A Shift in Focus – Challenging Tax Regulations Under the Administrative Procedure Act

Taxpayers from time to time challenge the validity of Treasury regulations. In recent years, the ground on which these challenges can be based has shifted. The rules governing substantive challenges have been changed by several Supreme Court decisions, and tax litigators have begun to increase their focus on the possibility of mounting procedural challenges. This update describes the differences between substantive and procedural claims and will address how those claims can be successfully asserted.

I. Substantive Challenges

For years, taxpayers in appropriate circumstances have challenged Treasury regulations on substantive grounds as inconsistent with congressional intent and contrary to statutory provisions. Section 706(2)(A) of the Administrative Procedure Act (APA)\(^1\) provides that courts can “hold unlawful and set aside agency action, findings, and conclusions found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.”

When a substantive challenge is asserted, courts traditionally give deference to agency interpretations. Over time the standard of deference accorded tax regulations has varied. From 1979 to 2011, *National Muffler Dealers Assn. v. United States*, 440 U.S. 472 (1979), provided the standard applicable to tax regulations. Under *National Muffler*, the amount of deference accorded to a Treasury regulation varied depending on various factors, including whether the regulation was promulgated contemporaneously with the statute, the length of time the regulation had been in effect, the reliance placed on it, the consistency of the IRS’s interpretation, and whether Congress had recognized the regulation in subsequent statutory reenactments.

From 1984 on, the *National Muffler* standard of deference was an exception to the generally applicable standard created in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). Under the *Chevron* standard, courts ask first whether Congress has directly addressed the precise issue in dispute. If yes, the statute controls. If the statute is silent or ambiguous,\(^2\) however, then as a second step courts will uphold the regulation unless it is arbitrary or capricious\(^3\) in substance or manifestly contrary to the statute. In this second step, the regulation need not be the best interpretation, but only a reasonable one.\(^4\)

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1. 5 U.S.C. §§ 551-59, 701-06.
2. For example, in *Dominion Resources, Inc. v. United States*, 681 F.3d 1313 (Fed. Cir. 2012), the Federal Circuit held that Code section 263A was ambiguous, permitting the analysis to proceed to *Chevron* step two.
3. In *Judulang v. Holder*, No. 10-694 (Dec. 12, 2011), the Supreme Court held that the arbitrary or capricious standard under section 706(2)(A) of the APA and the arbitrary and capricious standard under *Chevron* step two are “the same.”
4. For a recent example, see *Dominion Resources*, in which the Federal Circuit held that Treas. Reg. § 1.263A-11 was not a reasonable interpretation of the statute.
In 2001, in *Mayo Foundation for Medical Education and Research v. United States*, 562 U.S. ___ (2011), the Supreme Court ruled that, in challenges to Treasury regulations, *National Muffler* no longer applies and *Chevron* deference should be accorded. Typically, application of the *Chevron* standard of deference will make substantive challenges to Treasury regulations more difficult.

*Chevron* deference, however, will not apply to all IRS pronouncements, as several exceptions exist. If an exception applies, the applicable standard of deference may be as described in *National Muffler* or as set forth in *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944) (interpretations may be entitled to some lower level of deference, proportional to the court’s view of their “power to persuade”).

The first exception originated in *Mead*, in which the Supreme Court held that an agency interpretation will receive *Chevron* deference only if Congress delegated to the agency authority to make rules carrying the force of law and if the interpretation at issue is an exercise of that authority. In *Mayo*, the Court held that because Treasury regulations are issued under the express congressional authorization set forth in Code section 7805(a) and following notice and comment procedures, they are entitled to *Chevron* deference. In contrast, IRS pronouncements other than regulations are not entitled to *Chevron* deference. In *Mead*, the Federal Circuit noted (185 F.3d at 1307) that the both the Supreme Court and the Federal Circuit have held that IRS revenue rulings receive no *Chevron* deference and the Supreme Court cited that statement with approval. Likewise, in *United States v. Quality Stores, Inc.*, No. 10-1563 (6th Cir. Sept. 7, 2012), the Sixth Circuit held that IRS revenue rulings and private letter rulings do not have the force of law. The Treasury Regulations themselves state that “Revenue rulings . . . do not have the force and effect of Treasury Department Regulations.” Thus, revenue rulings, revenue procedures, notices and other pronouncements should not be accorded *Chevron* deference. Under *National Muffler* or *Skidmore*, however, such interpretations may be entitled to some lower level of deference.

