No. 17-1151

IN THE
# Supreme Court of the United States

DUQUESNE LIGHT HOLDINGS, INC. & SUBSIDIARIES F/K/A DQE, INC. & SUBSIDIARIES,
*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

On Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Third Circuit

## BRIEF OF THE CATO INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER


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## QUESTION PRESENTED

When unambiguous statutory or regulatory provisions authorize a taxpayer to take two deductions for the same economic loss, may the IRS nonetheless disallow one of the authorized deductions?

## TABLE OF CONTENTS

## TABLE OF AUTHORITIES

**Page(s)**

**CASES**

## TABLE OF AUTHORITIES
(continued)

**Page(s)**

**STATUTES**



**OTHER AUTHORITIES**

**TABLE OF AUTHORITIES**
(continued)

**Page(s)**

## INTEREST OF *AMICUS CURIAE*[1]

Established in 1977, the Cato Institute is a nonpartisan public policy research foundation dedicated to advancing the principles of individual liberty, free markets, and limited government. Cato's Robert A. Levy Center for Constitutional Studies was established in 1989 to help restore the principles of limited constitutional government that are the foundation of liberty. Toward those ends, Cato publishes books, studies, and the annual *Cato Supreme Court Review*, conducts conferences, and files *amicus* briefs.

This case concerns Cato because it involves administrative-agency action not grounded in statutory authority—and undue judicial deference to that action.

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[1] In accordance with Supreme Court Rule 37.6, amicus states that no party's counsel authored any of this brief, and that no person or entity, other than amicus and its counsel, made a monetary contribution intended to fund its preparation and submission. All parties received timely notice of amici's intent to file this brief as required under Rule 37. Both parties have consented to the filing of this brief.

## SUMMARY OF ARGUMENT

As the court below recognized and as the agency itself does not dispute, in this case a regulated entity followed controlling regulations to the letter but nevertheless was penalized tens of millions of dollars. The Third Circuit upheld that judgment based on generalized policy principles advanced by the agency, derived from a more than eighty-year-old precedent of this Court, *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934). Those principles are typically understood to provide only a background presumption for evaluating ambiguous agency rules, but the Third Circuit relied on them to override the unambiguous regulations that explicitly authorized the conduct at issue.

The Third Circuit's decision is wrong for all the reasons explained in the petition. It also implicates a broader debate about the proper deference to different types of federal agency rules and actions. Specifically, many of the criticisms raised against *Auer* or *Seminole Rock* deference apply with even greater force here. *See Auer v. Robbins*, 519 U.S. 452 (1997); *Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410 (1945).

*Auer* authorizes deference to federal agency interpretations of their own ambiguous regulations. 3 Charles H. Koch, Jr. & Richard Murphy, Administrative Law & Practice § 10:26 (3d ed. 2010). Such deference raises significant constitutional, legal, and prudential problems. It creates separation-of-powers concerns by allowing agencies to both promulgate rules and adjudicate their meaning. It bypasses the structure of the Administrative Procedure Act (APA), 5 U.S.C. §§ 551-59, by giving agencies the power to adopt vague regulations that they can later reinter-

pret without engaging in notice-and-comment rulemaking. And it denies regulated entities fair notice of what they must do to avoid punishment, as well as an opportunity to participate fully in crafting rules in the first instance.

Here, the Third Circuit not only allowed the agency to be legislator, executive, and judge simultaneously; it also blessed the agency's disregard of the rules that the agency itself created. There was no APA process; the agency simply proclaimed that its rules no longer meant what they said. The Third Circuit's rule creates perverse incentives for allowing agencies to reinterpret their rules at will. It is also fundamentally unfair to regulated parties: the regulated entity here relied on guidance that expressly and unambiguously authorized its behavior, only to be whipsawed by uncodified policy concerns.

Whatever the proper scope of deference to agency actions, this case falls well outside those boundaries. Certiorari should be granted.

