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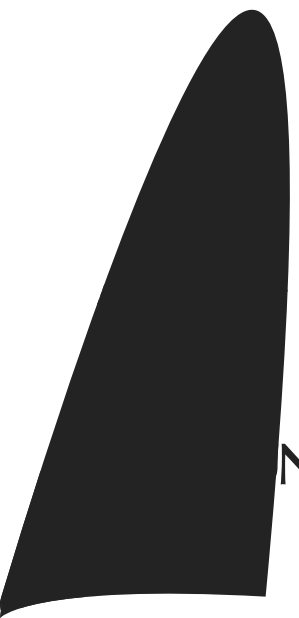
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Navigating a transition in U.S. tax administration

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1. INTRODUCTION

Judicial review is often an afterthought in many conversations about tax compliance and tax administration. To some extent, this lack of attention is entirely appropriate. Most taxpayers prefer to comply with rather than challenge the taxing authorities' interpretation of the law. Likewise, the goal of tax administrators is to encourage and facilitate voluntary tax compliance. For that matter, few enforcement matters lead to actual litigation. Hence, most tax professionals never see the inside of a courtroom.

Nevertheless, judicial review ought to be a consideration in evaluating tax risk. For But disagreements regarding the substantive meaning of the tax laws are only one part of the risk assessment equation. Most assessments of tax risk simply assume a fair degree of consistency both in how the government adopts regulations and other pronouncements interpreting the tax laws and also in how the courts evaluate disagreements between taxpayers

and the government. For tax professionals in the United States, such consistency is now in question.

After years of ignoring changes in administrative law doctrine, judicial review of tax administration efforts in the United States is undergoing a period of transition as a result of three recent, high-profile cases. Early in 2011, in *Mayo Foundation for Medical Education and Research v. United States*¹ the United States Supreme Court held that general authority Treasury regulations promulgated using the public notice and comment procedures imposed by the Administrative Procedure Act (APA) are eligible for the highly deferential standard of judicial review articulated in *Chevron*

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¹ 131 S.Ct. 704 (2011).

students who work for the academic institutions in which they are enrolled.⁷ In 2004, Treasury exercised its general rulemaking authority under IRC § 7805(a) to adopt a regulation declaring that medical residents are not students, reversing a longstanding IRS interpretation and rejecting federal circuit court precedent reaching the opposite conclusion.⁸ Institutions that withheld and paid the taxes unsuccessfully sought refunds and then promptly sued the government, challenging the validity of the regulation.

The standard of judicial review for most agency regulations derives from *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*⁹ The Chevron standard instructs a reviewing court to ask first whether the statute being interpreted is clear, “for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.”¹⁰ In evaluating statutory clarity, reviewing courts employ “traditional tools of statutory construction” as they have always done.¹¹ But where traditional interpretive methods fail to yield a conclusive sense of congressional intent, and the statute is susceptible of more than one reasonable construction, the Chevron standard recognizes the choice between competing alternatives to be a matter of policy preference instead of mere interpretation.¹²

States,¹⁷ applied instead.¹⁸ Other circuits expressly adopted Chevron rather than National Muffler as the standard of review for general authority Treasury regulations.¹⁹ Still other federal circuit courts wondered whether the Chevron and National Muffler standards were meaningfully different.²⁰ The Supreme Court's previous discussions of the issue were muddled and contradictory.²¹ Finally, the Mayo case brought the issue squarely before the Supreme Court. The National Muffler standard expressly called for considering, among other factors, an interpretation's consistency and longevity—factors that weighted against Treasury's new regulation—while Chevron expressly recognizes the need to allow agencies to change their interpretive positions. Also, unlike in prior cases before the Court, briefing in Mayo by the parties and by dueling amici clearly raised and thoroughly addressed the question of Chevron versus National Muffler review.²²

In upholding the regulation, an undivided Court unequivocally chose Chevron and rejected National Muffler as the standard of review for general authority Treasury regulations.²³ In reaching that decision, the Court offered several observations and conclusions, including that the Chevron and National Muffler standards “call for different analyses of an ambiguous statute”;²⁴ that National Muffler factors such as an agency's inconsistency or an interpretation's longevity or contemporaneity (or lack thereof) are not reasons for denying Chevron deference to a Treasury regulation;²⁵ that “[t]he principles underlying our decision in Chevron apply with full force in the tax context”;²⁶ and, finally, that “Chevron and Mead, rather than National Muffler . . . , provide the appropriate framework for 0e7rralx0 Tc 0 Tw 1.06 0 Td9(x)141 Tw 8.0e notury regulati

procedural grounds, seeking notice and comment as the appropriate forum for requiring the IRS to address the alleged inadequacies.

The Supreme Court has interpreted the APA as establishing a presumption in favor of judicial review of final agency action.³⁸ Separately, IRC § 7421, also known as the Anti-Injunction Act, generally prohibits any lawsuit “for the purpose of restraining the assessment or collection of any tax” until either the IRS issues a

exception from the APA.⁴⁶ Picking up the Supreme Court’s admonition in *Mayo* in favor of administrative law uniformity, quoted elsewhere in the majority opinion, the court concluded that “[t]he IRS is not special in this regard; no exception exists shielding it—unlike the rest of the Federal Government—from suit under the APA.”⁴⁷

Next, the court held that the Anti-Injunction Act and the Declaratory Judgment Act do not bar judicial review of the taxpayers’ APA procedural claim.⁴⁸ Citing and quoting extensively from *Hibbs v. Winn*, in which the Supreme Court interpreted a similar provision governing state taxation,⁴⁹ the court adopted a narrow, textualist interpretation of the Anti-Injunction Act’s limitation on judicial review. According to the court, the Anti-Injunction Act’s prohibition against suits to restrain “the assessment or collection of any tax” does not refer to a “‘single mechanism’ that ultimately determines the amount of revenue the Treasury retains” and is not “synonymous with the entire plan of taxation.”⁵⁰ Instead, “assessment” and “collection” are defined terms in the IRC: assessment represents “the trigger for levy and collection efforts,” and collection represents “the trigger for levy and collection efforts.”

