Mannella, *State Farm*, and the Arbitrary and Capricious Standard

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In *Mannella*, the Third Circuit agreed with the Seventh Circuit's *Lantz* decision, which upheld the validity of regulations imposing a two-year time limit on claims for equitable innocent spouse relief under section 6015(f). Dissenting in *Mannella*, Judge Thomas L. Ambro would have held that Treasury and the IRS violated step two of *Chevron* because they provided no explanation of their reasons for imposing this two-year time limit when the rule was adopted.

Judge Ambro concluded that in the absence of a contemporaneous explanation of an agency's reasoning, it is impossible for a reviewing court to exercise its role under *Chevron* in evaluating whether the agency's action represented reasonable decision-making. Judge Ambro's conclusion has substantial support in administrative law relating to the Administrative Procedure Act's arbitrary and capricious standard as interpreted in the Supreme Court's landmark 1983 *State Farm* decision.

State Farm requires that agencies engage in reasoned decision-making and that they provide contemporaneous explanations of their reasoning so reviewing courts can evaluate whether the agency has satisfied the reasoned decision-making requirement. The requirements imposed by *State Farm* are commonly viewed as substantially similar to the requirements of *Chevron* step two. Although *State Farm* violations are commonly asserted against other agencies, they are rarely asserted against Treasury and the IRS, even though the preambles to regulations often fail to provide the type of explanation *State Farm* requires.

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Background

In a previous article,[1] I discussed the first appellate court decision[2] to address the validity of a regulation[3] that imposes a two-year limit on claims for equitable innocent spouse relief under section 6015(f).[4] The regulation thus applies to the general provision of section 6015(f) the same time limit that is explicitly prescribed by statute for the more specifically defined forms of innocent spouse relief provided in section 6015(b) and (c).[5] In January the Third Circuit, in *Mannella v. Commissioner*,[6] became the second court of appeals to address the validity of the regulation.

Like the Seventh Circuit, the Third Circuit held that the two-year time limit in the regulation is valid.[7] And like the Seventh Circuit, the Third Circuit rejected the reliance by the Tax Court[8] and the taxpayers on the *Russello* principle that when

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[1]Patrick J. Smith, "Gaps in the Seventh Circuit's Reasoning in *Lantz*," *Tax Notes*, Sept. 27, 2010, p. 1375, *Doc 2010-18745*, *2010 TNT 186-19*.

[2]*Lantz v. Commissioner*, 607 F.3d 479 (7th Cir. 2010), *Doc 2010-12604*, *2010 TNT 110-17*.

[3]Reg. section 1.6015-5(b)(1). T.D. 9003 (July 18, 2002), *Doc 2002-16606*, *2002 TNT 138-1*.

[4]Section 6015(f) provides that if, "taking into account all the facts and circumstances, it is inequitable to hold the individual liable," and if "relief is not available to such individual under subsection (b) or (c)," then the IRS "may relieve such individual of such liability."

[5]Section 6015(b)(1)(E); section 6015(c)(3)(B).

[6]631 F.3d 115 (3d Cir. 2011), *Doc 2011-1183*, *2011 TNT 13-10*.

[7]The same issue is pending in several other circuits. *See Coulter v. Commissioner*, No. 10-680 (2d Cir.); *Jones v. Commissioner*, No. 10-1985 (4th Cir.); *Buckner v. Commissioner*, No. 10-2056 (6th Cir.); *Hall v. Commissioner*, No. 10-2628 (6th Cir.); *Payne v. Commissioner*, No. 10-72855 (9th Cir.). As of the time this report was written, oral argument had not yet taken place in any other circuit.

[8]*Lantz v. Commissioner*, 132 T.C. 131, 139 (2009), *Doc 2009-7979*, *2009 TNT 65-8*. The Tax Court did not cite *Russello* itself, but rather two later Supreme Court decisions quoting the relevant language from *Russello: City of Chicago v. Environmental Defense Fund*, 511 U.S. 328, 338 (1994), and *Keene Corp. v. United States*, 508 U.S. 200, 208 (1993).

"Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion."[9] As noted by the dissenting opinion, the Third Circuit's explanation of its reasons for rejecting reliance on this well-established principle and for concluding the time limit in the regulation is valid largely parallels the Seventh Circuit's reasoning and is no more persuasive than the Seventh Circuit opinion.[10] My previous article discussed at length the considerations supporting the conclusion that the two-year time limit in the regulation for claims for relief under section 6015(f) is invalid as a matter of statutory interpretation. It is not the purpose of this report to repeat those considerations.