## ARGUMENT

### I. The Third Circuit Allowed a Federal Agency to Penalize a Regulated Party that Followed the Agency's Regulations to the Letter

The Third Circuit's decision adopts a broad, new view of federal agency power: Even if a regulated entity conforms its behavior perfectly to controlling, unambiguous regulations, it may still be penalized for noncompliance with uncodified policy "principles" not articulated in either statute or the regulations. That "spirit of the regulations" approach is inconsistent with any legitimate view of the proper role of agencies and this Court's precedents.

The Third Circuit acknowledged that Duquesne Light Holdings, Inc. and its subsidiaries (Duquesne) followed the rules. It recognized that the relevant Treasury Regulations "failed to prevent a double deduction here because of how the Duquesne group structured the relevant transactions." Pet. App. 36a. The court reiterated this thought a few sentences later, stating that Duquesne "may nonetheless claim that it complied with [the relevant regulation] in the sense that it did not violate it." *Id.* at 36a-37a. And it acknowledged that "[i]f literally applied . . . Duquesne (and our dissenting colleague) make a strong argument" that the relevant regulations were followed. *Id.* at 37a.

Duquesne complied with the relevant regulations, and those regulations did not prohibit the deductions it claimed. That should have been the end of the case. Yet the Third Circuit went on. It adopted the IRS's argument that regulatory authorization for actions taken "is not enough." *Id.* It instead concluded that authorization for each deduction taken was required, plus a *third* authorization to take them both together. *See id.* at 20a (demanding "a clear declaration allowing double deductions for the same loss on consolidated returns").

In support of that triple-authorization requirement, the court pointed to what it termed an "interpretative principle" from *Ilfeld*, combined with an IRS interpretative notice. *Id.* at 37a-38a. Both interpretations gave the background principle "that the 'IRS and Treasury believe that a consolidated group should not be able to benefit more than once from one economic loss.'" Pet. App. 38a (quoting IRS Notice 2002-18, 2002-1 C.B. 644 (Mar. 9, 2002)); *see also Ilfeld*, 292

U.S. at 68 ("In the absence of a provision of the [Revenue] Act definitely requiring" a double deduction, that purpose "will not be attributed to lawmakers").

Neither authority supports the Third Circuit's conclusion. As Judge Hardiman explained in dissent, the very next sentence of the notice on which the court relied shows that the IRS recognized that certain double deductions (in fact, precisely the double deduction Duquesne took) were not prohibited by its then-current regulations. Pet. App. 55a. The IRS notice states that as a result the agency would promulgate new regulations in the future. *Id.* ("[i]f anything, [the interpretative notice] shows that the IRS . . . did not believe there was a regulatory mechanism in place to prevent a double deduction").

Judge Hardiman also explained why *Ilfeld* did not dictate the Third Circuit's outcome either. *Id.* at 44a. He explained that the passage of *Ilfeld* on which the Third Circuit relied was not necessary to the *Ilfeld* Court's decision because "the then-applicable regulations [in that case] prevented the taxpayer from recognizing the second claimed loss." *Id.* at 45a (citing *Ilfeld*, 292 U.S. at 67). In other words, the *Ilfeld* taxpayer had to choose between two regulations but could not follow both. And even if the passage relied upon by the Third Circuit majority were not dicta, Judge Hardiman explained that the separate portion of *Ilfeld* actually discussing the facts and regulations at issue in the case appears "to lay down a less rigorous rule." *Id.* It states only that barring "'a provision in the act or regulations *that fairly may be read to authorize it*, the deduction claimed is not allowable.'" *Id.* (quoting *Ilfeld*, 292 U.S. at 66). That standard is no

"triple deduction" requirement. Under it, Duquesne prevails.

Whether the Third Circuit deferred to the IRS's notice or used *Ilfeld* as a background principle to ignore the underlying regulatory texts, *see id.* at 38a n.15, the effect is the same: a federal court relied only on an agency's uncodified statement of its policy views, supported by a questionable presumption that double deductions are not allowed unless required, to affirm a judgment in the tens of millions of dollars against a company that did what the agency's controlling regulations allowed.

