No. 12-1085

In the Supreme Court of the United States

MARK CURCIO, *et al.*,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

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

REPLY BRIEF FOR PETITIONERS

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REPLY BRIEF FOR PETITIONERS

This case presents a fundamental question on which this Court's guidance is clearly needed: Whether a ruling that a deduction should not be allowed under § 162(a) of the Internal Revenue Code for "ordinary and necessary" business expenses is reviewable de novo (like other mixed questions of law and fact) or only for clear error (like pure factual issues). That question has touchstone significance for the availability of meaningful judicial review for individuals and small businesses of commonly recurring tax determinations. The Second Circuit reviews this mixed question of law and fact as a pure factual question under "the shackles of the 'unless clearly erroneous' rule." *Mamiye Bros. v. Barber S.S. Lines, Inc.*, 360 F.2d 774, 777 (2d Cir. 1966) (Friendly, J.). In this case, the court not only expressly invoked the clear-error rule (Pet. App. 13a-14a), but explicitly grounded its § 162(a) ruling on its finding of "no clear error" (*id.* at 17a-18a)—removing any doubt that the standard of review was key to its ruling.

Without disputing that the proper standard of appellate review is profoundly important (Pet. 22-26), the Commissioner contends that certiorari is not warranted. But his response is devoted largely to arguing the merits of the question presented. He provides no persuasive reason for denying certiorari. And the question presented is one that cries out for resolution by this Court. This Court's decisions send conflicting signals on the proper standard of review in this important area and remain infected by the discredited view that the Tax Court is entitled to *Chevron*-like deference on tax determinations. The doctrinal divide in this Court's own case law has produced a direct conflict among the circuits—which

the circuits themselves have recognized. *Infra* at 7-9. And this case presents an ideal vehicle for resolving the conflict—and ensuring that meaningful appellate review is available to individuals and small business of commonly recurring tax determinations.

I. THE COURT'S OWN CASE LAW UNDERSCORES THE NEED FOR REVIEW

The Commissioner's response focuses on arguing the merits of the question presented under this Court's precedents. Opp. 8-16. But his argument is unavailing.

1. The deductibility of business expenses under § 162(a) presents a prototypical mixed question of law and fact subject to de novo review. The Commissioner recognizes that a mixed question arises when the court must ask "'whether the rule of law as applied to the established facts is or is not violated.'" Opp. 10 (quoting *Pullman-Standard v. Swint*, 456 U.S. 273, 289 n.19 (1982)). But he fails to acknowledge that this is precisely what § 162(a) requires: "'the issue is whether the facts satisfy the statutory standard'" for ordinariness and necessity. *Id.* (quoting *Pullman-Standard*, 456 U.S. at 289 n.19) That is the question the Second Circuit should have reviewed de novo here.

The Commissioner's response is grounded on the premise that petitioners seek review only of the factual findings underlying the Tax Court's § 162(a) ruling. Opp. 9-10. That is incorrect. The question on appeal is whether—*accepting the facts as established below*—the Tax Court reached the correct *legal* conclusion that the expenses at issue are not deductible under § 162(a). The resolution of that legal question turns on the application of existing precedent, statutes, and IRS authorities. And petitioners have argued that the Tax

Court's § 162(a) ruling is legally flawed on numerous grounds. Pet. 26-31; Amicus Br. 8-16.

The Commissioner's assertion (at 10) that "[f]actual determinations" are reviewed for clear error is therefore beside the point. Petitioners seek review of the Tax Court's ultimate legal conclusion—accepting facts found by the Tax Court. Neither *Welch v. Helvering*, 290 U.S. 111 (1933), nor *Deputy v. du Pont*, 308 U.S. 488 (1940), is to the contrary. Neither case discussed the standard of appellate review of § 162(a) rulings. Nor does Justice Cardozo's observation that "'[l]ife in all its fullness must supply the answer,'" Opp. 9 (quoting *Welch*, 290 U.S. at 115), prove anything. The same can be said for probable cause—a mixed question of law and fact subject to de novo appellate review—which depends on "'factual and practical considerations of everyday life.'" *Ornelas v. United States*, 517 U.S. 690, 695 (1996) (citation omitted). Both § 162(a) and probable-cause cases alike must "'be decided on [their] own facts and circumstances.'" *Id.* at 696.

