No. 11-1528

IN THE

Supreme Court of the United States

NORTHROP CORPORATION EMPLOYEE INSURANCE BENEFIT PLANS MASTER TRUST,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

PETITIONER'S REPLY BRIEF

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PETITIONER'S REPLY BRIEF

This case involves an issue of statutory interpretation concerning a provision of the Internal Revenue Code on which there is a clear conflict between the Sixth Circuit and the Federal Circuit. This issue affects thousands of taxpayers and billions of dollars in tax liabilities. Accordingly, the petition should be granted. The government's position that the petition should be denied cannot be justified in light of the clear circuit conflict and the importance of the issue.

The government agrees there is a conflict between the Sixth Circuit and the Federal Circuit on the central issue in this case, namely, the proper interpretation of section 512(a)(3)(E)(i). "Petitioner correctly identifies a disagreement between the Federal and Sixth Circuits on the proper interpretation of the limit specified in Section 512(a)(3)(E)(i)." Brief in Opposition at 10. "Petitioner is thus correct to assert a conflict between the Federal and Sixth Circuits on the proper interpretation of 26 U.S.C. 512(a)(3)(E)(i)." *Id.* at 19. "The circuits are squarely in conflict … on the question whether investment income that is spent during the taxable year can 'result in' a year-end balance that exceeds the account limit described in Section 512(a)(3)(E)(i)." *Id.*

The petition should be granted to resolve the direct circuit conflict between the Federal Circuit's decision in *CNG Transmission Management VEBA v. United States*, 588 F.3d 1376 (Fed. Cir. 2009), on which the decision in the present case entirely rests, and the Sixth Circuit's decision in *Sherwin-Williams*

Co. Employee Health Plan Trust v. Commissioner, 330 F.3d 449 (6th Cir. 2003), regarding the proper interpretation of section 512(a)(3)(E)(i). Because of this circuit conflict, VEBAs that happen to be located in the Sixth Circuit can apply the interpretation of section 512(a)(3)(E)(i) adopted in *Sherwin-Williams*, while VEBAs located outside the Sixth Circuit must apply the interpretation of section 512(a)(3)(E)(i) adopted in *CNG* and the temporary regulation. The petition should be granted to eliminate this unjustified and unfair disparity in the tax treatment of VEBAs based on where the VEBA happens to be located.

Not only is there a direct conflict between the Sixth Circuit and the Federal Circuit on the central issue in this case, but there is also a clear conflict between the Federal Circuit's central holding in *CNG* that statutory language such as "result in" is clear and unambiguous in any statutory context, *see* 588 F.3d at 1379-80, and this Court's holding in *United States v. Tinklenberg*, 131 S. Ct. 2007, 2012-13 (2011), that the meaning of the statutory language "resulting from" could not be determined from the language alone but instead could be determined only by considering statutory context, structure, and purpose.

Moreover, the issue on which the Sixth Circuit and the Federal Circuit are in conflict affects substantial numbers of VEBAs. The IRS's own statistics indicate there are thousands of VEBAs and these VEBAs earn billions of dollars of investment income each year. *See* Petition at 10-11. In a filing in the Federal Circuit in *CNG*, the government acknowledged the issue in *CNG* was "an issue of

substantial economic and precedential importance to the Government." *See* Petition at 13. The government does not dispute that the issue in this case is important or that the issue affects thousands of taxpayers and billions of dollars in tax liability.

The government's position that this petition should be denied, even though the issue in this case affects thousands of taxpayers, contrasts with the position taken by the government in another case involving a federal income tax issue in which the petition was filed less than a month after the petition in this case. In that case, *PPL Corp. v. Commissioner*, No. 12-43, the government agreed the petition should be granted, even though the government acknowledged that, in that case, *only three taxpayers* would be directly affected by a decision by the Court. *See* Brief for the Respondent at 13, *PPL Corp. v. Commissioner*, No. 12-43 (Sept. 4, 2012). As the government noted in its response brief there, "[t]he specific question presented in this case is … unlikely to recur or to have significance for a large number of U.S. taxpayers." *Id.*

