FedEx, the Potential Demise of *Chevron* Deference, and the Future of Regulatory Challenges to Treasury Regulations

*By Robert J. Kovacev and Marissa J. Lee**

Wolters Kluwer®

FedEx Corporation and its subsidiaries ("FedEx") recently obtained a significant win in an $89 million refund case on denial of foreign tax credits.[1] The *FedEx v. United States* decision invalidated a Treasury Regulation based on its finding that the regulation conflicted with the unambiguous meaning of the underlying statute, applying the two-step analysis that courts have followed since the U.S. Supreme Court decided *Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc.*[2] FedEx's application of the *Chevron* doctrine comes at a time when courts and commentators are questioning whether that doctrine is too deferential to the government. Indeed, the Supreme Court will directly reconsider *Chevron* later this year. The Court's decision in *FedEx* comes at a critical juncture when the analytical framework for adjudicating the validity of regulations is up for grabs.

The *Chevron* Doctrine

Chevron deference has been the touchstone for adjudicating the validity of federal regulations for almost 40 years. In *Chevron*, the Supreme Court considered a challenge to certain Environmental Protection Agency ("EPA") regulations promulgated under the Clean Air Act. The Court's analysis focused on answering two questions: "whether Congress has directly spoken to the precise question at issue," and if not, "whether the agency's answer is based on a permissible construction of the statute."[3] Underlying this two-step test is a presumption that Congress may delegate authority to agencies both expressly and by implication. Thus, if a statute is silent or ambiguous, a "court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency."[4] In other words, even if the agency's interpretation is not the better interpretation of the statute, a court must defer to the agency,

ROBERT J. KOVACEV is a Member of the Tax Department with Miller & Chevalier in Washington, DC. **MARISSA J. LEE** is an Associate of the Tax Department with Miller & Chevalier in Washington, DC.

© 2023 R.J. KOVACEV AND M.J. LEE

absent unambiguous statutory language to the contrary, unless it is unreasonable (a very difficult standard to achieve). This obviously gives agencies, including the Internal Revenue Service ("IRS") and Treasury in the context of tax regulations, wide scope to implement their favored policy goals even if traditional statutory interpretation rules, applied *de novo*, would support a different interpretation of the underlying statute.

Treasury and the IRS may be forced to rethink the scope of their regulatory power if they can no longer count on Chevron deference.

As a practical matter, a successful challenge to a regulation must generally convince a court that the regulation unambiguously contravenes the statutory text under *Chevron* step one. Arguments that a regulation is unreasonable in the face of legislative silence or ambiguity under *Chevron* step two are far less likely to succeed. This article considers the *FedEx* decision against this background.

FedEx and Plain Text Reading in *Chevron* Step One

On March 31, 2023, the U.S. District Court for the Western District of Tennessee granted FedEx's motion for partial summary judgment and denied the government's motion for partial judgment. The issue was whether FedEx is eligible to receive U.S. tax credits for foreign taxes paid on earnings from its foreign subsidiaries offset by losses from its other related foreign subsidiaries ("Offset Earnings"). FedEx contended that it is entitled to receive the credit for these foreign taxes paid on Offset Earnings, based on its three arguments supporting the invalidity of the regulation issued by the Treasury and the IRS. First, the regulation disallows foreign tax credits that the Internal Revenue Code (the "Code" or "I.R.C.") unambiguously authorizes. Second, Treasury based the regulation on the erroneous premise that Code Sec. 965(b)(4)(A) results in an inclusion of Offset Earnings in income under Code Secs. 951(a) and 960(a)(1). Lastly, Treasury disregarded comments made with respect to the proposed regulation, and this lack of response was arbitrary and capricious under the Administrative Procedure Act. The Court addressed only the first two arguments and held that the regulation is contradicted by the plain terms of the Code.

