No. 11-1528

In the Supreme Court of the United States

NORTHROP CORPORATION EMPLOYEE INSURANCE BENEFIT PLANS MASTER TRUST, PETITIONER

v.

UNITED STATES OF AMERICA

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

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the investment income of a voluntary employees' beneficiary association is subject to income tax to the extent its year-end assets exceed the account limit described in 26 U.S.C. 512(a)(3)(E)(i).

2. Whether, in a case where petitioner's refund claim depends on the contention that an applicable Treasury Department regulation is invalid, petitioner was required to contest the validity of the regulation in its administrative appeal in order to preserve that challenge for judicial review.

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OPINIONS BELOW

The court of appeals affirmed (Pet. App. 1a) the judgment of the Court of Federal Claims without an opinion. The opinion of the Court of Federal Claims (Pet. App. 2a-23a) is reported at 99 Fed. Cl. 1.

JURISDICTION

The judgment of the court of appeals was entered on April 10, 2012. The petition for a writ of certiorari was filed on June 20, 2012. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. a. A voluntary employees' beneficiary association (VEBA) is an organization that "provid[es] for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or des-

ignated beneficiaries." 26 U.S.C. 501(c)(9). A VEBA's income is generally exempt from federal income tax. 26 U.S.C. 501(a). Like other organizations generally exempt from the payment of income tax, however, VEBAs must pay income tax on "unrelated business taxable income." 26 U.S.C. 511(a)(1). For VEBAs, "unrelated business taxable income" is equivalent to the organization's gross income, less allowable deductions, and less "exempt function income." 26 U.S.C. 512(a)(3)(A).

"Exempt function income" is the "gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members" goods or services "in furtherance of the purposes" constituting the basis of the organization's tax-exempt status. 26 U.S.C. 512(a)(3)(B). "Exempt function income" also includes income "which is set aside * * * to provide for the payment of life, sick, accident, or other benefits" as well as "reasonable costs of administration directly connected" with the provision of such benefits. 26 U.S.C. 512(a)(3)(B) and (ii).

In 1984, Congress placed a limit on the amount of income a VEBA may set aside as exempt function income. Deficit Reduction Act of 1984, Pub. L. No. 98-369, Div. A, Title V, § 511(b), 98 Stat. 860. Set-aside income may qualify as exempt function income "only to the extent that such set-aside does not result in an amount of assets set aside for [purposes of providing welfare benefits and associated administrative costs] in excess of the account limit determined under [26 U.S.C.] 419A * * * for the taxable year." 26 U.S.C. 512(a)(3)(E)(i). The cross-referenced provision specifies that "the account limit for any qualified asset account for any taxable year is the amount" necessary to fund "claims incurred but unpaid (as of the close of such taxable year)" and "administrative costs" relating to such claims. 26 U.S.C. 419A(c)(1)(A) and (B).[1] Thus, a VEBA's exempt function income does not include any investment income set-aside that "result[s] in an amount of assets," 26 U.S.C. 512(a)(3)(E)(i), greater than the account limit specified in 26 U.S.C. 419A, as modified, see n.1, *supra*. Accordingly, such investment income is subject to income taxation as unrelated business taxable income.

b. In 1986, the Internal Revenue Service (IRS) issued a temporary regulation addressing, *inter alia*, the limit on investment income that may be set aside as exempt function income under Section 512(a)(3)(E)(i). See 26 C.F.R. 1.512(a)-5T. The regulation explained that, in light of the limit on exempt function income under 26 U.S.C. 512(a)(3)(E)(i), a VEBA's unrelated business taxable income for a taxable year generally equals the lesser of "the excess of the total amount set aside as of the close of the taxable year * * * over the qualified asset account limit," or the VEBA's investment income for the taxable year. 26 C.F.R. 1.512(a)-5T, A-3(a) and (b).

2. Petitioner is a VEBA that was organized to provide certain welfare benefits to employees and retirees, and their beneficiaries, of Northrop Grumman Corporation and its subsidiaries. Pet. App. 17a. Between 1999 and 2003, petitioner filed tax returns treating various

[1] Section 419A of Title 26 specifies a limit, called the "account limit," 26 U.S.C. 419A(c), that factors into the determination of the tax deduction employers may take for contributions made to a VEBA. 26 U.S.C. 419A(b) and (c). Reserves held for post-retirement medical benefits are included in that account limit. 26 U.S.C. 419A(c)(2)(A). By contrast, the statutory limit on set-aside exempt function income excludes such reserves. 26 U.S.C. 512(a)(3)(E)(i). Thus, the account limit under Section 419A may be greater than the account limit under Section 512. We refer to the 419A account limit as incorporated into Section 512(a)(3)(E)(i) as the 419A account limit "as modified."

investment income as unrelated business taxable income, on which petitioner paid income tax. *Id.* at 17a-18a; see C.A. App. 107, 185, 257, 315, 381. Petitioner subsequently sought an income tax refund for each of those years, claiming that the investment income it had previously reported as unrelated business taxable income instead should have been excluded as exempt function income. Pet. App. 17a-18a. During those years, petitioner's "reported investment income was less than its expenditures for member benefits." *Id.* at 18a.

