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Taxpayer Fights Regulations, and Wins: 'Dominion Resources'

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Since the Supreme Court's decision last year in Mayo,[1] which made it clear that tax regulations promulgated by the Treasury Department under the Internal Revenue Code are entitled to the same high level of deference accorded under the *Chevron*[2] rule to regulations promulgated by other Federal agencies, a taxpayer considering the adoption of a position inconsistent with a tax regulation has faced a heavy burden if he desires to maintain that the regulation is invalid. Under the two-step method of analysis established by the Supreme Court in *Chevron* for determining the validity of a Federal regulation, it must first be determined whether Congress had directly addressed the question at issue by statute (Chevron Step One). If the statute is silent on the issue, or ambiguous, principles of administrative deference require that the regulation be upheld if it represents a reasonable interpretation of the statute (Chevron Step Two).

Chevron concerned a regulation promulgated by the Environmental Protection Agency, and courts had on occasion over the years used considerably less deferential criteria in reviewing tax regulations. In *Mayo*, the Supreme Court disapproved of some of this earlier case law and held that the Chevron method of analysis also applies to tax regulations promulgated by the Treasury Department.

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Mayo was viewed, for a time, as creating a hurdle almost impossible to clear with respect to challenging tax regulations. Earlier this year, however, the Supreme Court in *Home Concrete* identified one circumstance in which it would not grant deference to a tax regulation—when that regulation purported to interpret the statute in a manner contrary to a longstanding Supreme Court precedent.[3]

More recently, in *Dominion Resources, Inc. v. United States*,[4] the Court of Appeals for the Federal Circuit, reversing a decision of the Court of Federal Claims (CFC), found another basis for invalidating regulations interpreting the interest capitalization requirement of IRC Section 263A(f). While the complex accounting issue in *Dominion Resources* may be of direct interest to only a small group of taxpayers, this reminder that there are still sometimes ways to break free of *Chevron*- and *Mayo*-mandated deference to tax regulations may be susceptible of application throughout the tax law.

Facts in 'Dominion Resources'

A subsidiary of Dominion Resources, Inc. (Dominion) owned electric generating plants and sold the electricity to individual and commercial customers. These plants included two coal-fired electric generating complexes, one located in Virginia and the other in West Virginia, each of which was in turn comprised of several independent generating units.

In 1996, Dominion performed renovations at these two complexes that included replacement of certain coal burners to comply with federal environmental requirements. In order to replace the coal burners, Dominion was required to take out of service one generating unit at each of the two complexes for periods of approximately two to three months.

Under longstanding case law and IRC Sections 263 and 263A, the cost of improvements to capital assets such as the generating units must generally be capitalized, rather than deducted currently. By contrast, the cost of repairs is generally deductible, and Dominion apparently argued in connection with an IRS audit of the year at issue (1996) that the entire cost of replacing the burners should be deductible as a repair; that issue was addressed in a settlement agreement between the IRS and Dominion in 2007 and not before the courts here.[5] In the settlement agreement, however, Dominion reserved the right to claim a refund by reason of interest that the IRS had required to be capitalized, as an indirect cost incurred with respect to the improvements, under "avoided cost" rules discussed below.

Shortly after the settlement agreement was executed, Dominion in fact

filed a claim for refund of approximately $300,000 of corporate income tax with respect to the interest capitalization issue. The claim was denied, and Dominion then commenced an action to the Court of Federal Claims to pursue the refund claim.

Analysis

At issue in the CFC (through cross-motions for summary judgment made by Dominion and the government), and on appeal, was the application of IRC Section 263A(f). That provision generally requires a taxpayer engaged in certain production activities (such as the improvement of certain property) to capitalize, as part of the cost of the improvement, interest costs that are paid or incurred during the production period, and allocable to the improvement; accordingly, such costs cannot be deducted on a current basis. This seemingly straightforward interest capitalization rule is interpreted by intricate regulations that have spawned complex questions regarding their application.

Interest on debt the proceeds of which are directly traceable into production expenditures is allocated to the property being produced (e.g., the improvement). In situations, such as the power plant improvements before the courts in this case, in which production expenditures are not directly financed by borrowings by the taxpayer, interest on other debt is required to be capitalized "to the extent that the taxpayer's interest costs could have been reduced if production expenditures (not attributable to indebtedness [directly allocable to the production expenditures]) had not been incurred."[6] Under this so-called "avoided cost" methodology, if a property owner builds an improvement without incurring any debt specifically traceable to the improvement, but the property owner has other, unrelated debt outstanding during the production period, a portion of its overall interest expense must be capitalized.[7]

The regulations provide that, for purposes of applying the interest capitalization rule to an improvement of real property (such as Dominion's power units), the adjusted tax basis of any property that is temporarily withdrawn from service in order to complete the improvement is included in the production expenditures by reference to which the amount of interest to be capitalized is determined. This is often referred to as the "associated property" rule.[8]

The primary contentions of Dominion (and the only contentions discussed below) were that the associated property rule was invalid because it was inconsistent with Section 263A and because it had been adopted in a manner inconsistent with the requirements of the Administrative Procedure Act. More specifically, Dominion asserted that Treasury failed, in the course of promulgating the regulations that included the associated property rule, to provide any explanation of the reasoning that led it to adopt the rule, and that the rule was therefore invalid even if it were consistent with Section 263A.