Instead, I will discuss additional considerations raised by the dissenting opinion in *Mannella* by Judge Thomas L. Ambro. Those considerations involve two closely related but distinct points: (1) the failure of the IRS and Treasury to explain, at the time they made the decision to apply the two-year time limit to claims for relief under section 6015(f), their reasons for making that decision; and (2) the principle that agency action can be upheld by a court only on the basis of the reasons the agency relied on at the time of the agency action. Those considerations are grounded in well-established principles of administrative law and provide strong support for Judge Ambro's conclusions.

Those considerations apply well beyond the specific issue of the validity of the two-year time limit. They are potentially relevant in any challenge to the validity of tax regulations, particularly in light of the Supreme Court's recent decision in *Mayo Foundation for Medical Education and Research v. United States* confirming that tax regulations are subject to the same deference standards that have applied to the actions of all other federal agencies since 1984.[11]

Judge Ambro's Dissent

Judge Ambro agreed with the Third Circuit majority that the two-year time limit in the regulation governing relief under section 6015(f) should not be rejected as invalid under step one of *Chevron*.[12] However, he disagreed with the majority that the regulation satisfied step two of *Chevron*.

The *Mannella* majority concluded that the regulation's application of a two-year time limit to claims under section 6015(f) was "reasonable" for purposes of *Chevron* step two based on the arguments advanced by the Justice Department in its briefs and by the Seventh Circuit in *Lantz*. Judge Ambro, however, determined that those were inappropriate arguments on which to base the validity of the two-year time limit.

In his dissent, Judge Ambro concluded that under step two of *Chevron*, the reasons put forward by the Justice Department or appellate judges were irrelevant in evaluating the reasonableness of the two-year time limit. In his view, the relevant reasons were those relied on by Treasury and the IRS when they made the decision to apply the two-year time limit to claims under section 6015(f).

Judge Ambro concluded that it was impossible for a reviewing court to determine whether that decision was reasonable, as required under *Chevron* step two, because at the time Treasury and the IRS adopted the two-year limit, they failed to provide any explanation of their reasons for adopting the rule. That failure "leav[es] no basis to conduct the

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[9] *Russello v. United States*, 464 U.S. 16, 23 (1983).

[10] As noted in my prior article, the extremely well-established nature of the *Russello* principle is demonstrated by the fact that it has been applied by at least 24 Supreme Court cases in addition to *Russello* itself and the two cases cited by the Tax Court since the principle was first adopted by the Supreme Court in 1983. Smith, "Gaps in the Seventh Circuit's Reasoning in *Lantz*," *supra* note 1, at p. 1377 n.19. In *Duncan v. Walker*, 533 U.S. 167, 173 (2001), the Court referred to this principle as "well settled." Moreover, application of the *Russello* principle in the case of section 6015(f) is further supported by "the familiar rule that negative implications raised by disparate provisions are strongest when the portions of a statute treated differently" represent "contrasting statutory sections originally enacted simultaneously in relevant respects." *Lindh v. Murphy*, 521 U.S. 320, 330 (1997) (internal quotation marks omitted). Section 6015(b), (c), and (f) were all enacted at the same time and thus represent the type of case where "negative implications raised by disparate provisions are strongest." *Cf. Johnson v. United States*, 130 S.Ct. 1265, 1272-1273 (2010) (holding *Russello* inapplicable because the contrasting provisions were enacted eight years apart). As noted in a supplemental authority letter filed by the taxpayer in *Coulter*, the D.C. Circuit recently referred to the *Russello* principle as "one of the most basic tenets of statutory interpretation." *Village of Barrington v. STB*, No. 09-1002, slip op. at 22 (D.C. Cir. Mar. 15, 2011).

As noted in my prior article, none of the "borrowed" statute of limitations cases cited by the government or the Seventh Circuit involved a situation in which a time limit was borrowed from one subsection of a statutory provision and applied to a different subsection of the same provision where no time limit was stated. "Borrowing" time limits in that context is fundamentally at variance with the *Russello* principle. Moreover, as noted in my prior article, this borrowed statute of limitations approach almost always involves borrowing a state statute of limitations period and applying that time limit to a federal cause of action. Borrowing a federal statute of limitations period to apply to a different federal cause of action is rare. *See*, *e.g.*, *Graham County Soil & Water Conservation District v. United States ex rel. Watson*, 545 U.S. 409, 415 (2005) ("In the rare case, we have even borrowed analogous federal limitations periods in the absence of an expressly applicable one.").

