No. 12-684

IN THE

Supreme Court of the United States

UNION CARBIDE CORPORATION AND SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITIONER'S REPLY BRIEF

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PETITIONER'S REPLY

The court below held that this Court's decision in *Auer v. Robbins*, 519 U.S. 452 (1997), required it to defer to the government's arguments on the meaning of the Treasury Regulations as set forth in the government's legal brief, so long as those arguments were plausible. In resolving an issue of law by deferring to the government's arguments, the court, therefore, did *not* do what Congress had assigned it to do: resolve the legal issue by evaluating the opposing parties' competing arguments on even terms, construing the statutes and regulations, and deciding what the statutes and regulations mean. The panel's approach means that, in tax litigation, the government's legal arguments are favored over those of the taxpayer. The scales, therefore, are tipped decisively for the government and against the taxpayer in a forum – the courts – to which citizens have historically turned for an impartial resolution of legal issues involving taxation.

The result here is that the panel stripped an important tax credit of its efficacy in encouraging plant-based manufacturing process research. Had the panel employed the usual tools of legal and statutory interpretation, it would have reached the contrary result and the credit would be intact.

Although Respondent did not even claim a right to the deference conferred by the court below, Respondent now enthusiastically welcomes the idea of deference in this setting. Indeed, while he cites no direct precedent for the Second Circuit's decision to confer deference in this setting, he suggests that the decision is consistent with any number of this Court's precedents. Moreover, Respondent argues

that because he did not seek deference, the issue was not briefed below – and suggests that this renders the question of deference, though expressly addressed and decided by the court below, unsuitable for review.

For the reasons described below, Respondent's arguments are unavailing. The Petition should be granted to address (1) the proper application of *Auer* deference to government arguments presented as a self-interested litigant in a fighting brief; and, (2) whether the statutory requirement that creditable supplies be "used in the conduct of qualified research" requires that the supplies be additional supplies purchased specifically for the research.

I. RESPONDENT'S ARGUMENTS CONFIRM THAT THIS COURT'S GUIDANCE IS REQUIRED ON THE PROPER SCOPE OF *AUER*.

Respondent cites no direct precedent for the panel's decision granting *Auer* deference to the IRS's litigating position. Respondent nonetheless suggests that the decision is within the mainstream of this Court's cases on deference. Respondent invokes various kinds of cases in which an agency's interpretation of its own regulations was accorded deference. *See* Respondent's Brief In Opposition ("Opp.") at 13. Yet in each case cited by Respondent, Congress had created an intra-agency procedure for the agency to review and determine the scope of the agency's own regulations. A grant of deference in those circumstances rests on a far firmer footing than the grant of deference to a litigant's arguments in a brief. Respondent's mistaken reliance on cases arising in that setting highlights the confusion in the

courts below, and on the part of the government, regarding the proper scope of what has come to be called *Auer* deference.

For example, in *Thomas Jefferson University v. Shalala*, 512 U.S. 504, 510-511 (1994), the Secretary of Health and Human Services adopted an interpretation of an agency regulation pursuant to a formal internal review during a statutory administrative appeal procedure – *not* as a self-interested party in a litigation. The same was true in *Robertson v. Methow Valley Citizens Council*, 490 U.S. 332, 358-59 (1989) (Forest Service interpretation of permitting regulations during agency's determination whether to issue development permit), and *Northern Indiana Public Service Co. v. Porter County Chapter of the Izaak Walton League of America, Inc.*, 423 U.S. 12, 12-13 (1975) (interpretation of Atomic Energy Commission regulations applied by Commission's appeals board in reviewing decision of Commission's licensing board).

Where Congress has established the agency as decision-maker, the agency presumably will sometimes resolve issues about agency regulations in a way that favors the agency. When the agency performs the congressionally-assigned role of decision-maker, it is not surprising that the agency's decision may be entitled to deference upon further review in the courts.