2. The Commissioner briefly asserts (at 11) that, even if the § 162(a) determination is a mixed question of law and fact (which it plainly is), it is still reviewable only for clear error. In doing so, he simply ignores two critical tax cases confirming that de novo review applies to mixed questions of law and fact. *See Helvering v. Tex-Penn Oil Co.*, 300 U.S. 481, 491 (1937); *Helvering v. Rankin*, 295 U.S. 123, 131 (1935). Moreover, he ignores the arguments that the Solicitor General himself made to this Court in *Ornelas*, in explaining why probable-cause determinations—which require legal conclusions to be drawn from accepted facts—are subject to de novo rather than clear-error

review. U.S. Br. at 11-12, 16-20, *Ornelas*, 517 U.S. 690 (1996) (No. 95-5257), 1996 WL 32774 (*Ornelas* U.S. Br.).

The Commissioner does acknowledge (at 11-12) *Salve Regina College v. Russell*, 499 U.S. 225 (1991). But that case held that mixed questions are reviewed de novo unless "the district court is 'better positioned'" to decide the issue or if plenary review "will not contribute to the clarity of legal doctrine." *Id.* at 233. This is not at all a situation where trial courts are "better situated" to make rulings, such as with Rule 11 sanctions, *Cooter & Gell v. Hartmarx Corp.*, 496 U.S. 384, 404 (1990), or where rulings are based on knowledge of facts *outside* the record, *Pierce v. Underwood*, 487 U.S. 552, 560 (1988) (fee awards). And de novo review of § 162(a) rulings plainly will "contribute to the clarity of legal doctrine." Like probable cause, § 162(a) is a legal concept that "acquire[s] content only through application." *Ornelas*, 517 U.S. at 697. And like probable cause, "ordinary and necessary" jurisprudence is grounded on layered *legal* rules, not idiosyncratic factual inquiries. Pet. 18. In considering the same sort of mixed questions of law and fact at issue here, this Court has recognized that de novo review is necessary "'to maintain control of, and to clarify, the legal principles.'" *Salve Regina College*, 499 U.S. at 233 (citation omitted). Indeed, so has the Solicitor General. *See Ornelas* U.S. Br. at 19-20.

3. The Commissioner's attempt (at 13-14), to side-step *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978)—a case that powerfully supports de novo review of § 162(a) rulings—is also unpersuasive.

As explained (Pet. 15-17), in *Frank Lyon* the Court declared that: "The general characterization of a transaction for tax purposes is a question of law subject

to review. The particular facts from which the characterization is to be made are not so subject." 435 U.S. at 581 n.16 (citing *American Realty Trust v. United States*, 498 F.2d 1194, 1198 (4th Cir. 1974)). That statement compels the conclusion that the legal characterization of business expenses as deductible, or not, under § 162(a) is subject to de novo review. The Commissioner points (at 13-14) to the second sentence saying that the "'particular facts from which the characterization is to be made are not so subject,'" and says that this sentence "indicates that the Court viewed the district court's conclusions about the nature of the transaction as a *factual determination*." For several reasons, the Commissioner is mistaken.

First, as the first sentence quoted above makes clear, the nature of the transaction in *Frank Lyon* is not a "particular fact[];" it is a legal question based on the transaction as a whole. Second, the Fourth Circuit decision cited by *Frank Lyon* for the quoted proposition makes that clear. It recognized that the determination at issue "involves, ultimately, a *legal* conclusion, albeit one grounded in underlying findings of fact." *American Realty Trust*, 498 F.2d at 1198 (emphasis added). And third, the language from *Frank Lyon* tracked the Solicitor General's own position in *Frank Lyon*—in arguing for de novo review of the ultimate tax question at issue: "[T]he ultimate characterization of these arrangements for tax purposes presents a question of law freely reviewable by an appellate court." U.S. Br. at 70, *Frank Lyon*, 435 U.S. 561 (1978) (No. 76-624), 1977 WL 189156.

More generally, the Commissioner's attempt to sweep *Frank Lyon* under the rug is based on his mistaken position that petitioners seek review of the

Tax Court's factual findings (which they do not) as opposed to the ultimate legal conclusion that the Tax Court drew from those findings (which they do). The Commissioner's reading of *Frank Lyon* is also contradicted by the fact that *Frank Lyon* has been repeatedly cited by lower courts for the proposition that mixed questions of tax law and fact are subject to de novo review. Pet. 16 (citing cases). As Judge Posner observed in *Wellpoint, Inc. v. Commissioner*, any argument that clear-error review applies must "reckon" with *Frank Lyon*. 599 F.3d 641, 645 (7th Cir. 2010). If those courts incorrectly understood *Frank Lyon*, then that confusion simply underscores the need for further guidance from this Court on this issue.[1]

4. Finally, the Commissioner's reliance (at 14-16) on *Commissioner v. Heininger*, 320 U.S. 467 (1943), just highlights why this Court's review is needed to resolve the conflict in the Court's own case law.

