No. 99-258

In the Supreme Court of the United States

CONNECTICUT GENERAL LIFE INSURANCE COMPANY, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

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

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether Section 1.1502-47(m)(3)(vi) of the Treasury Regulations, 26 C.F.R. 1.1502-47(m)(3)(vi), prescribes the proper method for determining the amount of net operating losses of non-life insurance companies that may not be taken into account in determining taxable income on consolidated federal income tax returns that such companies file with life insurance companies.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-23a) is reported at 177 F.3d 136. The opinion of the Tax Court (Pet. App. 24a-38a) is reported at 109 T.C. 100.

JURISDICTION

The judgment of the court of appeals was entered on April 30, 1999. On July 20, 1999, Justice Souter extended the time for filing a petition for a writ of certiorari to August 12, 1999. The petition was filed on August 12, 1999. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Prior to 1981, life insurance companies were not permitted to file consolidated federal income tax returns with corporations that were not life insurance companies. For tax years beginning after December 31, 1980, Congress changed this rule, and permitted "life-nonlife consolidation."[1] In Section 1503(c) of the Internal Revenue Code, 26 U.S.C. 1503(c), however, Congress placed two limitations on the extent to which the net operating losses (NOLs) of nonlife companies may be used to reduce the taxable income reported on the consolidated return. One of those limitations, set forth in Section 1503(c)(2), is that an NOL of a nonlife company "shall not be taken into account" in determining the taxable income of the affiliated group unless the nonlife company has been a member of the group for the five years preceding the year the loss was incurred.

Regulations promulgated by the Secretary of the Treasury prescribe the method for determining the NOLs that, under Section 1503(c)(2), "shall not be taken into account." As pertinent here, the regulations require all nonlife companies within the group to set off their gains and losses against each other, and thereby determine whether the "nonlife subgroup" had a consolidated net operating loss (CNOL). 26 C.F.R. 1.1502-47(h)(2)(ii). The amount of the CNOL that could be used to offset the income of life companies in the group was to be "reduced by the ineligible NOL," *i.e.*, "the amount of the *separate* net operating loss * * * of any

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[1] Tax Reform Act of 1976, Pub. L. No. 94-455, § 1507, 90 Stat. 1739-1741.

nonlife *member* that is ineligible in that year."[2] 26 C.F.R. 1.1502-47(m)(3)(vi) (emphasis added).

2. Before March 31, 1982, Connecticut General Corporation was the parent corporation of Connecticut General Life Insurance Company (CG Life) and more than 40 other corporations. CG Life was the sole life insurance company in this group. Pursuant to the new rules permitting life-nonlife consolidation, CG Life joined with the other subsidiaries of Connecticut General Corporation in the filing of consolidated federal income tax returns for the period ending March 31, 1982 (Pet. App. 3a, 25a).

Prior to March 31, 1982, INA Corporation was the common parent of more than 160 affiliated non-life corporations that engaged primarily in the sale, underwriting, and servicing of property and casualty insurance. INA Corporation had filed consolidated federal income tax returns on behalf of itself and its subsidiaries (Pet. App. 4a). On March 31, 1982, Connecticut General Corporation and INA Corporation (the two parent companies) merged to form CIGNA Corporation. The merger was a "reverse acquisition" within the meaning of 26 C.F.R. 1.1502-75(d)(3), pursuant to which CIGNA succeeded Connecticut General as the common parent of the CG group, which continued to exist for tax purposes. CIGNA also became the common parent of each of the former members of the INA group, which group ceased to exist for tax

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[2] The regulations define an "ineligible" corporation as a corporation that is not eligible. 26 C.F.R. 1.1502-47(d)(13). An "eligible" corporation is defined, in part, as a corporation that has been a member of the affiliated group for at least five years preceding the taxable year for which the consolidated return and the determination of eligibility are made. 26 C.F.R. 1.1502-47(d)(12).

purposes. Thus, in effect, the CG group, which became the CIGNA group, acquired the former INA subsidiaries individually.

