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Prohibiting the Deduction for Non-Corporate Tax Deficiency Interest: When Treasury Goes Too Far, 34 J. Marshall L. Rev. 557 (2001)

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COMMENTS

PROHIBITING THE DEDUCTION FOR NON-CORPORATE TAX DEFICIENCY INTEREST: WHEN TREASURY GOES TOO FAR

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INTRODUCTION

Delta Foods, Inc. ("Delta") is a hypothetical grocery store.[1] Delta is treated as a corporation for federal income tax purposes.[2] Unintentionally, Delta computes its taxable income for federal income tax purposes erroneously. The error results in Delta underreporting its income on its federal income tax return. The Internal Revenue Service (IRS) selects Delta for audit. Upon examination, the IRS discovers the erroneous calculation of income and assesses additional tax on Delta. In addition to the tax assessed, the IRS assesses interest on the tax deficiency.[3] Delta pays the additional tax and corresponding interest and thereafter deducts the interest on its tax return without challenge by the IRS.[4] This result is not only permitted, but logical. One would expect this logical result regardless of the type of business entity the taxpayer chose to conduct the business. Unfortunately, not all business taxpayers are graced with the same logical result.

John Smith ("Smith") also operates a hypothetical grocery store.[5] However, Smith operates the grocery store as a sole-proprietorship.[6] After Smith erroneously calculates his business

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* J.D. Candidate, January 2002.

1. This is a hypothetical situation used to demonstrate the issues and problems addressed in this Comment.

2. Delta Foods, Inc. is organized under subchapter C of the Internal Revenue Code as a taxable corporation. *See generally* I.R.C. §§ 301-85 (1994) (illustrating the sections of the Internal Revenue Code that make up subchapter C).

3. *See* I.R.C. § 6601(a) (1994) (mandating that interest be assessed on all underpayments of tax).

4. *See* I.R.C. § 163(h)(1) (1994) (permitting the deduction of interest by corporate taxpayers). *See also* I.R.C. § 275(a)(1) (1994) (disallowing deductions by all taxpayers for federal income taxes).

5. This is a hypothetical situation used to demonstrate the issues and problems addressed in this Comment.

6. A sole-proprietor is an individual taxpayer that conducts a business

income for federal income tax purposes, he is selected for audit by the IRS. The IRS proposes adjustments to Smith's business income that result in additional tax being owed. Additionally, interest on the tax deficiency is assessed against Smith. Smith, like Delta, proceeds to deduct the interest on his federal income tax return as a business expense. However, in a subsequent audit the IRS disallows Smith's business deduction for the deficiency interest claiming that it is "personal" interest and not "business" interest.[7] Did Congress intend to distinguish between sole-proprietors and corporations in the context of tax deficiency interest, or is this an example of the IRS abusing its power?

Although corporations and sole-proprietorships are treated differently under most sections of the Internal Revenue Code (the "Code"), the Code should provide for uniform treatment of

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without the benefits and burdens of incorporation or business partners. WILLIAM P. STRENG, CHOICE OF ENTITY A-4 (700-2nd TAX MGMT. 1999). A sole-proprietor and his or her business are one and the same. THE ERNST & YOUNG TAX GUIDE 1999 485 (Peter W. Bernstein, ed., John Wiley & Sons, Inc. 1999). A sole-proprietor is required to report his or her business income and expenses on Schedule C of Form 1040, *U.S. Individual Income Tax Return. Id.*

7. *See* I.R.C. § 163(h)(1) (1994) (denying a deduction by all taxpayers, other than corporations, for "personal" interest). Section 163(h) states, in relevant part:

> (h) Disallowance of deduction for personal interest.
>
> (1) In general.
>
> In the case of a taxpayer other than a corporation, no deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year.
>
> (2) Personal interest.
>
> For purposes of this subsection, the term "personal interest" means any interest allowable as a deduction under this chapter other than-
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> (A) interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee).

I.R.C. § 163(h). *See also* Temp. Treas. Reg. § 1.163-9T(b)(2)(A) (1999) (defining "personal interest" to specifically include interest paid by individuals for underpayments of federal, state, or local income taxes). The result in this hypothetical, and throughout this Comment, would be the same if Delta Foods, Inc. were treated as a partnership or subchapter S corporation for Federal income tax purposes. *See* Temp. Treas. Reg. § 1.163-9T(b)(2)(C) (1999) (including tax deficiency interest paid by individuals in their capacity as partners in partnerships or shareholders in S corporations within the IRS' definition of "personal interest"). *See also* Temp. Treas. Reg. § 1.163-9T(b)(2)(C)(ii) (illustrating that tax deficiency interest paid by an S corporation shareholder as a result of the corporation underreporting its income that passed through to the shareholder is nondeductible personal interest); True v. United States, No. 91-CV-1004-J, 1993 WL 379417 (D. Wyo. 1993), *aff'd*, 35 F.3d 574 (10th Cir. 1994) (denying the Trues a deduction for tax deficiency interest that resulted from the underreporting of income passed through from family businesses being operated as partnerships and S corporations).

deductions for interest assessed on income tax deficiencies.[8] It is, however, no wonder why the IRS has chosen to treat these two business forms differently. Over the last twenty-three years, the number of taxpayers conducting business as sole-proprietors has grown dramatically.[9] This type of business-form discrimination may be a contributing cause to the American public's perception of the IRS as an agency that abuses its power.[10]

Historically, tax deficiency interest assessed on a sole-proprietor was considered a business expense and therefore

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8. *See* John Y. Taggart, *Denial of the Personal Interest Deduction*, 41 TAX LAW. 195, 198 (1988) (illustrating that deductions for personal interest should be allowed because they perform an equalization of the financial positions between those who choose to borrow to engage in personal transactions, and those who use their own capital, thus foregoing income on that capital). The result of denying the deduction for personal interest is that the one who borrows to engage in the personal transaction has higher taxable income than the one who uses his or her own capital, and thus foregoes the income on that capital. *Id.* at n.8. A basic premise for American economic growth is the ability to deduct interest. *Id.* at 198.

> [The] underlying notion [behind the interest deduction is] that if an individual or corporation desires to engage in purposive activity, there is no reason why a taxpayer who borrows for that purpose should fare worse from an income tax standpoint than one who finances the venture with capital that otherwise would have been yielding income.

Goldstein v. Comm'r, 364 F.2d 734, 741 (2d Cir. 1966).

9. *See* Internal Revenue Service, *IRS Statistical Overview: Number of Returns* (last modified Oct. 10, 2000) http://www.irs.gov/tax_stats/soi/other_nr.html (providing statistical information regarding the number of federal income tax returns and forms filed, or to be filed, by type, for calendar years 1975-1999). In 1975, the number of individuals conducting business as sole-proprietors exceeded the number of businesses conducted as corporations (Subchapter C corporations only) by more than four times. *Id.* In 1998, the number of sole-proprietors exceeded corporations by almost seven times. *Id.* Additionally, between 1975 and 1998, the number of individuals conducting business as sole-proprietors grew by more than 130 percent, while the number of new corporations grew by only 41 percent. *Id.*

10. *See* The Gallup Organization, *Public By 3 to 1 Margin Believes IRS Abuses Its Powers* (visited Oct. 5, 1999) *http://www.gallup.com/poll/releases/pr971003.asp* (discussing the American public's perception that the IRS is too powerful and frequently abuses its power). Over 70 percent of the American public perceive the IRS as having more power than it needs, and 69 percent believe the IRS often abuses its power. *Id.* It is often said that perception is reality, and when speaking of the IRS, the American public's perception is reality. The IRS is perhaps the most powerful governing body in the world. DAVID BURNHAM, A LAW UNTO ITSELF 16 (Random House 1989). With over 120,000 employees, the IRS is the largest law enforcement agency in the United States. *Id.* Furthermore, the IRS has the authority to grant or deny tax-exempt status to various types of educational, religious, and charitable organizations. *Id.* at 17. This power alone is great enough to affect significant aspects of American life including social, religious, educational, and political activities. *Id.*

allowed as a business deduction.[11] However, the Tax Reform Act of 1986 purportedly eliminated this well-defined precedent by denying individuals a deduction for "personal interest."[12] Congress defined "personal interest" "negatively" in the statute[13] and preserved an exception for the deductibility of "interest paid or accrued on indebtedness properly allocable to a trade or business."[14] At first blush the statute seemed clear, however, the Department of Treasury ("Treasury") later determined that the statute was unclear and decided to define one type of interest that it unquestionably considered personal: individual tax deficiency interest.[15] Therefore, shortly after Congress enacted the Tax Reform Act of 1986, Treasury promulgated Temporary Regulation § 1.163-9T,[16] which succinctly stated that personal interest

11. *See* Melinda L. Reynolds, Redlark v. Comm'r: *A "Bird in the Hand" for Noncorporate Taxpayers?*, 47 CASE W. RES. L. REV. 751, 751 (1997) (stating that prior to the Tax Reform Act of 1986, individuals could deduct interest on business-related debt). *See generally* Keith E. Engel, *Deducting Interest on Federal Income Tax Underpayments: A Roadmap Through a 50-Year Quagmire*, 16 VA. TAX REV. 237, 244-56 (1996) (discussing the history of the interest deduction for federal income tax purposes). Between 1861 and 1943, the deductibility of interest was virtually uncontested. *Id.* at 245. Taxpayers were entitled to deduct interest regardless of the source of the debt generating the interest. *Id.* Between 1944 and 1986, the deduction of deficiency interest was still intact, with the exception of a minor deviation in 1956. *Id.* at 244, 247-48. In 1956, the Tax Court held in *Maxcy v. Comm'r*, that deficiency interest was personal in nature because it related to the individual taxpayer's "personal income tax obligations." *Maxcy v. Comm'r*, 26 T.C. 526 (1956). The next year, the Tax Court mysteriously changed course. Engel, *supra*, at 249. In a series of cases between 1957-1960, the Tax Court allowed sole-proprietors to deduct deficiency interest as a business expense against the Commissioner's strong opposition. *Id.* at 249-51.

