirement of the Administrative Procedure Act (APA) was not satisfied. Specifically, 5 U.S.C. § 553(b) of the APA provides as follows:

> General notice of proposed rule making shall be published in the Federal Register, unless persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law. The notice shall include -
>
> (1) a statement of the time, place, and nature of public rule making proceedings;
>
> (2) reference to the legal authority under which the rule is proposed; and
>
> (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved.
>
> Except when notice or hearing is required by statute, this subsection does not apply -
>
> (A) to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice; or
>
> (B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.

With respect to P's notice and comment argument in the instant case, it is noted that following the repeal of the General Utilities doctrine in the Tax Reform Act of 1986, Treasury became concerned about whether the consolidated return regulation basis adjustment rules conflicted with General Utilities repeal. Specifically, in circumstances where a corporation acquired a target with built-in gain assets, the basis adjustment rules could be manipulated to permanently eliminate a corporate level tax on the recognized built-in gain. Accordingly, the Service published Notice 87-14, 1987-1 C.B. 445, which was previously released on January 6, 1987. The Notice announced that the Service intended to promulgate regulations affecting certain adjustments to the basis of the stock of a subsidiary that is a member of an affiliated group of corporations filing a consolidated return in order to reconcile the consolidated return regulations with the repeal of the General Utilities doctrine.

The Notice was applicable to targets acquired after January 6, 1987, and stated that positive basis adjustments that were attributable to built-in gain would be disregarded. The Notice made specific reference to the investment adjustment provisions of the consolidated return regulations (Treas. Reg. § 1.1502-32). The Notice also indicated that the regulations would affect the adjustment to stock basis in certain cases where one or more members have acquired stock in a target with a built-in gain asset. Furthermore, the Notice stated that in cases where a target's stock is sold, the regulations would prevent recognition of losses that are attributable to the subsidiary's recognition of built-in gains.

Following the publication of Notice 87-14, Treasury and the Service undertook an intensive study of the various methods for reconciling the results under the consolidated return regulations with the intent of Congress in repealing the General Utilities doctrine. The study also took into account the effect of each method on the problem of loss duplication. As a result of this study, on March 9, 1990, temporary regulations were filed with the Federal Register and published on March 14, 1990. This was the regulation that the Service announced in Notice 87-14 that it would publish. However, Temp. Treas. Reg. § 1.1502-20T adopted a "loss disallowance rule" that applied with respect to any stock disposition or deconsolidation of a subsidiary within a consolidated group on or after March 9, 1990. This LDR differed from Notice 87-14 because it disallowed all losses on a parent's disposition of a subsidiary's stock within a consolidated group.

Temp. Treas. Reg. § 1.1502-20T was accompanied by a lengthy preamble that described the significant provisions in the temporary regulation. The preamble also included a discussion of some of the approaches not adopted and explained the reasons therefor. For example, the preamble indicated that the tracing concept discussed in Notice 87-14 was specifically rejected because, after extensive study, it was determined that a tracing regime would be impossible to administer and would impose an enormous burden on both taxpayers and the Service. Nevertheless, Treasury recognized that the LDR differed from Notice 87-14, and

applied the LDR prospectively, for dispositions occurring on or after March 9, 1990, the date the regulation was filed with the Federal Register. For taxpayers who acquired targets after January 6, 1987, and for whom Temp. Treas. Reg. § 1.1502-20T did not apply (generally because the subsidiary was disposed of prior to March 9, 1990), a transitional rule, Temp. Treas. Reg. § 1.337(d)-1T, was enacted, which essentially adopted a tracing regime.

Both Temp. Treas. Reg. §§ 1.1502-20T and 1.337(d)-1T were issued without notice and comment. The regulations explained that because of the need to conform the consolidated return regulations to General Utilities repeal, it was impracticable and contrary to the public interest to issue the temporary regulations in accordance with the notice and public comment procedure under section 553(a) of the APA. However, at the same time that the temporary regulations were issued, a notice of proposed rule making was issued that cross-referenced the temporary regulations and indicated that the temporary regulations served as the comment document for the notice of proposed rule making. The notice of proposed rule making solicited written comments and indicated that a public hearing would be held. In response thereto, several written comments were received and a public hearing was held on June 26, 1990.

After considering the written comments and the testimony at the public hearing, Treas. Reg. § 1.1502-20T and its cross-referenced notice of proposed rule making were withdrawn and replaced with a second package of regulations that was filed with the Federal Register on November 19, 1990, and published on November 26, 1990. This package included the following:

(1) A new proposed section 1.1502-20;
(2) A final transitional regulation, section 1.337(d)-1; and
(3) A new temporary transitional regulation, section 1.337(d)-2T.

The preamble to the second proposed section 1.1502-20 regulations indicated that the LDRs were being modified and contained a lengthy discussion of the comments that were received as well as an explanation of the new proposed regulations. The second proposed section 1.1502-20 retained the LDR concept (rejecting tracing), but liberalized the LDR so that it permitted recognition of loss to a limited extent. The new regulations attempted to distinguish between real economic losses and losses attributable to recognized built-in gain and duplicated losses. The rules provided for three registers:

(1) extraordinary gain dispositions;
(2) positive basis adjustments; and
(3) duplicated losses.

To the extent the loss on the disposition of the subsidiary was greater than the sum of the registers, loss was permitted.

The transitional rule, Treas. Reg. § 1.337(d)-1, was clarified and made effective for all stock of a subsidiary that was acquired after January 6, 1987, but disposed of before November 19, 1990. It maintained the mechanics of the tracing regime laid out in the previous temporary regulation, Temp. Treas. Reg. § 1.337(d)-1T.

The temporary transitional rule, Temp. Treas. Reg. § 1.337(d)-2T, applied to all dispositions after November 18, 1990, regardless of when the subsidiary was acquired. It was added in response to comments that a transitional period should have been provided before the LDR became effective. Temp. Treas. Reg. § 1.337-2T continued the tracing regime, with modifications, until the effective date of Treas. Reg. § 1.1502-20. This temporary transitional rule was issued without notice and comment, like the temporary regulations in the prior package, due to the concern regarding circumvention of General Utilities repeal.