On November 20, 1984, a subsidiary of CIGNA acquired Preferred Health Care, Inc. (PHC) and its affiliated corporations, none of which were life insurance companies. Before the acquisition, the PHC group had filed consolidated federal income tax returns. All members of the PHC group immediately before the acquisition became separate members of the CIGNA group upon the acquisition, and the PHC group ceased to exist (Pet. App. 4a).

3. The consolidated federal income tax returns filed by CIGNA for 1982 through 1985 included the corporations that had been members of the former INA group, and the returns filed for 1984 and 1985 included the corporations that had been members of the former PHC group. CG Life was the only life insurance company included in these consolidated returns, and it had taxable income during each of these taxable periods. Some of the corporations that had formerly been members of the INA group and the PHC group had taxable income during these years, and others had tax losses (Pet. App. 7a).

In calculating the amount of the NOLs for the 1982 through 1985 consolidated returns that, under Section 1503(c)(2), "shall not be taken into account," CIGNA treated all corporations that were formerly members of the INA group as a single entity. Under this "single entity method," petitioners set off the losses of those former INA corporations that had losses against the income of those that had income. The result was a net loss for each taxable period. Petitioners did the same with respect to the former PHC companies, and the result was a net loss for the 1985 taxable year. It was

the resulting net losses calculated in this manner that CIGNA treated as the NOLs that "shall not be taken into account" under Section 1503(c)(2) (Pet. App. 7a-8a).

4. On audit, the Commissioner determined that CIGNA used an incorrect method to calculate the NOLs that shall not be taken into account. The Commissioner concluded that Section 1.1502-47(m)(3)(vi) of the Treasury Regulations does not permit CIGNA to treat all former members of the INA group as a single entity, and all former members of the PHC group as a single entity. The Commissioner determined that the regulation instead requires CIGNA to treat each corporation that had formerly been in the INA group and the PHC group as a separate member of the newly-constituted CIGNA group. Under this "separate entity method," the entire NOL of each corporation that had formerly been in the INA group and the PHC group is ineligible and is therefore to be disregarded (Pet. App. 8a-9a). Under this method, these NOLs are not to be "taken into account" at any time in the calculation of the taxable income reported on the consolidated returns.

5. Petitioners filed a petition in the Tax Court to challenge the Commissioner's determination. On cross-motions for summary judgment, the Tax Court ruled in favor of the Commissioner. The court observed that the regulations adopted under Section 1503(c)(2) are substantive legislative rules which require "each nonlife company that constitutes a member of the consolidated group [to be] treated as a separate entity" (Pet. App. 32a). It follows, the court said, that the consolidated NOL of all of the nonlife companies included in the consolidated federal income tax return "is reduced by the separate 'ineligible NOL' of each ineligible nonlife company that constitutes a member of the consolidated group" (*ibid.*). The court emphasized that (*id.* at 33a):

> [n]o provision is made in the above legislative regulations to treat a company that prior to acquisition had been a member of a group that had filed a consolidated income tax return as part of a single, aggregate group of companies and to net within that group losses of ineligible nonlife companies against income of other nonlife companies of the same acquired group.

6. Concluding "that the applicable Treasury regulation, as interpreted by the Commissioner, is a permissible interpretation of the statute" (Pet. App. 1a-2a), the court of appeals affirmed. The court of appeals first rejected petitioners' primary contention that the regulation is not even applicable to this case. Petitioners had claimed that the regulation applies only to acquired stand-alone corporations and not to acquired groups, such as its acquisitions of the INA corporations and the PHC corporations. In support of their argument, petitioners relied primarily on Section 1.1502-47(m)(4) of the Treasury Regulations which reads, in its entirety, "*Acquired Groups.* [Reserved]." 26 C.F.R. 1.1502-47(m)(4). Petitioners argued that this reserved section in the regulations shows that the Commissioner intended to except acquired groups from the general rule of Section 1.1502-47(m)(3)(vi). Petitioners argued that, in the absence of any specific rule applicable to acquired groups, they were entitled to use any reasonable means to calculate the amount of their ineligible NOLs.