[11] 131 S.Ct. 704 (2011), *Doc 2011-609*, *2011 TNT 8-10*.

[12] *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984).

analysis mandated by *Chevron* step two,'' Judge Ambro observed.[13] He pointed out that while Treasury and the IRS may have based their decision on reasons that a court would consider proper, it was also possible that their decision was based on reasons that a court would hold improper:

> There may exist justifications on which the IRS could have reasonably relied in order to impose a two-year limit on subsection (f) relief. The problem is that there are also arbitrary and capricious reasons that, if articulated by the Service as the basis for the two-year limit, would require us to strike down that limit — for example, if the IRS enacted the two-year deadline based on an incorrect belief that the statute required it, or based on a factual supposition belied by the administrative record. *See, e.g., Zheng v. Gonzales*, 422 F.3d 98, 120 (3d Cir. 2005) (rejecting immigration regulation at *Chevron* step two because it was based on an impermissible reading of the 8 U.S.C. section 1255(a)). Because the IRS has not articulated its reasoning, we cannot discern whether the two-year limit falls into the permissible, or the arbitrary and capricious, category.[14]

Judge Ambro's reference to arbitrary and capricious reasons refers to the standard set forth in the Administrative Procedure Act (APA) for judicial review of agency action: ''The reviewing court shall . . . 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.''[15]

Because Treasury and the IRS provided no contemporaneous explanation for adopting the two-year limit for section 6015(f) claims, both the Seventh Circuit and the Third Circuit majority had relied on a mere ''surmising of agency reasons'' as the basis for their conclusion that the regulation was reasonable and therefore satisfied step two of *Chevron*, according to Judge Ambro.[16] ''It is black-letter law — and a necessary corollary of the deference owed to agencies — that courts may not supplement deficient agency reasoning,'' he wrote.[17] In support of that position, Judge Ambro cited the first of the Supreme Court's two *Chenery* decisions.[18]

As further support for the *Chenery* principle, Judge Ambro quoted the following statement from the Supreme Court's *State Farm*[19] decision: ''It is well-established that an agency's action must be upheld, if at all, on the basis articulated by the agency itself.''[20] He did not quote the statement that immediately precedes that sentence — a statement that appears repeatedly in later decisions applying the *Chenery* principle: ''The courts may not accept appellate counsel's *post hoc* rationalizations for agency actions.''[21]

Thus, as Judge Ambro's dissent makes clear, no matter how persuasive the reasons offered by Justice Department lawyers in defending an agency action before the appellate court,[22] the *Chenery* principle dictates that the agency action cannot be upheld on the basis of those reasons unless it can be shown that they are the same reasons the agency itself relied on in making its decision. The rationale for this principle was expressed very clearly in the Supreme Court's second *Chenery* opinion:

> When the case was first here, we emphasized a simple but fundamental rule of administrative law. That rule is to the effect 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. If those grounds are inadequate or improper, the court is powerless to affirm the administrative action by substituting what it considers to be a more adequate or proper basis. To do so would propel the court into the

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[13]631 F.3d at 127 (Ambro, J., dissenting). For another discussion of Judge Ambro's dissent, see Steve R. Johnson, ''*Mayo* and the Future of Tax Regulations,'' *Tax Notes*, Mar. 28, 2011, p. 1547, *Doc 2011-3829*, or *2011 TNT 60-5*.

[14]*Id.* at 127-128. Judge Ambro's citation to a nontax case applying *Chevron* provides an answer to those in the tax community who have reacted to the Supreme Court's *Mayo* decision as leaving them with no guidance on the meaning of either step one or step two. *Chevron* was decided in 1984, and there is more than ample guidance on the application of *Chevron*'s two steps outside the tax area.

[15]5 U.S.C. section 706(2)(A).

[16]631 F.3d at 128.

[17]*Id.*

[18]*Id.* (citing and quoting *SEC v. Chenery Corp*, 318 U.S. 80, 87 (1943) (*Chenery I*)) (''The grounds upon which an administrative order must be judged are those upon which the record discloses that its action was based.''). I have discussed the *Chenery* principle in two prior articles: Smith, ''Omissions from Gross Income and the *Chenery* Rule,'' *Tax Notes*, Aug. 16, 2010, p. 763, *Doc 2010-16074*, *2010 TNT 158-3*; and Smith, ''*Mayo* and *Chenery*: Too Much of a Shift in Rationale?'' *Tax Notes*, Oct. 25, 2010, p. 454, *Doc 2010-21077*, *2010 TNT 207-12*.