But Congress made *courts* the decision-makers in litigation over questions of taxation. When the IRS and a taxpayer disagree on the application of the tax laws, the courts are responsible for deciding what the tax laws – statutes, regulations and prior decisional law – actually mean. Granting a naked

preference to the arguments of the tax collector over those of the taxpayer tips the scales of justice, and represents the abnegation of the court's assigned duty to impartially read and interpret the tax law in connection with the litigation at hand.

Similarly, Respondent cites (in addition to the inapposite cases noted above) *Mayo Foundation for Medical Education and Research v. United States*, __ U.S. __, 131 S. Ct. 704, 713 (2011), for the proposition that even "Treasury Department[] interpretations of ambiguous tax statutes are entitled to deference." Opp. at 14. But *Mayo* was a *Chevron* deference case. Congress had assigned Treasury the responsibility of issuing regulations interpreting the statute. The agency had issued regulations that disfavored the taxpayer. Those regulations were entitled to deference because of the *Chevron* doctrine and basic principles of administrative law. Here, in contrast, the panel below deferred not to duly promulgated regulations, but rather to the IRS's arguments in its litigation brief about the meaning of the agency's regulations – a form of deference that cannot be grounded in any principle of administrative law. Congress has assigned *courts* the responsibility to resolve litigation contests between the IRS and the taxpayer. This ordinarily includes the responsibility to decide what the law is and means. In that setting, there is no basis to grant the tax collector's arguments the edge over those of the citizen.[1]

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[1] Where the IRS offers its interpretation of a statute as an argument in a legal brief, it gets no deference for its views. *See Gonzales v. Oregon*, 546 U.S. 243, 256-58 (2006) (no *Auer* (continued…)

Indeed, although the IRS issues Revenue Rulings, which are subject to extensive internal review at the IRS and Treasury, and announces the IRS's views on the meaning of the Code and Treasury regulations, such Revenue Rulings are only given *Skidmore* deference. *See* Leandra Lederman, "The Fight Over 'Fighting Regs' and Judicial Deference in Tax Litigation," 92 *B.U. L. Rev.* 643, 664-68 (2012). Anomalously, under the decision of the court below, the IRS can now obtain greater deference, *via Auer*, if it disdains that process and simply argues what is convenient in a legal brief. The notion that the agency's well-considered interpretation of its regulations, announced in advance to the public, should receive *Skidmore* deference, while an argument conveniently created to support a litigation position should receive *Auer* deference (which, as applied to agency regulations, looks nearly as deferential as *Chevron*), is incongruous, at best.

On the one hand, deference may be granted where Congress has designated the agency as decision-maker and the agency has rendered and announced in advance a considered view. On the other hand, the government may merely be a litigant offering arguments in support of its cause in a courtroom setting. Respondent's failure to acknowledge that the case to be made for deference differs in these two very different settings serves to highlight that the scope and premises of *Auer* and its progeny (and predecessors, like *Bowles v. Seminole*

(continued)
deference for agency interpretations of regulations that merely parrot the statute).

Rock & Sand Co., 325 U.S. 410 (1945)) rest on uncertain footing and are poorly understood. The Second Circuit panel's rote reliance on *Auer* in this case, without any real regard for limitations on *Auer's* scope or rationale, confirms the need for clarification by this Court.[2] Indeed, members of the Court, the Court itself, and commentators, have observed the foundational difficulty and necessary limitations on the scope of what has come to be called the *Auer* doctrine. *See* Petition at 22, citing cases, opinions, and commentary.

II. THERE ARE NO OBSTACLES TO GRANTING *CERTIORARI* ON EITHER OF THE QUESTIONS PRESENTED.

1. Respondent acknowledges that in the court below it did *not* even *claim* that it was entitled to deference for arguments it advanced in its briefs. Respondent nonetheless suggests that because Petitioner did *not* brief the deference issue below – albeit because Respondent did not raise it – this militates against certiorari because only in exceptional cases will the court grant certiorari on issues not raised below. Opp. at 7.