The court of appeals concluded, however, that the Commissioner's interpretation of the Treasury Regulations to apply in this situation is entitled to deference. The court found that "nothing in Regulation [1.1502]-47(m)(4) contradicts the Commissioner's interpretation

of Regulation [1.1502]-47(m)(3)(vi) as applying to acquired groups." Because Regulation 1.1502-47(m)(3)(vi) makes no distinction between acquired stand-alone companies and acquired groups and, "by its own terms, applies to" the facts of this case (Pet. App. 17a-18a), the court of appeals concluded that it was proper to defer to the interpretation of the regulation by the agency that Congress charged with the enforcement of the statute and the adoption of the legislative rule (*id.* at 12a-14a, 18a) .[3]

ARGUMENT

The court of appeals held that petitioners must calculate the NOLs of their affiliates that "shall not be taken into account" (26 U.S.C. 1503(c)(2)) in determining taxable income on their consolidated federal income tax returns in the manner prescribed by Section 1.1502-47(m)(3)(vi) of the Regulations. This holding is correct and does not conflict with any decision of this Court or any other court of appeals. Indeed, the issue has never been addressed by this Court or any other court of appeals. Further review is therefore not warranted.

1. Section 1501 of the Internal Revenue Code, 26 U.S.C. 1501, grants affiliated groups of corporations the "privilege" of filing consolidated federal income tax returns. The privilege is available, however, only when each corporation in the affiliated group consents to all

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[3] The court of appeals also rejected petitioners' contention that the preamble to the Section 1.1502-47 regulations supports their argument that no rule was promulgated with respect to acquired groups. The court observed that the preamble "suggests that applying a rule other than that annunciated in [1.1502]-47(m)(3)(vi) would contradict 'the ordinary reading of section 1503(c)(2)' " of the Code (Pet. App. 17a).

consolidated return regulations issued by the Secretary of the Treasury. See *Charles Ilfeld Co.* v. *Hernandez*, 292 U.S. 62, 65 (1934). Congress did not set forth detailed rules in the statute prescribing how the consolidated taxable income of an affiliated group of corporations is to be determined. In Section 1502 of the Code, Congress charged the Secretary with prescribing "such regulations as he may deem necessary" to ensure that the tax liability of an affiliated group of corporations is properly determined. 26 U.S.C. 1502. See S. Rep. No. 960, 70th Cong., 1st Sess. 15 (1928) ("delegat[ing] power to the commissioner to prescribe regulations legislative in character").

When Congress enacted the statutory provisions permitting life-nonlife consolidation, it did not prescribe detailed rules on how the group's income was to be determined. As pertinent here, the only rule it provided was that the NOL of a nonlife member of the group "shall not be taken into account in determining the taxable income" of a life insurance company in the group unless the life and nonlife members have been in the same affiliated group for at least five years. 26 U.S.C. 1503(c)(2). The report of the Senate Finance Committee emphasized that, under this statute, "the details of the computation of the tax liability of an affiliated group which includes life or other mutual insurance companies is to be determined under regulations issued by the Treasury Department". S. Rep. No. 938, 94th Cong., 2d Sess. 456 (1976).

2. On June 8, 1982, the Secretary issued proposed regulations prescribing rules for filing life-nonlife consolidated returns (Pet. App. 4a). The proposed regulations made no distinction between acquired stand-alone companies and acquired groups. After the proposed regulations were issued, CIGNA wrote to the Com-

missioner suggesting that the Secretary adopt by regulation a special rule for acquired groups such as the one that petitioners have advocated in this lawsuit—that "separate nonlife members be treated as one entity if they are acquired in a single transaction by one group but were members of a different group prior to their acquisition" (*id.* at 5a). When the final regulations were ultimately issued, however, they did not include a special rule for acquired groups. In a letter sent to CIGNA after the final regulations were issued, the Chief Counsel of the IRS, Kenneth W. Gideon, specifically informed CIGNA that the "final life-nonlife consolidated return regulations * * * do not adopt your suggestion" (*id.* at 6a).

