Is the IRS Always Right? Judicial Deference to Treasury Regulations and Other IRS Positions

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Jeffrey N. Starkey and Thomas A. Cullinan provide their insights on judicial deference to Treasury regulations and discuss what they believe is the most important aspect of Mayo.

I. Introduction—Mayo Changes the Game

In the Mayo case decided last year, the United States Supreme Court significantly altered the relationship between federal tax law and general principles of administrative law. Until Mayo was decided, it was generally accepted that tax law was unique and that the Treasury Department and IRS were therefore subject to different administrative law standards than other administrative departments and agencies. The Mayo Court thoroughly dispelled that notion by flatly stating that it was “not inclined to carve out an approach to administrative review good for tax law only. To the contrary, we have expressly ‘recognized the importance of maintaining a uniform approach to judicial review of administrative action.’”

In furtherance of this new approach to the administrative aspects of federal tax law the Mayo Court addressed two specific issues. First, the Court determined that Treasury regulations produced through “notice-and-comment” rulemaking must be reviewed under the two-step framework articulated in Chevron rather than the alternative framework described in National Muffler. That is important because many practitioners and commentators consider the Chevron standard to be more deferential to agency action than the National Muffler standard. The Court explained that “[t]he principles underlying our decision in Chevron apply with full force in the tax context” and “[w]e 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.”

Second, the Court held that for purposes of applying Chevron to Treasury regulations, it is immaterial whether the regulation was promulgated under a specific grant of authority from Congress or the Treasury Department’s general authority under Code Sec. 7805(a) to “prescribe all needful rules and regulations for the enforcement” of the Code. As the Court explained, the level of deference afforded to a regulation “does not turn on whether Congress’s delegation of authority was general or specific.” In so holding, the Mayo Court expressly rejected its prior decisions in Rowan and Vogel, which had drawn a distinction between general and specific authority regulations.

These holdings and the manner in which the Court subsequently applied Chevron to the particular regulations at issue in Mayo raise a host of important issues that will likely take years to resolve. They also suggest that tax practitioners will need to become closely acquainted with general principles of administrative law and, in particular, the Administrative Procedure Act (APA). In Part II of this article, we provide an overview of what we consider to be the critical, tax-related questions that the Supreme Court has yet to answer. In Part III, we summarize the key provisions of the APA and explain why those provisions are likely to play an important role in tax administration in the coming years.
II. Mayo Leaves Many Questions Unanswered

After Mayo, it is clear that Treasury regulations promulgated through notice-and-comment rulemaking will receive Chevron deference, irrespective of whether such regulations are issued pursuant to a specific grant of authority or the general rulemaking authority contained in Code Sec. 7805(a). It is far from clear, however, how courts will apply the Chevron analysis and the Court’s holding in Mayo to the many other types of guidance published by Treasury and the IRS. We believe there are four key issues that will need to be resolved by courts in the future, each of which is outlined below.

First, it is unclear whether legislative history should be taken into account in performing the first step of the Chevron analysis, i.e., in determining “whether Congress has directly spoken to the precise question at issue.”11 This issue is highly important because step one of the Chevron analysis is a taxpayer’s best opportunity to prevail in challenging a regulation, as the vast majority of courts that reach Chevron step two uphold the regulation in question.12 The Chevron Court framed the step one analysis in terms of whether a court, “employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue.”13 It then implied that use of legislative history is a “traditional tool of statutory construction” by conducting a thorough review of the relevant legislative history. Yet several recent post-Chevron decisions from the Supreme Court suggest that it may not be appropriate to look at legislative history in performing the step one analysis, and have therefore muddied the waters on this question.14 The Mayo Court similarly focused exclusively on the terms of the statute in question, declining to mention or address the relevant legislative history (which was discussed in the briefs submitted by both parties).15 The role of legislative history in the Chevron step one analysis thus remains unclear.