The final section 1.1502-20 regulations were filed with the Federal Register on September 13, 1991, and were published on September 19, 1991. As announced in the proposed regulations, the final section 1.1502-20 regulations were effective February 1, 1991. At the same time that Treas. Reg. § 1.1502-20 was made final, the temporary transitional rule, Temp. Treas. Reg. § 1.337(d)-2T, was made final and applied to dispositions and deconsolidations of a subsidiary's stock on or after November 19, 1990, and not subject to Treas. Reg. § 1.1502-20. The first transitional regulation, Treas. Reg. § 1.337(d)-1, remained in effect for dispositions before November 19, 1990.

Prior to finalizing the LDRs, a public hearing was held on January 25, 1991. Careful consideration was given to the many comments that were received and additional modifications were made to the regulations. The preamble to the final regulations includes a lengthy discussion of the most significant comments on the modified loss disallowance approach of the proposed regulations and the reasons for accepting or rejecting those comments. The preamble expands the discussion in the earlier preambles of the issues that remained the principal focus of comments and discusses new issues raised by the amendments to the proposed regulations. This preamble addresses many of the issues raised by P as grounds for the regulation being invalid such as the extraordinary gain and positive investment factors attributable to the disposition by a subsidiary of after-acquired assets and netting of basis adjustments.

For purposes of the discussion in this FSA regarding compliance with the notice and comment requirements of the APA, the important point to keep in mind is that the final section 1.1502-20 regulations retained most of the salient features of the second proposed regulations. In this regard, while certain areas were clarified concerning the so-called reattribution rules, where a common parent was permitted to reattribute certain losses on the deconsolidation of a subsidiary if the LDR

applied, most of the modifications that were made to the proposed regulations were minor changes that benefitted taxpayers – i.e., they were ameliorative provisions.

Based upon the above, we believe that the notice and comment requirements of the APA were satisfied. The purpose of these requirements is to ensure "fairness and mature consideration of rules of general application and to give affected members of the public an opportunity to comment." American Standard, Inc. v. United States, 602 F.2d 256, 267 (Ct. Cl. 1979) (citations omitted). With respect to both notices of proposed rule making, the substance of the proposed rules were set forth, either through a cross-reference to the temporary regulations (first set of proposed regulations) or directly (second set of proposed regulations), including the subjects, issues and rules involved. In addition, both notices of proposed rule making solicited written comments and a public hearing was held with respect to each set of proposed regulations. Furthermore, it is clear from the preambles that the numerous comments which were received were fully considered and that the changes which were made to the regulations were driven, at least in part, by those comments. Thus, we believe that the purpose of the notice and comment requirements of the APA were satisfied.

On the contrary, P claims that significant changes were made to the proposed regulations when Treas. Reg. § 1.1502-20 was finalized and that these changes necessitated a new round of notice and comment. P relies on American Standard to support that proposition. That case involved Treas. Reg. § 1.1502-25, which deals with the consolidated section 922 deduction relating to Western Hemisphere Trade Corporations (WHTC). In American Standard, proposed regulations were issued and subsequently withdrawn and replaced by a second set of proposed regulations that were ultimately finalized, with changes being made at each step of the process. The taxpayer argued that there was inadequate notice given of the position ultimately adopted in the final regulation. The government argued that the insertion of certain language in the second set of proposed regulations presaged the position adopted in the final regulations. While the court found that the government's argument was not groundless, it concluded that it stretched the imagination and held that the public did not have fair notice of the intendment of the final form of the regulation. Hence, it held that the notice provision of the APA was violated and invalidated the regulation. 602 F.2d at 268.

There is a large body of case law, primarily outside the tax arena, concerning the adequacy of notice for purposes of the APA. From these cases, certain guiding principles can be gleamed. For example, in California Citizens Band Ass'n. v. United States, 375 F.2d 43 (9th Cir.), cert. denied, 389 U.S. 844 (1967), the court stated that section 553(b)(3) of the APA "does not require that an agency publish in advance every precise proposal which it may ultimately adopt as a rule." Id. at 48 (citations omitted). Similarly, in Trans-Pacific Freight Conference v. Federal Maritime Commission, 650 F. 2d. 1235 (D.C. Cir. 1980), cert. denied, 451 U.S. 984 (1981), the court noted that a final rule need not be identical to the original

proposed rule. “The whole rationale of notice and comment rests on the expectation that the final rules will be somewhat different-and improved-from the rules originally proposed by the agency.” Id. at 1249. Likewise, the court in American Federation of Labor v. Donovan, 757 F.2d 330 (D.C. Cir. 1985), stated that “where the change between the proposed and final rule is important, the question for the court is whether the final rule is a ‘logical outgrowth’ of the rule making proceeding.” Id. at 338. (Citations omitted). However, the court explained that “[I]f the final rule deviates too sharply from the proposal, affected parties will be deprived of notice and an opportunity to respond to the proposal." Id. (citations omitted).

Applying the above principles to the instant case, it is clear that adequate notice was given with respect to the promulgation and adoption of the LDRs. As discussed previously, written comments were received and a hearing was held following the issuance of the first package of temporary and proposed regulations. As a result of the public comments, certain ameliorative changes were made when the second package of temporary and proposed regulations were issued. Thus, under the second package of regulations, some losses were allowed that were disallowed under the first set of regulations. Furthermore, additional comments were received and another hearing was held following the issuance of the second package of regulations. Although certain modifications were made in the final regulations, they did not significantly change from the second package of regulations. In fact, the final regulations are substantially the same as the second package of regulations. This is evidenced by the fact that the final regulations adopted the three registers that are used to determine the losses to be disallowed in similar form to those contained in the second proposed regulations. Moreover, the changes that were made in the final regulations were a logical outgrowth of the rule-making process since the public commented on the different ways by which disallowed losses could be computed among which were the following: a tracing rule that eliminated positive investment adjustments and a rule that disallowed losses from such adjustments. Hence, the notice and comment requirement of section 553(b) of the APA was satisfied.