12. Tax Reform Act of 1986, Pub. L. No. 99-514, § 511(b), 100 Stat. 2085, 2246 (1986) (codified at I.R.C. § 163(h) (1994)). "In the case of a taxpayer other than a corporation, no deduction shall be allowed . . . for personal interest paid or accrued during the taxable year." I.R.C. § 163(h)(1) (1994).

13. *See* Reynolds, *supra* note 11, at 751. "Personal interest" is defined "negatively" in the statute because it is defined in terms of what does not constitute "personal interest."

14. I.R.C. § 163(h)(2)(A) (1994).

15. Congress has granted authority to the Secretary of the Treasury to "prescribe all needful rules and regulations for the enforcement of [Title 26]." I.R.C. § 7805(a) (1994). It is generally presumed that regulations enacted by Treasury pursuant to its rulemaking power in section 7805(a) are interpretive. Michael Asimow, *Public Participation in the Adoption of Temporary Tax Regulations*, 44 TAX LAW. 343, 358 (1991). Interpretive rules are intended to "advise the public of the agency's construction of the statutes and rules it administers." U.S. DEP'T OF JUSTICE, ATTORNEY GENERAL'S MANUAL ON THE ADMIN. PROCEDURE ACT 30, n.3 (1947). *See, e.g.*, Skidmore v. Swift & Co., 323 U.S. 134, 138 (1944) ("[Interpretive rules] provide a guide . . . as to how [the agency] will seek to apply the [the statute]."); Gibson Wine Co. v. Snyder, 194 F.2d 329, 331 (D.C. Cir. 1952) ("[I]nterpretative rules are statements as to what the [agency] thinks the statute . . . means.").

16. T.D. 8168, 1988-1 C.B. 80. Treasury occasionally "issues [t]emporary

includes interest paid "on underpayments of individual Federal, State or local income taxes."[17]

This Comment examines the history of the non-corporate tax deficiency interest deduction and how Treasury uprooted this well-established rule. The conclusion is that Temporary Regulation § 1.163-9T should be rendered invalid because it represents an abuse of Treasury's delegated authority to prescribe necessary rules. Treasury abused its general rulemaking authority by enacting a regulation that in effect creates new substantive law, rather than interpreting existing law.[18] In most circumstances, new substantive law is subject to public notice and a comment period under the Administrative Procedure Act.[19] When Treasury

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[r]egulations in response to a congressional or judicial change in the tax law." WILLIAM A. RAABE, ET AL., WEST'S FEDERAL TAX RESEARCH 82 (West Publishing Co., 3rd ed. 1991). Temporary regulations are effective immediately upon publication and must be followed until they are superseded. *Id.* Proposed regulations, by contrast, do not carry the force of law, and are only issued to solicit comments from the public. *Id.*

17. Temp. Treas. Reg. § 1.163-9T(b)(2) (1987).

18. *See* Kevin W. Saunders, *Interpretative Rules With Legislative Effect: An Analysis and a Proposal for Public Participation*, 1986 DUKE L.J. 346, 347-48 (1986) (suggesting that Congress may implicitly grant an administrative agency authority to issue rules and regulations that have the force and effect of a legislative rule). A legislative rule creates new substantive law in addition to that contained in the statute. *Id.* at 346. When Treasury adopts regulations that create "distinctions, refinements, formulas, or safe harbors," arguably it is acting in a legislative capacity. *See* Asimow, *supra* note 15, at 360. When Treasury adopts this type of new tax law, the regulation should be subject to public participation through the Administrative Procedure Act, "which serves as a surrogate for the protection ordinarily afforded taxpayers by the legislative process." *Id. See also* Robert A. Anthony, *"Interpretive" Rules, "Legislative" Rules and "Spurious" Rules: Lifting the Smog*, 8 ADMIN. L.J. AM. U. 1, 10 (1994) (proposing that non-legislative rules that should have been enacted legislatively be called "spurious rules"). Spurious rules are so named because interpretive rules, while not having legal effect, are given the appearance of law by the agency and the courts. *Id.*

19. The Administrative Procedure Act provides that, with certain exceptions, the agency proposing to make a rule must provide general notice of the rule in the *Federal Register* and give "interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation." Administrative Procedure Act, 5 U.S.C. § 553(b)-(c) (1994). One such exception to the Administrative Procedure Act is the "good cause" exemption. *Id* at § 553(b)(B). The general notice and comment period required for proposed rules by an agency of the federal government do not apply "when the agency for good cause finds . . . that notice and public procedure . . . are impracticable, unnecessary, or contrary to the public interest." *Id.* Professor Juan J. Lavilla conducted a detailed examination of federal agencies' use of the good cause exemption in enacting rules and regulations. Juan J. Lavilla, *The Good Cause Exemption to Notice and Comment Rulemaking Requirements Under the Administrative Procedure Act*, 3 ADMIN. L.J. 317, 339 n.86 (1989). Professor Lavilla observed that more than half the rules promulgated by the Internal Revenue Service (IRS) dispense with public notice and comment period, with

avoids compliance with public notice and comment periods, albeit through legislative exceptions provided in the Administrative Procedure Act, they violate the policy of the United States rulemaking process.[20]

Part I of this Comment provides a historical account of the relevant cases and legislative actions that are necessary to understand the nature of the dispute. The historical account of the dispute is examined within three well-defined periods,[21] 1957-1985, 1986-1996, and post-1996. Part II will analyze an argument raised in the 1986-1996 and post-1996 periods, that the temporary regulation denying sole-proprietors a deduction for tax deficiency interest is invalid. Additionally, Part II will include an analysis of the courts' method of reviewing administrative agency regulations and a discussion of the differences between interpretive and legislative regulations. Finally, Part III will propose an alternative theory for invalidating Temporary Regulation § 1.163-9T. The essence of the theory is that while Temporary Regulation § 1.163-9T is termed an interpretive regulation, it is legislative in effect and therefore, because it was not subject to public notice and a comment period, it should be held invalid.

I. AN INTEREST[ING] BACKGROUND

More than eighty years ago, the first modern income tax statute permitted United States citizens to deduct deficiency

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the justification that immediate public guidance is necessary. *Id.* at 341. The IRS does not even attempt to provide an explanation of why it is invoking the exception. *Id.* Another exception to the public notice and comment period requirements of the Administrative Procedure Act is for interpretative rules. 5 U.S.C. § 553(b)(A) (1994). Presumably, the IRS used this exception to avoid issuing a general notice of proposed rulemaking when it enacted Temporary Regulation § 1.163-9T, although the IRS stated its exception to § 553 was because it was issuing temporary regulations. *See* T.D. 8168, 1988-1 C.B. 80, 82. Temporary regulations are also known as interpretive regulations because they provide taxpayers with immediate guidance on the application of a new provision of the law. RAABE, *supra* note 16, at 82. Regulations classified as temporary are only subject to a post-effective date comment period, whereas proposed regulations are subject to a pre-effective date comment period. Asimow, *supra*, note 15, at 363.

20. *See* Government in the Sunshine Act, Pub. L. No. 94-409, § 2, 90 Stat. 1241, 1241 (1976) (codified as amended at 5 U.S.C. § 552b (1994)) ("It is . . . the policy of the United States that the public is entitled to the fullest practicable information regarding the decisionmaking processes of the Federal Government.").