Second, there is a substantial question as to whether temporary Treasury regulations will (or should) be afforded Chevron deference. In holding that the regulation at issue in Mayo qualified for Chevron deference, the Supreme Court expressly noted that “[t]he Department issued the [regulation] only after notice-and-comment procedures….”16 But the Treasury Department and IRS regularly promulgate temporary regulations, which generally are immediately binding on taxpayers, without following notice-and-comment procedures.17 The Supreme Court has previously indicated that notice-and-comment is not an absolute prerequisite for Chevron deference,18 but it has also acknowledged that “the overwhelming number of our cases applying Chevron deference have reviewed the fruits of notice-and-comment rulemaking or formal adjudication.”19 There is thus a significant question as to whether the rationale of Mayo extends to temporary Treasury regulations.20

Third, there will need to be a determination of the extent to which courts will defer to Treasury and IRS guidance other than regulations. In the non-tax case of Mead, the Supreme Court held that agency guidance to which Chevron does not apply should still receive some measure of deference.21 More specifically, the Court held that so-called Skidmore22 deference should apply to such pronouncements, under which administrative “rulings, interpretations and opinions” that are not binding on courts are to be afforded deference based on “the thoroughness evident in [their] consideration, the validity of [their] reasoning, [their] consistency with earlier and later pronouncements, and all those factors which give [them] power to persuade, if lacking power to control.”23 If, in accordance with Mayo, the world of federal tax is to be treated in the same manner as other areas of law, it seems likely that agency guidance other than Treasury regulations (and possibly temporary regulations) will receive Skidmore deference.24 The Department of Justice has gone on record saying it will no longer argue that revenue rulings and revenue procedures should receive Chevron deference.25 But that does not fully answer the question, because there are many additional types of “guidance” that are widely available to the public and upon which taxpayers and their advisers currently rely. For example, technical advice memoranda, which the IRS maintains have no precedential value under Code Sec. 6110(k)(3), bear a close resemblance to the Customs ruling that was at issue in Mead. The Court’s decision in Mayo could therefore result in Skidmore deference being afforded to a wide range of administrative pronouncements.

Fourth, the application of Chevron deference to Treasury regulations promulgated through notice-and-comment procedures gives rise to the possibility that Treasury and the IRS may be able to substantially affect the outcome of pending litigation by promulgating regulations with retroactive effective dates.26 In particular, there are questions as to whether Treasury and the IRS can “overrule” prior judicial determinations through the rulemaking process.27 That question was previously addressed in the non-tax case of Brand X, where a divided Court held that “[o]nly a judicial precedent holding that the statute unambiguously forecloses the agency’s interpretation, and therefore
contains no gap for the agency to fill, displaces a conflicting agency construction.\textsuperscript{28} The Supreme Court recently had the opportunity to clarify the application of \textit{Brand X} in the context of federal tax law, but its decision in \textit{Home Concrete}\textsuperscript{29} largely failed to provide any additional guidance.

The specific question before the Court in \textit{Home Concrete} was whether a taxpayer’s understatement of basis causes the taxpayer to “omit from gross income an amount properly includible therein” for purposes of triggering the six-year statute of limitations contained in Code Sec. 6501(e)(1)(A). The Court had previously addressed that precise issue in \textit{Colony},\textsuperscript{30} where it reviewed the predecessor to Code Sec. 6501(e)(1)(A), for which the operative language was identical, and determined that an understatement of basis was not an omission from gross income. Years later, in response to the fact that a number of assessments relating to so-called Son-of-Boss transactions were barred by the standard three-year statute of limitations, and while \textit{Home Concrete} was already in litigation, Treasury and the IRS promulgated new regulations that purportedly rendered the extended statute of limitations applicable to \textit{Home Concrete}.

The \textit{Home Concrete} majority concluded simply that “\textit{Colony} has already interpreted the statute, and there is no longer any different construction that is consistent with \textit{Colony} and available for adoption by the agency.”\textsuperscript{31} A four Justice plurality addressed the \textit{Brand X} issue by refining the \textit{Brand X-Chevron} step one analysis to ask whether the \textit{Colony} Court had determined that the statute contained a “gap” to be filled through administrative rulemaking. In the eyes of the plurality, \textit{Colony} reflected a determination that there was no such “gap” because, after reviewing the relevant legislative history, the \textit{Colony} Court had identified a clear Congressional intent that the six-year statute would not be triggered by an overstatement of basis.\textsuperscript{32} As the plurality explained: “The question is whether the Court in \textit{Colony} concluded that the statute left such a gap. And, in our view, the opinion (written by Justice Harlan for the Court) makes clear that it did not.” The remaining five Justices avoided the \textit{Brand X} issue altogether.\textsuperscript{33} The lack of consensus begs several questions, including: Can the Treasury Department “overrule” a Supreme Court case in which, unlike \textit{Colony}, the Court did not identify a clear Congressional intent underlying the relevant statutory provision? And can Treasury promulgate a regulation to “overturn” an adverse lower court decision while an appeal is pending, and apply the regulation retroactively? The answers to these questions may depend on whether the judicial decision in question pre- or post-dates \textit{Chevron},\textsuperscript{34} and whether the refinement to \textit{Brand X-Chevron} step one reflected in the plurality opinion of \textit{Home Concrete} gains traction in the future.