That result falls well outside normal "agency deference" cases. This is not a case involving regulations implementing a statute. *See, e.g.*, *United States v. Mead*, 533 U.S. 218, 229-31 (2001) (discussing express and implicit rulemaking authorization); *Chevron U.S.A. Inc. v. Nat'l Res. Def. Council, Inc.*, 467 U.S. 837, 842-44 (1984). It is not even a case involving an agency's interpretations of its own ambiguous regulations. *See, e.g.*, *Auer*, 519 U.S. at 461; *see also* Pet. App. 56a-57a (Hardiman, J., dissenting) (explaining Third Circuit decision goes beyond normal deference doctrines). It makes unambiguous regulations that Duquesne complied with subject to agency and judicial override.

If an agency believes its regulations need revision, it can change them in accordance with the APA. It should not be allowed to do what the IRS did here—lie in wait for regulated entities to follow its rules and then assert a policy rationale to override them.

## II. The Petition Implicates Broader Concerns over Deference to Agencies

Although *Auer* deference is not directly at issue here, the concerns that justices of this Court and commentators have expressed for many years in that context provide a helpful framework for understanding the dangers of the Third Circuit's approach. That framework places what happened below in the proper context of broader unease with unchecked deference to agency actions.

*Auer* deference raises at least three interrelated problems. The first is a separation-of-powers concern regarding consolidation of legislative, executive, and judicial power into a single agency. Next, even if *Auer* deference is constitutional, it nevertheless gives agencies perverse incentives to disregard the legislatively imposed structure of the APA. *See* 5 U.S.C. §§ 551-59. Finally, *Auer* deprives regulated entities of the fair notice they need to conform their behavior to the rules and to avoid penalties for noncompliance.

These problems are significant enough when dealing with an agency's interpretations of its own ambiguous rules. They apply with even greater force here, where the Third Circuit allowed an agency to ignore the express language of its regulations.

### A. *Auer* implicates separation-of-powers concerns

The separation of powers is one of the most important and cherished features of our form of government. Its central insight, implicit in the constitutional structure, is that no entity should both write law and interpret its meaning. As now-Dean of Harvard Law School John Manning explained more than

twenty years ago in his seminal work cautioning against judicial deference to agency interpretations of their own rules, "a core objective of the constitutional structure was to ensure meaningful separation of lawmaking from the exposition of a law's meaning." John F. Manning, *Constitutional Structure and Judicial Deference to Agency Interpretations of Agency Rules*, 96 Colum. L. Rev. 612, 644 (1996).

Separation of powers is a bulwark to protect freedom. As James Madison wrote in Federalist Number 47, the "accumulation of all powers, legislative, executive, and judiciary, in the same hands, whether of one, a few, or many, and whether hereditary, self-appointed, or elective, may justly be pronounced the very definition of tyranny." The Federalist No. 47, at 301 (James Madison) (Clinton Rossiter ed., 1961). Madison himself was echoing principles laid down by earlier pillars of the English common law tradition upon which the Founders built. *See* Manning, *Constitutional Structure*, 96 Colum. L. Rev. at 646 ("Locke, Montesquieu, and Blackstone all emphasized that some separation of lawmaking from law-exposition promoted the rule of law and controlled arbitrary government.").

The growth of the modern administrative state altered the traditional tripartite structure between the legislative, executive, and judicial branches. "[I]t is well established that the modern administrative agency effectively exercises 'lawmaking' power—that is, an agency sometimes 'speaks as the legislature, and its pronouncement has the force of a statute.'" *Id.* at 638 (citing *Arizona Grocery Co. v. Atchison, T. & S.F. Ry.*, 284 U.S. 370, 386 (1932)).