Despite acknowledging the extremely limited direct impact of a decision by the Court in *PPL*, the government nevertheless contended that, because of a circuit conflict, the petition in *PPL* should be granted: "The Third and Fifth Circuits are … squarely in conflict on the question presented. This Court's intervention is necessary to resolve that conflict." *Id.*

While the government suggested a decision by this Court in *PPL* might possibly have some broader significance than just resolving the narrow issue in that case with its extremely limited applicability,

nevertheless, the government relied primarily on the existence of a circuit conflict as the rationale for granting the petition:

> [T]his Court's guidance on the correct analytical approach for evaluating foreign taxes under Section 901 and the Treasury regulation may have significant administrative importance beyond the specific foreign tax law at issue here. And in any event, the square circuit conflict with respect to the U.K. windfall tax itself implicates the important federal interest in uniform enforcement of the federal tax laws. Accordingly, the Commissioner agrees that this Court should grant the petition for a writ of certiorari to resolve the conflict between the Third and Fifth Circuits.

Id. at 14 (citations omitted).

It is not apparent why the existence of a circuit conflict should be grounds for granting the petition in *PPL* but not for granting the petition here. It is not apparent why "the important federal interest in uniform enforcement of the federal tax laws" is "implicate[d]" by the circuit conflict in *PPL* but not by the circuit conflict here.

On October 29, the Court granted the petition in *PPL*. This petition should likewise be granted, because of the clear circuit conflict here, and because the issue has a direct effect on a much larger number of taxpayers than the issue in *PPL*.

Despite the government's repeated and unambiguous acknowledgments that there is a clear conflict between the Sixth Circuit and the Federal Circuit on the central issue in this case concerning the proper interpretation of section 512(a)(3)(E)(i),

the government nevertheless contends the petition should be denied. Brief in Opposition at 10, 17, 19, 23. The government presents two arguments to support that position. Both arguments are based on unsound premises.

The government's first argument for denying the petition is as follows:

> Petitioner does not contend that the statutory limit on exempt function income unambiguously excludes from taxation investment income purportedly spent on benefits or associated administrative costs. Indeed, petitioner's reliance on an implicit incorporation of an ordering rule precludes such an argument…. Accordingly, petitioner can prevail in this litigation only if the IRS regulation is held to be invalid.
>
> …. Petitioner contends (Pet. 25-29) that the regulation is invalid, and that judicial deference is therefore inappropriate, because the IRS issued the regulation without adequate explanation and without engaging in notice-and-comment rulemaking. As the court below explained, however, "[i]t is undisputed that [petitioner] did not assert that 26 C.F.R. § 1.512(a)-5T was invalid in its refund claims presented to the IRS." …. Petitioner is therefore precluded from challenging the validity of the regulation in this litigation.

Id. at 20-21.

This argument is based on multiple incorrect premises. By far the most important of these is the government's contention petitioner does not argue section 512(a)(3)(E)(i) "unambiguously" supports the

interpretation petitioner advocates. What the government apparently means by this is to contend that petitioner does not argue petitioner's interpretation is the required interpretation of section 512(a)(3)(E)(i) under step one of the two-step test set forth in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). This contention is clearly wrong.

Starting on page 13 of the petition, petitioner made clear that petitioner's primary position is that the interpretation of section 512(a)(3)(E)(i) petitioner advocates is the interpretation that is required under step one of *Chevron*'s two-step test:

> …. In interpreting section 512(a)(3)(E)(i), *CNG* refused to consider the relationship between section 512(a)(3)(E)(i) and sections 419 and 419A. *CNG* thus ignored the basic principle of statutory construction that a statutory provision must be interpreted in the context provided by related provisions rather than in isolation.
>
> …. Under *Chevron*'s first step, the issue is whether the "court, employing traditional tools of statutory construction," can ascertain "that Congress had an intention on the precise question at issue." One of the "traditional tools of statutory construction" is the principle that statutory provisions are not interpreted in isolation but are instead interpreted in their statutory context.
>
> > In determining whether Congress has specifically addressed the question at issue, a reviewing court should not confine itself to examining a particular statutory provision in

> isolation. The meaning – or ambiguity – of certain words or phrases may only become evident when placed in context….

FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 132-33 (2000).

CNG was incorrect to conclude "result in" in section 512(a)(3)(E)(i) reflects a concept of causation so clear that it warrants ignoring statutory context….

While ignoring statutory context is never appropriate, *causation* is such an inherently unclear concept that ignoring statutory context is particularly inappropriate in interpreting statutory provisions involving causation, as illustrated by *United States v. Tinklenberg*, 131 S. Ct. 2007 (2011)….

CNG incorrectly concluded that because section 512(a)(3)(E)(i) does not cross-reference the ordering rules in section 419, sections 419 and 419A should be ignored in interpreting section 512(a)(3)(E)(i). The principle that statutory provisions must be interpreted in their statutory context rather than in isolation is not contingent on the existence of cross-references. Moreover, section 512(a)(3)(E)(i)'s cross-reference to section 419A shows the need for consistency between section 512(a)(3)(E)(i) and sections 419 and 419A.

….

…. [W]hen section 512(a)(3)(E)(i) is properly interpreted in the context provided by sections 419 and 419A, the set-aside of current income for a purpose described in section 512(a)(3)(B) does not "result in" year-end assets

> if, under the ordering rule in section 419(c), the income is considered spent in the year it is earned. The set-aside "result[s] in" year-end assets only if the income is instead considered accumulated for use in a later year….
>
> This conclusion is confirmed by the parallel between the limitation in section 512(a)(3)(E)(i) and the limitation in section 419A….
>
> As *Sherwin-Williams* recognized, the direct parallel between the limitation in section 512(a)(3)(E)(i) and the limitation in section 419A demonstrates that only income accumulated to pay benefits after the year the income is earned is subject to the limitation in section 512(a)(3)(E)(i), because the parallel limitation in section 419A applies only to employer contributions accumulated to pay benefits after the year of the contribution.

Petition at 13, 14-15, 16-17, 23, 24 (some citations omitted).

As the foregoing extensive quotations make clear, petitioner's primary position is that the interpretation of section 512(a)(3)(E)(i) petitioner advocates is the interpretation that is required under the first step of *Chevron*'s two-step test. This is precisely the position the government erroneously contends petitioner does not assert. That petitioner's primary argument is based on *Chevron* step one was also clear in its briefs in the Federal Circuit and the Court of Federal Claims. For example, petitioner's opening brief in the Federal Circuit stated as follows: "*CNG* was incorrectly decided and should be overruled. The meaning of section 512(a)(3)(E)(i) can

be determined under *Chevron* step one using 'traditional tools of statutory construction.'" Brief of Appellant at 9, *Northrop Corp. Employee Insurance Benefit Plans Master Trust v. United States*, 467 Fed. Appx. 886 (2012), No. 2011-5125. Thus, the basic premise underlying the government's first argument for denying the petition is clearly incorrect.

At no point in the litigation of this case has the government contended petitioner is barred from arguing the interpretation of section 512(a)(3)(E)(i) petitioner advocates is the interpretation that is required under *Chevron* step one, and the government does not make that contention now. Instead, the government now contends petitioner does not rely on *Chevron* step one. That contention is clearly wrong.

Thus, contrary to the government's contention, in order for petitioner to prevail in this case, it is not necessary for petitioner to prevail in its alternative arguments that the temporary regulation was issued in violation of both the arbitrary and capricious standard and the notice-and-comment requirements in the Administrative Procedure Act.