21. Other authors addressing the deductibility of non-corporate tax deficiency interest have chosen to delineate the history of this issue into similar periods. *See, e.g.*, Reynolds, *supra* note 11, at 755-66 (discussing the history of the non-corporate tax deficiency interest deduction in terms of pre-1987 case law, post-1986 case law, and finally, the Tax Court's decision in *Redlark*); Engel, *supra* note 11, at 246-62 (analyzing the underpayment interest deduction dispute during the period 1944-1986 and after 1986).

interest.[22] Over the course of these eighty years, however, the interest deduction has undergone incessant modifications.[23]

This part of the Comment describes the history of the forty-year dispute over the deficiency interest deduction in terms of three periods. Section A discusses the first period, which occurred between 1957-1985. During this period, the United States Tax Court consistently held that non-corporate tax deficiency interest was deductible by sole-proprietors as an ordinary and necessary business expense.[24] Section B discusses the second period of the dispute, 1986-1996. That period included the enactment of the Tax Reform Act of 1986,[25] which denied individuals a deduction for "personal interest," and Temporary Regulation § 1.163-9T,[26] which defines "personal interest" as individual income tax deficiency interest. This period concluded with the pivotal decision in *Redlark v. Commissioner*,[27] where the Tax Court invalidated Temporary Regulation § 1.163-9T insofar as it established a per se rule of nondeductibility for income tax deficiency interest. Finally, Section C will examine the present period, which includes the post-1996 cases. In the post-1996 line of cases, the United States Tax Court and the Federal appellate courts disagree on the validity of Temporary Regulation § 1.163-9T.

A. Emergence of the Conflict: 1957-1986

In 1957, the Tax Court delivered one of the first decisions

22. *See* JOHN HARLLEE, JR., INTEREST EXPENSE DEDUCTIONS A-1 (536-2nd TAX MGMT. 1998) (discussing the Revenue Act of 1916 which permitted U.S. citizens to "unconditionally" deduct interest paid on all forms of indebtedness). *See also* Engel, *supra* note 11, at 244 (noting that "[b]y 1913, Congress allowed individuals to deduct all forms of interest, including personal interest.").

23. *See generally* HARLLEE, *supra* note 22, at A-1 to A-3 (discussing the voluminous legislative history of the interest deduction). Beginning with the genesis of the interest deduction in 1916, Congress enacted numerous revenue acts that modified the interest deduction in various respects. *Id.*

24. *See, e.g.*, Reise v. Comm'r, 35 T.C. 571 (1961), *aff'd*, 299 F.2d 380 (7th Cir. 1962); Polk v. Comm'r, 31 T.C. 412 (1958), *aff'd*, 276 F.2d 601 (10th Cir. 1960); Standing v. Comm'r, 28 T.C. 789 (1957), *aff'd*, 259 F.2d 450 (4th Cir. 1958). *But see* Maxcy v. Comm'r, 26 T.C. 526, 527 (1956) (holding that the taxpayer could not deduct federal income tax deficiency interest that resulted solely from the failure to timely file income tax returns).

25. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). The Tax Reform Act of 1986 disallowed deductions by individuals for "personal interest." *Id.* at 2246. Section 511(b) of the Tax Reform Act of 1986 defined personal interest, in relevant part, as "interest paid or accrued on indebtedness incurred or continued in connection with the conduct of a trade or business (other than a trade or business of performing services as an employee)." *Id.*

26. Temp. Treas. Reg. § 1.163-9T (1987).

27. Redlark v. Comm'r, 106 T.C. 31, 47 (1996), *rev'd*, 141 F.3d 936 (9th Cir. 1998) (holding that Temporary Regulation § 1.163-9T was "an impermissible reading of the statute").

involving the deductibility of non-corporate tax deficiency interest. In *Standing v. Commissioner*,[28] the Tax Court held that the interest on tax deficiencies arising from an individual's trade or business was deductible as an "ordinary and necessary" business expense.[29] In *Standing*, the underlying tax assessment was clearly related to the taxpayer's lumber business that he operated as a sole-proprietorship.[30] The Tax Court likened tax deficiency interest incurred in a taxpayer's trade or business to legal expenses incurred in a taxpayer's trade or business and held that the two were synonymous.[31] Therefore, the court held that interest on the income tax deficiency was properly deductible as an ordinary and necessary business expense.[32]

Soon thereafter, the Tax Court in *Polk v. Commissioner*,[33] relying on its holding in *Standing*, again held that interest on income tax deficiencies was deductible as an ordinary and necessary business expense.[34] It was clear in *Polk*, as it was in *Standing*, that the income tax deficiency arose in connection with the taxpayer's business.[35] Consequently, the deficiency interest must have also arisen in connection with the taxpayer's business.[36]

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28. Standing v. Comm'r, 28 T.C. 789 (1957), *aff'd*, 259 F.2d 450 (4th Cir. 1958). James Standing operated a retail lumber and building supply business as a sole-proprietor. *Id.* at 789. An IRS examination of the Standings' 1945-1949 income tax returns resulted in an increase to Mr. Standing's business income and a corresponding assessment of additional tax and deficiency interest. *Id.* at 790. Mr. Standing subsequently claimed a business deduction on his 1951 individual income tax return for the deficiency interest he paid as a result of the audit. *Id.* at 791.

29. Deductions shall be allowed for "[a]ll the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." I.R.C. § 162(a) (2000). Deductions shall also be allowed for "[a]ll interest paid or accrued within the taxable year on indebtedness." I.R.C. § 163(a) (2000).

30. *Standing*, 28 T.C. at 790 (noting that the revenue agent's report stated that: "The additional tax is due to an increase in business income.").

31. *Id.* at 793-94. The court noted: "[W]e are unable to perceive any real distinction between an expenditure for attorney's fees made to secure payment of the earnings of the business and a like expenditure to retain such earnings after their receipt. One is as directly connected with the business as the other." *Id.* at 794 (quoting Kornhauser v. United States, 276 U.S. 145, 153 (1928)).

32. *Id.* at 795.

33. Polk v. Commissioner, 31 T.C. 412 (1958), *aff'd*, 276 F.2d 601 (10th Cir. 1960). Frank and Marie Polk were engaged in the business of raising and producing livestock as sole-proprietors. *Id.* at 414. In 1948, the IRS assessed additional income tax and deficiency interest as a result of the IRS' revaluation of the Polk's livestock inventory. *Id.* In computing their taxable income for 1952, the Polks deducted the deficiency interest as a business expense, which generated a net operating loss for that tax year. *Id.* at 413-14.

34. *Id.* at 415.

35. *Id.*

36. *Id.* *But see* Commissioner v. Polk, 276 F.2d 601, 602 (10th Cir. 1960),

In *Reise v. Commissioner*,[37] the Tax Court followed its reasoning in *Standing* and *Polk* and again allowed a business deduction for deficiency interest.[38] Again, it was clear that the income tax deficiency arose in connection with the taxpayer's business,[39] and therefore the interest charge on that deficiency must have "[arisen] in connection with" and been "proximately related" to the taxpayer's business.[40]

Consequently, until the Tax Reform Act of 1986, it was well settled that individual taxpayers were permitted to claim a business deduction for deficiency interest that was attributable to the individual's trade or business.[41] However, the Tax Reform Act of 1986 made significant changes to the interest deduction, which led to the present controversy over the deductibility of tax deficiency interest.[42]

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aff'g 31 T.C. 412 (1958) (cautioning that "[a]n item of expense is not deductible as a business expense merely because it arose in connection with the taxpayer's business and was proximately related thereto."). The affirming appellate court challenges the Tax Court's comparison of legal fees and "penalty interest." *Id.* at 603. Penalty interest "stand[s] in a different light." *Id.*

> Unless it can be said that the failure to properly evaluate inventories, which form a part of a taxpayer's return, arises because of the nature of the business, and is ordinarily and necessarily to be expected, interest on a deficiency assessment does not arise out of the ordinary operation of the business and may not be deducted [as a business expense].

Id. (footnote omitted). The reasoning in *Polk* suggests that even though tax adjustments arise as a result of adjustments to business income, the real question is whether the error giving rise to the adjustment is one that is commonly encountered in that taxpayer's trade or business. *See* Reynolds, *supra* note 11, at n.36 (stating that the level of taxpayer negligence will vary depending on the particular taxpayer and reviewing court).

37. Reise v. Commissioner, 35 T.C. 571 (1961), *aff'd*, 299 F.2d 380 (7th Cir. 1962). Elmer Reise, a dealer in hides and skins, conducted his business as a sole-proprietor. *Id.* at 572. In 1949, the Wisconsin Department of Revenue and the IRS conducted examinations of Mr. Reise's individual income tax returns and disallowed deductions for federal and state deficiency interest. *Id.* Mr. Reise erroneously computed his business income on the cash basis of accounting and created a tax deficiency. *Id.*

38. *Id.* at 579.

39. *Id.* at 572.

40. *Id.* at 580 (quoting Polk v. Commissioner, 31 T.C. 412, 415 (1958)).

41. *See* Engel, *supra* note 11, at 256-57 (summarizing the state of the interest deduction prior to 1969 and from 1969 until the Tax Reform Act of 1986). *See also* Czar Vigil, *Deducting Interest on Non-Corporate Trade or Business Tax Deficiencies:* Redlark v. Commissioner, 50 TAX LAW. 685, 686 (1997) (noting that the courts had consistently permitted the deduction of deficiency interest arising from business income adjustments prior to the Tax Reform Act of 1986).