The final regulations differed from the proposed regulations by adding the "reserved" paragraph at Section 1.1502-47(m)(4).[4] The preamble to the final regulations states that "notwithstanding the ordinary reading of section 1503(c)(2) [of the Code]," the Treasury Department intended to study further whether to adopt an exception from the rule such as the one that CIGNA had proposed. The preamble stated that the agency would consider whether it would "be consistent with the intent of section 1503(c)(2), or correct as a matter of policy," to adopt a rule such as the one suggested by CIGNA (Pet. App. 6a).

Internal Treasury and Internal Revenue Service memoranda that petitioners relied upon below (C.A. App. 199-216) show that during the three year period after the issuance of the final regulations, the Treasury

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[4] The "reservation" of a paragraph of the regulations is not unique to Section 1.1502-47(m)(4). For example, eight other paragraphs or subparagraphs of Section 1.1502-47 alone are marked "reserved." See 26 C.F.R. 1.1502-47(i), (j), (k)(1)-(k)(4), (*l*)(1), (*l*)(2).

did, in fact, study the possibility of issuing a special rule for "acquired groups" similar to the rule suggested by CIGNA. These memoranda discuss the advantages and disadvantages of such a rule, and reveal that there were differences of opinion within the Treasury and IRS as to whether a special rule for acquired groups would be appropriate. Despite this lengthy and in-depth study of the CIGNA proposal, however, the agency has declined to promulgate the special rule for acquired groups sought by petitioners.

The internal Treasury and IRS memoranda that CIGNA relied upon repeatedly refer to the issue raised in this case as the "CIGNA issue" (C. A. App. 199, 201, 204, 215). Despite its vigorous efforts before the agency, CIGNA never succeeded in persuading the Treasury to adopt the rule it advocated. Undeterred, CIGNA has decided in this lawsuit to "wag[e] in a judicial forum a specific policy battle which [it] ultimately lost in the agency." *Chevron U.S.A Inc.* v. *Natural Resources Defense Council*, 467 U.S. 837, 864 (1984). This battle is misguided. "When a challenge to an agency construction of a statutory provision, fairly conceptualized, really centers on the wisdom of the agency's policy, rather than whether it is a reasonable choice within a gap left open by Congress, the challenge must fail." *Id.* at 866.

3. The NOLs involved in this case were incurred by members of the former INA group *after* the merger. Because these losses took place *after* the merger, they could not be considered losses of the INA group, which ceased to exist upon the merger. The losses were, instead, losses of separate members of the newly-constituted CIGNA group. Because the former members of the INA group had been members of the CIGNA group for less than five years, they were

"ineligible" corporations and, under the plain language of Treasury Regulation 1.1502-47(m)(3)(vi), their *separate* NOLs therefore had to be subtracted from the nonlife consolidated NOL to determine the "offsetable nonlife consolidated net operating loss." 26 C.F.R. 1.1502-47(m)(3)(vi).

Petitioners' primary contention is that the court of appeals erred in deferring to the Commissioner's interpretation of the straightforward text of the regulations. Although petitioners purport to acknowledge the settled rule that courts are to defer to an agency's interpretation of its own regulations, see *Bowles* v. *Seminole Rock & Sand Co.*, 325 U.S. 410, 413-414 (1945), they assert that the agency's interpretation is not entitled to deference when it is first advanced in litigation. That contention, however, is based on a false premise. Contrary to petitioners' assumption, the position advanced by the Commissioner in this case—that the ineligible NOLs had to be calculated under Regulation 1.1502-47(m)(3)(vi)—was unquestionably not the invention of the IRS counsel who represented the Commissioner in the Tax Court. As we have just described, the Treasury determined at the time that it issued the final regulations *not* to adopt the special "CIGNA rule" espoused by petitioners. Moreover, although the Treasury and the Internal Revenue Service further studied the "CIGNA issue" for several years after the final regulations were issued, the special rule espoused by petitioners has not been adopted. In these circumstances, the agency's announced interpretation of its own legislative regulations plainly "reflect[s] the agency's fair and considered judgment on the matter in question" and was properly accorded deference by the court of appeals. *Auer* v. *Robbins*, 519

U.S. 452, 462 (1997).[5] See also *Thomas Jefferson Univ.* v. *Shalala*, 512 U.S. 504, 512 (1994).

