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UNITED STATES TAX COURT
WASHINGTON, DC 20217

RENKA, INC.,	)	
Petitioner(s),	)	
v.	)	Docket No. 15988-11R.
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent	)	

ORDER AND DECISION

This case was assigned to this division of the Court because it's related to four others that were originally on our June 18, 2012 San Francisco trial calendar. It arises from a final determination letter the Commissioner sent Renka in April 2011. In that letter the Commissioner said the Employee Stock Ownership Plan (ESOP) that owned 100% of Renka didn't qualify as a tax-exempt trust under § 401(a) "effective for plan years ending December 31, 1998 and subsequent plan years."[1] The letter gave two separate reasons for this determination. First, it said that in 1998 Renka and American Nutritional Corporation (ANC) were a controlled group under § 414(b). Second, it said that in 1998 and all subsequent years Renka and ANC were an "affiliated service group" under § 414(m)(5).

[1] The Court assumes the parties' familiarity with the record, the terms of art in this complicated area of tax law, and the general principles of summary-judgment law. Section references are to the Internal Revenue Code and regulations.

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Why would it matter if Renka and ANC were one of these types of groups? Because it would change whom the ESOP had to benefit. To qualify as a tax-exempt trust, an ESOP that benefits a company's "highly compensated employees" must also benefit a certain number of that company's "not highly compensated employees," *see* § 410(b)(1)(B) -- unless of course there aren't any, *see* § 410(b)(6)(F). When a company is part of a controlled group or an affiliated service group, all the employees of every company in the group count when determining whether the required ratio is met. *See* § 414(b), (m)(1), and (m)(4). If Renka and ANC were related, Dieter Jr. would count as highly-compensated because § 318(a)(1)(A)(ii) attributes to him his father's 50% interest in ANC. *See* § 414(q)(1)(A) and (q)(2) (5% owner counts as "highly compensated employee"); § 416(i)(1)(B)(i)(I) (5% ownership calculated using § 318's attribution rules). And because the ESOP only benefited Dieter Jr. and not any of ANC's not-highly-compensated employees, it would fail § 410(b)'s minimum-coverage test.

The First Motion for Summary Judgment

In response to the Commissioner's final determination, Renka timely petitioned our Court for a declaratory judgment under § 7476. In October 2012 the Commissioner moved for summary judgment, arguing only that Renka and ANC were a controlled group under § 414(b) -- the first theory from his letter. But he didn't argue, as he had in his letter, that they were a controlled group in 1998; instead, he said they were a controlled group in 1999. We found that they weren't a controlled group in 1999 and denied the motion.

We also said that even if the Commissioner had been right about 1999 the *Chenery* doctrine might've made us deny his motion anyway. *See SEC v. Chenery Corp.* (*Chenery II*), 332 U.S. 194 (1947); *SEC v. Chenery Corp.* (*Chenery I*), 318 U.S. 80 (1943). That doctrine says that "a reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the agency." *Chenery II*, 332 U.S. at 196 (describing holding of *Chenery I*). We suggested that the *Chenery* doctrine might prevent us from using facts from 1999 to uphold a determination for 1998, but because we didn't need to reach the issue, we didn't.

The New Motions for Summary Judgment

After resolving some motions involving the contents of the administrative record, we're once again considering summary-judgment motions. Renka argues that its ESOP qualified in 1998. In his cross-motion, the Commissioner agrees. But he says he's still entitled to summary judgment because the ESOP didn't qualify in 1999. Instead of arguing as he did in his first motion that ANC and Renka were a consolidated group in that year, he now says they were an affiliated service group -- that is, he's moved on to the second theory from his letter. But he still relies on facts specific to 1999.

Here's his argument. Since 1988 Renka had been ANC's exclusive agent "in connection with soliciting, negotiating, and servicing orders." According to the Commissioner, these count as "management functions," and Renka generated about 80% of its gross income by doing them. That means Renka's "principal business * * * [was] performing, on a regular and continuing basis, management functions" for ANC, which made Renka and ANC a § 414(m)(5) affiliated service group. So when the ESOP first conferred a benefit on constructively-highly-compensated Dieter Jr. -- which was in 1999 -- it failed § 410(b)'s coverage requirements because it didn't in that year also confer any benefits on any not-highly-compensated ANC employees.