42. *See* Engel, *supra* note 11, at 257 (stating that the Tax Reform Act of 1986 permitted the IRS to challenge all interest deductions by individuals and disallow them as personal). While interest was generally deductible regardless of the type of interest involved, it was a significant advantage to

B. An Interest[ing] Reform: 1986-1996

In 1986, Congress amended the Code and disallowed deductions for personal interest by individuals.[43] However, the amended Code retained an exception for the deduction of interest attributable to a trade or business.[44] Specifically, the deduction for interest on individual income tax deficiencies arising from adjustments solely to business income is not addressed in the statute.[45] In 1987, Treasury attempted to resolve the uncertainty surrounding the deductibility of deficiency interest by issuing Temporary Regulation § 1.163-9T.[46] Temporary Regulation § 1.163-9T clearly states that all interest associated with individual income tax deficiencies is nondeductible personal interest.[47] Although the IRS now argues that deficiency interest is nondeductible personal interest rather than a nondeductible business expense, the controversy continues.[48]

The first case to address the deficiency interest controversy after the enactment of the Tax Reform Act of 1986 was *Miller v. United States*.[49] The North Dakota District Court followed the

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deduct interest as a business expense because it was an "above-the-line" deduction. *Id.* at 256. After 1969, Congress began categorizing interest based on its type: business, investment, or personal. *Id.* at 257.

43. Tax Reform Act of 1986, Pub. L. No. 99-514, § 511(b), 100 Stat. 2085, 2246 (1986) (codified as amended at I.R.C. § 163(h) (1994)). Congress amended section 163 by adding subsection (h)(1) which states: "In the case of a taxpayer other than a corporation, no deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year." *Id.*

44. *Id.* Section 511(b)(2)(a) of the Tax Reform Act of 1986 excepts from the definition of personal interest "interest paid or accrued on indebtedness incurred or continued in connection with the conduct of a trade or business (other than the trade or business of performing services as an employee)." *Id.* Congress subsequently amended section 163(h)(2)(A) by replacing "incurred or continued in connection with the conduct of" with "properly allocable to." Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1005(c)(4), 100 Stat. 3342, 3390 (1988).

45. I.R.C. § 163 (1994).

46. Vigil, *supra* note 41, at 685-86.

47. Temp. Treas. Reg. § 1.163-9T(a)(2) (1987). The regulation specifically states:

> (2) Interest relating to taxes-(i) In general. Except as provided in paragraph (b)(2)(iii) of this section, personal interest includes interest-
> (A) Paid on underpayments of individual Federal, State or local income taxes and on indebtedness used to pay such taxes (within the meaning of § 1.168-8T), regardless of the source of the income generating the tax liability.

Id.

48. *See* Engel, *supra* note 11, at 256 (noting that the deficiency interest deduction controversy still exists even after enactment of the Tax Reform Act of 1986 and temporary regulations).

49. Miller v. United States, 841 F. Supp. 305 (D.N.D. 1993), related proceeding, 95-1 U.S.T.C. ¶ 50,068, at 87,228 (D.N.D. 1994), *aff'd in result*, 65 F.3d 687 (8th Cir. 1995). Miller was a farmer. *Id.* at 306. As part of an

"ordinary and necessary" business expense reasoning in the *Standing*, *Polk*, and *Reise* line of cases and rejected Temporary Regulation § 1.163-9T.[50] The court did not believe that Congress intended to change the long history of case law supporting a business deduction for deficiency interest incurred in connection with the conduct of a trade or business.[51] However, the court left open for rehearing the question of whether the tax deficiency interest at issue was of the type that could be deducted as an ordinary and necessary business expense.[52] On rehearing, the North Dakota District Court determined that the tax deficiency interest involved was not an ordinary and necessary business expense and disallowed the deduction.[53] The Eighth Circuit, while affirming the lower court's decision, did not agree that the regulation was invalid.[54]

The first notable Tax Court case to address the deficiency interest deduction after enactment of the Tax Reform Act of 1986 was *Redlark v. Commissioner*.[55] As an initial matter, the Tax

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income deferral scheme involving a wholly-owned corporation, Miller underreported his taxable income by approximately $1.5 million. *Miller*, 95-1 U.S.T.C. at 87,231. Upon review, the IRS assessed additional tax and interest on the deficiency. *Id.* Miller subsequently deducted the deficiency interest as a business expense. *Id.* Upon IRS challenge, Miller argued that the underpayment of income tax was an ordinary and necessary business expense, and therefore deductible. *Id.* at 87,229.

50. *Miller*, 841 F. Supp. at 309-10. The court concluded that Temporary Treasury Regulation § 1.163-9T was "unreasonable and therefore invalid." *Id.* at 310.

51. *Id.* at 310. The court based its decision on I.R.C. § 163(h)(2)(A), legislative history, case law, and a 1989 tax article. *Id.* at 309-10. The court held that as a matter of law, Temporary Regulation § 1.163-9T(b)(2)(A) was an invalid construction of the term "personal interest." *Id.* at 310.

52. *Miller*, 95-1 U.S.T.C. at 87,230.

53. *Id.* at 87,232. Although the court ultimately denied Miller's deduction for deficiency interest, it did so because the tax deficiency arose out of an improper income deferral scheme that could not be construed as ordinary and necessary in Miller's line of business. *Id.* "[T]he underlying tax deficiency must be the result of an error which is typical of, and reasonably anticipated in, the commercial field in which the taxpayer engages." *Id.*

54. *Miller*, 65 F.3d at 691. The Eighth Circuit Court of Appeals agreed with the district court that the tax deficiency interest was not of the type that would ordinarily and necessarily be of the type incurred in Miller's trade or business, but rejected the reasoning that Temporary Regulation § 1.163-9T was inconsistent with the language of I.R.C. § 163(h). *Id.* In the court's view, the per se denial of tax deficiency interest in Temporary Regulation § 1.163-9T was dispositive of the taxpayer's claimed interest deduction. *Id.*

55. Redlark v. Commissioner, 106 T.C. 31 (1996) (Ruwe, J. and Halpern, J., dissenting), *rev'd*, 141 F.3d 936 (1997). *Redlark* was heard by the entire Tax Court. *Id.* Both the majority and dissenting opinions each gained the support of eight judges. *Id.* *Redlark* was not the first post-Tax Reform Act of 1986 Tax Court case to address the deficiency interest controversy. On three previous occasions, the Tax Court held that the individual taxpayers could not deduct tax deficiency interest because they could not adduce sufficient proof that the

Court determined that the deficiency interest was sufficiently related to the taxpayer's trade or business to be considered ordinary and necessary.[56] The Tax Court next considered the more critical issue before the court: whether Temporary Regulation § 1.163-9T(b)(2) was a valid interpretation of I.R.C. § 163(h).[57] The Tax Court ultimately held the regulation invalid and that the deficiency interest at issue was properly allocable to a trade or business and therefore deductible as a business expense.[58] However, the Ninth Circuit reached a contrary result and reversed the Tax Court.[59]

The Tax Court's decision in *Redlark* was significant for a number of reasons,[60] most notably because so many members of the court could not agree on: (1) the ambiguousness of section 163(h); (2) the ambiguousness of the related legislative history; and (3) how much weight to give I.R.C. § 163(h)'s legislative

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assessment arose from the taxpayers' trade or business. *See, e.g.*, Rose v. Commissioner, 69 T.C.M. (CCH) 1914 (1995) (holding interest expense incurred because the petitioner failed to pay income taxes on time); Tippin v. Commissioner, 104 T.C. 518, 530 (1995) (holding that "protection payments" for a lien on unpaid income tax were not a deductible business interest expense); Crouch v. Commissioner, 69 T.C.M. (CCH) 3038 (1995) (holding that tax litigation expenses are not deductible business expenses, but can be deducted as a miscellaneous itemized deduction). James E. Redlark was engaged in the business of installing telephone equipment. *Redlark*, 141 F.3d at 938. Redlark conducted his business as a sole-proprietor. *Id.* Following an examination of several years' returns, the IRS proposed adjustments to Redlark's business income and assessed additional income tax. *Redlark*, 106 T.C. at 32. Redlark paid the additional tax and deficiency interest and proceeded to deduct the interest as a business expense. *Id.* The IRS subsequently disallowed Redlark's business deduction for the deficiency interest asserting that the interest was personal interest. *Id.* at 32-33.