The next two exceptions can be viewed as instances where deference would be accorded under *Chevron*, but the Supreme Court felt a need to avoid that result. In *National Cable & Telecommunications Assn. v. Brand X Interned Services*, 545 U.S. ___ (2005), the Ninth Circuit had held that an FCC interpretation that was inconsistent with a prior Ninth Circuit decision was invalid because the prior decision controlled. The Supreme Court reversed, stating that a court’s prior contrary decision will trump an agency interpretation that otherwise is entitled to *Chevron* deference only if the prior decision holds that its ruling follows from the unambiguous terms of the statute and leaves no room for agency discretion. In contrast, if the prior court decision interpreted an ambiguous statute, the agency interpretation can overturn that prior court decision.

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5 United States v. Mead, 533 U.S. 218, 234 (2001) ("Chevron did nothing to eliminate Skidmore’s holding that an agency’s interpretation may merit some deference whatever its form . . ."). It is possible that *National Muffler* persists in tax cases under the same rationale.

6 Commissioner v. Schleier, 515 U.S. 323, 336 n.8 (1995) (IRS revenue rulings are interpretive rulings that "do not have the force and effect of regulations"); B.F. Goodrich v. United States, 94 F.3d 1545, 1550 n.5 (Fed. Cir. 1996) ("IRS Revenue Rulings have no binding effect on this court.").


The third exception was set forth in *United States v. Home Concrete & Supply, LLC*, 566 U.S. ___ (2012). In a prior case, the Supreme Court had held basis overstatements do not bring into play the Code section 6501(e) 6-year statute of limitations on assessment. Subsequently, Congress modified that provision and, thereafter, the IRS issued a regulation contrary to the Supreme Court’s prior decision. The Court held that the regulation could not trump its prior decision, despite the fact its prior decision had recognized that the statute was ambiguous, which would have been determinative under *Brand X*. To reach this result, the Court held that the key question is whether Congress delegated “gap filling” power to the Service. The Court held Congress did not delegate that power because the taxpayer had the better statutory argument, the better legislative history argument, and the more congruous position. Thus, the Court held Congress saw no “gap” to fill and its prior decision controlled.

Obviously, post-*Mayo*, challenging Treasury regulations on substantive grounds likely will be more difficult. Again, a regulation need not assert the best interpretation, only one that is not unreasonable. Nevertheless, *Brand X*, *Home Concrete* and *Dominion Resources* demonstrate that in the proper circumstances the difficulty is not insurmountable.

**II. Procedural Challenges**

In addition to substantive challenges, taxpayers in appropriate circumstances also can challenge Treasury regulations on procedural grounds. Procedural challenges have been relatively rare, but recent developments should encourage their increased use.

These challenges are appropriate when the process followed by the IRS in issuing the regulation violates the procedural requirements imposed by the APA. Under the APA, a court may declare a regulation invalid under section 706(2)(A) if it is “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law” or invalid under section 706(2)(D) if it is promulgated “without observance of procedure required by law.”

Section 553 of the APA sets forth the applicable rule making procedural requirements. Typically, the arguments advanced are that the agency either (1) failed to publish notice of proposed rulemaking and failed to give interested persons an opportunity to provide comments or (ii) failed to incorporate in the rules a concise general statement of their basis and purpose.

Surprisingly, the IRS takes the position that it need not adhere to the APA procedural requirements when issuing Treasury regulations. Section 553(b) of the APA exempts “interpretative rules” from the procedural requirements and the IRS contends that “most IRS/Treasury regulations are interpretative.”

This assertion appears to be based on the historic distinction in tax practice made between “legislative” and “interpretive” Treasury regulations. In the APA context, however, “interpretive rules” refer to non-binding rules that inform the public of agency views, as distinguished from rules with binding legal effect.