This conclusion is supported by the recent opinion of the Tax Court in Schwalbach v. Commissioner, 111 T.C. 215 (1998). That case involved Treas. Reg. §§ 1.469-2(f)(6) and 1.469-4(a) relating to the definition of the term "activity". Specifically, the dispute centered on the addition of an attribution rule in the final regulations that attributed the activities of a C corporation to an individual who materially participates in that activity. In Schwalbach, the position adopted in the final regulations differed from the two previous sets of proposed regulations. The notices of proposed rule making relating to the two sets of proposed regulations set forth either in the document or by a cross-reference to temporary regulations, the substance of the proposed regulations, including the subjects, issues and rules involved, and invited written comments and requests for a public hearing. Based

upon the comments that were received, changes were made to the regulations. The pertinent facts found by the court are as follows:

> As was true with respect to the first set of proposed regulations, but which was untrue with respect to the second set, the final regulations addressed the treatment of activities which were conducted through a C corporation. In a complete reversal from the position stated in the first set of proposed regulations, the final regulations provided an attribution rule under which a taxpayer's activities include activities conducted through a C corporation subject to section 469.

Id. at 224-225.

In ruling that the notice and comment requirements of the APA were not violated, the Tax Court commented that:

> The mere fact . . . that the Commissioner adopted a new position in section 1.469-4(a) . . . does not necessarily mean that the Commissioner was required to give another notice and allow another comment period on that position. The Commissioner is not required by the APA . . . to include in proposed regulations every precise rule that ultimately appears in the final regulations.

Id. at 226 (citations omitted). The court went on to explain its conclusion as follows:

> The consensus among the Courts of Appeals is that a final rule must differ substantially from a proposed rule in order to require another round of notice and comment, but even when it does differ substantially, the final rule will not require another notice and comment period if it is "in character with the original proposal" and a "logical outgrowth" of the notice and comments on the proposed rule.

Id. at 226-227 (citations omitted).

The court then continued:

> Whether a final rule meets such a test rests on whether "'the purposes of notice and comment have been adequately served.'" The critical inquiry is whether commentators have had a fair opportunity to present their views on the final plan in a way that the Commissioner might find convincing. Stated differently, the Commissioner's final regulations are not subject to another notice and comment period where the proposed regulations fairly apprise interested persons of subjects and issues that may be addressed in the final regulations. The purposes

> of notice and comment are adequately served when proposed rules generate diverse public comment, are fair to affected parties, and give affected parties an opportunity to develop evidence in the record.

Id. at 227-228 (citations omitted).

The court cautioned, however, that:

> The purpose of notice and comment is not adequately served, on the other hand, where interested persons could not reasonably anticipate the final rules from the proposed rules. Where the final rules deviate too sharply from the proposed rules, notice is inadequate.

Id. at 228 (citations omitted).

In applying the above tests and concluding that another notice and comment period was not required, the Tax Court pointed out that comments were invited with respect to both sets of proposed regulations and hearings were held. In addition, the court found that the two sets of proposed regulations fairly apprised interested persons of the wide range of issues that had to be addressed in the final rules defining the term “activity”. Thus, commentators had an opportunity to express their views on the final plan. Moreover, the court determined that the final rule was a logical outgrowth of the two rounds of notice and comment on the proposed regulations. In upholding the validity of the regulation, the court stated that “Whereas petitioners would force the Commissioner to comply with the APA . . . upon the issuance of any taxpayer-unfriendly rule, the APA . . . does not require such a Draconian result.” Id. at 229-230.

It is our opinion that under the standards and analysis applied by the Tax Court in Schwalbach, another round of notice and comment was not required by the APA and the LDRs should be upheld. As was true with respect to the passive loss regulations under section 469 that were at issue in Schwalbach, the two sets of proposed regulations regarding the loss disallowance rules at issue in the instant case generated a large volume of comments. Furthermore, the preambles to those proposed regulations contained lengthy discussions of the issues that needed to be addressed, the possible approaches that were being considered, and with respect to the second set of proposed regulations, the prior comments that were received. Moreover, it is evident that serious consideration was given to the comments and changes to the regulations were made where it was considered appropriate and feasible, consistent with the balancing of competing policy considerations that were involved. Accordingly, interested persons had an opportunity to express their views and meaningfully participate in the development of the final plan, and the resulting changes that were adopted in the final regulations, which were mostly ameliorative, were a logical outgrowth of that process. Consequently, the purpose of the notice and comment requirements of the APA were met in the instant case. Therefore,

Treas. Reg. § 1.1502-20 should not be invalidated on this ground.

3. Retroactivity Issue

P also argues that Treas. Reg. § 1.1502-20 is invalid because it was applied retroactively in violation of the Administrative Procedure Act. Specifically, the final LDRs generally apply with respect to dispositions and deconsolidations occurring on or after February 1, 1991, but taxpayers may elect to apply them to dispositions and deconsolidations occurring on or after November 19, 1990. However, the final section 1.1502-20 regulations were not filed with the Office of the Federal Register until September 13, 1991, and they were not published in the Federal Register until September 19, 1991. In the instant case, P claims that a binding agreement for the sale of the S stock was executed on Date 1, and the transaction was closed on Date 2. Thus, as to the transaction in question, the LDRs have retroactive effect.

The basis for P's argument is 5 U.S.C. § 553(d) of the APA. That section provides as follows:

> The required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except -
>
> (1) a substantive rule which grants or recognizes an exemption or relieves a restriction;
> (2) interpretative rules and statements of policy; or
> (3) as otherwise provided by the agency for good cause found and published with the rule.

P relies on Rowell v. Andrus, 631 F.2d 699 (10th Cir. 1980), in support of the position that Treas. Reg. § 1.1502-20 is invalid. In Rowell, a nontax case, the Department of Interior published a proposed regulation in the Federal Register on March 18, 1976. The proposed regulation had a tentative effective date of July 1, 1976. After receiving and considering numerous comments, Interior filed the adopted regulation with the Office of the Federal Register on December 30, 1976, and the regulation was published in the Federal Register on January 5, 1977. The regulation as promulgated was identical to the proposed regulation except that the effective date was changed to February 1, 1977. Thus, the regulation as issued appeared in the Federal Register in final form less than 30 days before its effective date. The district court granted summary judgment for the government holding that 5 U.S.C. § 553(d) did not require publication of a final substantive rule at least 30 days before the rule's effective date and that the notice of proposed rule making was sufficient. On appeal, the Tenth Circuit disagreed. It determined that the publication referred to in 5 U.S.C. § 553(d) is the final or adopted rule rather than the earlier publication of the proposed rule under 5 U.S.C. § 553(b). In addition, the court concluded that the actual publication date rather than the filing date controlled for purposes of computing the 30-day period required by 5 U.S.C.

