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LEGAL ALERT

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Federal Circuit Invalidates a Tax Regulation Because Treasury Did Not Provide a Reasoned Explanation as Required by *State Farm*

In early 2011, the U.S. Supreme Court stated that it was "not inclined to carve out an approach to administrative review good for tax law only" and seemingly rejected the generally accepted view that tax regulations were subject to different administrative procedures than rules and regulations promulgated by other administrative agencies. *See Mayo Foundation for Medical Ed. v. United States*, 131 S. Ct. 704, 713 (2011). Although not explicit on this point, many believe that *Mayo*'s implicit holding is that tax regulations are subject to the Administrative Procedure Act (APA) -- a belief which has left tax practitioners scrambling to become familiar with a large body of APA guidance that has rarely been applied to tax rules and regulations. After *Mayo*, it seems increasingly likely that courts will begin to review tax regulations under the same standards (including the APA) that have long been applied to other administrative pronouncements. In this context, the U.S. Court of Appeals for the Federal Circuit's recent holding in *Dominion Resources* is particularly noteworthy because it is one of the first cases after *Mayo* to consider how the APA should be applied to tax regulations within the framework set by the Supreme Court in *Chevron*. *See Dominion Resources, Inc. v. Commissioner*, ___ F.3d ___, 2012 WL 1948995 (Fed. Cir. 2012).

Background

In *Motor Vehicles Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983), the Supreme Court held that an agency's actions will be considered arbitrary and capricious under section 706(2) of the APA if the agency has not "examine[d] the relevant data and articulate[d] a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'" One year later, in *Chevron v. Natural Resources Defense Council*, 467 U.S. 837 (1984), the Court adopted a two-part test for assessing the validity of an agency's action. Under *Chevron* step one, the court must determine whether Congress has specifically addressed the question at issue. If Congress has not addressed the issue, or if the statute is ambiguous, *Chevron* step two requires the court to determine whether the agency's interpretation is based on a "reasonable" or "permissible" construction of the statute.

The *Dominion Resources* Decision

In *Dominion Resources*, the Federal Circuit reversed a decision of the Court of Federal Claims and held that the interest capitalization rule involved in that case[1] was unreasonable under step two of *Chevron* as applied to interest attributable to property temporarily withdrawn from service. The court held that, as applied, the regulation required a result that "makes no sense" and contradicted the objective of the statute with respect to the capitalization of avoided costs. After concluding that the regulation failed under step two of *Chevron*, the court held that the regulation was *also* arbitrary and capricious under *State Farm* because it failed to provide a reasoned explanation for the agency's decision. Implicitly rejecting the government's argument that *State Farm* did not provide an additional basis for review beyond *Chevron* step two, the court held that Treasury's failure to explain why it chose the regulation's specific calculation method was an alternative basis for holding the regulation to be invalid. Judge Clevenger filed a separate

[1] The relevant regulation was Treas. Reg. § 1.263A-11(e)(1)(ii)(B).

opinion, concurring in part and concurring in the result, stating that he would have preferred a narrower decision invalidating the regulation under the *State Farm* standard alone.

Application of *State Farm* in Challenges to Tax Regulations

Until now, tax regulations have rarely been challenged for being arbitrary and capricious under the APA and *State Farm*. *See, e.g., Swallows Holding, Ltd. v. Commissioner*, 126 T.C. 96, 162 (2006) (Holmes, J., dissenting); *Carpenter Family Inv., LLC v. Commissioner*, 136 T.C. 373, 398 (2011) (Halpern and Holmes, JJ., concurring); *Intermountain Ins. Serv. of Vail, Ltd. Liability Co. v. Commissioner*, 134 T.C. 211, 226 (2010) (Halpern and Holmes, JJ., concurring).

The IRS has claimed that most tax regulations are generally not subject to the APA. *See, e.g.,* I.R.M. § 32.1.5.4.7.5.1 (2011). The IRS argues that regulations promulgated under its section 7805(b) general authority are "interpretative" rules, not "legislative" rules subject to notice and comment. The IRS considers most regulations interpretative because the underlying statute implemented by the regulation contains the necessary legal authority for the action taken and any effect of the regulation flows directly from that statute. *See* I.R.M. § 32.1.1.2.6. This position is not entirely consistent with the IRS litigating position that all tax regulations carry the force and effect of law. (In administrative law, regulations with the force and effect of law are considered "legislative" regulations.) While the IRS generally uses APA-like procedures in promulgating regulations (i.e., it provides for notice and comment, and includes explanations of its reasoning in the preambles to proposed and final regulations), many IRS regulations could be vulnerable under a *State Farm* analysis. Importantly, after the Federal Circuit's decision in *Dominion Resources*, the government filed a brief in another case now pending in the Court of Federal Claims - *Balestra v. United States, No. 09-283* - raising similar issues, in which it did not argue that *State Farm* and the APA were inapplicable to regulations promulgated under its section 7805(b) general authority. That may suggest a shift in how the government will defend regulations after *Mayo*.

Although there has been no definitive holding on the matter, indications are that the Supreme Court believes that tax regulations are subject to the APA. *See Mayo Foundation for Medical Ed. v. United States*, 131 S. Ct. 704, 714 (2011). The *Mayo* Court rejected the distinction between rules adopted pursuant to the IRS's general authority under section 7805(b) (which the IRS claims is interpretive) and rules adopted pursuant to a specific grant of authority. *Id.* at 713 ("Our inquiry . . . does not turn on whether Congress's delegation of authority was general or specific."). Instead, the Court focused on the consistent application of judicial review to all administrative agencies (including the IRS), and on whether Congress intended the IRS to have "gap-filling" regulatory authority. Even if the *State Farm* analysis cannot be applied independently of *Chevron* step two, *Mayo* indicated that if the IRS does not follow APA procedures, *Chevron* deference may not apply.

Sutherland Observation: It will be interesting to see if the Department of Justice seeks certiorari in *Dominion Resources*. If the Federal Circuit decision stands, *State Farm* analysis could be a new tool for taxpayers to challenge tax regulations independent of *Chevron* step two. Tax regulations may be particularly vulnerable to APA-based attacks because the IRS has not strictly followed APA notice and comment procedures, and it cannot attempt to justify a rule based on grounds different from those given when the rule was adopted. *See SEC v. Chenery*, 318 U.S. 80, 87 (1943). A challenge under *State Farm* may only provide a temporary reprieve if Treasury can re-promulgate the regulation after articulating a "reasoned explanation" for the rule, however taxpayers may find it advantageous to argue that *State Farm* is an independent basis for invalidating a regulation.

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

David C. Cho	202.383.0117	david.cho@sutherland.com
N. Jerold Cohen	404.853.8038	jerry.cohen@sutherland.com
Thomas A. Cullinan	404.853.8075	tom.cullinan@sutherland.com
Joseph M. DePew	404.853.8009	joe.depew@sutherland.com
Dwaune L. Dupree	202.383.0206	dwaune.dupree@sutherland.com
Ken C. Jones	202.383.0825	kendall.jones@sutherland.com
John A. Lanier	404.853.8184	john.lanier@sutherland.com
Jerome B. Libin	202.383.0145	jerome.libin@sutherland.com
Shane A. Lord	404.853.8091	shane.lord@sutherland.com
Mary E. Monahan	202.383.0641	mary.monahan@sutherland.com
Daniel H. Schlueter	202.383.0146	dan.schlueter@sutherland.com
Jeffrey N. Starkey	202.383.0203	jeffrey.starkey@sutherland.com