The correct statement of the rule that Respondent appears to be invoking is actually that this Court will generally not consider claims "neither

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[2] The Second Circuit panel treated this Court's decision in *Christopher v. SmithKline Beecham Corp.* __ U.S. __, 132 S. Ct. 2156, 2166 (2012), as if the "enumerated categories" cited in that case provided the exclusive list of circumstances where the court was entitled to reject government arguments about the meaning of agency regulations. *See* Pet. App. at 9a.

raised *nor addressed* below," *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 455 (2007) (emphasis added), or claims "neither raised nor *decided* below," *Clingman v. Beaver*, 544 U.S. 581, 598 (2005) (emphasis added). Here, Petitioner had no occasion to develop the deference issue below precisely because *Respondent* did not seek deference. Indeed, in its reply below, Petitioner simply observed in passing that, because the IRS had not requested deference, Second Circuit precedent mandated that the IRS should not be granted deference.[3]

The Second Circuit panel nevertheless chose to reach and squarely decide the deference issue *sua sponte*. It read this Court's precedents to require deference and used that deference as a substitute for its own analysis of the statute and regulations. The issue was thus *decided* below. The Second Circuit's decision squarely presents an issue of law readily briefed, argued and resolved in this Court. Indeed, Respondent's failure to claim deference in this setting highlights the novelty and reach of the Second Circuit's holding on the deference issue.

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[3] In its reply below, Petitioner noted that where the government did not seek deference, Second Circuit precedent held that no deference should be granted. Petitioner offered the following citation: "*See also Robinson Knife Mfg. Co. v. Commissioner*, 600 F.3d 121, 134 n.11 (2d Cir. 2010) (no *Auer* deference is due the IRS's interpretation of its regulation when the IRS has not argued for *Auer* deference in its brief; moreover, '[t]he Commissioner's reading of the regulation is contrary to the plain meaning of its text.')." Appellant's Reply Brief (in the Second Circuit) at 12-13. Notwithstanding the IRS's failure to request *Auer* deference, the panel felt itself obliged – under a misreading of *this Court*'s precedents – to defer to the government's arguments.

2. Respondent asserts (Opp. at 15) that the second "question presented" by the Petition contains no reference to the notion that "deference might be unwarranted here because the relevant agency interpretation was set forth in the government's litigation briefs, rather than announced before the suit began." Opp. at 15.

Respondent's objection to Petitioner's phrasing of the second question is hard to fathom. The fact that the government's arguments were raised as a litigant in its brief is a central focus of the Petition, is fairly included in the second question as stated, and is a central feature of the case and the decision below. The second question refers specifically to government arguments advanced "in a case" in which the government is a financially-interested party. Petition at (i). Indeed, the introductory paragraphs to the "Questions Presented" observe that the deference afforded here was to a "position that the IRS articulated for this litigation." *Id.* That is the context in which the court below considered *Auer* here: where the "interpretation" at issue "appears in a legal brief." Pet. App. 9a.

Lest there be doubt, Petitioner confirms that the question concerning *Auer* deference that it seeks to present to this Court is in relation to government arguments presented as a financially-interested party in a legal brief. Moreover, if the Court deemed it appropriate, the Court could, of course, reframe and clarify either question presented. *See* Eugene Gressman, *et al.*, *Supreme Court Practice* 459 (9th ed. 2007) (citing cases) ("[I]f the Court is dissatisfied with the phrasing of the question presented in the petition, it may recast the question itself in the order granting certiorari.").

III. THE UNDERLYING ISSUE CONCERNING THE SCOPE OF THE RESEARCH TAX CREDIT IS OF GREAT IMPORTANCE TO MANY INDUSTRIES, AND WOULD HAVE BEEN RESOLVED DIFFERENTLY BUT FOR THE SECOND CIRCUIT'S INAPPROPRIATE RELIANCE ON *AUER*.