In its filings with the IRS, petitioner explained that it had set aside and spent the investment income on benefits or administration relating to benefits during the taxable year. See, *e.g.*, C.A. App. 163. Petitioner argued that the limit on exempt function income in 26 U.S.C. 512(a)(3)(E)(i) applies "only to those assets accumulated, but not spent, during the course of the year." C.A. App. 163; see *id.* at 235, 408, 501, 505. In support of that contention, petitioner relied on *Sherwin Williams Co. Employee Health Plan Trust* v. *Commissioner*, 330 F.3d 449 (2003), in which the Sixth Circuit held that Section 512(a)(3)(E)(i) does not "apply to funds that are set aside and spent on the reasonable costs of administration directly connected with the provision of benefits * * * during the course of the year." *Id.* at 454. Based on its assertion that it had actually spent its investment income on member benefits during the taxable year, petitioner sought a refund of approximately $24 million, plus interest. Pet. App. 18a.

After evaluating petitioner's refund request, an examiner proposed to disallow in full petitioner's claims. C.A. App. 416-423, 432-434. The examiner explained that, under 26 C.F.R. 1.512(a)-5T, there is no provision "for allocating income from a particular source to the payment of a particular expense." C.A. App. 422. Rather, "the total amount set aside in the trust at the end of the taxable year in excess of" the statutory limit on set-aside assets "is compared with [petitioner's] investment income" for the taxable year. *Ibid*. Petitioner's unrelated business taxable income for a given taxable year therefore is the lesser of (a) petitioner's investment income and (b) the amount of assets set aside at the end of the taxable year that exceeds the statutory limit. *Ibid*. Because petitioner did not demonstrate that it was entitled to a refund under this standard, the examiner proposed to disallow petitioner's claim in full. *Id.* at 422-423.

Petitioner filed an administrative appeal. C.A. App. 506, 512. Again relying on the Sixth Circuit's decision in *Sherwin Williams*, petitioner argued that the statutory limit on set-aside exempt function income does not apply to income "used within a reasonable time to pay employee health and welfare benefits." *Id.* at 511; see *id*. at 516. In its administrative appeal, petitioner cited 26 C.F.R. 1.512(a)-5T as one of the "authorities" applicable to this case. C.A. App. 508, 509. Petitioner described the regulation as providing "that the amounts set aside in a VEBA 'as of the close of a taxable year of such VEBA * * * may not be taken into account for purposes of determining "exempt function income" to the extent that such amounts exceed the qualified asset account limit.'" *Id*. at 509; see *id*. at 514. The administrative appeal did not otherwise discuss the regulation's validity or its relevance to this case.

3. a. Petitioner subsequently filed suit in the Court of Federal Claims (CFC).[2] C.A. App. 17. Petitioner's

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[2] The record does not contain any final decision from the IRS on petitioner's administrative appeal. However, a taxpayer seeking a

suit was stayed pending disposition of another case in the CFC that also involved the statutory limit on set-aside exempt function income. Pet. App. 3a. In that case, a VEBA sought a refund of income tax, arguing, as petitioner does here, that it had erroneously treated as unrelated business taxable income investment income that it had actually used to fund benefits for its members before the end of the taxable year. *CNG Transmission Mgmt. VEBA* v. *United States*, 84 Fed. Cl. 327, 328-329 (2008). The VEBA argued that 26 U.S.C. 512(a)(3)(E)(i), the statutory limit on set-aside exempt function income, as construed by 26 C.F.R. 1.512(a)-5T, applies only to investment income held by the VEBA "at the close of the taxable year." *CNG*, 84 Fed. Cl. at 335 (citation omitted).