For context, the Tax Cuts and Jobs Act of 2017 (the "TCJA"),[5] changed how the U.S. taxes corporations, shifting from a "worldwide" system imposing a tax on U.S. corporations' domestic and foreign income to a "territorial" system imposing a tax on only their domestic income and not foreign income. Under the prior system, corporations could defer paying U.S. tax on foreign earnings held in their foreign subsidiaries until the earnings were repatriated to U.S. shareholders. In transitioning to the different regime, the TCJA enacted a one-time tax (the "transition tax") on these deferred and untaxed foreign earnings under Code Sec. 965. Congress, however, recognized that some U.S. corporations had foreign subsidiaries with losses. Corporations could pay the transition tax on the net amount combining the losses of these foreign subsidiaries and the earnings of their other foreign subsidiaries.

FedEx raised that it should be able to claim a credit for its foreign taxes paid on Offset Earnings, based on the operation of the Code sections related to deemed repatriation of foreign income and foreign tax credits. According to FedEx, its Offset Earnings are excluded from income under Code Secs. 959 and 965(b). Offset Earnings are treated as dividends for which a credit is given under Code Secs. 901 and 902. The foreign taxes associated with Offset Earnings are not previously deemed paid by former Code Sec. 960(a)(1).[6] Former section 960(a)(3) provides a credit for foreign taxes paid on Offset Earnings.

The government countered that the Code disallows tax credits for Offset Earnings, and the regulation fills the gap effectuating the credit disallowance if the statutory language is ambiguous. The government added that the foreign tax credit was intended to avoid double taxation, and a credit for Offset Earnings not subject to U.S. tax in the first place would be therefore inappropriate.[7]

In an issue of first impression, FedEx successfully argued that the regulation is invalid under the plain language of the Code. Reg. §1.965-5(c)(1)(ii) provides that "[n]o credit is allowed under former Code Sec. 960(a)(3) or any other section for foreign income taxes that would have been deemed paid under former Code Sec. 960(a)(1) with respect to the portion of a Code Sec.

965(a) earnings amount that is reduced under Reg. §1.965-1(b)(2) or §1.965-8(b) [*i.e.,* foreign taxes on Offset Earnings]."

In determining whether the regulation is valid, the Court applied the well-known two-step *Chevron* analysis. The first step requires asking "whether Congress has directly spoken to the precise question at issue."[8] At this step, the Court adopted a more robust analysis: it "uses all of the ordinary tools of statutory construction to interpret the statute and does not defer to the agency's views" and "the plainness or ambiguity of statutory language is determined by reference to the language itself, the specific context in which that language is used, and the broader context of the statute as a whole."[9] If the statute is ambiguous—"subject to more than one reasonable interpretation"—the Court proceeds to step two.[10] The Court defers to the agency's expertise and upholds the regulation based on a "permissible" construction of the statute.[11] The interpretation is "permissible" if it is "within the bounds of reasonable interpretation" and is not "arbitrary, capricious, or manifestly contrary to the statute."[12] Here, the Court found that the regulation did not make past *Chevron* step one, and even if the statute was deemed ambiguous, the regulation would fail step two.

The key statute is Code Sec. 965(b)(4)(A), and the parties disagreed on interpreting this provision. Code Sec. 965(b)(4)(A) states:

> [f]or purposes of applying section 959 in any taxable year beginning with the taxable year described in subsection (a), with respect to any United States shareholder of a deferred foreign income corporation, an amount equal to such shareholder's reduction under paragraph (1) which is allocated to such deferred foreign income corporation under this subsection shall be treated as an amount which was included in the gross income of such United States shareholder under section 951(a).