Moreover, as the court of appeals emphasized (Pet. App. 8a-9a), the interpretation of the regulation advanced by the Commissioner in this litigation is precisely the same that the agency has asserted throughout the lengthy audit of petitioners' consolidated returns. This Court has consistently concluded that an agency's interpretation of its regulations is entitled to deference even if the interpretation is first adopted during administrative proceedings. As the Court stated in *Martin* v. *Occupational Safety and Health Review Commission*, 499 U.S. 144, 158 (1991), "the Secretary's interpretation is not undeserving of deference merely because the Secretary advances it for the first time in an administrative adjudication."

4. Petitioners err in contending (Pet. 21) that the decision of the court of appeals conflicts with decisions holding that the rule of lenity may require ambiguous tax provisions to be construed in favor of the taxpayer. The most recent of the decisions of this Court cited by petitioners for this proposition is *Hassett* v. *Welch*, 303 U.S. 303, 314 (1938). In the subsequent decision of *White* v. *United States*, 305 U.S. 281, 292 (1938), however, the Court stated:[6]

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[5] In this case, as in *Auer* v. *Robbins*, *supra*, the Commissioner's position "is in no sense a '*post hoc* rationalizatio[n]' advanced by an agency seeking to defend past agency action against attack." 519 U.S. at 462. Contrary to petitioners' unsupported assertion (Pet. 20), the decision in this case thus does not "threaten[] to eviscerate" this Court's decision in *Bowen* v. *Georgetown University Hospital*, 488 U.S. 204 (1988).

[6] Petitioners also err in their understanding of how the rule of lenity applies to the interpretation of ambiguous statutes. "The rule of lenity applies only if, 'after seizing everything from which

> We are not impressed by the argument that, as the question here decided is doubtful, all doubts should be resolved in favor of the taxpayer. It is the function and duty of courts to resolve doubts. We know of no reason why that function should be abdicated in a tax case more than in any other where the rights of suitors turn on the construction of a statute and it is our duty to decide what that construction fairly should be.

It is, in any event, an elementary rule in tax law that deductions from income are matters of legislative grace that must be "strictly construed and allowed only 'as there is a clear provision therefor.'" *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. 79, 84 (1992), quoting *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (1934). See also *Deputy* v. *DuPont*, 308 U.S. 488, 493 (1940); *A.E. Staley Mfg. Co.* v. *Commissioner*, 119 F.3d 482, 486 (7th Cir. 1997) (deductions from income are "strictly construed"); *UNUM Corp.* v. *United States*, 130 F.3d 501, 509 (1st Cir. 1997) (same), cert. denied, 119 S. Ct. 42 (1998); *Durando* v. *United States*, 70 F.3d 548, 550 (9th Cir. 1995) (same); *Weingarden* v. *Commissioner*, 825 F.2d 1027, 1029 (6th Cir. 1987) (same). Because the

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aid can be derived,' *Smith* v. *United States*, 508 U.S. 223, 239 (1993) (internal quotation marks and brackets omitted), we can make 'no more than a guess as to what Congress intended.' *Ladner* v. *United States*, 358 U.S. 169, 178 (1958)." *Reno* v. *Koray*, 515 U.S. 50, 64-65 (1995). One of the principles "from which aid can be derived" in the interpretation of statutes and legislative regulations is the principle that deference is to be given to reasonable interpretations adopted by the Treasury—the agency that Congress has charged with enforcement of these complex provisions. See, *e.g.*, *Atlantic Mut. Ins. Co.* v. *Commissioner*, 523 U.S. 382, 389-390 (1998); *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 477 (1979).

statutory and regulatory provisions that govern this case allow deductions from income that would otherwise be subject to tax, they are to be strictly construed. The Court long made clear, even prior to its decision in *White* v. *United States*, *supra*, that, in a deduction case, "[t]he rule that ambiguities in statutes imposing taxes are to be resolved in favor of taxpayers does not apply. Deductions are allowed only when plainly authorized." *Helvering* v. *Inter-Mountain Life Ins. Co.*, 294 U.S. 686, 689 (1935).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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