56. *Id.* at 37. The adjustment related to errors made in converting Redlark's business income from the accrual to cash basis for federal income tax purposes. *Id.*

57. *Id.*

58. *Id.* at 47. Temporary Regulation § 1.163-9T was promulgated pursuant to its authority under I.R.C. § 7805(a) and not pursuant to a legislative directive. *Id.* at 38. Regulations enacted pursuant to Treasury's general rulemaking authority are referred to as "interpretive" regulations. *Id.* Interpretive regulations are generally owed less deference than a regulation issued pursuant to a specific grant of authority by Congress. *Id.* Rowan Cos. v. United States, 452 U.S. 247, 253 (1981). Temporary Regulation § 1.163-9T will be upheld only if it "implement[s] the congressional mandate [of section 163(h)] in some reasonable manner." United States v. Vogel Fertilizer Co., 455 U.S. 16, 24 (1982) (quoting United States v. Correll, 389 U.S. 299, 307 (1967)). *See generally* Vigil, *supra* note 41, at 688-90 (discussing various explanations provided by the Tax Court in *Redlark* as to why Temporary Regulation § 1.163-9T is an unreasonable interpretation of section 163(h)).

59. *Redlark*, 141 F.3d at 942. The court held that Temporary Regulation § 1.163-9T(b)(2)(i)(A) is a reasonable interpretation of I.R.C. § 163(h)(2). *Id.*

60. *See* Reynolds, *supra* note 11, at 753. (discussing the significance of *Redlark*).

history.[61] The controversy intensified in the post-*Redlark* line of cases where the Tax Court maintained its position that Temporary Regulation § 1.163-9T was invalid, while the Federal appellate courts took a contrary view.

C. *The Aftermath of Redlark: Post-1996*

Only one month before the Ninth Circuit reversed the Tax Court's decision in *Redlark*, the Tax Court upheld its position on the invalidity of Temporary Regulation § 1.163-9T and decided *Kikalos v. Commissioner*[62] in favor of the taxpayer. There was no dispute that the interest paid by Kikalos on the tax deficiency was a result of the operation of Kikalos' sole-proprietorship.[63] With that premise, the Tax Court applied its reasoning in *Redlark* and allowed the deficiency interest deduction because it was "properly allocable to his trade or business."[64]

The Seventh Circuit ultimately reversed the Tax Court's decision in *Kikalos*.[65] The Seventh Circuit held that Temporary Regulation § 1.163-9T was a reasonable interpretation of I.R.C. § 163(h) and therefore valid[66] despite the court's reluctance to give Temporary Regulation § 1.163-9T the same degree of deference that a final regulation would ordinarily be given.[67]

In addition to the Seventh, Eighth, and Ninth Circuits, the Fourth and Sixth Circuits recently joined the appellate courts' unanimity in finding Temporary Regulation § 1.163-9T a valid

61. *Id.*

62. Kikalos v. Commissioner, 75 T.C.M. (CCH) 1924 (1998), *rev'd*, 190 F.3d 791 (7th Cir. 1999). Nick Kikalos operated a liquor store business as a sole-proprietorship. *Id.* at 1925. Kikalos dealt substantially in cash and did not retain cash register receipts for the years examined by the IRS. *Id.* The IRS analyzed Kikalos' business income based on industry averages of the percentage markup on the cost of goods sold by Kikalos. *Id.* at 1928. The IRS concluded that Kikalos had underreported his business income and therefore assessed additional tax and interest on the deficiency. *Id.* at 1927. Kikalos subsequently deducted the deficiency interest as a business expense and the IRS disallowed the deduction. *Id.*

63. *Id.* at 1933.

64. *Id.*

65. *Kikalos*, 190 F.3d at 799.

66. *Id.*

67. *See id.* at 796 (questioning the amount of scrutiny Temporary Regulation § 1.163-9T has undergone in the past twelve years). The court noted that "one could argue that section 1.163-9T(b)(2)(i)(A) is entitled to no more deference than a proposed regulation." *Id.* The court stated in dicta that Kikalos would have benefited if he argued that temporary regulations should not be entitled to as much deference as final regulations. *Id.* However, because Kikalos did not raise this issue, but instead, embraced the Tax Court's view that the regulation was invalid, the court reserved for another day the proper degree of deference that should be afforded temporary regulations issued without prior notice and comment periods. *Id.* at 796.

interpretation of I.R.C. § 163(h).[68] In addition, other federal district courts have adopted the Ninth Circuit's reasoning in *Redlark* and denied sole-proprietors a business deduction for deficiency interest attributable to their trade or business.[69]

Taxpayers have endured a long history of conflicting interpretations by the courts over the deductibility of non-corporate tax deficiency interest.[70] This issue will continue to provide uncertain results for taxpayers until the Supreme Court rules on the issue or legislative action is taken.[71]

II. CHALLENGING THE VALIDITY OF TEMPORARY REGULATION §1.163-9T

Throughout the recent history of the deficiency interest deduction dispute, taxpayers have had mixed success in challenging the validity of Temporary Regulation § 1.163-9T.[72] This part of the Comment will examine both the taxpayers' and the IRS' arguments regarding the deductibility of deficiency interest and will examine the support for each position. First, Section A will outline the central arguments raised by taxpayers and the IRS. Next, Section B will examine the legislative history of I.R.C. § 163(h) as a means to determine whether Congress intended to retain a deduction for deficiency interest attributable to a trade or business. With I.R.C. § 163(h)'s legislative history as a backdrop, Section C will present the two forms of statutory analysis used by the courts to determine whether or not I.R.C. § 163(h) is ambiguous. Lastly, Section D will analyze the distinction between interpretive and legislative regulations and discuss the amount of deference that the courts afford each.

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68. *See* Allen v. United States, 173 F.3d 533, 534 (4th Cir. 1999), *rev'g*, 987 F.Supp. 460 (E.D.N.C. 1997) (finding Temporary Regulation § 1.163-9T to be a reasonable construction of I.R.C. § 163(h)); McDonnell v. United States, 180 F.3d 721, 723 (6th Cir. 1999) (adopting the Ninth Circuit's analysis in *Redlark* and holding that Temporary Regulation § 1.163-9T is a valid interpretation of I.R.C. § 163(h)).

69. *See, e.g.*, Stecher v. United States, 98-2 U.S.T.C. ¶ 50,543, at 85,236 (E.D. Colo. 1998) (holding that the taxpayers' tax deficiency interest was personal interest in accordance with the Ninth Circuit's reasoning in *Redlark*); Kirk v. United States, 99-2 U.S.T.C. ¶ 50,687, at 89,277 (E.D. Ky. 1999) (adopting the reasoning of the Fourth, Eighth, and Ninth Circuits (*Allen*, *Miller*, and *Redlark*, respectively) rejecting a business deduction for tax deficiency interest); Davis v. United States, 99-2 U.S.T.C. ¶ 50,783, at 89,568 (W.D. Tex. 1999) (following the Fourth, Sixth, Eighth, and Ninth Circuits (*Allen*, *McDonnell*, *Miller*, and *Redlark*, respectively) denying a business deduction for tax deficiency interest).

70. Richard I. Newmark & Ted D. Englebrecht, *Courts Split on Individuals' Deficiency Interest Deduction*, 62 PRAC. TAX STRATEGIES 87, 87 (1999).

71. *Id.*

72. *Id.*

A. The Arguments

A flurry of challenges over the validity of Temporary Regulation § 1.163-9T occurred when it was enacted in 1987.[73] When attempting to claim a business deduction for interest incurred on federal income tax deficiencies, taxpayers have argued that Temporary Regulation § 1.163-9T is an invalid interpretation of I.R.C. § 163(h).[74] The basis for the argument is that I.R.C. § 163(h) is clear, and therefore Treasury did not have the authority to issue regulations purporting to clarify that section.[75]

In contrast, the IRS argues that the regulation is a valid interpretation of I.R.C. § 163(h) because the legislature had to further clarify and define what is "properly allocable to a trade or business."[76] Surprisingly, both taxpayers and the IRS rely on the legislative history of I.R.C. § 163(h) as support for their arguments.[77]

B. Legislative History: Clarity or Confusion

When a court resorts to legislative history, it is generally to resolve doubt, not create it.[78] Unfortunately, when Congress eliminated the deduction for personal interest in the Tax Reform Act of 1986, neither I.R.C. § 163(h) nor its legislative history clarified whether the exclusion applied to non-corporate tax

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73. *See, e.g.*, Miller v. United States, 95-1 U.S.T.C. ¶ 50,068, at 87,228 (D.N.D. 1994); Redlark v. Commissioner, 106 T.C. 31, 33 (1996); *Allen*, 987 F.Supp. at 463; Kikalos v. Commissioner, 75 T.C.M. (CCH) 1924 (1998).

74. Newmark, *supra* note 70, at 93.

75. The dispute centers around the language in section 163(h)(2)(A) which excludes from the category of "personal interest" interest paid or accrued on debt "properly allocable to a trade or business." *Redlark*, 106 T.C. at 39. Because Congress did not specifically grant to Treasury the authority to issue regulations interpreting the meaning of "personal interest," Temporary Regulation § 1.163-9T is an "interpretative regulation." Richard M. Lipton, *Divided Tax Court Allows Deduction of Interest on Tax Arising from a Trade or Business*, 84 J. TAX'N 218, 219 (1996). The purpose of interpretative regulations is to explain or clarify a statute enacted by Congress. *See generally supra* note 15 and accompanying text.