The government is also incorrect in its contention that the variance rule applies equally to petitioner's two APA arguments. *Judulang v. Holder*, 132 S. Ct. 476, 483 n.7 (2011), confirmed that the APA arbitrary and capricious standard and *Chevron* step two are essentially equivalent to one another. Because the government does not contend petitioner is barred by the variance rule from relying on *Chevron* step one, petitioner is likewise not barred from relying on *Chevron* step two. The government explicitly acknowledged in the trial court that, to the

extent *Chevron* step two is equivalent to the arbitrary and capricious standard, petitioner is not barred by the variance rule from relying on the arbitrary and capricious standard:

> Northrop suggests that its arbitrary-and-capricious argument is not barred by variance because of "the similarity between *Chevron* step two and the ... arbitrary and capricious standard." Of course, to the extent that the two arguments overlap, so that disposition of the *Chevron* issue would, *a fortiori*, resolve Northrop's arbitrary-and-capricious argument, then Northrop is correct.

Defendant's Reply in Support of Its Cross-Motion for Summary Judgment at 15, *Northrop Corp. Employee Insurance Benefit Plans Master Trust v. United States*, 99 Fed. Cl. 1 (2011), No. 08-023T. Thus, it is only petitioner's argument that the temporary regulation violated the APA notice-and-comment requirements that is potentially subject to the variance rule.

Finally, the government is also incorrect in its contention that the variance rule bars petitioner's argument that the temporary regulation violated the APA notice-and-comment requirements. The government provides no response to petitioner's argument that the variance rule is a non-jurisdictional exhaustion of administrative remedies requirement and is accordingly subject to the exceptions the courts of appeals have applied to such requirements, and that several of these exceptions apply here.

In any event, even apart from the issue of whether the temporary regulation violated the APA

notice-and-comment requirements, the issuance of the temporary regulation without the benefit of notice-and-comment procedures is a relevant factor in deciding whether the regulation is entitled to deference under *Chevron*. *See*, *e.g.*, *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704, 714 (2011) ("The Department issued the fulltime employee rule only after notice-and-comment procedures, again a consideration identified in our precedents as a 'significant' sign that a rule merits *Chevron* deference") (citations omitted).

The government's second argument against granting the petition is likewise based on faulty premises. That argument is as follows:

> The Court also should defer consideration of the issue because the IRS recently has undertaken a regulatory project that may culminate in notice-and-comment rulemaking to address the statutory limit on exempt function income. The Court's interpretation of Section 512(a)(3)(E)(i) should await the considered views of the agency entrusted by Congress with the administration of the statute.

Brief in Opposition at 17-18.

The government's contention that the Court should deny the petition because the IRS has included an item related to the issue in this case on its list of projects for future consideration is unsupportable. The government cites no authority for the proposition that the *mere possibility* of future action by an agency on an issue should have any effect on pending cases involving that issue. The government suggests the IRS *may* "promulgate[ ] a new regulation that unambiguously rejects the

Sherwin Williams court's understanding of Section 512(a)(3)(E)(i)." *Id.* at 23. The government does not explain why such a new regulation would be needed, since the current regulation unambiguously adopts an interpretation that is clearly in conflict with the *Sherwin-Williams* interpretation. The government's contention the petition should be denied based on speculation concerning what the Sixth Circuit *might* do if the IRS were to take the unusual step of issuing a new regulation saying exactly the same thing the current regulation already says is not a proper basis for denying the petition. The lack of any public action on this "priority" project during the two years since it was first included in this IRS list of agency projects for future consideration demonstrates how little "priority" this project actually has for the IRS.

Moreover, the government's contention that "[t]he Court's interpretation of Section 512(a)(3)(E)(i) should await the considered views of the agency entrusted by Congress with the administration of the statute" ignores the fact that the IRS already has issued a regulation addressing the issue in this case. If the government, in making this contention, means to acknowledge that the *existing* regulation *does not* represent "the considered views of the agency entrusted by Congress with the administration of the statute," that acknowledgment is clearly damaging to the government's position that the existing regulation is entitled to deference.

Thus, both of the government's arguments against granting the petition are based on incorrect premises. This case involves an issue of statutory interpretation concerning a provision of the Internal Revenue Code on which the government agrees there

is a clear conflict between the Sixth Circuit and the Federal Circuit. The government does not dispute that this issue affects thousands of taxpayers and billions of dollars in tax liabilities. As a consequence, the petition should be granted.

Respectfully submitted,

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