§ 553(d). Nonetheless, the court did not invalidate the regulation but merely delayed the effective date until February 4, 1977, and remanded the case to the district court.

For the reasons discussed below, it is our position that 5 U.S.C. § 553(d) does not preclude the retroactive issuance of tax regulations. Hence, since Rowell is a nontax case, it is of no consequence here. Moreover, since the instant case is not appealable to the Tenth Circuit, Rowell is not binding precedent in this Court A action.

At the outset, it should be noted that while retroactive application of a statute is disfavored, a federal agency will have the power to promulgate retroactive rules if "that power is conveyed by Congress in express terms." Bowen v. Georgetown University Hospital, 488 U.S. 204, 208 (1988). In section 7805(b) as it existed for the years pertinent to this case, [1] Congress expressly conveyed that power to the Secretary of the Treasury with respect to the promulgation of tax regulations. Prior to amendment in 1996, that section provided as follows:

> The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

I.R.C. § 7805(b). Consequently, in light of section 7805(b), there is a presumption that tax regulations apply retroactively. A. Tarricone, Inc. v. United States, 4 F. Supp.2d 323, 326 (S.D.N.Y. 1998).

The same conclusion was reached by the Fifth Circuit in Anderson, Clayton & Co. v. United States, 562 F.2d 972 (5th Cir. 1977), cert. denied, 436 U.S. 944 (1978), wherein the court stated:

> In undertaking to discern the intent of Congress as to the retroactivity of such regulations as were authorized under Section 7805(b) we are compelled to note that the authorization to deal with the matter of retroactivity is worded in a manner that indicates clearly that in a generality of cases such rulings or regulations are to be applied *with* retroactive effect. This results from the fact that the authorization to

---

[1] As part of the Taxpayer Bill of Rights II (TBOR2), Pub. L. No. 104-168, § 1101(b), 110 Stat. 1468 (1996), section 7805(b) was amended to restrict (but not eliminate) the Secretary's power to apply regulations retroactively. The amendment, however, is only effective with respect to regulations that relate to statutory provisions enacted on or after July 30, 1996, and thus, it does not apply to the LDRs at issue in this case.

> the Secretary is to prescribe the extent, if any, to which they shall be applied without such effect. We discern from this a clear implication that regulations adopted under the authority of that section will generally have retroactive effect.

Id. at 979 (emphasis in original).

Similarly, in Wendland v. Commissioner, 79 T.C. 355 (1982), aff'd sub nom. Redhouse v. Commissioner, 728 F.2d 1249 (9th Cir.), cert. denied, 469 U.S. 1034 (1984), the Tax Court reviewed the legislative history to section 7805(b) and confirmed that the general rule was for tax regulations to apply retroactively. The court explained the purpose of section 7805(b) as follows:

> The history of section 7805(b), . . ., is illuminating in that it reveals that the section originally was conceived as a way to permit the Secretary of the Treasury to assist taxpayers who were adversely affected by subsequent changes in the regulations. In other words, section 7805(b) was intended to be a taxpayer-relief provision by granting the Internal Revenue Service power to avoid inequitable results by applying its regulations and rulings with prospective effect only. As such, retroactive effect was presumed, and prospective application could only be achieved by specific provision. See H. Rept. 350, 67th Cong., 1st Sess. (1921), 1939-1 C.B. (Part 2) 168; S. Rept. 275, 67th Cong., 1st Sess. (1921), 1939-1 C.B. (Part 2) 181. See also H. Rept. 704, 73d Cong., 2d Sess. (1934), 1939-1 C.B. (Part 2) 554, 583 ("in some cases the application of regulations, Treasury decisions, and rulings to past transactions which have been closed by taxpayers in reliance upon existing practice, will work such inequitable results that it is believed desirable to lodge in the Treasury Department the power to avoid these results by applying certain regulations, Treasury decisions, and rulings with prospective effect only.")

79 T.C. at 380-381.

The Tax Court in Wendland then examined the legislative history to the APA. With respect to the 30-day rule, the court stated:

> The legislative history of the APA reveals the purpose of the 30-day rule of 5 U.S.C. sec. 553(d) was to afford affected persons a reasonable time to prepare for final effectiveness of a rule or to take any action which the issuance of the rule may require.

Id. at 381 (citations omitted). See also United States v. Gavrilovic, 551 F.2d 1099, 1104 n. 9 (8th Cir. 1977). Accord Rowell v. Andrus, 631 F.2d 699, 702-703 (10th Cir.

1980). Based upon its review of the respective legislative histories, the court held that section 7805(b) does not conflict with the purpose behind 5 U.S.C. § 553(d). See Wing v. Commissioner, 81 T.C. 17, 29 (1983).

In Wing, which involved an attack on the same regulation that was at issue in Wendland, (Treas. Reg. § 1.612-3(b)(3) relating to advanced royalties), the Tax Court made an important observation and remarked as follows:

> Even though in *Wendland* we stated that we see no inherent conflict between the APA and the Code, were such a conflict to in fact be unavoidable, this would not alter our decision. The APA is a general statute, applying equally to all Federal agencies (unless excepted). The Code, and more specifically sec. 7805, reflects a *specific* congressional action to address a particular issue (the power of the Secretary to establish regulations necessary to accomplish the raising and collecting of revenue.) If two statutes conflict or overlap in application, the rule is that the more specific of the two takes precedence. As stated by the Supreme Court:
>
> "For it is familiar law that a specific statute controls over a general one 'without regard to priority of enactment.' [*Bulova Watch Co. v. United States*, 365 U.S. 753, 758 (1961).]"