Although space constraints do not permit a full discussion in this article of the parties' arguments with regard to the consistency of the regulation with the statute, the arguments may be briefly and somewhat crudely summarized as follows: With respect to the two-step analysis required under *Chevron*, Dominion argued that the associated property rule failed both Chevron Step One and Step Two. In particular, Dominion maintained that the regulation was inconsistent with Congressional intent expressed in the definition of the avoided cost method and in the definition of production expenditures; and that, even if that position were not accepted, the rule failed Chevron Step Two because it was not a reasonable interpretation of the statutory provision.

The CFC concluded that the statute was unclear as to what production expenditures should be taken into account for purposes of the avoided cost rule, and therefore that the associated property rule did not contradict the statute—and the Federal Circuit agreed with this conclusion. As to the Chevron Step Two analysis, the government made two arguments in support of the associated property rule: (i) that the rule was a surrogate for capitalizing the lost revenue, resulting from taking the improvement out of service, which in an economic sense should be viewed as part of the cost of the improvement; and (ii) that the owner of the property being improved could have chosen to sell it rather than improve it, and (by choosing to improve, rather than to sell and to apply the proceeds to pay down debt) effectively chose to incur additional interest expense that could otherwise have been avoided.

The CFC characterized these "not very satisfying" rationales, and Dominion's counter-arguments, as a very close case, but declined to conclude that Treasury had overstepped the latitude given to it by a complicated and to some degree circular statutory provision.

On appeal, the Federal Circuit found that the associated property rule in the regulations was not a reasonable construction of the statutory avoided cost rule. It noted that there was no realistic possibility that Dominion would sell, rather than improve, boilers that were an integral part of large power plants. Moreover, the associated cost rule could lead to absurd results; for example, it computed production expenditures in a manner that resulted in very different interest amounts being required to be capitalized for the each of the two power units improved -- because there was a large difference between the adjusted bases of the underlying power units -- notwithstanding that the direct costs of the two improvements were very similar. If the Federal Circuit had ended its opinion here, we would be focusing in this article on whether that court's apparent resistance to granting the deference mandated by the Supreme Court in *Mayo* could be justified on the particular facts of this case.

Of broader interest, though, is that the Federal Circuit's opinion opens the door to another method of challenging tax regulations, one that does not require distinguishing away the Supreme Court's precedents in *Chevron* and *Mayo*. The Federal Circuit concluded that the court below had erred in dismissing Dominion's claim that the associated property rule violated the re-

quirement, imposed by statute and case law, that a Federal agency adopting a regulation provide a reasoned explanation for its action.[9] The Federal Circuit observed that, although the notice of proposed rulemaking that preceded the issuance of the regulation in final form stated that the adjusted basis of existing structures would be taken into account in applying the avoided cost method, neither that notice nor any other guidance relating to the regulations provided a rationale for the associated property rule other than the general statement that it was intended to implement the avoided cost method.[10]

Judge Clevenger, one of the three judges on the Federal Circuit panel, agreed, in his concurring opinion, that the decision of the CFC should be reversed on the basis of the government having failed to provide a reasoned explanation, at or before the time the regulation was issued, for the associated property rule. He also asserted, however, that it was premature and unnecessary at this time to decide that the associated property rule was incompatible with the statutory provisions relating to the application of the avoided cost method. He therefore dissented from the *Chevron* analysis in the court's opinion.

The concurring opinion also characterized the government's appellate briefing as "to say the least, opaque"; and observed that a possible justification for the associated property rule that was rejected by the government at oral argument was then advocated by the government in a post-argument letter.

Observations

As noted in the Federal Circuit opinion, the rejection of the associated property rule has the potential for substantially increasing the amounts of interest that may be deducted currently by property owners engaging in production activities. At least in part for that reason, it seems likely that the government will make further efforts to defend this rule in other forums, if not in the Federal Circuit.

Setting aside the specifics of this issue, however, it will be interesting to see whether the government will feel compelled, in light of Dominion's victory in the Federal Circuit, to provide more lengthy and detailed justifications, in the course of issuing regulations, for each of the rules set forth in those regulations. *Dominion* makes clear that, even after *Mayo*, courts remain open to the consideration of issues potentially critical to the validity of tax regulations.

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1 *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011).

2 *Chevron U.S.A. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

3 *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012); *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958). The issue in *Home Concrete* was whether or not the special six-year statute of limitations period applicable under IRC Section 6501(e) for certain substantial omissions from gross income applies to overstatements of basis.

4 *Dominion Resources, Inc. v. United States*, Docket no. 2011-5087, 109 AFTR 2d 1012-___ (Fed. Cir. 2012), reversing 107 AFTR 2d 2011-1033 (Ct. Fed. Cl. 2011).

5 In late 2011, the Treasury Department promulgated extensive temporary regulations (T.D. 9564, Dec. 23, 2011) relating to the distinction between "repairs" and "improvements," but those new regulations were not at issue in this case.

6 IRC § 263A(f)(2)(A).

7 See Reg. §§ 1.263A-9(c), 1.263A-11.

8 Reg. § 1.263A-11(e)(1)(ii)(B).

9 See generally Elliot Pisem and Jason K. Binder, "BLAK Affirms the Necessity of Raising Statute of Limitations Defense Early in TEFRA Partnership Proceedings," 112 Journal of Taxation 222 (April 2010).

10 The CFC opinion noted that comments were received regarding the proposed associated property rule, to the effect that property should be treated as taken out of service for purposes of this rule only if it was taken out of service for depreciation purposes. The IRS did not adopt this suggestion but expanded a related de minimis exception in Reg. §1.263A-11(e)(2).

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