### III. Time to Brush Up on the APA

In the long run, the most important aspect of Mayo may be that it results in a large-scale expansion of APA-related principles into the world of federal tax practice. There is a large body of guidance and case law under the APA that has only rarely (and in some areas, never) been applied in the tax context. And it seems likely that after Mayo courts will begin to review administrative tax guidance under the same standards (including the APA) that other agency pronouncements have long been subject to. This could have significant implications for taxpayers seeking to challenge administrative pronouncements, as well as for the Treasury Department and IRS in terms of administrative practice.

The aspect of the APA that may, at first, seem novel to members of the federal tax community is that the APA is primarily about process, whereas traditional challenges to administrative tax pronouncements (and the deference issues they raise) have generally focused on substance. In other words, it is entirely possible for an otherwise reasonable interpretation of law to be struck down under the APA on purely procedural grounds.

The general procedural requirements for rulemaking are located in Sec. 553 of the APA. They provide that an agency must: (1) publish a general notice of proposed rulemaking;\textsuperscript{35} (2) provide interested persons with an opportunity to comment on the proposed rule;\textsuperscript{36} (3) consider the comments received when formulating the final rule and provide a concise statement of the basis and purpose of the final rule;\textsuperscript{37} and (4) in most instances, publish the final rule at least 30 days before its effective date.\textsuperscript{38} There are, however, two important exceptions to the procedural requirements of notice-and-comment.\textsuperscript{39}

First, notice and the opportunity to comment are not required for “interpretative rules.”\textsuperscript{40} The IRS claims that “most” Treasury regulations are “interpretative” rules that fall within this exception.\textsuperscript{41} That position is suspect, however, because it conflicts with the notion that Treasury regulations should receive \textit{Chevron} deference. The Supreme Court has made clear that “administrative implementation of a particular statutory provision qualifies for \textit{Chevron} deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the
exercise of that authority. Regulations that fall within this standard are referred to as “legislative” regulations for purposes of administrative law because they carry the “force of law,” rather than merely “interpret” existing law. The Court’s decision in Mayo may therefore undermine the government’s ability to characterize Treasury regulations as interpretive rules that are exempt from notice-and-comment requirements. This is particularly important with respect to temporary Treasury regulations, which, as noted above in Part II, are frequently issued without following notice-and-comment procedures.

Second, rules need not go through notice-and-comment “when the agency for good cause finds ... that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.” Treasury and the IRS often rely on this “good cause” exception in promulgating regulations, generally citing the need for “immediate guidance” in furtherance of the public good. Such a practice may be supportable in the context of shutting down transactions that the government perceives as abusive, but is much less so in the context of more common “gap filling” regulations.

Taxpayers and practitioners seeking to challenge regulations and other administrative pronouncements in the future will need to familiarize themselves with these provisions and the substantial body of case law interpreting them. The APA permits a court to “hold unlawful and set aside agency action, findings, and conclusions” based on a determination that the rule in question either (1) is “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law” or (2) fails to comply with the procedural requirements described above. The recent case of Dominion Resources nicely illustrates how these provisions may increasingly impact federal tax administration, as well as the importance of understanding their nuances.

In Dominion Resources, the Federal Circuit reviewed an interest capitalization rule that had been upheld by the Court of Federal Claims. The court struck down the regulation on substantive grounds, finding that it was not a reasonable interpretation of the underlying statute under step two of the Chevron analysis. Perhaps more importantly, however, the Federal Circuit also determined that the regulation was invalid under the APA because the Treasury Department had failed to provide a reasoned explanation for the regulation. (In a case known as State Farm, the Supreme Court held that an agency pronouncement is “arbitrary and capricious,” and therefore invalid under the APA, unless “the agency ... examine[s] the relevant data and articulate[s] a satisfactory explanation for its action....”) This alternative holding reflects one of the first post-Mayo applications of general APA principles in the context of federal tax law, and we are likely to see more decisions along similar lines in the future.