The Commissioner recognizes (at 14-15) that Congress reversed this Court's decision in *Dobson v. Commissioner*, 320 U.S. 489 (1943), which called for heightened deference to Tax Court decisions under a *Chevron*-like rationale. Pet. 19-20. But the Commissioner fails to recognize that the standard of appellate review stated by *Heininger*—a case that was

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[1] Before his response in this case, the Solicitor General had repeatedly recognized that *Frank Lyon* calls for de novo review of the mixed question of whether a transaction lacks economic substance for tax purposes. *See, e.g.*, Br. for U.S. in Opp., *Dow Chemical Co. v. United States*, No. 06-478, 2007 WL 119435, at *16 (U.S. Jan. 12, 2007); Br. for U.S. in Opp., *Sala v. United States*, No. 10-1047, 2011 WL 2159626, at *9-10 (U.S. June 1, 2011). Section 162(a) rulings are not meaningfully different.

decided the same day as *Dobson*—is directly tied to *Dobson*. *Heininger* specifically cited *Dobson* as support for its formulation of the standard of review. 320 U.S. at 475 n.13 (citing *Dobson*). And a *Dobson*-minded view of the world—in which courts must afford *Chevron*-like deference to the Tax Court because of its supposed tax expertise—is the only way to explain *Heininger*'s formulation of the standard for review.

Appellate deference to mixed questions of law and fact—except when a court determines that a legal question is "unmistakably involved"—is cut from the same cloth as *Dobson*'s mandate the appellate courts must affirm absent "a clear-cut mistake of law." 320 U.S. at 502. After Congress reversed *Dobson* by enacting 26 U.S.C. § 7482(a)(1), *Heininger*'s distorted standard of review is no longer good law. Yet the Commissioner relies heavily on *Heininger* to support its position—citing the case *passim* in his brief. The confusion over the continuing force of *Heininger*, especially after *Frank Lyon*, alone justifies review.

II. THE CIRCUITS ARE DIVIDED ON THE STANDARD OF REVIEW

Although the Commissioner refuses (at 16) to acknowledge the direct circuit conflict on the standard of review of § 162(a) rulings, the circuits themselves have. *See, e.g.*, *Wellpoint, Inc.*, 599 F.3d at 645 (recognizing split between Sixth and Seventh Circuits); *cf. Sala v. United States*, 613 F.3d 1249, 1252 (10th Cir. 2010), *cert. denied*, 132 S. Ct. 91 (2011).

The Sixth Circuit reviews de novo "whether the law as applied to the [uncontroverted] facts fulfills the statutory requirement" of § 162(a). *Mitchell v. Commissioner*, 73 F.3d 628, 631 (6th Cir. 1996); *Malone*

& Hyde, Inc. v. Commissioner, 62 F.3d 835, 838 (6th Cir. 1995). The Commissioner tries to distinguish *Mitchell* and *Malone* on the ground that those cases involved application of the law to "uncontroverted facts." Opp. 16-17. But as discussed (*supra* at 2-3), the same goes here: the question is whether the Tax Court reached the right legal conclusion on the facts found by that court (which are undisputed on appeal).

As the Commissioner acknowledges (at 17), other circuits sometimes apply plenary review to § 162(a) determinations—"depending on whether legal or factual issues predominate." *See, e.g.*, *Pollei v. Commissioner*, 877 F.2d 838, 839-40 (10th Cir. 1989); *Moss v. Commissioner*, 831 F.2d 833, 838 (9th Cir. 1987). That sliding standard of review is not only quite different than the standard applied in circuits that apply either clear error or de novo review, but requires an unwieldy, wholly subjective inquiry into whether a mixed question is "predominantly" legal or factual.

In outright conflict with these circuits, the Second and Seventh Circuits review § 162(a) rulings only for clear error—even when (as here) the § 162(a) issue is the application of law to *established* facts. *See* Pet. App. 14a; *Wellpoint, Inc.*, 599 F.3d at 645 (Posner, J.) ("Classifying a particular expenditure as an [ordinary and necessary] expense on the one hand or as a capital expenditure on the other is applying a legal standard to facts" such that "appellate review is deferential."); *see also Wright v. Commissioner*, 571 F.3d 215, 219 (2d Cir. 2009) ("'[T]he application of a legal standard to a given factual pattern'" is "'reviewed under the clearly erroneous standard.'" (citation omitted)).