The CFC rejected that argument and granted summary judgment to the United States. First, the court found ambiguous the statutory limit on set-aside exempt function income. *CNG*, 84 Fed. Cl. at 331-333. The statute provides that investment income set-aside for the payment of benefits may not "result in an amount of assets set aside * * * in excess of the account limit determined under section 419A," as modified. 26 U.S.C. 512(a)(3)(E)(i). But the statute does not state whether "investment income results in an excess over the account limit *only* when the member benefits paid that year amount to less than the investment income for that year," as the taxpayer argued, or whether such income

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refund of taxes paid may file suit six months after filing a claim with the IRS. 26 U.S.C. 6532(a)(1), 7422(a). Petitioner's suit complied with that requirement. See C.A. App. 17 (complaint filed Jan. 14, 2008); 135 (amended return filed Nov. 17, 2003); 223 (amended return filed Feb. 23, 2004); 286 (amended return filed Feb. 17, 2004); 352 (same); 397 (amended return filed July 2, 2007).

instead results in an excess whenever the year-end assets exceed the account limit, as the government argued. *CNG*, 84 Fed. Cl. at 332.[3]

Because it found the statute ambiguous, the CFC considered the IRS's interpretation of the statutory limit as set forth in 26 C.F.R. 1.512(a)-5T. The court concluded that the regulation requires consideration of a VEBA's investment income for the taxable year rather than the set-aside investment income purportedly left over at the close of the taxable year, after the VEBA has paid member benefits. *CNG*, 84 Fed. Cl. at 334-336. Finding that regulation a "reasonable interpretation of the statute," the court deferred to it and granted summary judgment to the United States. *Id*. at 336, see *id*. at 338.

The court of appeals affirmed. *CNG Transmission Mgmt. VEBA* v. *United States*, 588 F.3d 1376 (Fed. Cir. 2009). Unlike the CFC, the court of appeals found the statutory limit unambiguous. The court observed that, under the statute, "income does not qualify as exempt function income if it 'result[s] in' an account balance that is 'in excess' of the statutory account limit." *Id*. at 1379 (quoting 26 U.S.C. 512(a)(3)(E)(i)). The court concluded that, because "[t]he plain meaning of the term 'results in' is 'causes,'" and because the VEBA's "account overage was caused by, or occurred as a consequence of, the investment income it made," that income "was not tax-exempt." *Id*. at 1379-1380. The court of appeals further explained that it would reach the same result even if it found the statute ambiguous, in light of the deference that would be due to the "reasonable interpretation of

[3] The CFC did not believe that the legislative history of the 1984 statute adding the limit on set-aside exempt function income resolved the ambiguity. *CNG*, 84 Fed. Cl. at 333.

the statute" contained in 26 C.F.R. 1.512(a)-5T. *CNG*, 558 F.3d at 1380.

The court of appeals in *CNG* rejected the VEBA's argument that 26 U.S.C. 419(c) requires investment income to be treated as the first source of funds to pay member benefits, and that the same rule should apply in calculating the limit on set-aside exempt function income under 26 U.S.C. 512(a)(3)(E)(i). *CNG*, 588 F.3d at 1381. The court explained that Section 419(c), by its terms, applies only "[f]or purposes of this section" and therefore has no application to Section 512. *Ibid.* (quoting 26 U.S.C. 419(c)). The court also concluded that Section 419(c) is inapplicable to Section 512 because the two provisions "were enacted to deal with two fundamentally different problems." *Ibid.* Congress enacted Section 512(a)(3)(E)(i) to "address[] the problem of allowing a VEBA to generate excessive tax-free income." *Ibid.* Section 419, by contrast, "addresses the problem of excessive employer deductions for contributions to a VEBA" by limiting "the extent to which an employer can deduct contributions to a VEBA." *Id.* at 1381-1382.

The court of appeals in *CNG* found that *Sherwin Williams* was factually distinguishable from the case before it "because the parties there stipulated that the investment income at issue had been spent on administrative costs." *CNG*, 588 F.3d at 1382. In addition, the Federal Circuit disagreed with the Sixth Circuit's conclusion in *Sherwin Williams* that Section 512(a)(3)(E)(i) "imposes a limit on a VEBA's 'accumulated funds' rather than its set-aside funds." *Ibid.* The court in *CNG* explained that the "plain terms" of the statute "appl[y] to amounts 'set aside' to pay for welfare benefits, not to amounts 'accumulated' after expenses have been paid." *Ibid.* (discussing 26 U.S.C. 512(a)(3)(B) and (E)(i)).

b. After the court of appeals issued its decision in *CNG*, petitioner and the United States filed cross-motions for summary judgment in the present case. Pet. App. 2a. Petitioner argued, as it had before the IRS, that its investment income had not resulted in set-aside assets exceeding the statutory limit because "[i]n each of the relevant tax years, [petitioner's] reported investment income was less than its expenditures for member benefits." *Id.* at 18a. For the first time, petitioner also argued that 26 C.F.R. 1.512(a)-5T is invalid because the IRS had issued it without any explanation of the agency's reasoning and without following the notice and comment requirements of the Administrative Procedure Act. Pet. App. 21a; see 5 U.S.C. 553.