FedEx read the statutory language above to say Congress characterizes Offset Earnings as previously taxed income ("PTI") *only and specifically* "[f]or purposes of applying Code Sec. 959," which provides that certain amounts of the earnings and profits of foreign subsidiaries are treated as PTI. Congress thus does not characterize Offset Earnings as PTI for the purposes of the transition tax or any other foreign tax credit provisions of the Code. In contrast, the government pointed to the last phrase and stressed that although Offset Earnings are not actually included in income under Code Sec. 951, they must be treated as income. The government reasoned that the Code Sec. 951 reference requires examining the related former section 960. Former section 960(a)(1) states that "if there is included [in income] under Code Sec. 951(a) ... any amount attributable to earnings and profits of a foreign corporation ... Code Sec. 902 shall be applied as if the amount so included were a dividend paid." The government observed that given Offset Earnings are deemed to have been included in income, FedEx's foreign taxes are deemed to have been paid already under former section 960(a)(1). Former section 960(a)(2) specified that foreign taxes previously deemed paid under former section 960(a)(1) will not be credited the second time. Former section 960(a)(3) limits credit to foreign taxes "which were not deemed paid by the domestic corporation under [former section 960(a)(1)] for any prior taxable year." The government reiterated that because Offset Earnings are treated as included in income under Code Sec. 951, they cannot be credited under Code Sec. 960.

The Court sided with FedEx and found Code Sec. 965(b)(4)(A) unambiguous. The Court explained that the language "[f]or purposes of applying Code Sec. 959" clearly establishes that the statute applies to Code Sec. 959 but not to other sections, including Code Sec. 960. The Court described that the government's expansive interpretation contradicts the plain meaning of the statute and would "create unintended consequences."[13] Had Congress intended to address both Code Secs. 959 and 960, it could have drafted language to that effect. The Court also commented that the government's interpretation is "unpersuasive" when its interpretation relied on Code Sec. 960(a)(1) to "perform a dual and self-contradictory role"—not deeming taxes paid under Code Sec. 960(a)(1) but treating taxes as previously paid under Code Sec. 960(a)(3).[14] The Court concluded that FedEx's interpretation is "simpler and more convincing" and the application of Code Sec. 960(a)(1) independent of Code Sec. 960(a)(3) resolves the contradiction.[15]

The Court further rejected the government's argument that policy considerations should weigh against FedEx's interpretation of the statute. The government raised that considering Offset Earnings are untaxed, extending foreign credits to those earnings is not mitigation of double tax but is the elimination of any tax. The Court's analysis, however, stopped at *Chevron* step one, concluding that the Court cannot proceed with examining extra-textual factors, including legislative intent and policy considerations.

Wolters Kluwer®

3M and the Limits of *Chevron* Step One

FedEx stands in contrast to the U.S. Tax Court's recent decision in *3M Co. & Subsidiaries v. Comm'r*,[16] in which the Tax Court applied *Chevron* in a much more deferential way when it considered the validity of a Treasury Regulation. The IRS asserted that the royalty paid by the 3M Brazilian subsidiary to the 3M U.S. parent and owner of the intellectual property was below the arm's-length price and the parent's income should be increased based on the arm's-length price under Code Sec. 482. 3M argued that the resulting upward adjustment should be lower, capped at the amount that could be fully remitted under Brazilian law, and the Code Sec. 482 regulation disregarding the Brazilian legal restrictions is invalid. Reg. §1.482-1(h)(2) specifies that a foreign legal restriction on payments is not taken into account unless certain requirements are met.

As the first part of its *Chevron* step one analysis, the Court did not agree with 3M's argument that prior case law already held that Code Sec. 482 unambiguously prevented an allocation of income that could not be legally received. The Court referred to *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*[17] for the proposition that if the judicial precedent held that the statute was unambiguous, then that precedent controls over the agency interpretation. The Court rejected 3M's reliance on *Comm'r v. First Security Bank*[18] and the related lower court cases. The Court said that *First Security Bank* was analyzing the regulation, not the text of the then-effective statute preceding Code Sec. 482 of the I.R.C. of 1986 and thus found no support in 3M's argument that "the [U.S.] Supreme Court in *First Security* [*Bank*] determined that the plain meaning of Code Sec. 482 precludes the interpretation adopted by the Commissioner in Reg. §1.482-1(h)(2)." The Court concluded that "*First Security Bank* was not a *Chevron* step one opinion."[19] Further, the Court added that *First Security Bank* and its related cases were "distinguishable" because they construe the predecessor statutory provision and do not account for the subsequent statutory changes specific to the commensurate-with-income standard.[20] In her concurring opinion, Judge Kathleen Kerrigan concluded: "the version of Code Sec. 482 that the Supreme Court interpreted in *First Security Bank* differs significantly from the statutory text that controls this case."[21] She further concluded, given the cases cited by 3M are all prior to the 1986 amendment of Code Sec. 482, "there is no reason to construe our decision in the present case as overturning either of our precedents, as there we were dealing with a different version of the law as it relates to income from intangibles."[22]