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9 Internal Revenue Manual § 32.1.5.4.7.5.1.2.
10 *Boeing Co. v. United States*, 537 U.S. 537, 446 (2003) (“Even if we regard the challenged regulation as interpretive because it was promulgated under § 7805(a)’s general rulemaking grant rather than pursuant to a specific grant of authority, we must still treat the regulation with deference.”)
Clearly Treasury regulations are not simply informative, but rather have binding legal effect\(^\text{11}\) and it is disingenuous for the IRS to contend otherwise. Indeed, in Mayo the Supreme Court expressly held that the applicability of Chevron deference “does not turn on whether Congress’s delegation of authority was general or specific.” \(^562\text{ U.S. at }\_\_\) As could be expected, other cases also have held that Treasury regulations are subject to the APA procedural requirements.\(^\text{12}\)

Because final Treasury regulations typically are issued after notice and comment, procedural challenges on this ground are rare, although they have occurred.\(^\text{13}\) A question can arise, however, regarding temporary regulations, which generally are issued without notice and comment.\(^\text{14}\) Similar questions may be justified in the case of some revenue rulings and revenue procedures, which may impose legal obligations or liabilities, and which uniformly are issued without notice and comment. A challenge also may be appropriate when a transaction is determined to be and is named in a notice or similar publication, without notice and comment, as a “listed” transaction.\(^\text{15}\) Once that occurs, substantial consequences result; a taxpayer’s tax accrual workpapers are exposed\(^\text{16}\) and additional statutory penalty exposure results.\(^\text{17}\) When the IRS makes a determination of what taxpayers and transactions are subject to statutory consequences, that determination should be subject to notice and comment. The question of what IRS actions other than the promulgation of Treasury regulations are subject to notice and comment requirements remains to be explored.

Procedural challenges will be available more often on the ground that a regulation either fails to reflect a thorough and reasoned analysis or fails to include an explanation of the regulation’s basis and purpose. In Motor Vehicle Manufacturers Association of the U.S. v. State Farm Mutual Automobile Insurance Co., 463 U.S. 29 (1983), the Supreme Court stated that an “agency must examine the relevant data and articulate a satisfactory explanation for its action.”

The first part of this requirement is reasoned decision making, which means that the agency must reach a result “based on consideration of the relevant factors.” \(^\text{Id. at 43}\). This argument may have less force when a regulation is based solely on statutory interpretation. Nevertheless, this requirement may present

\(^{11}\) E.g., Swallows Holding, Ltd. v. Commissioner, 515 F.3d 162, 168-69 (3d Cir. 2008) (footnote 10 lists relevant cases in various circuits).

\(^{12}\) See, e.g., Dominion Resources, supra.

\(^{13}\) See, E.g., American Medical Assn. v. United States, 887 F.2d 760, 765 (7th Cir. 1989).

\(^{14}\) Hospital Corp. of America v. Commissioner, 348 F.3d 136, 145 n.3 (6th Cir. 2003) (“Hospital Corporation does not challenge the temporary regulations as violations of the notice and comment requirements for rulemaking, see 5 U.S.C. § 553. Accordingly, we do not reach the issue of whether the Administrative Procedure Act requires notice and comment procedures before Treasury may promulgate temporary interpretive regulations that make substantive choices among permissible statutory interpretations.”)

\(^{15}\) Treas. Reg. 1.6011-4(b)(2).


\(^{17}\) Code sections 6662(d)(3), 6662A(b)(2), 6664(d), 6707A(c).
an opportunity when the IRS issues a “fighting regulation” not based on reasoned statutory analysis but instead based on a desire to obtain deference for the IRS’s position.\(^{18}\)

The second part of the *State Farm* requirement is that “an agency must cogently explain why it has exercised its discretion in a given manner.” *Id.* at 48. The opportunity to advance this type of challenge will arise more often, because the IRS takes the position that “it is not necessary to justify” the regulations it issues or the alternatives that were considered\(^{19}\) and typically fails to do so. In *Dominion Resources*, the Federal Circuit held that a regulation “violates the *State Farm* requirement that Treasury provide a reasoned explanation for adopting a regulation.” In that case, the court found both that the regulation was unreasonable and that the procedural requirement of providing a cogent explanation was not met. It is unclear whether the court would have held for the taxpayer if only the procedural defect was present. If so, these types of challenges would be commonly available.

### III. Making a Successful Challenge

When tax litigators contemplate pursing APA claims, they must ensure that they comply with applicable procedural rules. These rules require that the APA claim or claim be specifically and adequately stated.