The CFC found the facts of this case indistinguishable from those in *CNG*, and it found the court of appeals' decision in that case controlling. Pet. App. 17a-18a. It was "undisputed that '[a]t the end of each [relevant tax] year, [petitioner's] assets exceeded the account limit under section 419A by an amount greater than the investment income for the year.'" *Id.* at 22a (quoting Pet. Br. Supp. Mot. Summ. J. 2) (last alteration added); see *id.* at 18a (noting parties' stipulation that petitioner's account limit under 26 U.S.C. 419A, as modified, for each of the taxable years at issue was zero). Applying the court of appeals' *CNG* decision, the CFC held that petitioner's "account overage was caused by, or occurred as a consequence of, the investment income it made." *Id.* at 22a (quoting 588 F.3d at 1379). Accordingly, the CFC concluded that petitioner's investment income was not tax exempt. *Ibid.* Because the court of appeals' interpretation of the statute resolved petitioner's claims, the CFC did not consider petitioner's challenge to the validity of the IRS regulation or the United States' argument that petitioner was precluded from challenging the regulation because it had not done so in the administrative proceedings. *Id.* at 21a-22a.

4. The court of appeals affirmed without an opinion. Pet. App. 1a.

ARGUMENT

The court of appeals correctly affirmed the CFC's determination that petitioner is not entitled to a refund of the taxes it paid on its investment income. Congress has given preferential tax treatment to the income of voluntary employees' beneficiary associations (VEBAs). However, Congress also has imposed a limit on the income that a VEBA may exempt from taxation. Any investment income a VEBA sets aside to provide for welfare benefits that "result[s] in an amount of assets set aside * * * in excess of the account limit determined under section 419A," 26 U.S.C. 512(a)(3)(E)(i), as modified, is classified as unrelated business taxable income. Because petitioner's investment income resulted in year-end assets that exceeded that limit, it was taxable.

Petitioner correctly identifies a disagreement between the Federal and Sixth Circuits on the proper interpretation of the limit specified in Section 512(a)(3)(E)(i). Under the Sixth Circuit's approach, if petitioner could establish that it actually spent its investment income on the provision of benefits or associated administrative costs during the taxable year, its investment income would be treated as tax-exempt. See *Sherwin Williams Co. Employee Health Plan Trust* v. *Commissioner*, 330 F.3d 449, 454 (2003).

This Court's resolution of that conflict is not warranted at this time, however. Petitioner does not contend that 26 U.S.C. 512(a)(3)(E)(i) unambiguously excludes from taxation investment income purportedly spent on benefits or administrative costs. And petitioner now acknowledges that the investment income at issue in this case was taxable under the temporary IRS regulation interpreting that provision. Pet. 4 (discussing 26 C.F.R. 1.512(a)-5T). Although petitioner now challenges (Pet. 25-38) the validity of that regulation, it did not do so in the administrative proceedings.

Because petitioner must establish the invalidity of the IRS regulation in order to prevail in this litigation, and petitioner failed to preserve its challenge to the rule in the administrative proceedings, this case is an unsuitable vehicle for resolving the circuit split that petitioner identifies. The Court also should defer consideration of the issue because the IRS recently has undertaken a regulatory project that may culminate in notice-and-comment rulemaking addressing the statutory limit on exempt function income.

1. The court of appeals correctly held that petitioner's investment income did not qualify as exempt function income because the investment income resulted in year-end assets that exceeded the limit identified in 26 U.S.C. 512(a)(3)(E)(i).

a. The statutory text, structure, and legislative history unambiguously disclose Congress's intent to treat VEBAs' investment income as taxable under the circumstances presented here. See *Chevron U.S.A. Inc.* v. *NRDC*, 467 U.S. 837, 842 (1984) ("If the intent of Congress is clear, that is the end of the matter."). Under Section 512(a)(3)(E)(i), a VEBA's set-aside investment income qualifies as exempt function income "only to the extent that such set-aside does not result in an amount of assets set aside for [the provision of benefits or associated administrative costs] in excess of the account limit determined under section 419A," as modified. Section

419A, in turn, defines the "account limit" for "any taxable year" as "the amount reasonably and actuarially necessary to fund—(A) claims incurred but unpaid (as of the close of such taxable year) for benefits," and "(B) administrative costs with respect to such claims." 26 U.S.C. 419A(c)(1). Thus, if a VEBA's investment income for a taxable year "result[s] in an amount of assets set aside," 26 U.S.C. 512(a)(3)(E)(i), at the end of the taxable year that is greater than an amount necessary to pay benefit "claims incurred but unpaid (as of the close of such taxable year)," 26 U.S.C. 419A(c)(1), and associated administrative costs, *ibid.*, then the investment income (up to the amount of excess assets) constitutes unrelated business taxable income, 26 U.S.C. 512(a)(3)(A).