The Court next delved further into legislative history. The Court established that it is to "consult the plain language of the statute, and, if the intent of Congress is not clear, the legislative history."[23] Having assessed that the text of Code Sec. 482 makes no reference to the treatment of legal restrictions, the Court expanded the discussion of legislative history of Code Sec. 482 and the 1986 changes mentioned above related to the commensurate-with-income standard. Judge Kerrigan's concurrence noted that "[w]hen we look to the legislative history of the 1986 amendment, we find that Congress' aim was to assist the IRS in the difficult task of determining an arm's-length value for the transfer and license of intangibles between related companies."[24]

3M asserted that the 1986 statutory change adding the commensurate-with-income sentence is "irrelevant" to the effect of legal restrictions on Code Sec. 482 allocations because the scope of this change was limited to requiring some other adjustments made time to time as specified in the one House report. The Court disagreed, stating that "the commensurate-with-income sentence is worded too broadly to support an interpretation confining the operation of the sentence to such a purpose."[25] The Court reasoned:

> [if the taxpayer] is right that the scope of the commensurate- with-income sentence of section 482 is limited to remedying the "timeframe" concern, then only this small portion of the vast 1994 final regulations was authorized by the second sentence of section 482. The rest of the 1994 final regulations would be unauthorized, including the comparable-profits method, 26 C.F.R. sec. 1.482-5 (2006), and the profit-split method, 26 C.F.R. sec. 1.482-6 (2006). These methods have a strong conceptual tie to the commensurate-with-income standard.

In further explaining that the post-1986 changes were substantial, the Court detailed its review of various congressional documents and commented that "[i]t is reasonable to think that Congress would have expected that the interpretive questions posed by Code

Sec. 482 as amended in 1986 would be resolved by subsequent regulations, not by pre-amendment legislative history."[26]

3M was a 98 split decision and included a strong dissent. In one of the three dissenting opinions, Judge Ronald Buch, joined by four other judges, emphasized that to the extent that Treasury drafted a regulation inconsistent with the Supreme Court's holding in *First Security Bank* that income a taxpayer cannot legally receive cannot be taxed under Code Sec. 482, the regulation is invalid. In contrast with the majority's interpretation of *First Security Bank*, he observed that the Supreme Court "did not rely on that regulation, but merely cited it for the proposition that even the Commissioner recognized that blocked income could not be taxed" and "was clear that it was interpreting the statute."[27] Further, he described that the majority's finding of the statutory ambiguity was "cursory" and support based on legislative history "unavailing."[28] In another dissenting opinion, Judge Cary Pugh argued that the Supreme Court in *First Security Bank* and Tax Court in *Procter & Gamble Co. v. Comm'r* [29] had already addressed the definition of "income" under Code Sec. 482.[30] And because the 1986 amendment to Code Sec. 482 did not modify the meaning of "income" in that section, Treasury could not issue a contrary regulation based on *stare decisis*. These opinions highlight divergent views even within the Tax Court on the questions of when *Chevron* analysis should be applied and what tools of statutory interpretation are considered appropriate for use at *Chevron* step one.

While *FedEx* and *3M* involved different Treasury Regulations, the two courts took very different approaches to the *Chevron* doctrine. The *FedEx* Court applied a strict textual analysis, divined the plain meaning of the underlying statute, and found the regulation inconsistent with the statutory text under *Chevron* step one. So, too, did the primary dissent in *3M*. The *3M* majority opinion, by contrast, applied a much looser reading of the statutory text even in the face of contrary Supreme Court precedent, leading the Court to defer to the IRS under *Chevron* step two. As discussed below, the *FedEx* approach is consistent with recent trends in Supreme Court jurisprudence, while the *3M* majority may soon find itself on the wrong side of history.