This concern arises first during the preparation of a claim for refund. The doctrine of variance provides that no issue can be asserted in a complaint if the facts and grounds underlying the issue were not set forth adequately in the refund claim. When preparing the refund claim, careful attention must be paid to whether substantive and/or procedural APA claims will be asserted and on what grounds. Then, the facts and grounds for the claim(s) should be specifically set forth in the refund claim. Simply asserting that the regulation “should be held unlawful under section 706 of the APA” invites a later variance challenge. Likewise, a statement that a regulation “violates the notice and comment requirements of the APA” is likely to prevent the later assertion of substantive claims in the complaint.

The specificity concern arises a second time in drafting the court complaint or petition, in which the APA claim(s) must be adequately set forth. An example of this risk is contained in a Memorandum Opinion issued on October 29, 2012, in the long-distance telephone excise tax case refund suit litigation. *In Re Long-Distance Service Federal Excise Tax Refund Litigation*, No. 1:07-mc-0014 (D.D.C. 2012). The controversy began when the IRS issued Notice 2006-50 without notice and comment. In the case, three cases initiated by three separate complaints were consolidated for pre-trial proceedings. The Memorandum Opinion addressed whether final judgment could be entered in each case based on a procedural APA claim. The court ruled that final judgment could be entered in each case only if the complaint raised the procedural APA claim. The three complaints differed from each other and set forth:

\(^{18}\) See, e.g., *Chock Full O’ Nuts Corp. v. United States*, 453 F.2d 300 (2nd Cir.1971) (“the taxpayer contends that that Regulation should not be given retroactive effect, arguing that it represented an effort to change the policy of existing regulations in order to support the Government’s position in its pending litigation with the taxpayer”). But see *Smiley v. Citibank (South Dakota)*, N.A., 517 U.S. 735, 741 (1996) (the fact that a “regulation was prompted by litigation” was held to be immaterial to the Court’s analysis).

\(^{19}\) Internal Revenue Manual § 32.1.5.4.3(1)
- **Cohen** - Challenged Notice 2006-50 as an “arbitrary and unreasonable administrative action” that was “adopted by the government arbitrarily, unreasonably, and unlawfully.” The complaint made no reference to notice and comment or to any other procedure used in issuing the notice.

- **Gurrola** - The complaint stated no claim for relief based on the APA. However, the taxpayer’s response to the government’s motion to dismiss alleged that Notice 2006-50 was issued without notice and comment.

- **Sloan** - The complaint stated both substantive and procedural APA challenges to Notice 2006-50.

The Memorandum Opinion entered final judgment only for the taxpayers in the Sloan case, and entered final judgment for the government in the Cohen and Gurrola cases. The court justified its rulings as follows:

- **Cohen** - This complaint states only a substantive APA claim, not a procedural one. The complaint makes no reference to notice and comment procedures or to the procedures used in issuing Notice 2006-50.

- **Gurrola** - This complaint raises neither a substantive nor a procedural APA claim. Raising the procedural APA claim “in subsequent briefs does not alleviate their failure to include this theory in the complaint.”

- **Sloan** - This complaint stated a procedural APA claim.

As the song goes, what a difference a pleading makes. While “notice pleading” prevails, the foregoing illustrates that careful pleading is still required. And, if the original complaint is lacking in specificity, care should be taken to file an amended complaint in a timely fashion, early enough that the government cannot make a reasonable assertion of prejudice.

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**About the Author**

A partner in Steptoe’s Washington office, **J. Walker Johnson** formerly was a trial attorney in the Tax Division, US Department of Justice, where he litigated numerous tax cases. Since 1987 he has been an adjunct law professor in the LL.M. in Taxation program at Georgetown University Law Center, presenting the course Taxation of Financial Institutions and Products. At Steptoe, he has litigated numerous major tax cases, including cases such as New York Life (payment vs. deposit), American Electric Power (COLI policies), Textron (tax accrual workpapers), John Hancock (cross-border leveraged leasing), and others. He is recognized as a leading tax litigator by *Chambers and Legal 500*. Mr. Johnson can be reached at wjohnson@steptoe.com or +1 202.429.6225.