This change resulted in various new doctrines to deal with agency policies and decisions, depending on the type of agency action at issue. *See, e.g.*, *Decker v. Nw. Envtl. Def. Ctr.*, 568 U.S. 597, 616 (2013) (Roberts, C.J., concurring) (scope of deference "is a basic [issue] going to the heart of administrative law"). Of particular relevance here, while *Chevron* deference preserves the legal fiction that Congress retains its legislative power but delegates it to an agency for interpretation, *see, e.g.*, *Mead*, 533 U.S. at 229-30 (citing examples), *Auer* deference "allows the agency to act as the primary interpreter of regulations that the agency itself promulgated." Matthew C. Stephenson & Miri Pogoriler, Seminole Rock's *Domain*, 79 Geo. Wash. L. Rev. 1449, 1460 (2011); *see also* Manning, *Constitutional Structure*, 96 Colum. L. Rev. at 631 ("By permitting agencies both to write regulations and to construe them authoritatively, *Seminole Rock* effectively unifies lawmaking and law-exposition—a combination of powers decisively rejected by our constitutional structure.").

As a result, *Auer* has been severely criticized on separation-of-powers grounds. *See, e.g.*, Ilya Shapiro & David McDonald, Gloucester County School Board v. G.G.*: Judicial Overdeference Is Still A Massive Problem*, 18 Federalist Soc'y Rev. 8, 11 (2017) ("Affording controlling deference to agencies' interpretations of their own regulations gives executive agencies the power both to write the regulations they are charged with enforcing and later to declare just what the ambiguous words of those regulations mean—a task traditionally left to courts."); Kevin M. Stack, *The Interpretive Dimension of Seminole Rock*, 22 Geo. Mason L. Rev. 669, 677 (2015) (*Auer* "augments the potential for

abuse incident to the consolidation of power in a single institution: the agency.").

In fact, Justice Scalia, who wrote *Auer*, later noted that he was "increasingly doubtful" of the decision's validity, explaining that "[i]t seems contrary to fundamental principles of separation of powers to permit the person who promulgates a law to interpret it as well." *Talk Am., Inc. v. Mich. Bell Tel.*, 564 U.S. 50, 68 (2011) (Scalia, J., concurring); *Decker*, 568 U.S. at 621 (Scalia, J., concurring) (*Auer* "contravenes one of the great rules of separation of powers: He who writes a law must not adjudge its violation"); *see also Perez v. Mortgage Bankers Ass'n*, 135 S. Ct. 1199, 1217 (2015) (Thomas, J., concurring) (*Auer* "represents a transfer of judicial power to the Executive Branch, and it amounts to an erosion of the judicial obligation to serve as a 'check' on the political branches.").

### B. *Auer* undermines the Administrative Procedure Act

Apart from significant constitutional concerns, *Auer* also rewards agencies for avoiding the congressionally required procedures for rulemaking codified in the APA. Because agencies' interpretations of their own regulations receive deference only if the regulations are ambiguous, *Auer* gives agencies perverse incentives to regulate broadly and fill in gaps later under the guise of interpreting an agency's own ambiguous regulations.

"The APA establishes the procedures federal administrative agencies use for 'rule making,' defined as the process of 'formulating, amending, or repealing a rule.' § 551(5)." *Perez*, 135 S. Ct. at 1203 (2015) (quoting *Chrysler Corp. v. Brown*, 441 U.S. 281, 302-303

(1979)). The APA therefore provides a structure for citizens and regulated entities to receive notice of pending rules and to have an opportunity to provide their input through comments that the agency must consider before it may regulate with the force of law. *See* Stephenson & Pogriler, Seminole Rock's *Domain*, 79 Geo. Wash. L. Rev. at 1462. Those procedures also guarantee that citizens "know what conduct is permitted or prohibited by an agency rule." 3 Richard J. Pierce, Jr., Administrative Law Treatise § 6.8 (5th ed. 2010).