81 T.C. at 30 n. 17 (emphasis in original). This footnote was cited with approval by the Ninth Circuit in Redhouse v. Commissioner, 728 F.2d 1249 ($9^{th}$ Cir. 1984), aff'g Wendland, supra, as support for its conclusion that "It is doubtful that treasury regulations need to comply with the 30-day notice requirement." 728 F.2d at 1253.

At this juncture, it is noted that in addition to the general authority under section 7805(b) to issue tax regulations with retroactive effect, since the instant case involves a consolidated return regulation issued under section 1502, section 1503(a) is applicable. That section provides as follows:

> In any case in which a consolidated return is made or is required to be made, the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under section 1502 prescribed before the last day prescribed by law for the filing of such return.

I.R.C. § 1503(a). Since that provision states that the tax relating to a consolidated return shall, inter alia, be **adjusted** in accordance with the section 1502 regulations prescribed before the due date of the return, it follows that Treas. Reg. § 1.1502-20 may properly be applied to P's Year 4 taxable year because the final LDRs were adopted prior to the due date of P's return for that year. Therefore, under section

1503(a), it is irrelevant whether a binding contract was entered into and the transaction in question in fact closed prior to the publication of Treas. Reg. § 1.1502-20 in the Federal Register.

Notwithstanding the above, which establishes that the Secretary has the authority to issue retroactive regulations, it should be kept in mind that the Secretary's failure to limit regulations to prospective application is subject to judicial review under an abuse of discretion standard. Anderson, Clayton, 562 F.2d at 979. See Wendland v. Commissioner, 739 F.2d 580, 581 (11th Cir. 1984), aff'g per curiam 79 T.C. 355 (1983); Redhouse, 728 F.2d at 1254; A. Tarricone, 4 F. Supp.2d at 326. In this regard, however, it is noted that the Secretary will be found to have abused his discretion only if "the retroactive regulation alters settled prior law or policy upon which the taxpayer justifiedly relied and if the change causes the taxpayer to suffer inordinate harm." A. Tarricone, 4 F. Supp.2d at 326, quoting CWT Farms, Inc. v. Commissioner, 755 F.2d 790, 802 (11th Cir. 1985). Similarly, the Fifth Circuit in Anderson, Clayton listed the following nonexhaustive factors that have been found to be relevant to a court in reviewing the Secretary's exercise of his discretionary power to adopt retroactive regulations:

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

562 F.2d at 981 (footnote omitted).

As applied to the instant case, it is clear that reliance on settled prior law or policy would not be justified here because the loss disallowance rules at issue were promulgated to implement Congress' repeal of the General Utilities doctrine by limiting the losses of consolidated groups and eliminating duplication of losses with respect to the stock of subsidiaries. In other words, since Congress took action to alter settled prior law, continued reliance on it would not be justified. Hence, P is taking a different but related tact here.

In particular, P's abuse of discretion argument in this case seems to rest, at least in part, on P's purportedly reasonable reliance on the Service's earlier pronouncements following the repeal of the General Utilities doctrine, such as Notice 87-14 and the temporary and proposed regulations under sections 1502 and 337(d). Specifically, P claims that based on those pronouncements, it was

reasonable to expect that the final LDRs would apply prospectively only and that until the LDRs were effective, taxpayers would be permitted to show that their claimed losses were not attributable to built-in gains. We do not believe that the inferences drawn, and purported reliance, by P was reasonable.

As the Claims Court stated in Garvey, Inc. v. United States, 83-1 USTC ¶ 9163 (Cl. Ct. 1983), aff'd, 726 F.2d 1569 (Fed. Cir.), cert. denied, 469 U.S. 823 (1984), with respect to proposed amendments to Treas. Reg. § 1.1502-32, which would have excepted a carryover basis for the stock of an affiliate from reduction of basis for a dividend from preaffiliation earnings and profits, but were not adopted:

> The heart of plaintiff's argument is that it was justified in relying on its belief that the proposed amendments would be adopted in final form and that there would be no basis adjustment as a result of the distributions by Petroleum. However, reliance on the possible adoption of proposed amendments is not the reasonably justifiable conduct that is necessary to create an estoppel. As the term itself makes clear, proposed amendments are merely preliminary proposals. They are published in the Federal Register pursuant to the Administrative Procedure Act, 5 U.S.C. § 553, in order to give notice to the public of a proposed regulation that is under consideration. But there is nothing that requires the government to adopt in final form a regulation published as a proposed amendment . . . .
>
> * * *
>
> Plaintiff's underlying assumption is that once a proposed amendment is published it is binding on the government and may only be modified or deleted so as to *favor* taxpayers. But it is difficult to comprehend why this should be so. The notice of the proposal is made not only to those adversely affected thereby but to all interested persons - e.g., public interest groups, tax law commentators and academicians, members and staffs of Congressional committees having oversight responsibilities, and other Treasury and Internal Revenue Service personnel. Furthermore, nothing in the notice prevents the promulgators from reconsidering it in light of pertinent statutes and its adverse effects upon the revenue. *See Georgia Pacific Corp. v. Commissioner*, 63 T.C. [790,] 802-803 [(1975)].

83-1 USTC at 86,262.

Moreover, in light of P's acknowledgment that the proposed LDR regulations were controversial and that the LDRs underwent several changes during the drafting process, it is difficult to understand how P can argue that its expectations and reliance were reasonable. On the contrary, it should have been abundantly clear to

P that Treasury was reconsidering the proposed regulations based upon the numerous comments that were received and that it was quite likely that further modifications would be made before the LDRs were finalized.

In this regard, however, it is noted that the instant case is more favorable to the Service than Garvey. To begin with, in the instant case, it appears that P is complaining that changes (at least with respect to the effective date) were not made, rather than that changes were made. In addition, although in the instant case significant substantive changes were made to the regulations between the first package of regulations and the second package of regulations, only relatively minor changes were made between the second package of regulations and the final regulations. Furthermore, the changes throughout the process were generally ameliorative. Hence, retaining the effective date stated in the second set of regulations was justified. Accordingly, while it may be said that P unsuccessfully gambled that the effective date would be postponed when the LDRs were finalized and was arguably adversely affected as a consequence of that not occurring, that does not constitute inordinate harm or establish that failing to make such a change was an abuse of discretion.