As the Federal Circuit has correctly observed, the ordinary meaning of the term "results in" is "causes." See *CNG Transmission Mgmt. VEBA* v. *United States*, 588 F.3d 1376, 1379 (2009). Under Section 512(a)(3)(E)(i), set-aside investment income is taxable to the extent it causes the VEBA's year-end assets to exceed the amount necessary to fund claims incurred but not paid at the end of the year, and any associated administrative costs. The determination whether that causal link exists does not depend on how a VEBA spends the particular dollars that it acquires through its investments. Even if a VEBA can show that it used its investment income to pay current-year expenses, the investment income will still "result[] in" greater year-end assets than the VEBA would otherwise possess, since it will allow the VEBA to set aside *other* funds that would have been used for current-year expenses if the investment income had not been realized. As the Federal Circuit explained in *CNG*, "[m]oney is fungible, and [a VEBA] cannot avoid taxation by claiming that it spent money from investment income, rather than money from some other source, on member benefits." 588 F.3d at 1380; see *id.* at 1379 (explaining that "CNG's account overage was caused by, or occurred as a consequence of, the investment income it made in" the relevant taxable year).[4]

The legislative history of the relevant 1984 statute further supports the court of appeals' interpretation. As the court explained in *CNG*, 588 F.3d at 1380, Congress enacted restrictions on the exemption of VEBA income and employer deductions because it was concerned about the "tax-shelter potential of welfare benefit plans." H.R. Rep. No. 432, 98th Cong., 2d Sess. Pt. 2, at 1275 (1984) (*1984 House Report*). Accordingly, Congress enacted Sections 419 and 419A to limit the deductions employers could take for contributions to VEBAs, and it enacted Section 512(a)(3)(E)(i) "to limit the extent to which a VEBA could set aside income on a tax-free basis." 588 F.3d at 1380; see H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1162 (1984) ("The income of a VEBA * * * for a year is subject to the tax on unrelated business income to the extent that benefit plan reserves for the year exceed the reserve limit."); see also Staff of the Joint Comm. on Taxation, 98th Cong., 2d

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[4] By way of analogy, suppose that an individual earns $100,000 each year in after-tax wages and incurs $90,000 in expenses, for a yearly surplus of $10,000. If in a particular year the individual received additional income of $20,000, that income would "result in" a higher-than-usual (*i.e.*, $30,000) year-end surplus. That would be so even if the $20,000 were deposited into a separate account and devoted to current-year expenses, leaving the account devoid of funds at year's end. By allowing the individual to save $20,000 in wages that would otherwise have been used to defray current-year expenses, the new income would cause the greater year-end surplus to exist, regardless of which particular dollars were spent and which were saved.

Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* 790 (Comm. Print 1984) ("Under the Act, the tax [on unrelated business income] applies to an amount equal to the lesser of the income of the fund or the amount by which the assets in the fund exceed a specific limit on amounts set aside for exempt purposes.") (*General Explanation*).[5]

It is "undisputed that '[a]t the end of each [relevant tax] year, [petitioner's] assets exceeded the account limit under section 419A by an amount greater than the investment income for the year.'" Pet. App. 22a (quoting Pet. Br. Supp. Mot. Summ. J. 2) (last alteration added). Consequently, petitioner's investment income was subject to tax as unrelated business taxable income.

b. Petitioner's contrary arguments lack merit.

Petitioner's principal contention (Pet. 17-24) is that the limit on exempt function income in Section 512(a)(3)(E)(i) must be understood in light of what petitioner describes as the "ordering rule in [26 U.S.C.] 419(c)." Pet. 17. Section 419 addresses the amount of deductions an employer may take for contributions to a welfare benefit fund, such as that used to pay the benefits provided by a VEBA. Section 419(b) limits deductions to an amount equal to the VEBA's "qualified cost for the taxable year," a defined term. 26 U.S.C. 419(b);

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[5] House and Senate Committee Reports in the 99th Congress also reflect the committees' understanding that the Deficit Reduction Act of 1984 had eliminated the tax exemption for VEBA income that results in an amount of year-end assets exceeding the specified limit. See S. Rep. No. 313, 99th Cong., 2d Sess. 1007 (1985) ("Under present law, the tax on unrelated business taxable income of [a VEBA] applies to an amount equal to the lesser of the income of the fund or the amount by which the assets in the fund exceed a specific limit on amounts set aside for exempt purposes."); H.R. Rep. No. 426, 99th Cong., 1st Sess. 984 (1985) (same).

see 26 U.S.C. 419(c). Section 419(c)(2) provides that the "qualified cost for any taxable year shall be reduced by such fund's after-tax income for such taxable year." 26 U.S.C. 419(c)(2). Thus, the amount of a VEBA's after-tax income reduces the amount of deductions an employer may take for contributions to a VEBA.