76. Newmark, *supra* note 70, at 93.

77. Engel, *supra* note 11, at 262-63.

78. Caroline Elizabeth Costle, *Judicial Deference to Interpretive Regulations in the Face of Inconclusive Legislative History: The Example of Nalle v. Commissioner*, 47 TAX LAW. 259, 268 (1993) (quoting American Community Builders, Inc. v. Commissioner, 301 F.2d 7, 13 (7th Cir. 1962)). Justice Scalia equated legislative history with "entering a crowded cocktail party and looking over the heads of the guests for one's friends." *Id.* at 259. *See also* Conroy v. Aniskoff, 507 U.S. 511, 519 (1993) (Scalia, J., concurring) (quoting Judge Harold Leventhal). Justice Scalia used this metaphor to illustrate the unreliability of legislative history because it will often contain both supporting and non-supporting statements that permit the parties to pick and choose material that supports their interpretation. *Id.*

deficiency interest.[79] This Section will discuss the two primary sources of legislative history that courts have used to determine the intent of Congress in enacting I.R.C. § 163(h).

1. Conference Committee Report

The Conference Committee Report offers scarce support. Both the taxpayers' argument and the IRS' argument rest on one sentence in the Committee Report: "Personal interest also generally includes interest on tax deficiencies."[80] The heart of the debate focuses on the word "generally." It appears that the word "generally" was meant to exclude some forms of personal interest from complete disallowance.[81] The IRS, however, has argued that the word "generally" was only meant to exclude interest paid on past-due business taxes, such as sales and excise taxes, which are specifically provided for in the regulations.[82] The Tax Court rejected the IRS' argument relying on the fact that "deficiency" has a "long-established and well-known meaning."[83] The word "deficiency" has been held to include income, estate, and gift taxes.[84] Therefore, the court concluded that Congress must have intended to exclude some forms of income, estate, and gift taxes from the definition of personal interest.[85] Accordingly, a logical extension of the term "generally," in the context of the exception clause of I.R.C. § 163(h)(2)(A), is that Congress intended to exclude interest on tax deficiencies that are allocable to a trade or business of the taxpayer.[86]

While the Committee Report may have offered little in the way of concrete support for either party, the 1987 Bluebook was

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79. Vigil, *supra* note 41, at 685-86.

80. H.R. CONF. REP. NO. 99-841, Vol. II, at 154 (1986), *reprinted in* 1986-3 C.B. 154 [hereinafter Committee Report]. The full text of the Committee Report is as follows:

> Under the conference agreement, personal interest is not deductible. Personal interest is any interest, other than interest incurred or continued in connection with the conduct of a trade or business (other than the trade or business of performing services as a employee), investment interest, or interest taken into account in computing the taxpayer's income or loss from passive activities for the year. Personal interest also *generally* includes interest on tax deficiencies.

Id. (emphasis added).

81. Reynolds, *supra* note 11, at 780.

82. *Redlark*, 106 T.C. at 44. *See also* Temp. Treas. Reg. § 1.163-9T(b)(2)(iii)(A) (1987) (excluding from the definition of personal interest, interest paid on underpayments of "sales, excise, and similar taxes that are incurred in connection with a trade or business").

83. *Redlark*, 106 T.C. at 44.

84. *Id.*

85. *Id.* at 45.

86. *Id.* The court further notes that adopting the IRS' position would require the use of the word "always" instead of "generally" in the Committee Report and require a more expansive definition of the term "deficiency." *Id.*

explicitly clear.

2. *General Explanation of the Tax Reform Act of 1986 ("Bluebook")*

The second illuminating piece of legislative history is the 1987 Bluebook issued by the Joint Tax Committee.[87] The Bluebook clearly supports the IRS' position that interest on income tax deficiencies is not deductible.[88] However, the courts have refused to acknowledge the Bluebook as a part of a statute's legislative history because it is not prepared for the Congress that enacted a particular statute.[89] Furthermore, "[t]he Bluebook is on especially weak ground when it adopts anti-taxpayer positions not taken in the committee reports."[90] With this foundation, the majority in *Redlark* disregarded the Bluebook as an indicator of congressional intent.[91]

The indeterminacy of I.R.C. § 163(h)'s legislative history leaves neither the taxpayer nor the IRS with a superior argument. Because the legislative history of I.R.C. § 163(h) adds little support for upholding or rejecting Temporary Regulation § 1.163-9T, the actual text of I.R.C. § 163(h) must be scrutinized.

C. Statutory Analysis

The next logical step toward determining congressional intent is to analyze the text of I.R.C. § 163(h).[92] A conclusion about the

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87. STAFF OF THE JOINT COMMITTEE ON TAXATION, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 266 [hereinafter Bluebook]. It is interesting to note that the Bluebook was issued more than six months after the enactment of the Tax Reform Act of 1986.

88. HARLLEE, *supra* note 22, at A-115. The Bluebook states in relevant part:

> Personal interest also includes interest on underpayments of individual Federal, State or local income taxes notwithstanding that all or a portion of the income may have arisen in a trade or business, because such taxes are not considered derived from the conduct of a trade or business. However, personal interest does not include interest payable on estate tax deferred under sections 6163 or 6166.

Bluebook at 266 (footnote omitted).

89. *Redlark*, 106 T.C. at 45 n.7. *See also* Hutchinson v. Commissioner, 765 F.2d 665, 669-70 (1985) (stating that the Bluebook does not rise to the level of legislative history because it was written by congressional staff and not by Congress); Condor Int'l, Inc. v. Commissioner, 98 T.C. 203, 227 (1992) (noting that the Bluebook is not part of the legislative history of the statute it explains).

90. Michael Livingston, *What's Blue and White and Not Quite as Good as a Committee Report: General Explanations and the Role of "Subsequent" Tax Legislative History*, 11 AM. J. TAX POL'Y 91, 93 (1994).

91. *Redlark*, 106 T.C. at 46.

92. *See* Ellen P. Aprill, *Muffled Chevron: Judicial Review of Tax Regulations*, 3 FLA. TAX REV. 51, 54 (1996) (noting that the review of tax regulations usually begins with the statutory text, although the interpretive

clarity of I.R.C. § 163(h) will determine whether Temporary Regulation § 1.163-9T is valid.[93] There are generally two approaches used by the courts in determining the clarity of statutory text: the *Chevron* approach and the "plain meaning" approach.

1. The Chevron Approach

The most common method used to determine a statute's clarity was laid out by the court in *Chevron U.S.A., Inc. v. Natural Resources Defense Counsel, Inc.*[94] The first step in the *Chevron* approach is to use "traditional tools of statutory construction" and legislative history to determine congressional intent.[95] If Congress has directly addressed the issue, the court must give effect to the unambiguous intent of Congress and hold the regulation invalid.[96] If, however, the court determines that the statute does not address the question at issue, the court must determine whether the regulation is based on a permissible construction of the statute.[97] The *Chevron* approach, however, has not been strictly adopted in tax cases.[98]

In *Redlark*, for example, Judge Tannenwald began with an examination of the text of I.R.C. § 163(h).[99] Based on the pre-Tax Reform Act of 1986 case law, Judge Tannenwald stated that the

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answer is rarely obvious).

93. Reynolds, *supra* note 11, at 774.

94. 467 U.S. 837, 842-43 (1984). *See* Aprill, *supra* note 92, at 54 (noting that the *Chevron* standard has been applied in tax cases since 1989 and used by the Tax Court since 1992).

95. Aprill, *supra* note 92, at 63-64 (quoting *Chevron*, 467 U.S. at 843 n.9). The Supreme Court stated:

> First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute . . . . Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

Chevron, 467 U.S. at 842-43.

96. *Chevron*, 467 U.S. at 842-43.

97. Before *Chevron*, the courts generally gave legislative regulations "strong" deference and interpretive regulations "weak" deference. *Aprill*, *supra* note 92, at 57. Interpretive regulations would be upheld as long as they "implemented the congressional mandate in some reasonable manner." *Id.* at 58. *See id.* at 58 (discussing the Supreme Court's explanation in *Nat'l Muffler Dealers Ass'n v. U.S.*, 440 U.S 472 (1979)). *See also id.* at 57-61 (discussing the pre-*Chevron* deference afforded interpretive regulations).

98. *See generally* Aprill, *supra* note 92, at 66-67 (discussing the Tax Court's reformulated application of the *Chevron* standard).