Finally, in light of the policy considerations reflected in the final LDRs that were discussed in a prior FSA which was issued in this case regarding the validity of Treas. Reg. § 1.1502-20 on the merits, we do not believe that it would be inordinately harsh to apply the LDRs retroactively in this case. In this regard, attention is drawn to Rev. Proc. 91-11, 1991-1 C.B. 470, in which the Service granted blanket permission to taxpayers to discontinue filing consolidated returns. The permission was effective for the consolidated group's taxable year that included November 19, 1990, but the application originally had to be filed before July 1, 1991. However, in Rev. Proc. 91-39, 1991-2 C.B. 694, the Service extended the deadline for seeking permission to discontinue filing consolidated returns until 90 days after the proposed section 1.1502-20 regulations were superseded by final regulations. Therefore, there is no question that P had sufficient time to avoid the LDRs by seeking permission to cease filing consolidated returns, beginning with its Year 3 return, i.e., the year before the disposition transaction in question. To the best of our knowledge, no such request was made by P. Consequently, since relief was potentially available to P and it failed to timely seek said relief, P should not be heard to complain now. Accordingly, it was not an abuse of discretion to issue Treas. Reg. § 1.1502-20 with retroactive effect and to apply it in the instant case.

Alternatively, if the court determines that notwithstanding the above arguments, section 553(d) of the APA still applies to tax regulations in general and the consolidated return regulations in particular, it is also our position that 5 U.S.C. § 553(d) was not violated in the instant case. As indicated above, section 553(d) of the APA generally requires that the publication of a substantive rule shall be made not less than 30 days before its effective date unless it is a substantive rule which grants or recognizes an exemption or relieves a restriction, or unless good cause is

shown. One tax case interpreting this requirement is Wendland v. Commissioner, 79 T.C. 355 (1982), aff'd sub nom. Redhouse v. Commissioner, 728 F.2d 1249 (9th Cir.), cert. denied, 469 U.S. 1034 (1984). In Wendland, the taxpayer acquired a coal mine on December 31, 1976, and claimed a deduction for an advanced royalty on its 1976 tax return. The Service disallowed the deduction because no coal had been mined in 1976. The Service relied on Treas. Reg. § 1.612-3(b)(3), which was recently amended to provide that an advanced lump-sum royalty could only be deducted when the coal to which it related had been sold. The taxpayer contended that the amended regulations were invalid because they did not comply with section 553(d) of the APA since the effective date of the regulations was not at least 30 days subsequent to their publication.

In fact, the amended regulations at issue in Wendland were made retroactive to October 29, 1976. On that date, the Service issued a news release in which it announced proposed amendments to the regulations relating to advanced royalties under mineral leases. The news release stated that as of October 29, 1976, advanced royalty payments could only be deducted in the year of sale of the mineral product. The proposed amendments were published in the Federal Register on November 2, 1976. On December 19, 1977, the final regulations were published in substantially the same form as the proposed regulations and made effective as of October 29, 1976.

The Tax Court determined that the purpose behind the 30-day rule of section 553(d) of the APA was to afford affected persons a reasonable time to prepare for final effectiveness of a rule or to take any action that the issuance of the rule may require. The court found that the taxpayer had been informed of the intent to make the regulation retroactive to October 29, 1976, and that between such date and December 19, 1977, the taxpayer had ample time to prepare for the final regulations. Additionally, the court stated that the taxpayer had been put on notice of the Service's intention to amend the regulation with respect to the deductibility of advanced royalty payments as of October 29, 1976, and therefore, "the petitioners . . . entered into the transaction [on December 31, 1976] with full knowledge that the venture would likely be questioned by the Internal Revenue Service." 79 T.C. at 383. See also Wing v. Commissioner, 81 T.C. 17 (1983), wherein the court stated in connection with another advance royalty case that it failed "to see how petitioner could not have received notice of the proposed changes and governed his plans accordingly." Id. at 30.

The facts in the instant case are similar to the facts in Wendland. In the instant case, the second package of regulations, which was issued on November 19, 1990, outlined the three registers by which the amount of disallowed losses would be calculated. The second package of regulations stated that they would be effective with respect to all dispositions occurring after January 31, 1991. On September 13, 1991, the Service issued the final regulations, which adopted the three registers in substantially the same form as in the second package of regulations. The final

regulations were made retroactive to dispositions after January 31, 1991, as stated in the second set of regulations. [2] P entered into a binding agreement to sell the stock of S on Date 1 and the transaction was closed on Date 2. Hence, P was notified of the Service's intention to apply the three registers at least w months before entering into the transaction, and thus, P had full knowledge that the transaction would likely be subject to the LDRs. Therefore, as in Wendland, the purpose of the 30-day rule of section 553(d) of the APA was satisfied in the instant case.

Moreover, even if the court determines that the 30-day rule was not satisfied, we believe that one or more of the exceptions under section 553(d) of the APA apply. The first exception, under section 553(d)(1), applies to substantive rules that grant or recognize an exemption or relieve a restriction. In Independent U.S. Tanker Owners Committee v. Skinner, 884 F.2d 587 (D.C. Cir. 1989), the court found that a regulation that had been made effective less than 30 days after its publication in the Federal Register, nevertheless complied with section 553(d) because the regulation relieved a restriction. Tanker dealt with the Merchant Marine Act, which authorized the Secretary of Transportation to subsidize construction costs for ships built in American shipyards on the condition that such subsidized vessels would only be used in foreign trade. In 1980, Transportation published an interim regulation that allowed the repayment of the subsidies which in turn would allow the vessels to participate in domestic commerce. [3] However, the option to repay the

---

[2] Transitional regulations under section 337(d) were included as part of both the first and second package of regulations. The transitional regulations used a tracing mechanism by which losses could be either allowed or disallowed. The first transitional regulations, Treas. Reg. § 1.337(d)-1, applied to dispositions before November 19, 1990, of stock acquired after January 6, 1987. The second transitional regulations, Treas. Reg. § 1.337(d)-2, applied to dispositions and deconsolidations after November 18, 1990, and before the effective date of Treas. Reg. § 1.1502-20. Therefore, the second transitional regulations applied to dispositions after November 18, 1990, regardless of when the subsidiary stock had been acquired.