Agencies must publish public notice of the rule under consideration, detailing the timing, legal justification, and issues involved. 5 U.S.C. § 553(b)(1)-(3). Interested parties have the right "to participate in the rule making through submission of written data, views, or arguments," which the agency must consider. *Id.* § 553(c). In practice, notice-and-comment rulemaking under the APA is often a time-consuming process in which the views of numerous stakeholders are weighed and evaluated.

When an agency rule does not go through the APA process, it lacks binding legal force. *Id.* § 553(b)(3)(A) (authorizing informal guidance). In other words, there is a "pay me now or pay me later" principle at work. Stephenson & Pogriler, Seminole Rock's *Domain*, 79 Geo. Wash. L. Rev. at 1464. A rule is subject to "either the ex ante constraint of meaningful procedural safeguards or the ex post check of rigorous judicial review." *Id.* at 1461.

*Auer* allows an agency to circumvent the APA process while still receiving deference. That is, *Auer* allows agencies to issue vague and ambiguous rules through APA procedures and only later "resolve all

the controversial points by issuing interpretive rules." *Id.* at 1464. The obvious concern is that deferring to post hoc interpretations of ambiguous rules will reward and invite regulatory ambiguity in the first place.

A well-written regulation that plainly lays out the rule's requirements locks the agency into a position that cannot be changed without going through the rulemaking process again. *See Thomas Jefferson Univ. v. Shalala*, 512 U.S. 504, 525 (1994) (Thomas, J., dissenting) (it is "perfectly understandable" for an agency to issue vague regulations because "to do so maximizes agency power and allows the agency greater latitude to make law through adjudication rather than through the more cumbersome rulemaking process"); *Christopher v. SmithKline Beecham Corp.*, 567 U.S. 142, 158 (2012) (*Auer* "creates a risk that agencies will promulgate vague and open-ended regulations that they can later interpret as they see fit"); *Perez*, 135 S. Ct. at 1212 (Scalia, J., concurring) (same). "[I]f an agency issues an imprecise or vague regulation, it does so secure in the knowledge that it can insist upon an unobvious interpretation, so long as its choice is not 'plainly erroneous.'" Manning, *Constitutional Structure*, 96 Colum. L. Rev. at 657. *Auer* "provides no disincentive for agencies to promulgate vague regulations in part because the doctrine allows agencies to obtain deference to their own interpretation of those vague regulations." Stack, *Interpretive Dimension,* 22 Geo. Mason L. Rev. at 676; *see also* Kevin O. Leske, *A Rock Unturned: Justice Scalia's (Unfinished) Crusade Against The* Seminole Rock *Deference Doctrine*, 69 Admin. L. Rev. 1, 6 (2017); Shapiro & McDonald, *Judicial Overdeference*, 18 Federalist

Soc'y Rev. at 11. Thus agencies are rewarded, not for promulgating the best regulation possible but for issuing ambiguous regulations that give agencies maximum flexibility.

### C. *Auer* deprives regulated entities of fair notice

Finally, when an agency issues ambiguous rules under which it later seeks *Auer* deference, regulated entities are deprived of fair notice of how to comply with the law. In the *Auer* context, commentators have explained that when an agency issues a "murky and complex regulation," it makes it difficult, "if not impossible, for even the most astute reader to determine ex ante" what is required of him. Manning, *Constitutional Structure*, 96 Colum. L. Rev. at 659.

Yet there are real consequences for wrong guesses. Ambiguous regulations nevertheless carry the full penalties of noncompliance. *Id.* at 670 ("If *Seminole Rock* deference makes agency regulations more unpredictable, regulated parties may find it more difficult to have a clear picture of relevant legal requirements until such parties have offended them."); *see also Thomas Jefferson Univ.*, 512 U.S. at 525 (Thomas, J. dissenting) (same); *Talk Am.*, 564 U.S. at 69 (Scalia, J., concurring) (*Auer* "frustrates the notice and predictability purposes of rulemaking, and promotes arbitrary government").