In response, Renka says *Chenery* prevents us from using facts from 1999 to uphold a determination for 1998. The Commissioner seems to agree with Renka that *Chenery* applies to § 401 cases, but he thinks he's safe from that doctrine because in his final determination letter he said that Renka and ANC were a § 414(m)(5) affiliated service group for 1998 "and all subsequent plan years." He also argues that even though it turns out that the ESOP did qualify in 1998, his determination wasn't an abuse of discretion because "the independent *gravamen* of the [final determination letter] and its Issue Two pertaining to * * * § 414(m)(5) (as being reviewed by the Court) remain correct" (emphasis in original). He goes on to say that "when all other erroneous materials are stripped away from the specific written findings in the Final Revocation Letter, the respondent correctly determined that the ESOP failed to comply with * * * § 401(a) for the plan year ending December 31, 1999" -- in other words, if we ignore all the things he did wrong, then he was right.

Does *Chenery* Mean the Commissioner Loses?

The parties agree that *Chenery* applies in § 401 cases, and for good reason. In *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 55 (2011), the Supreme Court emphasized "the importance of maintaining a uniform approach to judicial review of administrative action" and said it was "not inclined to carve out an approach to administrative review good for tax law only." (Citation and internal quotation marks omitted.) Taking the hint, we subsequently followed the *Chenery* doctrine in collection due process cases, where -- as in § 401 cases -- we review IRS determinations for abuse of discretion. *See, e.g.*, *Antioco v. Commissioner*, 105 T.C.M. 1234, 1240 (2013); *Jones v. Commissioner*, 104 T.C.M. 364, 367 (2012); *Salahuddin v. Commissioner*, 103 T.C.M. 1764, 1768 (2012). We've also applied it when reviewing the Commissioner's determinations in whistleblower cases. *See Kasper v. Commissioner*, 150 T.C. ___, ___ (slip op. at 24-25) (Jan. 9, 2018). *Chenery* must apply in § 401 cases, too. And the standard of review in § 401 cases is likewise abuse of discretion. *See Buzzetta Constr. Corp. v. Commissioner*, 92 T.C. 641, 651 (1989).

Following a full-page explanation of the affiliated-service-group argument, the Commissioner's final determination letter concluded that

> [s]ince the sole employee of the affiliated service group benefiting from the ESOP for the plan year ending December 31, 1998 was a highly compensated employee, the ESOP failed to satisfy any of the tests for minimum coverage * * * for the plan year ending December 31, 1998 and all subsequent plan years.

The Commissioner now says the ESOP didn't fail the minimum coverage requirements in 1998 -- he admits that the grounds he gave for his determination were wrong. His determination was therefore an abuse of discretion.

What about the Commissioner's arguments for why we should use facts from 1999 to uphold his erroneous determination for 1998? First he says we should uphold his determination because it was a continuing determination -- that is, it was for 1998 "and all subsequent plan years." But his letter didn't make a specific finding for each year. Instead, it found that the plan didn't qualify in 1998 and said it therefore also didn't qualify throughout the rest of Renka's existence -- an approach consistent with our caselaw, which says that once a plan is correctly disqualified, it stays disqualified, even if in individual subsequent years it meets the statutory requirements. *See, e.g.*, *Pulver Roofing Co. v. Commissioner*, 70 T.C. 1001, 1015 (1978). Because the letter doesn't contain any reasoning about 1999, there's no determination for that year for us to evaluate, so the Commissioner's argument can't help him. Moreover, because we don't let correctly disqualified plans fluctuate into qualification in a subsequent year, *see id.*, we also wouldn't find that a qualified plan fluctuated out.

The Commissioner points out that a footnote to the explanation in his final determination letter says that Dieter Jr. received benefits from the ESOP from 1999 through 2003. That footnote goes on to say that the Commissioner's "affiliated service group and coverage failure analysis * * * applies with equal force to each of the plan years." But the footnote's facts weren't the basis of the Commissioner's determination -- the body of the explanation the Commissioner attached to his letter of final determination made clear that the basis of his determination was his mistaken belief that the ESOP didn't qualify in 1998. Maybe the Commissioner could've applied his affiliated-service-group reasoning to every year from 1999 to 2003, but he didn't. Because we can consider only the reasoning he actually applied, his footnote doesn't help him.

Next the Commissioner suggests we should ignore the letter's details and consider instead its "independent *gravamen*" (emphasis in original). Unsurprisingly, he doesn't cite any authority that says we can decide whether a final agency determination was an abuse of discretion by considering only the determination's gravamen. It's true that we can "uphold * * * [an administrative agency's] decision of less than ideal clarity if the agency's path may reasonably be discerned," *Bowman Transp., Inc. v. Arkansas-Best Freight Sys., Inc.*, 419 U.S. 281, 286 (1974), but the reasoning in the Commissioner's letter here isn't ambiguous -- it's just wrong.