[19]*Motor Vehicle Manufacturers Ass'n Inc. v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983).

[20]*Id.* at 50 (quoted at 631 F.3d 127).

[21]463 U.S. at 50 (using language borrowed from *Burlington Truck Lines Inc. v. United States*, 371 U.S. 156, 168 (1962)).

[22]Judge Ambro made clear that he did not find the reasons provided by the Justice Department and relied on by the Seventh and Third circuits majority persuasive in this case in any event — a conclusion with which I agree.

domain which Congress has set aside exclusively for the administrative agency.[23]

As discussed in a prior article, the foregoing rationale ties the *Chenery* rule closely to *Chevron*, and particularly to step two of *Chevron*.[24] Under *Chevron*, if a matter of statutory interpretation involves an issue on which a court determines Congress did not have a clear intent, the choice among reasonable or permissible alternatives in resolving that issue of statutory interpretation represents what the above quotation from the second *Chenery* decision refers to as ''a determination or judgment which [the] administrative agency alone is authorized to make.'' The reviewing court's task is to evaluate whether the agency's choice was reasonable.

If, in evaluating the agency's action, the court considered reasons other than those on which the agency relied, it would not be evaluating the choice made by *the agency*. Instead, as described in the second *Chenery* decision, the court would be propelled ''into the domain which Congress has set aside exclusively for the administrative agency.''

As noted in the first *Chenery* decision, ''if an order is valid only as a determination of policy or judgment which the agency alone is authorized to make and which it has not made, a judicial judgment cannot be made to do service for an administrative judgment.''[25] Thus, Judge Ambro's reason for disagreeing with the majority was based on very well-established administrative law principles.

State Farm

Judge Ambro's dissent cited *State Farm* only as providing further support for the *Chenery* principle. *State Farm*'s strong reiteration of the *Chenery* principle, and its confirmation that the principle applies not only to agency adjudication but also to agency rulemaking, are unquestionably important aspects of the *State Farm* opinion. Nevertheless, it is usually cited not for those points, but as the landmark Supreme Court decision that provides content for the APA's arbitrary and capricious standard.

While *Chevron* is unquestionably by far the most prominent judicial landmark in the administrative law landscape, *State Farm* is clearly also an extremely important landmark in that landscape. Although *State Farm* and the arbitrary and capricious standard are rarely cited in tax cases, parties challenging agency actions outside the tax context almost always assert a violation of the arbitrary and capricious standard as an element (if not the sole element) of their case.[26]

The following passage from *State Farm* is most often cited as providing guidance on the meaning of the arbitrary and capricious standard:

> The scope of review under the ''arbitrary and capricious'' standard is narrow and a court is not to substitute its judgment for that of the agency. Nevertheless, the agency must examine the relevant data and articulate a satisfactory explanation for its action including a ''rational connection between the facts found and the choice made.'' *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962). In reviewing that explanation, we must ''consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment.'' *Bowman Transportation, Inc. v. Arkansas-Best Freight System, Inc.* [419 U.S. 281], at 285 [(1974)]; *Citizens to Preserve Overton Park v. Volpe* [401 U.S. 402], at 416 [(1971)]. Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise. The reviewing court should not attempt itself to make up for such deficiencies; we may not supply a reasoned basis for the agency's action that the agency itself has not given. *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947). We will, however, ''uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned.'' *Bowman Transportation, Inc. v. Arkansas-Best Freight System, Inc.*, supra, at 286. See also *Camp v. Pitts*, 411 U.S. 138, 142-143 (1973) (*per curiam*).[27]

Thus, to satisfy the arbitrary and capricious standard, the agency must articulate a satisfactory explanation for its action, so a reviewing court can determine whether the decision was based on a

[23] *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947) (*Chenery II*).

[24] Smith, ''*Mayo* and *Chenery*,'' *supra* note 18, at 458-459. As noted there, the connection between the *Chenery* principle and step two of *Chevron* is discussed in Kevin M. Stack, ''The Constitutional Foundations of *Chenery*,'' 116 *Yale L.J.* 952, 1005-1006 (2007).

[25] *Chenery I*, 318 U.S. at 88.