Concerns about notice have animated prior decisions of this Court. For example, in *Christopher* the Court limited *Auer*'s scope, at least in situations involving agency changes in interpretation during litigation following long periods of acquiescence. *See*

*Christopher*, 567 U.S. at 158-59 ("It is one thing to expect regulated parties to conform their conduct to an agency's interpretations once the agency announces them; it is quite another to require regulated parties to divine the agency's interpretations in advance or else be held liable" in enforcement proceedings). In that context, this Court has recognized that *Auer* can create significant "gotcha" problems for even the most well-intentioned parties.

Additionally, *Auer*'s tolerance of ambiguity can deprive the public of the opportunity to participate meaningfully in the rulemaking process. As just discussed, *Auer* encourages agencies to promulgate purposely ambiguous rules in the APA notice-and-comment process and interpret them later to mean whatever the agency wishes. *See supra* Part II.C; *see also* Robert A. Anthony & Michael Asimow, *The Court's Deferences—A Foolish Inconsistency*, 26 Admin. & Reg. L. News 1, 10-11, 21 (2000). When that occurs, regulated parties are denied meaningful participation in the APA process because they have to guess how an agency will interpret its proposed rule, or worse still may not even realize that they should care about a regulation. The agency is deprived of relevant data and viewpoints; regulated entities are denied what may be their only meaningful opportunity to be heard.

### D. The Third Circuit's decision heightens each of the concerns raised against *Auer*

All of these problems caused by *Auer* deference apply with even greater force here. The Third Circuit allowed *Ilfeld* and an agency's policy preferences, stated in a nonbinding notice, to *override* regulations,

"literally applied." Pet. App. 37a. This is a step beyond the already-significant concerns raised by *Auer*.

First, the Third Circuit's decision raises significant separation-of-powers concerns. *Auer* gives agencies significant power to act as legislator, executive, and judge, even to the point of permitting "a nonlegislative or ad hoc document *interpreting* a regulation [to receive] greater judicial deference (and thus potentially greater legal force) than does a legislative rule, such as the one involved in *Chevron*." Robert A. Anthony, *The Supreme Court and the APA: Sometimes They Just Don't Get It*, 10 Admin L.J. Am. U. 1, 5 (1996) (emphasis added). The decision below does all that and more, enabling an agency to create, enforce, and adjudicate all while *ignoring* the rules it creates in its legislative capacity.

Second, the Third Circuit's decision also raises significant statutory concerns under the APA. At least under *Auer*, regulations must be ambiguous before an agency can purport to interpret them. *See Christensen v. Harris Cty.*, 529 U.S. 576, 588 (2000) ("*Auer* deference is warranted only when the language of the regulation is ambiguous."). The Third Circuit's approach allows an agency to invoke policy concerns to override even *unambiguous* regulations—and to do so without warning and without following the requirements of the APA. If *Auer* provides perverse incentives to craft ambiguous regulations, offering agencies a path to reinterpret unambiguous regulations is far worse. Under that view, APA rulemaking is not just subject to potential agency abuse; it is irrelevant.

Finally, the Third Circuit's decision deprives regulated entities of any advance notice of the rules they must follow. At least under *Auer*, regulated entities

have a *chance* to guess what an ambiguous regulation means, whether in conforming their behavior to it or offering comments about its promulgation. The Third Circuit deprived Duquesne of even *Auer*'s dubious benefit of attempting to read the tea leaves. Instead, the decision below authorized agencies to convert regulatory certainty into unpredictability without warning. This Court should hold agencies to their clear regulations. Anything less denies notice to parties who depend on certainty to function.

If *Ilfeld* retains any validity, it should be as an interpretive presumption for close cases, not a free-wheeling basis for an agency to disregard its own explicit rules. This Court should grant certiorari to clarify that no agency may seize upon presumptions (whether stated in this Court's prior opinions or not) to penalize actions authorized by the express terms of its own regulations.

## CONCLUSION

The petition for writ of certiorari should be granted.

MARCH 19, 2018

Respectfully submitted,

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