IV. Conclusion

The Supreme Court’s decision in Mayo effected a fundamental change in the relationship between federal tax law and general principles of administrative law by holding that tax law is not unique and that Treasury and the IRS are subject to the same administrative law requirements as other agencies. Mayo provided clarity regarding the level of deference to be afforded Treasury regulations promulgated through notice-and-comment procedures, but also left many questions unanswered, including those discussed above. Although it may take years for courts to sort through the important issues raised by Mayo, one thing is for certain—administrative law will become an increasingly important aspect of federal tax practice in the coming years, as evidenced by the Federal Circuit’s recent holding in Dominion Resources.

ENDNOTES

2 Id. 131 SCt, at 713 (quoting Dickinson v. Zurko, SCt, 527 US 150, 154, 119 SCt 1816 (1999)).
3 Chevron. U.S.A., Inc. v. Natural Res. Def. Council, SCt, 467 US 837, 104 SCt 2778 (1984). “When a court reviews an agency’s construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency’s answer is based on a permissibly constructed statute.” Id. 467 US, at 842-43.
4 Nat’l Muttieler Dealers Ass’n, SCt, 79-1 USTC ¶9264, 440 US 472, 99 SCt 1304. “[W]e look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose. A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner’s interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute.” Id. 440 US at 477.
A closely related question is whether the administrative landscape has changed significantly. We have held that Chevron deference is appropriate when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency’s interpretation claiming deference was promulgated in the exercise of that authority.” (quoting Mead Corp., 533 U.S. 218, 226-27, 121 S Ct 2164 (2001)). The APA is located at 5 USC §§551-559 and §§701-706.


Supra note 3, 467 US at 843 n.9. See e.g., Nat’l Cable & Telecommns. Ass’n v. Brand X Internet Servs., 545 U.S. 967, 989, 125 SCt 2688 (2005) (focusing the step one analysis on the “statute’s plain terms”).

See supra note 1, 131 SCt, at 711.

Id. 131 SCt, at 714.

See e.g., Kristin E. Hickman, A Problem of Remedy: Responding to Treasury’s Lack of Compliance with Administrative Procedure Act Rulemaking Requirements, 76 Geo. Wash. L. Rev. 1153, 1158-60 (2008) (noting that temporary regulations are regularly promulgated and purportedly made binding on taxpayers without following notice-and-comment procedures).

Mead, supra note 9, 533 US, at 230-31 (“[A] significant as notice-and-comment is in pointing to Chevron authority, the want of that procedure here does not decide the case, for we have sometimes found reasons for Chevron deference even when no such administrative formality was required and none was afforded.”). Id. 533 US, at 230.

A closely related question is whether the Treasury Department and IRS can elevate otherwise deficient temporary regulations to Chevron status by following notice-and-comment procedures after the temporary regulations have been issued. The Fifth Circuit has suggested that this question should be answered in the negative. D.S. Burks, CA-5, 2011-1 ustc ¶50,220, 363 F3d 347, 360 n.9 (noting Mayo’s emphasis on notice-and-comment procedures and stating “[t]hat the government allowed for notice and comment after the final Regulations were enacted is not an acceptable substitute for pre-promulgation notice and comment.”) (citing United States Steel Corp. v. United States EPA, CA-5, 595 F2d 207, 214-15 (1979)).

Mead, supra note 9, 533 US, at 234 (“To agree with the Court of Appeals that Customs ruling letters do not fall within Chevron is not, however, to place them outside the pale of any deference whatever. Chevron did nothing to eliminate Skidmore’s holding that an agency’s interpretation may merit some deference whatever its form...”).


Id. 323 US, at 140.

The precise meaning of the standard adopted in Skidmore is the subject of some debate. See generally Kristin E. Hickman and Matthew D. Krueger, In Search of the Modern Skidmore Standard, 107 Colum. L. Rev. 1235 (2007). On the one hand, some practitioners and courts believe that Skidmore requires deference when the agency’s position is persuasive. In other words, the standard simply boils down to the proposition that a court should defer to the agency’s interpretation if the court agrees with the agency. Others, however, believe that Skidmore requires a court to review the specific factors identified therein—e.g., thoroughness of reasoning and consistency with prior pronouncements—in a more structured analysis. With regard to this latter school of thought, we note that the Skidmore standard bears a significant resemblance to the National Muffler standard (see supra note 4) that the Mayo Court rejected in the context of Treasury regulations promulgated through notice-and-comment procedures.