Respondent does not take issue with Petitioner or *amici*'s description of the importance of the Second Circuit's ruling as it bears on the research tax credit for plant-based manufacturing process research – a matter of vital significance to many industries. *See* Petition at 14-18; Brief of *Amici Curiae* National Association of Manufacturers, American Chemistry Council, and Chamber of Commerce of the United States of America at 10-22 ("Despite the need for supplies to test innovative processes on a full-plant scale, the Second Circuit's decision arbitrarily denies the research credit for these necessary costs if they produce, or potentially could [] produce, salable products. . . . The denial of a credit for those key costs essential to test the processes will necessarily reduce the willingness of companies to engage in process research.") (*id.* at 20).

The qualified experiments could not have been conducted without the supplies at issue. Because one cannot project from a small-scale reaction how chemicals will interact when combined in large quantities, the only way to verify one's hypothesis regarding improvements to a manufacturing process is often to run the experiment at normal manufacturing levels. The supplies used, in normal quantities, are an essential part of the qualified research, with nothing "indirect" about them. This

is true whether the supplies are specially ordered for the experiment or not.

Respondent argues, however, that the Second Circuit panel might have reached the same result *without* deferring to the IRS's arguments on the "indirect cost" regulation. Of course, one cannot know for certain what the panel below would have done if it had not misread this Court's precedents to require deference. The more logical conclusion, however, is that the court below found it necessary to grant deference because otherwise the IRS's position could not be sustained.

Respondent's Opposition cites passages from the decision below that he asserts would support a ruling in his favor even without benefit of *Auer* deference. For example, Respondent (Opp. at 9) cites the panel's citation of the title of the statutory section as supportive of his view. But reliance on the title is misguided because the reference to increasing research activities reflects only the basic structure of section 41, providing that increases in research activities over those conducted in base period years lead to a credit.

Similarly, Respondent cites the assertion that the IRS's position was consistent with congressional intent. Opp. at 9-10. But that assertion was entirely conclusory: there is no indication from context or any legislative materials that Congress either did, or would have, sided with the IRS on the issue here. The plain language of the statute is the only reliable indicator of Congress's intent here.

Respondent says finally that the panel below was justified in rejecting dictionary definitions of "used," in favor of examining the relevant statutory

"phrase as a whole." Opp. at 7 (citing Pet. App. 7a). To be sure, the panel below discoursed on why it should not "make a fortress out of the dictionary." Pet. App. 6a. But Respondent (and the court below) offer no explanation why looking at the phrase as a whole – "supplies used . . . in the conduct of qualified research" – changes the meaning of "used." The word "used" does not "suggest[ ]" "[a]t first blush," that "the statute only covers supplies purchased for the purpose of conducting qualified research." Opp. at 7 (quoting Pet. App. 7a). If Congress meant supplies "purchased for" research, it could have said so. What the court did here "on first blush" was apply its presupposition of how a tax credit ought to operate, rather than construe the words of the statute or the regulations as written.

If the panel below had examined the language of the regulations in context, rather than defer, it would have seen that the government's argument for its interpretation of "indirect" in Treas. Reg. § 1.41-2(b)(1) was inconsistent with other provisions of the same regulations. *See* Petition at 29-32. For example, the very next provision sets forth a special rule for utility costs. *See* Treas. Reg. § 1.41-2(b)(2) (Pet. App. 309a-310a). That special rule for utility costs states that only "additional expenditures" necessitated by the research activities, above and beyond what would otherwise have been spent, are used in computing the credit. It prescribes for *utility* costs the treatment that the IRS apparently wishes it had prescribed for supply costs, but did not. Nonetheless, because the panel below deemed itself obliged to defer to the government's arguments, it declined to consider that point or construe the regulations (and statute) as written. *See also* Petition at 29-32 (noting other aspects of the

Treasury Regulations that militate against Respondent's view).

In short, both questions presented, (1) whether deference was properly granted to the government's fighting brief argument on the meaning of its own regulations; and, (2) whether "supplies used in the conduct of qualified research" includes only additional supplies specially purchased for research, warrant review.

CONCLUSION

The Petition should be granted.

Respectfully submitted,

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