Loper and the Future of *Chevron*

On May 1, 2023, the Supreme Court granted *certiorari* in *Loper* on the question raised by the petitioners along with 18 states and various groups as *amici* and whether the Court should overrule *Chevron* or at least clarify that statutory silence concerning controversial powers expressly but narrowly granted elsewhere in the statute does not constitute an ambiguity requiring deference to the agency.[31] The D.C. Circuit had ruled 21 in favor of the federal agency, the National Marine Fisheries Service, and applied *Chevron* deference.[32] A group of fishing companies challenged the agency's rule that requires the fishing industry to pay for at-sea monitoring programs. The Court observed at *Chevron* step one that the text of the statute, the MagnusonStevens Act, makes clear the agency may direct fishing boats to carry monitors but is "silen[t]" on whether the agency or industry must pay for them.[33] Then the Court proceeded to step two. The Court considered the Act's "necessary and appropriate" clauses in addition to the statutory provision at issue. The Court determined that the agency's interpretation was "reasonable" when it was "necessary and appropriate" for the agency to come up with "practical steps to implement" the monitoring programs, including the choice of funding mechanism and cost-shifting decisions.[34] The dissent instead pointed out that the statute unambiguously does not authorize the agency to require the industry to fund the monitoring programs, and the *Chevron* analysis stops at step one. According to the dissent, Congress's silence does not automatically create ambiguity, and silence in fact indicates a lack of authority. And the agency has the "burden" to positively demonstrate where Congress empowered the agency to act and failed to meet that burden.[35]

At least three Supreme Court judges previously expressed their concerns about *Chevron* and may reiterate such views in *Loper*. Judge Clarence Thomas noted that *Chevron* differs from the Court's historical practice of applying traditional interpretive canons to contemporaneous, consistent interpretations of statutes by executive officers in several ways: it requires deference regardless of whether the interpretation began around the time of the statute's enactment, an agency has changed its position, or the agency's interpretation has the sanction of long practice, and applies in actions in which courts had interpreted statutes independently.[36] Judge Neil Gorsuch emphasized that "[w]hen reading statutes, we insist that courts pay careful attention to text, context, and traditional tools of interpretation" and *Chevron* "[requires] us to suppose that statutory silences and ambiguities are both always intentional and always created by Congress to favor the government over its citizens fits with none

of this" and "is neither a traditional nor a reasonable way to read laws."[37] Judge Brett Kavanaugh commented that *Chevron*'s "fundamental problem once again is that different judges have wildly different conceptions of whether a particular statute is clear or ambiguous" and "the key move from step one (if clear) to step two (if ambiguous) of *Chevron* is not determinate because it depends on the threshold clarity versus ambiguity determination."[38] He suggested that courts should "[f]irst, find the best reading of the statute by interpreting the words of the statute, taking account of the context of the whole statute, and applying any appropriate semantic canons."[39]

The justifications for abandoning or significantly narrowing *Chevron* deference are particularly strong when it comes to tax regulations. The *Chevron* doctrine rests on the assumption that a federal agency has superior expertise in its field, and that courts should therefore defer to the agency's expertise unless Congress has unambiguously said otherwise. Whatever the applicability to other agencies, the notion that the IRS or Treasury's expertise in tax law is superior to that of the private tax bar is, at best, debatable—particularly when one considers that the person who drafts a regulation while in government is often the same person who later advocates for an interpretation on that regulation in private practice. Tax law is not a function of scientific, technical, or industry knowledge but is simply a creature of positive law in the form of statutes and regulations. The IRS cannot plausibly claim to be superior to the federal bench in its ability to interpret statutes. For the same reasons that federal courts do not permit expert witnesses to testify as "legal experts" on the meaning and interpretation of federal laws, they should also decline to defer to the IRS as a supposed "expert agency" on the meaning and interpretation of the I.R.C.