(even if a refund was their ultimate goal), and IRC § 7422 does not offer that remedy.⁵⁶ Both opinions addi

that the relevant statutory language was ambiguous,⁷⁸ and the Supreme Court agreed, thus opening the door for Chevron deference in light the Court's holding in *Brand X*.⁷⁹ By contrast, *Colony* was a Supreme Court decision. The Court had never addressed whether its reasoning in *Brand X* allowing agencies to reject federal circuit court outcomes through notice-and-comment rulemaking extends to its own opinions.

The procedures that Treasury used in promulgating the *Home Concrete* regulations were also potentially problematic. The APA contemplates a particular procedural sequence for agencies adopting regulations that carry the force and effect of law like those at issue in both *Mayo* and *Home Concrete*. Specifically, APA § 553(b) requires an agency to provide public notice of its proposed rules through publication in the *Federal Register*.⁸⁰ Next, APA § 553(c) commands the agency pursuing the rulemaking to offer interested persons an opportunity to participate through the submission of written comments.⁸¹ Only “after consideration of the relevant matter presented” through the comments may the agency issue the final, legally binding regulations along with a “concise general statement of their basis and purpose.”⁸² In other words, the APA anticipates that regulated parties will receive notice of proposed agency rules and have the opportunity to submit comments before finding themselves legally bound by those rules.

In adopting the regulation at issue in *Mayo*, Treasury followed the procedural sequence contemplated by the APA.⁸³ And in extending Chevron deference to that regulation, the Court particularly acknowledged Treasury's use of notice-and-comment rulemaking.⁸⁴ In promulgating the regulation at bar in *Home Concrete*, however, Treasury employed an alternative procedural sequence known most commonly by courts and administrative law scholars as interim-final rulemaking. Specifically, as noted above, Treasury issued legally-binding temporary regulations simultaneously with its notice of proposed rulemaking requesting comments. In other words, Treasury inverted the procedural sequence contemplated by the APA, providing the public with the opportunity to comment only after they were already legally bound. The government has acknowledged that the final regulation, issued several months later, “track[ed] the temporary regulation in virtually every respect.”⁸⁵

The general legal consensus holds that interim-final rulemaking violates the APA unless the agency can validly claim an exception from the procedural requirements of

APA § 553.⁸⁶ Although the government has asserted a couple of exceptions from APA § 553 in the course of the Home Concrete litigation,⁸⁷ those claims are legally questionable.⁸⁸ Yet, the fact remains that Treasury did accept public comments in the course of finalizing the challenged regulations. Even as they disapprove of post-promulgation notice and comment, the federal circuit courts have disagreed over whether invalidating the regulation ought to be the appropriate remedy for under these circumstances.⁸⁹ Meanwhile, the Supreme Court has never addressed the legality of or the remedy for interim-final rulemaking. Nor has the Court considered whether it

regulations interpreting the tax laws are susceptible to the same arguments concerning their procedural validity as have been raised in the Home Concrete litigation. In light of the opinions the Fifth Circuit in *Burks* case and of Tax Court Judges Halpern and Holmes in *Intermountain*, taxpayers in at least some circuits may have a potentially winning procedural argument they can raise in challenging tax assessments based on regulations that Treasury initially issued in temporary form.¹⁰⁶ Given particularly the recent decisions of the Federal Circuit in *Grapevine Imports* and the D.C. Circuit in *Intermountain*, however, other taxpayers are faced with the prospect that such regulations will not only be considered procedurally valid but will be reviewed under the highly deferential Chevron standard.¹⁰⁷ Given the sheer number of Treasury regulations with temporary origins, what will happen to the tax system if one or two circuits begin regularly invalidating Treasury regulations on APA procedural grounds while other circuits do not?

Likewise, the pronouncement at issue in *Cohen*, Notice 2006-50, is by no means unique among IRS guidance documents. The IRS annually issues hundreds of revenue rulings, revenue procedures, and notices, many if not most of which contain substantive interpretations of the tax laws.¹⁰⁸ The IRS now considers itself bound by these pronouncements¹⁰⁹ and predicates many enforcement actions on the failure of taxpayers to comply with the interpretations advanced therein. But the IRS almost never seeks public comments in issuing IRB guidance; on the rare occasions when the IRS does seek public input,¹¹⁰ it does not purport to comply with APA notice-and-comment rulemaking procedures. Largely on the basis of this lack of public notice and comment, the federal circuit courts thus far have declined to extend Chevron deference to legal interpretations advanced in these formats.¹¹¹ Yet, the legal arguments and conclusions that led the courts to invalidate Notice 2006-50 in the *Cohen* litigation apply equally to many if not most other such guidance documents, leaving them susceptible to invalidation d t2/then p2alin1eeeeeñ lOtaln asp fo o-2(c)11()8(i)ace tom dn