The ability of an individual or small business to receive meaningful appellate review of important tax

determinations should not depend on whether they are located in New York, Ohio, or California.

III. THIS CASE IS AN IDEAL VEHICLE TO RESOLVE THIS IMPORTANT QUESTION

The Commissioner's tail-end attempt (at 19-20) to identify a vehicle problem also fails. His suggestion that the question presented was not properly raised below is baseless. This Court may review "[a]ny issue 'pressed or passed upon below.'" *Verizon Commc'ns Inc. v. FCC*, 535 U.S. 467, 530 (2002) (citation omitted). All agree petitioners explicitly argued below that the § 162(a) issue is subject to de novo review. Opp. 20; Pet. 26-27. And that issue was passed upon by the Second Circuit. Pet. 13a. Furthermore, a party seeking certiorari is not "limited to the manner in which the question was framed below" or specific arguments presented below. *Yee v. City of Escondido*, 503 U.S. 519, 535 (1992). The Solicitor General himself frequently elaborates on arguments raised below. There is no support for the Commissioner's novel suggestion that a litigant must *re*-raise arguments in its reply brief and petition for rehearing to press the issue before this Court. Opp. 20. That requirement would be especially inappropriate where, as here, a party is facing established circuit precedent.

The Commissioner's passing suggestion (at 19) that the standard of review is immaterial in this case is likewise unfounded. The standard of appellate review is a matter of touchstone importance to the resolution of issues on appeal. Pet. 22-24. Here, the Second Circuit explicitly grounded its § 162(a) holding in the clear-error standard. Pet. App. 17a-18a; Pet. 27. The Commissioner emphasizes (at 19) that the Tax Court stated that the plan contributions were for petitioners'

"'personal benefit,'" but that does not dispose of the § 162(a) question. Whether an expense is deemed for "personal" or "business" benefit turns on the "general characterization" (*Frank Lyon*, 435 U.S. at 581 n.16) of the facts. Moreover, petitioners argued on appeal that the Tax Court's § 162(a) ruling is riddled with *legal* defects requiring reversal—even accepting that premise. Pet. 27-29; *see* Amicus Br. 8-16. The Second Circuit never seriously considered petitioners' legal challenge because it reviewed only for clear error.[2]

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[2] The Commissioner (at 19) says that the § 162(a) ruling follows from the fact that the plan reportedly was for "personal benefit." Opp. 19. But he offers no legal support for that conclusion. Legally, the existence of a personal benefit is *not* a categorical bar to deductibility. *See* Boris I. Bittker *et al.*, *Federal Income Taxation of Individuals* § 11.02 (3d ed. 2002) ("[N]o matter how severely the term 'business expense' is defined, many items will continue to qualify for deduction [under § 162], although they confer 'personal' benefits on a taxpayer."); *see also, e.g.*, *Berkley Machine Works & Foundry Co. v. Commissioner*, 27 T.C.M. (CCH) 1487 (1968) (corporation allowed § 162(a) deduction where services "redounded to the personal benefit" of shareholder). And contributions to employee benefit plans on behalf of a corporation's sole shareholder (which create a personal benefit under the Commissioner's theory) both have been held deductible under § 162(a), e.*g.*, *Schneider v. Commissioner*, 63 T.C.M. (CCH) 1787 (1992), and serve a recognized business purpose (Pet. 28). Moreover, the Second Circuit simply declined to consider petitioners' alternative legal argument under 26 U.S.C. § 419A because of its finding of no clear error. Pet. App. 18a. De novo review, in short, would transform the § 162(a) issue on appeal, particularly when the Commissioner's heightened burdens under 26 U.S.C. § 7491 are taken into account. Pet. 31; Amicus Br. 20-21.

Furthermore, the Commissioner does not dispute that clear-error review of the Tax Court's § 162(a) determination infected the Second Circuit's conclusion that penalties were proper. Pet. 29-31.

* * * * *

The question presented goes to the heart of the independent role of the Article III courts in reviewing tax determinations on mixed questions of law and fact, which typically are made in the first instance by the Article I Tax Court. The IRS wields great authority. Individuals and small businesses deserve a fair shake in challenging its determinations. That includes an opportunity for de novo appellate review of mixed questions of law and fact like the one at issue here—free from "the shackles of the 'unless clearly erroneous' rule." *Mamiye Bros.*, 360 F.2d at 777.

CONCLUSION

For the foregoing reasons, and those stated in the petition, certiorari should be granted.

Respectfully submitted,

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