Conclusion

The Supreme Court will directly address the matter soon in *Loper*, and the current majority of the Court may be leaning toward restricting or overruling *Chevron*. If so, challenges to tax regulations will increase, and the likelihood of success will improve. Treasury and the IRS may be forced to rethink the scope of their regulatory power if they can no longer count on *Chevron* deference. In the meantime, taxpayers should preserve challenges to Treasury Regulations in open years in anticipation that such challenges may prove stronger if *Chevron* is narrowed or overruled.

Wolters Kluwer®

ENDNOTES

* The authors can be reached at *rkovacev@milchev.com* and *mlee@milchev.com*, respectively.

1 *FedEx Corp. & Subsidiaries*. No. 2:20-cv-02794, 2023 WL 2755311 (W.D. Tenn. Mar. 31, 2023).

2 SCt, 467 US 837, 842-43, 104 SCt 2778, 2781-82 (1984).

3 *Id*. at 836-37, 842.

4 *Id*. at 844.

5 Pub. L. No. 115-97, 131 Stat. 2054 (Dec. 22, 2017).

6 For certain provisions, pre-TCJA statutory language applies to FedEx's claim for a refund for the tax year 2018 and dates back to the 2016 version of the Code.

7 *See* 84 FR 1838, 1855 (Feb. 9, 2019).

8 *Chevron*. SCt, 467 US at 842, 104 SCt at 2781.

9 *FedEx*, 2023 WL 2755311, at *3.

10 *Id*.

11 *Chevron*. SCt, 467 US at 843, 104 SCt at 2782.

12 *FedEx*, 2023 WL 2755311, at *4.

13 *Id*. at *9.

14 *Id*.

15 *Id*. at *10.

16 160 TC No. 3, Dec. 62,159 (2023), WL 1861866 (2023).

17 SCt, 545 US 967, 125 SCt 2688 (2005).

18 SCt, 72-1 USTC ¶9292A, 405 US 394, 92 SCt 1085 (1972)

19 *3M*, 2023 WL 1861866, at *132.

20 *Id*., at *137.

21 *Id*., at *153 (Kerrigan, J., concurring).

22 *Id*., at *159.

23 *Id*., at *140 (citing *Ark. AFL-CIO v. FCC*, CA-8, 11 F3d 1430, 1440 (1993); *see also Succar v. Ashcroft*, CA-1, 394 F3d 8, 30–31 (2005) ("This circuit has used the approach of considering legislative history in *Chevron* stage one analysis where appropriate to discern and/or to confirm legislative intent"). *Cf. Geiser*, CA-3, 527 F3d 288, 295 (2008) ("[L]egislative history should not be considered at *Chevron* step one").

24 *3M*, 2023 WL 1861866, at *157 (Kerrigan, J., concurring).

25 *Id*., at *142.

26 *Id*., at *139.

27 *Id*., at *163 (Buch, J., dissenting).

28 *Id*., at *170.

29 95 TC 323, Dec. 46,876 (1990).

30 *3M*, 2023 WL 1861866, at *171 (Pugh, J., dissenting).

31 *Loper Bright Enterprises v. Raimondo*. No. 22-451, 2023 WL 3158352 (Sup. Ct. May 1, 2023).

32 DC-DC, 45 F4th 359 (2022).

33 *Id*. at 368.

34 *Id*. at 369.

35 *Id*. at 374–75 (Walker, J., dissenting).

36 *Baldwin*. SCt, 140 SCt 690, 694 (2020) (Thomas, J., dissenting).

37 *Buffington v. McDonough*. SCt, 143 SCt 14, 19 (2022) (Gorsuch J., dissenting).

38 Brett M. Kavanaugh, Book Review, *Fixing Statutory Interpretation Judging Statutes*, 129 HARV. L. REV. 2118, 2152 (2016).

39 *Id*. at 2163.

This article is reprinted with the publisher's permission from International Tax Journal, a bimonthly journal published by CCH Incorporated. Copying or distribution without the publisher's permission is prohibited. To subscribe to International Tax Journal or other journals, please call 1-800-344-3734 or visit taxna.wolterskluwer.com. All views expressed in this publication are those of the author and not necessarily those of the publisher or any other person.

Wolters Kluwer