[26] This generalization can be confirmed by an examination of the decisions issued by the D.C. Circuit, but the generalization holds true in other circuits as well, for example, in challenges to agency action based on environmental issues, which are frequently brought in the Ninth and Tenth circuits.

[27] 463 U.S. at 43 (alterations added).

consideration of the relevant factors. Consequently, if the agency relied on factors that Congress did not intend it to consider, or if the agency entirely failed to consider an important aspect of the problem, its rule would be considered arbitrary and capricious.

Later in the opinion, the Court reemphasized the requirement that an agency must explain the reason for its decision: ''We have frequently reiterated that an agency must cogently explain why it has exercised its discretion in a given manner, and we reaffirm this principle again today.''[28] The Court concluded that the agency in *State Farm* had not satisfied the explanation requirement: ''In these cases, the agency's explanation for [its action] is *not* sufficient to enable us to conclude that the [action] was the product of reasoned decisionmaking.''[29]

While challenges to agency action under the arbitrary and capricious standard are often based on assertions that the agency's reasoning (as revealed in the explanation required by *State Farm*) is flawed or deficient, it is at least as common for a challenge to be based on an assertion that the agency's *explanation of its reasoning* was inadequate.[30] Thus, case law on the arbitrary and capricious standard amply supports Judge Ambro's conclusion that the lack of an explanation by Treasury and the IRS is a significant defect in the section 6015(f) regulation.

State Farm and *Chevron* Step Two

As noted above, there is a close connection between the *Chenery* principle and step two of the *Chevron* test. Correspondingly, there is also a close connection between the *State Farm* arbitrary and capricious standard and step two of *Chevron*. In explaining why the agency's decision was reasonable, the *Chevron* Court relied on the conclusion that ''the agency considered the matter in a detailed and reasoned fashion.''[31]

A recent decision by the D.C. Circuit illustrates the close relationship between *Chevron* step two and the arbitrary and capricious standard:

> At *Chevron* step two we defer to the agency's permissible interpretation, *but only if the agency has offered a reasoned explanation for why it chose that interpretation.* After all, we defer to an agency's statutory interpretations not only because Congress has delegated law-making authority to the agency, but also because that agency has the expertise to produce a reasoned decision. If an agency fails or refuses to deploy that expertise — for example, by simply picking a permissible interpretation out of a hat — it deserves no deference.[32]

In prior cases as well, the D.C. Circuit has made clear the close connection between the arbitrary and capricious standard and step two of *Chevron*.[33] A conclusion reached by an agency cannot be considered ''reasonable'' as required by *Chevron* step two unless it is the product of the same type of reasoned decision-making process that is required by *State Farm* and the arbitrary and capricious standard. Moreover, just as a contemporaneous explanation by the agency of the reasons for its decision is necessary for a reviewing court to determine whether the decision was based on reasoned

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[28]*Id.* at 48-49 (citations omitted).

[29]Id. at 52 (emphasis in original; alterations added).

[30]*See, e.g.*, *Arrington v. Daniels*, 516 F.3d 1106, 1114 (9th Cir. 2008) (''The Bureau failed to set forth a rationale for its decision. . . . This failure renders the Bureau's final rule invalid under the APA.''); *Ctr. for Biol. Divsty. v. Nat'l Highway Traffic Safety Admin.*, 538 F.3d 1172, 1202 (9th Cir. 2008) (''NHTSA simply did not, 'examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made'''); *Utah Envtl. Cong. v. Troyer*, 479 F.3d 1269, 1288 (10th Cir. 2007) (''consistent with . . . *Chenery*, we may not affirm the project approvals on a 'basis . . . [not] . . . set forth [in the record] with such clarity as to be understandable'' (alterations in original)); *Ky. Wwys. All. v. Johnson*, 540 F.3d 466, 492 (6th Cir. 2008) (''The EPA's decision document . . . fails to aim its analysis at the legally operative question''); *Yale-New Haven Hosp. v. Leavitt*, 470 F.3d 71, 85, 86 (2d Cir. 2006) (''The Secretary also fails to explain how adoption of a *per se* coverage standard comports with congressional purposes''; ''Because the Secretary acted arbitrarily and capriciously under section 706(2)(A) in promulgating the 1986 Manual Provision, we conclude that it is invalid and unenforceable''); *Owner-Operator Indep. Drivers Ass'n Inc. v. Fed. Motor Carrier Safety Admin.*, 494 F3d 188, 206 (D.C. Cir. 2007) (''the agency's failure of explanation renders the restart provision arbitrary and capricious''); *Shays v. FEC*, 414 F.3d 76, 102 (D.C. Cir. 2005) (''the FEC has given no rational justification for [the three rules], as required by the APA's arbitrary and capricious standard'').