[3] The Merchant Marine Act instituted a program by which domestic vessels could compete in international commerce. The program consisted of subsidizing the construction of vessels as long as such subsidized vessels would be used solely in foreign trade. Therefore, they were not allowed to conduct trade domestically as long as they remained subsidized. Due to the over supply of tankers in the international market, many vessels were not able to compete in foreign trade any longer. As a result, the owners of many of the vessels wanted to enter the domestic market. However, because the vessels had been subsidized, they were not allowed to enter the domestic market. As a solution, the Maritime Administration issued regulations that would allow subsidized vessels to repay the subsidy. However, the first package of regulations imposed limitations regarding who was eligible to repay the subsidies. The

subsidies was limited to tankers over a certain weight and only in exceptional circumstances after a determination that the vessels had little prospect for viable employment in foreign trade had been made. Transportation then published regulations providing that for a one-year period beginning on June 6, 1985, any tanker could enter into the repayment program. During this period, three additional vessels applied for the repayment of the subsidies. On June 22, 1987, Transportation issued final regulations that were made effective immediately whereby the June 6, 1985 regulation was reaffirmed. On July 11, 1987, Congress passed and the President signed an appropriations bill which invalidated the subsidy repayment regulation. The plaintiff, the Independent U.S. Tanker Owners Committee, [4] asserted that the three additional vessels that had entered the program within the one-year window could no longer repay their subsidies because the congressional bill invalidated the program. The plaintiff also argued that since the final regulation became effective less than 30 days after its publication in the Federal Register, it did not comply with section 553(d) of the APA. The court rejected plaintiff's arguments based on section 553(d)(1). The court stated that Transportation did not need to comply with the 30-day rule because the final regulation relieved a restriction, i.e., the rule lifted the ban on the three vessels' participation in domestic shipping. See also Hou Ching Chow v. Attorney General, 362 F. Supp. 1288 (D.D.C. 1973); British American Commodity Options Corp. v. Bagley, 552 F.2d 482 (2d Cir.), cert. denied, 434 U.S. 938 (1977) (court implied that 30-day rule need not be complied with because the rule relaxed requirements previously imposed).

In the instant case, the 30-day rule similarly does not apply because the final regulations relieved a restriction. Prior to the issuance of the final regulations, which adopted the substance of the second proposed regulations, the temporary regulations disallowed all losses attributable to the disposition of the stock of a subsidiary with built-in gain. Most of the changes that were made from the second proposed regulations to the final regulations were relatively minor and ameliorative. The final regulations adopted a three register system whereby some losses, previously disallowed, could be allowed. As a result, the final regulations relieved a restriction. Therefore, it was unnecessary to comply with the 30-day rule in the instant case because the exception contained in section 553(d)(1) of the APA applies.

---

final regulations, which were being disputed by the ITOC, eliminated the limitations and essentially allowed all vessels to be eligible for repayment of the subsidies.

[4] The Independent U.S. Tanker Owners Committee (ITOC) wanted to prevent the three vessels from entering into the domestic arena. Although the reasons are not stated in the opinion, it seems that ITOC wanted to lessen the amount of competition in domestic trading.

In addition, the good cause exception contained in section 553(d)(3) of the APA also applies in this case. The good cause exception under section 553(d) is different than the good cause exception under section 553(b). See Juan J. Lavilla, *The Good Cause Exemption to Notice and Public Comment Rule-Making Requirements Under the Administrative Procedure Act*, 3 Adm. L. J. 317 (1989). In determining good cause, the courts have looked at the purpose behind section 553(d). For example, in Omnipoint Corporation v. Federal Communications Commission, 78 F.3d 620 (D.C. Cir. 1996), the court stated that "In determining whether good cause exists, an agency should 'balance the necessity for immediate implementation against principles of fundamental fairness which require that all affected persons be afforded a reasonable amount of time to prepare for the effective date of its ruling.' " Id. at 630 (citation omitted). See also Buckeye Cablevision, Inc. v. Federal Communications Commission, 387 F.2d 220, 228 n. 34 (D.C. Cir. 1967).

Applying the above standard to the instant case, we believe that good cause existed for not complying with the 30-day rule. Specifically, the repeal of the General Utilities doctrine necessitated the immediate implementation of the final regulations. Otherwise, it is likely that there would have been an influx of sales prior to the effective date of the final regulations in an effort to avoid the application of the LDRs. Additionally, fundamental fairness is met because the final regulations were adopted in substantially the same form as the second proposed regulations, which were published w months prior to the date P entered into the binding contract to sell S and y months prior to the close of the transaction.

4. Deference Issue

In light of P's challenge to the validity of Treas. Reg. § 1.1502-20, a question arises concerning the degree of deference to be afforded the regulation. The answer to this question ostensibly turns on whether the LDRs are legislative or interpretive. This is because legislative regulations are entitled to greater deference than interpretive regulations. See Bingler v. Johnson, 394 U.S. 741 (1969); Commissioner v. South Texas Lumber Co., 333 U.S. 496 (1948). See also United States v. Vogel Fertilizer Co., 455 U.S. 16, 24 (1982); Rowan Cos. v. United States, 452 U.S. 247, 253 (1981).

In tax cases, the courts have distinguished between legislative and interpretive regulations based upon the source of authority for promulgating the regulation. Specifically, regulations promulgated under the general authority of section 7805(a) "to prescribe all needful rules and regulations for the enforcement of [the Internal Revenue Code], including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue", are considered interpretive and regulations promulgated pursuant to a specific grant of authority under a particular Code section are considered legislative. See Ellen P. Aprill, Muffled *Chevron*: Judicial Review of Tax Regulations, 3 Fla. Tax Rev. 56-57 (1996);

Bankers Life and Casualty Co. v. United States, 142 F.3d 973, 978 (7th Cir.), cert. denied, 119 S. Ct. 403 (1998).