According to petitioner, this formula for determining an employer's deductions has the effect of treating a VEBA's income as "the first source of funds considered used to pay current benefits." Pet. 17. Petitioner contends that Section 419(c)'s "ordering rule," *ibid.*, should similarly apply to the determination of the limit on a VEBA's exempt function income under Section 512(a)(3)(E)(i), Pet. 21. Petitioner further contends that, if Section 419(c)'s ordering rule applies, then a VEBA's investment income would be "considered used to pay current benefits," and so would not constitute unrelated business taxable income unless the investment income exceeded the cost of benefits. *Ibid.* Petitioner's argument is wrong for two independent reasons.

First, there is no statutory basis for importing the ordering rule in Section 419(c) into Section 512(a)(3)(E)(i). See *CNG*, 588 F.3d at 1381 ("[T]here is nothing to indicate that section 419's alleged ordering rule should be applied to section 512."). Section 512(a)(3)(E)(i) defines the limit on exempt function income by cross-reference to the "account limit" specified in Section 419A. See 26 U.S.C. 419A(c) (defining "account limit"). But Section 512(a)(3)(E)(i) does not reference Section 419(c) or any ordering rule in that section. Nor does Section 419(c) anywhere reference Section 512(a)(3)(E)(i). Indeed, Congress prefaced Section

419(c) by explaining that it applies "[f]or purposes of this section." 26 U.S.C. 419(c).[6]

Second, and more fundamentally, application of petitioner's proposed ordering rule to Section 512(a)(3)(E)(i) would not change the outcome of this case. Even if petitioner's investment income were deemed to be the first source for the payment of benefits and associated administrative costs, that investment income still "result[ed] in an amount of assets set aside for [benefits and costs] in excess of the account limit," 26 U.S.C. 512(a)(3)(E)(i), since petitioner's investment income caused its year-end set-aside assets for the tax years at issue here to be greater than they would otherwise have been. See pp. 12-13, *supra*. As the court in *CNG* explained,

> [m]oney is fungible, and [a VEBA] cannot avoid taxation by claiming that it spent money from investment income, rather than money from some other source, on member benefits. There is no requirement in section 512(a)(3)(E)(i) that a VEBA's investment income can result in a year-end account overage only to the

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[6] Petitioner relies in part on a committee report accompanying the House bill that eventually became the 1984 statute enacting the limit on exempt function income. Pet. 18, 20. In the report, the committee expressed its view that "there should be reasonable limits on the extent to which a [VEBA] may *accumulate income, tax-free*." Pet. 18 (quoting *1984 House Report* 1292); see Pet. 20. Petitioner's reliance on the term "accumulate" is misplaced. It is common ground in this case that petitioner's investment income cannot be taxed unless petitioner's year-end account balance exceeds the statutory account limit. To that extent, taxability depends on accumulation of assets beyond a statutory cap. The disputed question in this case is whether petitioner's acknowledged year-end exceedance of the statutory account limit was caused by petitioner's investment income. The committee-report language on which petitioner relies does not speak to that question.

> extent that the actual dollars in the account at year end are directly traceable to income made on investments.

588 F.3d at 1380.[7]

2. Petitioner correctly identifies a disagreement between the Federal and Sixth Circuits on the interpretive question presented here. Petitioner cannot prevail in this litigation, however, because it is barred from challenging 26 C.F.R. 1.512(a)-5T, a temporary IRS regulation interpreting Section 512(a)(3)(E)(i), which supports the Federal Circuit's construction. This case therefore is a poor vehicle for resolving the circuit split. The Court also should defer consideration of the issue because the IRS recently has undertaken a regulatory project that may culminate in notice-and-comment rulemaking to address the statutory limit on exempt function income. The Court's interpretation of Section 512(a)(3)(E)(i) should await the considered views of the

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[7] Petitioner contends that if the ordering rule in Section 419(c) is not applied to determine the limit on a VEBA's exempt function income under Section 512(a)(3)(E)(i), that would lead to "the nonsensical result" of "a double denial of tax benefits." Pet. 18; see Pet. 18-20. But there is nothing nonsensical about an interpretation of the tax code that limits the tax preferential treatment of income. See *Mayo Found. for Med. Educ. & Research* v. *United States*, 131 S. Ct. 704, 715 (2011) ("[E]xemptions from taxation are to be construed narrowly.") (citation omitted). In any event, because the "account limit" for determining an employer's deductions can be considerably larger than the limit for determining a VEBA's exempt function income, see n.1, *supra*, interpreting 26 U.S.C. 419(c) literally to apply "[f]or purposes of this section" would not necessarily result in a denial of tax benefits to both the VEBA and a contributing employer. Indeed, Northrop Grumman Corporation took substantial deductions for its contributions to petitioner in the relevant tax years. See C.A. App. 28, 30, 31, 33, 451.