Maree Sapirici, DOJ Won’t Argue for Chevron Deforrence for Revenue Rulings and Procedures, Officil Says, 131 Tax Notes 674 (May 16, 2011) (“The Department of Justice will no longer argue for Chevron deference for revenue rulings and revenue procedures, said Gilbert Rothenberg, appellate section chief in the DOJ’s Tax Division.”). Notably, in describing Chevron principles, the Mayo Court stated that “we have found it immaterial to our (Chevron) analysis that a ‘regulation was prompted by litigation.’” Supra note 1, 131 SCt, at 712 (quoting Smiley v. Citibank (South Dakota), N.A., 517 US 753, 741, 116 SCt 1730 (1996)).

The general rule is that a final Treasury regulation cannot apply to tax years ending before the earlier of (1) the date on which the proposed or temporary version of the regulation is published in the Federal Register, or (2) the date on which a notice substantially describing the regulation is issued to the public. Code Sec. 7805(b)(1). It is important to note, however, that the Secretary has broad authority to issue “rulings” (e.g., revenue rulings) that apply retroactively. Code Sec. 7805(b)(8).

28 Brand X, supra note 14, 545 US, at 982-83.

29 Home Concrete & Supply, LLC, SCT, 132 SCt 1836 (2012).


31 supra note 29, 132 SCt, at 1843.

32 Notably, the Colony Court had expressly acknowledged that the statutory text on its own was ambiguous (or at least not “unambiguous”). supra note 30, 357 US at 33. But the Home Concrete plurality explained “(there is no reason to believe that the linguistic ambiguity noted by Colony reflects a post-Chevron conclusion that Congress had delegated gap-filling power to the agency.” Supra note 29, 132 SCt, at 1844.

33 supra note 29, 132 SCt, at 1844. Justice Scalia joined the plurality opinion except with respect to the portion that addressed Brand X. In a concurring opinion, he argued that “[a] risk a court has decided upon its de novo construction of the statute, there no longer is a different construction that is consistent with the court’s holding and available for adoption by the agency.” supra note 29, 132 SCt, at 1846 (quoting Brand X, 545 US at 1018 n.12 (Scalia, J. dissenting)). The four dissenting Justices were of the view that post-Colony modifications to the other Code provisions around Code Sec. 6501(e)(1)(A) provided Treasury and the IRS with sufficient leeway to promulgate the new regulation without implicating Brand X. See supra note 29, 132 SCt, at 1849-53 (Kennedy, J. dissenting).

34 See supra note 33. This apparently is the view of IRS Chief Counsel William Wilkins. See Shamik Trivedi, ABA Meeting: Wilkins Comments on Regulatory Process Following Home Concrete, 2012 TTN 94-2 (May 15, 2012) (describing Wilkins’ comments: “most pre-Chevron Supreme Court decisions should be read as final determinations that can’t be changed through regulations, while for post-Chevron cases … we will have to look for whether the word “ambiguous” is used.”).

5 USC §553(b). The notice must be published in the Federal Register and must provide specific information about the rulemaking proceedings, reference the legal authority for the proposed rule, and provide the terms of the proposed rule or a description of the subjects and issues involved. Id.

5 USC §553(c).

Id.

5 USC §553(d).

Similar exceptions exist for the effective date requirement stated above. See 5 USC §553(d) (providing exceptions for: (1) substantive rules that grant exemptions or relieve restrictions; (2) interpretative rules and statements of policy; and (3) for good cause “found and published with the rule”).

5 USC §553(b)(3)(A). The same is true with respect to general policy statements and rules

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relating to agency organization, procedure, or practice. *Id.*

43 IRM §32.1.5.4.7.5.1(2) ("[M]ost IRS/Treasury regulations will be interpretative regulations because they fill gaps in legislation or have a prior existence in the law. Generally, the underlying Internal Revenue Code section imposing the tax or providing for collection of a tax will provide an adequate legislative basis for the action in the regulations. The regulations provide a mechanism to implement the Internal Revenue Code provision passed by Congress.").

44 IRM §32.1.5.4.7.5.1(7) ("The Service will generally rely on the necessity of immediate guidance as good cause [in the public interest] but the preamble should discuss and describe the circumstances causing the need for immediate guidance.").

45 5 USC §706(2)(A).

46 5 USC §706(2)(D). The APA also provides other bases for courts to set aside agency action that are less relevant in the context of federal tax practice. See generally 5 USC §706(2).


48 The regulation in question was Reg. §1.263A-11(e)(1)(ii)(B).

49 *Supra* note 47.


51 *Id.* at 43 (citing *Burlington Truck Lines*, SCt, 371 US 156, 168, 83 SCt 239 (1962)).