In determining whether Treas. Reg. § 1.1502-20 is a legislative or interpretive regulation, it is noted that the authority to promulgate regulations with respect to the making of consolidated returns stems not only from the Secretary's general rule-making power granted in section 7805(a) but also from the specific provisions of section 1502. Section 1502 provides as follows:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

I.R.C. § 1502. Thus, it is well settled that the consolidated return regulations are legislative in nature. See, e.g., Idaho First National Bank v. Commissioner, 997 F.2d 1285, 1289 (9th Cir. 1993); Garvey, Inc. v. United States, 83-1 USTC ¶ 9163 (Cl. Ct. 1983), aff'd, 726 F.2d 1569 (Fed. Cir.), cert. denied, 469 U.S. 823 (1984); Union Electric Co. of Missouri v. United States, 305 F.2d 850, 854 (Ct. Cl. 1962); Alumax Inc. v. Commissioner, 109 T.C. 133 (1997). This is amply supported by the legislative history to section 1502 and its predecessors. For example, during the consideration of the proposed revision of the revenue law that ultimately became the Revenue Act of 1928, the Senate Finance Committee recommended the addition of a provision granting broad authority to the Commissioner to promulgate regulations dealing with the problems that arose with respect to consolidated returns. The Senate Finance Committee explained the reasons for its proposal as follows:

> Many difficult and complicated problems . . . have arisen in the administration of the provisions permitting the filing of consolidated returns. * * * The committee believes it to be impracticable to attempt by legislation to prescribe the various detailed and complicated rules necessary to meet the many differing and complicated situations. Accordingly, it has found it necessary to delegate power to the Commissioner to prescribe regulations **legislative in character** covering them.

S. Rep. No. 70-960, at 15 (1928), 1939-1 C.B. (Part 2) 409, 419 (emphasis added). Similarly, the House Ways and Means Committee Report regarding the Bill that became the 1954 Code stated as follows:

> Since the Revenue Act of 1928, the law has provided that the Secretary is to prescribe regulations, **legislative in character**, giving detailed rules for the filing of a consolidated return by an affiliated group of corporations.

H.R. Rep. No. 83-1337, at 87 (1954) (emphasis added). For a good discussion of the legislative history concerning consolidated returns, see Regal, Inc. v. Commissioner, 53 T.C. 261 (1969), and Alumax, 109 T.C. at 192-196.

This brings us to the question of the degree of deference owed to a legislative tax regulation in the face of a challenge to its validity. In general, legislative regulations are given "controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 844 (1984). Interpretive regulations, on the other hand, are given less deference but still "considerable weight" and "a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency." Id. at 844. As applied in the context of tax regulations, however, it has been stated:

> the distinction between legislative and interpretative regulations is often blurred in practice, and the supposedly diverse standards of judicial review tend to converge and even to coalesce.

Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶ 110.4.2, at 110-38 (2d ed. 1992)(footnotes omitted).

With respect to tax regulations, it is well settled that a court should ordinarily defer to the regulation if it "implement[s] the congressional mandate in some reasonable manner." United States v. Corell, 389 U.S. 299, 307 (1967). Accord Commissioner v. Portland Cement Co. of Utah, 459 U.S. 156, 169 (1981); National Muffler Dealers Ass'n v. United States, 440 U.S. 472, 476 (1979); United States v. Cartwright, 411 U.S. 546, 550 (1973). In one of the leading cases regarding the validity of tax regulations, National Muffler, the Supreme Court set forth this oft-quoted guiding principle for determining reasonableness:

> In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose.

440 U.S. at 477. The Court also made it clear that "The choice among reasonable interpretations is for the Commissioner, not the courts." Id. at 488.

Based upon the foregoing, Treas. Reg. § 1.1502-20 should be given great weight. This is especially true in the instant case because in addition to section 1502, the

LDRs were promulgated pursuant to another specific grant of authority as well, namely, section 337(d). That section provides, in pertinent part, as follows:

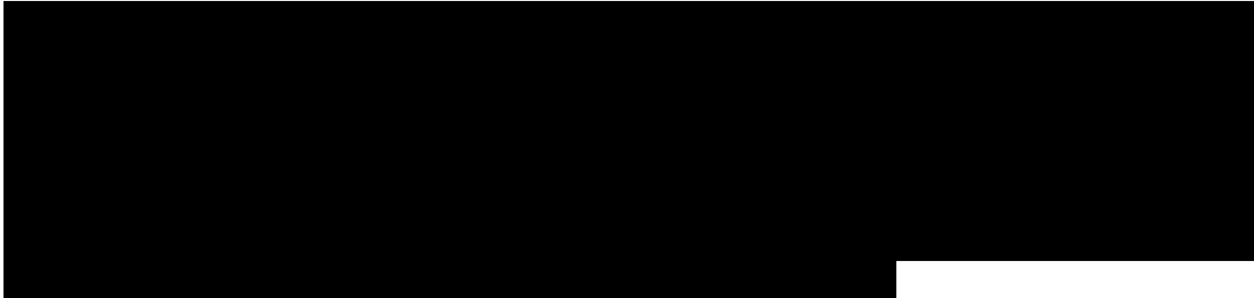
> The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made by subtitle D of title VI of the Tax Reform Act of 1986 [relating to the repeal of the General Utilities doctrine], including -
>
> (1) regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (**including the consolidated return regulations** . . . .

I.R.C. § 337(d) (emphasis added). Hence, since the LDRs were promulgated not only to implement the repeal of the General Utilities doctrine but also to prevent potential abuse in the consolidated return area as a result of said repeal, Treas. Reg. § 1.1502-20 should be afforded a high degree of deference. [5] Accordingly, so long as the regulation is within Congress' delegation of authority to the Secretary, see Rowan Cos., 452 U.S. at 253, or unless P can demonstrate that the LDRs are unreasonable and plainly inconsistent with the revenue statutes, see Portland Cement, 450 U.S. at 169, quoting South Texas Lumber, 333 U.S. at 501, they should be upheld.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[5] The consent requirement under section 1501 adds further support to affording a high degree of deference to a consolidated return regulation. Supplemental advice concerning the consent requirement under section 1501 may be provided at a later time.

.



Deborah A. Butler
Assistant Chief Counsel (Field Service)

By: ________________________________
HENRY S. SCHNEIDERMAN
Technical Assistant to the
Assistant Chief Counsel (Field Service)