agency entrusted by Congress with the administration of the statute.

a. In *Sherwin Williams Co. Employee Health Plan Trust* v. *Commissioner*, 330 F.3d 449 (2003), the Sixth Circuit held that the limit on exempt function income does not apply to funds set aside by a VEBA and actually spent on welfare benefits or the associated costs of administration. *Id.* at 454. Construing the operative phrase "'result[s] in an amount' in excess of the account limit," the Sixth Circuit concluded that the statutory limit "suggests a focus not on the aggregate quantity of money that has passed through the account over the relevant window of time, but on the sum that exists in the account at the relevant moment." *Ibid.* (quoting 26 U.S.C. 512(a)(3)(E)(i)). It thus understood the limit to proscribe VEBAs from "accumulat[ing]" investment income. *Id.* at 455. Based on the parties' stipulation that the VEBA actually had spent its investment income on administrative costs directly associated with the provision of benefits, *id.* at 453, the Sixth Circuit held that the limit on exempt function income did not apply to that income, *id.* at 456.

In *CNG*, the Federal Circuit found *Sherwin Williams* "distinguishable on its facts" because of the parties' stipulation in that case. 588 F.3d at 1382; see *ibid.* ("[T]he pivotal issue before us is whether a VEBA can avoid taxation by purporting to spend income from investments, rather than income from some other source, in providing member benefits."). In addition, however, the Federal Circuit "disagree[d]" with the Sixth Circuit's understanding that the limit on exempt function income applies only to "accumulated funds." *Ibid.* (citation omitted); see *ibid.* ("[T]he term 'accumulated' appears nowhere in section 512(a)(3)(E).") (citation and quotation marks omitted). The Federal Circuit also faulted the Sixth Circuit for failing to "take account of the formula contained in Treasury Regulation § 1.512(a)-5T, which * * * imposes tax on the lesser of a VEBA's investment income and its excess over statutory account limits, regardless of whether income is spent on member benefits during the year." *Ibid.*

Petitioner is thus correct to assert a conflict between the Federal and Sixth Circuits on the proper interpretation of 26 U.S.C. 512(a)(3)(E)(i). If petitioner had brought this suit in the Sixth Circuit, and had established to that court's satisfaction that petitioner spent its investment income on the provision of benefits or associated administrative costs, petitioner would have prevailed. To be sure, the Sixth Circuit would not necessarily have accepted petitioner's contention that the ordering rule in 26 U.S.C. 419(c) can be used to determine how petitioner's investment income was spent (or should be deemed to have been spent). The circuits are squarely in conflict, however, on the question whether investment income that is spent during the taxable year can "result in" a year-end balance that exceeds the account limit described in Section 512(a)(3)(E)(i).

b. For two related reasons, however, this Court's resolution of that conflict is not warranted at this time.

In 1986, the IRS issued 26 C.F.R. 1.512(a)-5T, a temporary regulation interpreting Section 512(a)(3)(E)(i)'s limit on exempt function income. The regulation described a formula that captured the IRS's understanding of the statutory limit. Under that regulatory formula, a VEBA's unrelated business taxable income for a taxable year equals the lesser of: "the income of [a VEBA] for the taxable year * * * ; or, the excess of the total amount set aside as of the close of the taxable year * * * over the qualified asset account limit * * * for the taxable year." 26 C.F.R. 1.512(a)-5T, A-3(b). That formula mirrors the earlier explanations of the effect of the limit on exempt function income in congressional publications following the enactment of the Deficit Reduction Act of 1984. See *General Explanation* 790; S. Rep. No. 313, 99th Cong., 2d Sess. 1007 (1985); H.R. Rep. No. 426, 99th Cong., 1st Sess. 984 (1985); n.5, *supra*.

Petitioner does not contend that the statutory limit on exempt function income unambiguously excludes from taxation investment income purportedly spent on benefits or associated administrative costs. Indeed, petitioner's reliance on an implicit incorporation of an ordering rule precludes such an argument. And petitioner acknowledges that, under the interpretation of the limit set forth in the IRS regulation, petitioner's investment income is unrelated business taxable income. Pet. 4; see Pet. App. 18a. Accordingly, petitioner can prevail in this litigation only if the IRS regulation is held to be invalid.