99. *Redlark*, 106 T.C. at 39 (1996).

language of I.R.C. § 163(h) was sufficient for Redlark to prevail.[100] However, Judge Tannenwald went on to consider I.R.C. § 163(h)'s legislative history.[101] Judge Tannenwald's examination of I.R.C. § 163(h)'s legislative history departed from traditional *Chevron* analysis where legislative history is used only at the first step in determining whether Congress has addressed the particular question at issue.[102] The Tax Court's departure from traditional *Chevron* analysis is representative of the gradual shift in tax cases towards the use of the plain meaning approach.[103]

2. *The "Plain Meaning" Approach*

While the plain meaning approach is not embraced by a majority of the Supreme Court,[104] its use has increasingly been used in statutory interpretation cases.[105] The plain meaning approach looks at the words used in the statute itself, rather than the congressional intent or purpose inherent in the legislative history.[106] A statute's language is analyzed based on its dictionary definitions, rules of textual construction and the way a specific provision relates to the statute as a whole.[107]

Unfortunately, the plain meaning approach does not provide a workable standard for reviewing statutory text.[108] The courts continue to inconsistently apply the plain meaning approach to statutory interpretation.[109] This inconsistent application of the

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100. *Id.*

101. *Id.*

102. *But see* Aprill, *supra* note 92, at 81-82 (denoting this standard of reviewing statutory text as the "muffled" *Chevron* doctrine). The muffled *Chevron* doctrine is a combination of the standards espoused by the Supreme Court in *National Muffler* and *Chevron*. *Id.* at 82.

103. *See, e.g.*, *Redlark*, 106 T.C. at 48, 54-55 (illustrating the Tax Court's move towards a more textualist approach to reviewing the Code). Judges Swift and Laro would have both held Temporary Regulation § 1.163-9T invalid based solely on the statutory language. *Id.* Judge Swift was of the opinion that I.R.C. § 163(h) "[spoke] for itself." *Id.* at 48. Judge Laro was also of the opinion that the statute spoke for itself and felt that "legislative history should be sought to embellish the text only when the meaning of the words therein are 'inescapably ambiguous'." *Id.* at 54-55.

104. *See* Aprill, *supra* note 92, at 65 (noting that Justice Scalia espouses the strict-construction approach to interpreting statutory text).

105. Mary L. Heen, *Plain Meaning, The Tax Code, and Doctrinal Incoherence*, 48 HASTINGS L.J. 771, 771-73 (1997). *See also* Aprill, *supra* note 92, at 64-65 (noting that Justice Scalia has changed the *Chevron* approach to fit with his textualist theory of interpretation).

106. *Id.* at 771-72. *See, e.g.*, Aprill, *supra* note 92, at 65 (discussing Justice Scalia's attack on the use of legislative history as a tool of statutory construction).

107. Heen, *supra* note 105, at 773.

108. *See id.* at 811-12 (discussing the Supreme Court's inconsistent approach to interpreting statutory text).

109. *See id.* at 812 (noting that the Court applied the plain meaning

plain meaning approach could lead to disjointed and inconsistent interpretations of the Code.[110]

Because of the confusion among the courts, and specifically the Supreme Court, over the proper standard to apply in analyzing statutory text, an argument that Temporary Regulation § 1.163-9T is invalid because the text of I.R.C. § 163(h) is unambiguous may be futile. Even if it is assumed that I.R.C. § 163(h) is ambiguous, the question of judicial deference to regulations that purport to interpret congressional intent must be considered.

D. Interpretive vs. Legislative Regulations: A Blurred Distinction

Administrative law recognizes two types of regulations: legislative and interpretive.[111] A legislative regulation is similar in weight to a statute.[112] Legislative regulations create "legally enforceable duties" that are binding on the agency promulgating the regulation, the courts, and private parties.[113] An interpretive regulation, by contrast, does not create new duties.[114] Interpretive regulations merely interpret or clarify a dispute created by the passage of a particular statute.[115] The distinction between legislative and interpretive regulations is especially important in the context of judicial review of tax regulations and public involvement in adopting tax regulations.[116]

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approach to a statute three years after it had chosen not to).

110. *Id.* Even if the plain meaning approach were applied consistently by the courts, inherent limitations in its application would continue. *Id.* The plain meaning approach would restrict important contextual information, eliminate the use of legislative history, and pose a risk of misinterpretation in tax cases. *Id.*

111. Aprill, *supra* note 92, at 55.

112. *Id.*

113. RICHARD J. PIERCE, JR. ET AL., ADMINISTRATIVE LAW AND PROCESS 285 (The Foundation Press, Inc., 2d ed. 1992). In the tax context, Treasury adopts legislative rules pursuant to a specific grant of rulemaking authority. Asimow, *supra* note 15, at 358.

114. PIERCE, *supra* note 113, at 285. Interpretive tax regulations are adopted pursuant to the Treasury Department's general rulemaking power in I.R.C. § 7805(a). Asimow, *supra* note 15, at 358. Regulations adopted under I.R.C. § 7805(a) are almost uniformly classified as interpretive by tax authorities. *Id.*

115. PIERCE, *supra* note 113, at 285. *But see* Anthony, *supra* note 18, at 10 (defining "spurious rules" as interpretive regulations that have the appearance of law by the agency promulgating the regulation and the courts enforcing the regulation); Toni Robinson, *Retroactivity: The Case for Better Regulation of Federal Tax Regulators*, 48 OHIO ST. L.J. 773, n.60 (1987) (discussing the view of one commentator who believes that interpretive tax regulations are nothing more than "creative law making").

116. Asimow, *supra* note 15, at 351. *See generally* Peter A. Appel, *Administrative Procedure and the Internal Revenue Service: Delimiting the Substantial Understatement Penalty*, 98 YALE L.J. 1435, 1442-46 (1989) (discussing the history of the distinction between legislative and interpretive rules).

1. *Judicial Review of Interpretive Tax Regulations*

Historically, the courts have given greater deference to legislative regulations than interpretive regulations.[117] However, in the tax context, this rule has become more pragmatic than real.[118] Currently, the general rule for reviewing interpretive tax regulations is that the courts should defer to Treasury's interpretation of the Internal Revenue Code as long as the interpretation is reasonable.[119] However, courts have not consistently applied this general rule.

In *Redlark*, the Tax Court gave Temporary Regulation § 1.163-9T less deference than a legislative regulation because it was interpretive.[120] This lesser deference allowed the Tax Court to find that Temporary Regulation § 1.163-9T was an impermissible interpretation of I.R.C. § 163(h).[121] On appeal, however, the Ninth Circuit reversed the Tax Court, languidly giving full deference to Treasury's interpretation of I.R.C. § 163(h)[122]

When the courts presume the validity of the Treasury regulations, it raises serious concerns over Treasury's ability to establish substantive law without public involvement and with minimal judicial interference.[123]

2. *Enacting Interpretive Tax Regulations*

The Administrative Procedure Act generally requires a federal agency to provide public notice of proposed rules in the *Federal Register*.[124] When notice is published in the *Federal Register*, the public is given the opportunity to participate in the

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117. Aprill, *supra* note 92, at 57.

118. *Id.* at 58.

119. Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554, 560-61 (1991). An interpretation will be considered reasonable if the regulation "harmonizes with the plain language of the statute, its origins, and its purpose." Costle, *supra* note 78, at 264 (quoting National Muffler Dealers Ass'n v. United States, 440 U.S. 472, 477 (1979)).

120. Redlark v. Commissioner, 106 T.C. 31, 38 (1996).

121. *Id.* at 47. In dicta, Judge Tannenwald stated that he did not think that "the Secretary of the Treasury should be entitled to use . . . section 7805(a) to construct a formula which excludes an entire category of interest expense in disregard of a business connection such as exists herein." *Id.* at 40.

122. Redlark v. Commissioner, 141 F.3d 936, 939 (1998). The court stated: "So long as the Commissioner issues regulations that 'implement the congressional mandate in some reasonable manner,' we must defer to the Commissioner's interpretation." *Id.* (citing Rowan Cos. V. United States, 452 U.S. 247, 252 (1981)).

123. *See* Asimow, *supra* note 15, at 366 (suggesting that when agencies make new law without public involvement, the agency eliminates any direct accountability to the voters and that a democratic system of government requires that the people who will be governed by the laws have some say about their scope).

124. Administrative Procedure Act, 5 U.S.C. § 553(b) (1994).

rulemaking process, and the agency is required to consider any information presented by the public before making the regulation final.[125] However, the Administrative Procedure Act provides an exception to the public notice and comment period requirements for agencies proposing rules that are "interpretative."[126]

Treasury enacted Temporary Regulation § 1.163-9T pursuant to its authority under I.R.C. § 7805.[127] Because regulations enacted under I.R.C. § 7805 are uniformly considered interpretive rules,[128] Temporary Regulation § 1.163-9T was not subject to the pre-adoption public notice and comment period requirements of the Administrative Procedure Act. This lack of public involvement in enacting interpretive regulations, coupled with the high degree of judicial deference to those regulations, goes beyond the mere interpretation of a statute.[129] That practice gives Treasury the unbridled power to enact binding rules that have the force and effect of law in the courts and on taxpayers. This practice is exemplified by Treasury's narrow construction of I.R.C. § 163(h), which excludes an "entire category of interest expense."[130] Treasury's failure to provide pre-adoption public notice and a comment period for an overreaching regulation like Temporary Regulation § 1.163-9T raises significant concerns over the power of a federal agency to act in a legislative capacity.[131]

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125. 5 U.S.C. § 553(c).