We similarly reject the Commissioner's suggestion that we strip away the "erroneous materials * * * from * * * [his] specific written findings" and uphold the rest. Our role is to determine whether his final determination was an abuse of discretion based on the rationale he gave, not to edit the rationale he gave into something that isn't an abuse of discretion.

Was the Commissioner Right About 1999?

If *Chenery* didn't require us to rule against the Commissioner, would his determination still be an abuse of discretion? His argument only works if ANC and Renka were an affiliated service group during the relevant years. The Code describes a few different things that would make two organizations an affiliated service group, *see* § 414(m), but in his final determination letter the Commissioner specifically relied on the paragraph that says such a group exists where one organization's principal business is regularly and continuously performing "management functions" for another organization, *see* § 414(m)(5). Here, the Commissioner says Renka generated about 80% of its revenue from being ANC's exclusive agent "in connection with soliciting, negotiating, and servicing orders." The Commissioner calls these activities "marketing", and then tells us that "marketing" is "management". In support of this linguistic leap, he cites a proposed regulation that said "'management functions' * * * include determining, implementing, or supervising (or providing advice or assistance in accomplishing any of the foregoing) -- (I) Daily business operations (such as production, sales, marketing, purchasing, advertising, etc.)."[2] 26 C.F.R. § 1.414(m)-5(c)(1), 52 Fed. Reg. 32504 (Aug. 27, 1987).

There are many problems with the Commissioner's argument. The first is that it relies on a proposed regulation. Proposed regulations are merely "suggestions made for comment." *LeCroy Research Sys. Corp. v. Commissioner*, 751 F.2d 123, 127 (2d Cir. 1984), *rev'g* 47 T.C.M. 1345 (1984). It's true that we will defer to proposed regulations if they persuade us. *See Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944); *Hulett v. Commissioner*, 150 T.C. __, __ (slip op. at 37 n.20) (Jan. 29, 2018). But that's also true of the parties' arguments; as the Ninth Circuit has explained, "'proposed regulations carry no more weight than a position advanced on brief.'" *Tedori v. United States*, 211 F.3d 488, 492 (9th Cir. 2000) (quoting *Estate of Howard v. Commissioner*, 910 F.2d 633, 637 n.1 (9th Cir. 199) (Rymer, J., dissenting), *rev'g* 91 T.C. 329 (1988)); *see also Laglia v. Commissioner*, 88 T.C. 894, 897 (1987); *F.W. Woolworth Co. v. Commissioner*, 54 T.C. 1233, 1265 (1970). Here the only authority the Commissioner cites in support

[2] Under the proposed regulation, such "management" only counted if it had been historically performed by employees in that industry or an analogous industry in 1982. 26 C.F.R. § 1.414(m)-5(c)(1) and (2), 52 Fed. Reg. 32504 (Aug. 27, 1987). Services that professionals -- such as accountants, doctors, or lawyers -- rendered in relation to such activities also counted as "management". *See id.* subpara. (c)(1) (flush language); 26 C.F.R. § 1.414(m)-1(c), 48 Fed. Reg. 8296 (Feb. 28, 1983).

of his contention that “marketing” is “management” is an unenacted regulation -- which means his argument rests on something that carries no more weight than the argument itself. Finding no other source of support, we won’t defer to the proposed regulation or accept the Commissioner’s definition.

Even if we deferred to the proposed regulation, the contract that made Renka ANC’s exclusive sales and marketing agent didn’t say Renka would determine, implement, supervise, advise, or assist in ANC’s sales and marketing -- it said Renka would *do* ANC’s sales and marketing. The contract specifically said that Renka would use its experience with soliciting new business and servicing customer accounts to sell ANC’s products. *Doing* another company’s marketing isn’t *managing* that company’s marketing under this proposed regulation. If it was, then a contract manufacturer that did another company’s production would also count as performing “management functions,” which would be absurd.

And, finally, the proposed regulation that the Commissioner relies on was withdrawn in 1993. *See* 58 Fed. Reg. 25588 (Apr. 27, 1993). So even if we deferred to it, and even if it did say that marketing was management, the Commissioner can’t rely on it now to support a final determination about 1998 or 1999. We therefore find that Renka and ANC were not members of an affiliated service group, which alone would mean that the Commissioner’s final determination was an abuse of discretion.

It is therefore

ORDERED that Renka’s November 12, 2017 motion for summary judgment is GRANTED. It is also

ORDERED that the Commissioner’s November 17, 2017 motion for summary judgment is DENIED. It is also

DECLARED, ADJUDGED, and DECIDED that Renka, Inc. Employee Stock Ownership Plan and Trust # 001 is a qualified retirement plan under I.R.C. § 401(a).

(Signed) Mark V. Holmes
Judge

ENTERED AUG 16 2018