In *CNG*, the court of appeals held in the alternative that, if Section 512(a)(3)(E)(i) were ambiguous, the court "would be compelled to accord deference to the Treasury's reasonable interpretation of the statute." 588 F.3d at 1380; see *Mayo Found. For Med. Educ. & Research* v. *United States*, 131 S. Ct. 704, 713 (2011) ("We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to *Chevron* to the same extent as our review of other regulations."); *id.* at 711-714. Petitioner contends (Pet. 25-29) that the regulation is invalid, and that judicial deference is therefore inappropriate, because the IRS issued the regulation without adequate explanation and without engaging in notice-and-comment rulemaking. As the court below explained, however, "[i]t is undisputed that [petitioner] did not assert that 26 C.F.R. § 1.512(a)-5T was invalid in its refund claims presented to the IRS." Pet. App. 18a. "In most cases, an issue not presented to an administrative decisionmaker cannot be argued for the first time in federal court." *Sims* v. *Apfel*, 530 U.S. 103, 112 (2000) (O'Connor, J., concurring in part and concurring in the judgment); see *ibid.* (noting that "the Court is unanimous" on "this underlying principle of administrative law."). Petitioner is therefore precluded from challenging the validity of the regulation in this litigation.

Petitioner contends (Pet. 30-38) that, because the governing statute does not make administrative exhaustion of particular issues a prerequisite to judicial review, this Court may excuse petitioner's failure to challenge the validity of the IRS regulation in the administrative proceedings. That argument lacks merit. In *Sims*, this Court held that where "an agency's regulations" require administrative issue exhaustion, "courts reviewing agency action regularly ensure against the bypassing of that requirement by refusing to consider unexhausted issues." 530 U.S. at 108. When *neither* the governing statute *nor* an agency's regulations require administrative issue exhaustion, courts "as a general rule" impose such a requirement. *Id.* at 109; see *id.* at 108-109. But in the absence of a statute or regulation requiring exhaustion, "the desirability of a court imposing a requirement of issue exhaustion depends on the degree to which the analogy to normal adversarial litigation applies in a particular administrative proceeding." *Id.* at 109.

Here, the IRS regulations that govern administrative appeals unambiguously require issue exhaustion. See 26 C.F.R. 301.6402-2(b) ("The claim must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof."). Under *Sims*, courts may not consider an issue that petitioner did not properly raise before the IRS. Because petitioner cannot prevail in this litigation without demonstrating the invalidity of the regulation, and petitioner failed to assert that the regulation was invalid during its administrative appeal, this case is a poor vehicle for resolving the conflict between the Federal and Sixth Circuits over the interpretation of 26 U.S.C. 512(a)(3)(E)(i).[8]

The Court's review is unwarranted at this time for an additional reason. In late 2010, after the circuit split concerning 26 U.S.C. 512(a)(3)(E)(i) arose, the Treasury Department and the IRS identified as a priority matter consideration of "[r]egulations under §512 explaining how to compute unrelated business taxable income of voluntary employees' beneficiary associations described in §501(c)(9)." Dep't of the Treasury, *2010-2011 Priority Guidance Plan* 7, Dec. 7, 2010, http://www.irs.gov/pub/irs-utl/2010-2011_pgp.pdf. That project continues to be a departmental priority. See Dep't of the Treasury, *2011-2012 Priority Guidance Plan* 9, Apr. 27, 2012 (Third Quarter Update), http://www.irs.gov/pub/irs-utl/

[8] Petitioner contends (Pet. 37-38) that it was not required to challenge the validity of 26 C.F.R. 1.512(a)-5T in its claim before the IRS because, it asserts, the IRS could not invalidate the regulation. But 26 U.S.C. 7422(a) prohibits courts from hearing tax refund suits "until a claim for refund * * * has been duly filed with the Secretary, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof." The applicable IRS regulation requires administrative issue exhaustion and contains no futility exception. See 26 C.F.R. 301.6402-2(b). Section 7422(a) thus precludes judicial consideration of any argument not first presented to the IRS.

2011-2012_pgp_3rd_update.pdf. Any regulation promulgated as a result of the Department's consideration would follow notice-and-comment rulemaking.

The Sixth Circuit in *Sherwin Williams* believed that the current Treasury regulation supported its interpretation of Section 512(a)(3)(E)(i). See 330 F.3d at 456. Petitioner evidently recognizes that this reading of the current regulation is incorrect, since petitioner argues that the rule is invalid. If the Treasury Department promulgates a new regulation that unambiguously rejects the *Sherwin Williams* court's understanding of Section 512(a)(3)(E)(i), the Sixth Circuit may reconsider its prior holding. And even if the current circuit conflict persists in the face of a new regulation, this Court would benefit from the most recent interpretation of the expert agency charged with implementing this complex statute. Premature adjudication of the issue could result in a waste of judicial resources, see *National Cable & Telecomms. Ass'n* v. *Brand X Internet Servs.*, 545 U.S. 967, 982 (2005), or could unnecessarily cabin the discretion of the agency. Further review is not now warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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