126. 5 U.S.C. § 553(b)(A). *See also supra* note 19 and accompanying text (discussing exceptions to the notice and comment period requirements of the Administrative Procedure Act). The Administrative Procedure Act refers to "interpretative" rules rather than "interpretive" rules. Both words are commonly used and used interchangeably. *See, e.g.*, Chrysler Corp. v. Brown, 441 U.S. 281, 301, 313 (1979). For purposes of this Comment, the author prefers to use the word "interpretive" for stylistic reasons. It is interesting to note that a Senate version of the Omnibus Taxpayers' Bill of Rights Act would have repealed the interpretive rule exception to the Administrative Procedure Act for Treasury regulations. S. 604, 100th Cong. § 17(a) (1987). Furthermore, a later Senate version of the Omnibus Taxpayers' Bill of Rights Act would have required the Secretary of the Treasury to certify that a rule proposed by the Internal Revenue Service is the only alternative to meet the mandate of a particular statute before it will be considered an interpretive rule for purposes of the Administrative Procedure Act. S. 1774, 100th Cong. § 8(a) (1987).

127. T.D. 8168, 1988-1 C.B. 80, 83.

128. Asimow, *supra* note 15, at 358.

129. As Judge Laro clearly illustrated:

> If the Congress had intended to disallow any deduction for deficiency interest that was an ordinary and necessary business expense under section 162(a), the Congress would have said so. Instead, the Congress clearly stated that personal interest does not include 'interest paid or accrued on indebtedness properly allocable to a trade or business.'

Redlark, 106 T.C. at 57 (Laro, J. concurring).

130. Redlark v. Commissioner, 106 T.C. at 40.

131. *See* Asimow, *supra* note 15, at 343 (questioning whether the Treasury Department's practice of promulgating rules that are not subject to the

III. ENDING THE DEFICIENCY INTEREST DEDUCTION CONTROVERSY

To challenge the validity of Temporary Regulation § 1.163-9T, one must do more than simply attack the amount of deference given to the regulation by the courts, or claim that Treasury did not have authority to issue the regulation in the first place. An effective argument to invalidate Temporary Regulation § 1.163-9T must concede Treasury's authority to issue the regulation (given the recent weight of authority) and argue that Temporary Regulation § 1.163-9T is invalid because it was enacted in violation of the Administrative Procedure Act.[132]

Section A proposes that interpretive regulations may be legislative in effect. Temporary Regulation § 1.163-9T is legislative in effect and therefore should not fall within the interpretive rule exception to the Administrative Procedure Act. A regulation that is legislative in effect should be subject to the same pre-adoption public notice and comment period requirements that legislative regulations are subject.[133] Temporary Regulation § 1.163-9T did not comply with the pre-adoption public notice and comment period requirements of the Administrative Procedure Act, and therefore should be held invalid.[134]

Section B proposes that Congress eliminate the interpretive rule exception to the Administrative Procedure Act.[135] This would

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Administrative Procedure Act is good policy).

132. Very few tax cases have considered whether Treasury has complied with the public notice and comment period requirements of the Administrative Procedure Act in its rulemaking process. Asimow, *supra* note 15, at 359. *See, e.g.*, American Standard, Inc. v. United States, 602 F.2d 256, 268 (Ct. Cl. 1979) (invalidating a legislative regulation because of improper public notice under the Administrative Procedure Act). Even fewer tax cases have examined the applicability of the interpretive rule exception to the Administrative Procedure Act. Asimow, *supra* note 15, at 359. *See, e.g.*, American Med. Ass'n v. United States, 688 F. Supp. 358, 364 (N.D. Ill. 1988), *rev'd on other grounds*, 887 F.2d 760 (7th Cir. 1989) (stating that the regulation at issue, which was adopted under I.R.C. § 7805(a), was legislative and therefore did not fall within the interpretive rule exception to public notice and comment period requirements of the Administrative Procedure Act). The district court stated that "regulations that define or give substantive content to language undefined with any real specificity in the Code (hence being 'legislative' in the legal-realism sense that recognizes administrative agencies as potential lawmakers)" are legislative. *Id.*

133. *See supra* note 19 and accompanying text (discussing the notice and comment period requirements in the adoption of federal agency regulations).

134. *Cf.* Kikalos v. Commissioner, 190 F.3d 791, 796 (1999) (hypothesizing that temporary regulations that are not subject to pre-adoption notice and comment periods may not be entitled to any more deference than a proposed regulation). *See also* Costle, *supra* note 78, at 277 (arguing that the courts should give interpretive regulations less deference).

135. *See supra* note 19 and accompanying text (discussing the interpretive rule exception to the Administrative Procedure Act). *See also supra* note 126 and accompanying text (illustrating recent attempts to eliminate the

ensure that future rules promulgated by Treasury would be subject to a pre-adoption public notice and comment period, which will have the effect of diluting Treasury's delegated authority and furthering the government's general rulemaking policy.[136]

A. Interpretive Regulations with Legislative Effect

Regulations denoted as interpretive by Treasury, such as Temporary Regulation § 1.163-9T, enjoy a presumption of validity by the courts.[137] A judicial presumption that interpretive Treasury regulations are valid necessarily implies that Treasury may establish rules having the same "force and effect of law" as legislative regulations.[138] Consequently, because the legal effect of interpretive regulations and legislative regulations is the same, both types of regulations should be subjected to the same pre-adoption procedures.[139] Accordingly, the first step toward subjecting all Treasury regulations to the same pre-adoption procedures is to eliminate the Administrative Procedure Act's interpretive rule exception.

B. Eliminating the Interpretive Rule Exception

Regulations with legislative effect should not be exempted from pre-adoption public participation merely because Treasury attaches an "interpretive" label on its face.[140] Permitting the adoption of Treasury regulations without pre-adoption public participation undermines United States rulemaking policy, which advocates public involvement in the rulemaking process by the people destined to be governed by those laws.[141] In order to

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interpretive rule exception).

136. *See supra* note 20 and accompanying text (stating Congress' declaration of United States rulemaking policy).

137. *See supra* notes 117-23 and accompanying text (discussing the amount of deference given to interpretive Treasury regulations by the courts).

138. *See* Batterton v. Francis, 432 U.S. 416, 425 n.9 (1977) (deciding that administrative interpretations of statutory terms may have legislative effect). The Supreme Court further stated:

> [T]he Secretary [of the treasury], rather than . . .the courts, [have] the primary responsibility for interpreting the statutory term. In exercising that responsibility, the Secretary adopts regulations with legislative effect. A reviewing court is not free to set aside those regulations simply because it would have interpreted the statute in a different manner.

Id. at 425.

139. *See* Asimow, *supra* note 15, at 359-60 (arguing that all regulations issued by Treasury should be treated as legislative and subject to the public participation requirements of the Administrative Procedure Act).

140. *See* Chamber of Commerce v. OSHA, 636 F.2d 464, 468 (D.C. Cir. 1980) (stating that an "interpretive" label is indicative but not dispositive of the type of regulation at issue). The real inquiry is what is the substance of the regulation. *Id.*

141. *See id.* at 470 (rejecting an OSHA regulation for failure to comply with

advance United States rulemaking policy, the interpretive rule exception of the Administrative Procedure Act should be eliminated.

Furthermore, it is unlikely that either Congress or the courts will establish a bright-line test to distinguish between legislative rules, interpretive rules, and interpretive rules with legislative effect.[142] If the interpretive rule exception is eliminated, there will be uniformity in the enactment of Treasury regulations, thereby eliminating questions over the proper amount of judicial deference that should be afforded a particular regulation.

CONCLUSION

It is questionable whether the specific classification of all interest as personal interest on individual federal income tax deficiencies in Temporary Regulation § 1.163-9T was necessary to the enforcement of I.R.C. § 163(h). If anything, the limitation is an additional restriction on the deductibility of interest in a trade or business context, and one that was not specifically considered by Congress.

Consequently, future taxpayer challenges to Temporary Regulation § 1.163-9T should be premised on the fact that strong judicial deference to interpretive regulations necessitates public involvement in enacting those regulations. Without public participation, taxpayers are rendered powerless against Treasury's lawmaking ability.[143] When taxpayers lack the proper degree of influence over the content of Treasury regulations, Treasury is effectively placed in a tyrannical position that enables it to alter congressional intent as it sees fit. When this occurs, Treasury has clearly gone too far.

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the Administrative Procedure Act because it was an attempted exercise of legislative power).

142. *See* Appel, *supra* note 116, at 1444 (noting that the distinction between interpretive and legislative regulations remains unclear).

143. *See* Asimow, *supra* note 15, at 366 (commenting that public notice and comment periods "serve fundamental democratic purposes."). By not allowing public participation in the adoption of agency regulations an agency can make new law without direct accountability to the public. *Id.* Agency regulations should not be effective until after the democratic process of public involvement has occurred. *Id.*