[31]467 U.S. at 865.

[32]*Village of Barrington v. STB*, No. 09-1002, slip op. at 19-20 (D.C. Cir. March 15, 2011) (citations omitted; emphasis added).

[33]*See, e.g.*, *Rettig v. PBGC*, 744 F.2d 133, 156 (D.C. Cir. 1984) (For purposes of applying *Chevron* step two, the agency ''must provide some basis in the record for us to conclude that the agency 'considered the matter in a detailed and reasoned fashion.'''); *Gen. Instrument Corp. v. FCC*, 213 F.3d 724, 732 (D.C. Cir. 2000) (''We have recognized that an arbitrary and capricious claim and a *Chevron* step two argument overlap, and because of that we have not been sticky as to whether an argument in the area of overlap is characterized as a *Chevron* step two claim or as an arbitrary and capricious challenge.''); *Shays v. FEC*, 528 F.3d 914, 924 (D.C. Cir. 2008) (''The next issue is whether the FEC's decision . . . fails *Chevron* step two review or violates the APA. As our cases explain, these inquiries overlap.''); *Northpoint Tech. Ltd. v. FCC*, 412 F.3d 145, 151 (D.C. Cir. 2005) (''The inquiry at the second step of *Chevron* overlaps analytically with a court's task under the Administrative Procedure Act.'').

decision-making, the same type of contemporaneous explanation is necessary for the court to determine whether the agency's decision-making was ''reasonable.''

The leading administrative law treatise states: ''It seems apparent that step two of *Chevron* is *State Farm*.''[34] Thus, it was entirely proper for Judge Ambro, in applying *Chevron* step two, to make use of the reasoned explanation requirement that is more often associated with *State Farm* and the arbitrary and capricious standard.

Fox Television

In a decision two years ago, *FCC v. Fox Television Stations Inc.*,[35] the Supreme Court reaffirmed the vitality of *State Farm* and clarified its application. The Court began its discussion by noting that under the arbitrary and capricious standard as interpreted by *State Farm*, ''we insist that an agency 'examine the relevant data and articulate a satisfactory explanation for its action.'''[36] The Court also referred to ''the requirement that an agency provide reasoned explanation for its action''[37] and ''the requirement of reasoned decision-making.''[38] Thus, the Court clearly reaffirmed that the requirements of *State Farm* have lost none of their force.

Fox Television clarified *State Farm* by rejecting the position taken by some courts of appeals that changes in agency policy should be subjected to a more demanding standard under arbitrary and capricious review than agency policies adopted for the first time: ''Our opinion in *State Farm* neither held nor implied that every agency action representing a policy change must be justified by reasons more substantial than those required to adopt a policy in the first instance.''[39]

In post-*Mannella* filings in the Second, Fourth, Sixth, and Ninth circuits — where cases are pending on the same issue — the Justice Department has contended that for purposes of the *State Farm* requirement of a reasoned explanation by the agency, ''an agency must articulate a basis only for changing course, not for taking a position in the first instance, as was done here.''[40] In light of the *Fox Television* decision, that contention is clearly incorrect. By clarifying that agency changes in position are not subject to a higher standard under *State Farm* than agency positions adopted for the first time, *Fox Television* also made clear that *State Farm* is not limited to agency changes in position, but that the reasoned explanation requirement also applies to agency positions adopted for the first time.

Dissent's Argument Not Made by Taxpayer

Judge Ambro's reasoning regarding the failure by Treasury and the IRS to explain their reasons, and the consequence of that failure under *Chevron* step two, was not based on any arguments made by the taxpayer in *Mannella* or on any considerations identified by the Tax Court opinions. However, the taxpayer's brief in the Fourth Circuit *Jones* case made the *Chenery* argument before *Mannella* was decided,[41] and it is possible that Judge Ambro (or one of his clerks) saw that brief, which is easily available through the federal courts' PACER system.

The *Mannella* majority opinion did not address the reasoning set forth in Judge Ambro's dissent regarding Treasury and the IRS's failure to provide a contemporaneous explanation for imposing the two-year limit on section 6015(f) claims. The majority may have been troubled that the dissent's central focus was a line of argument that had not been raised by the taxpayer.

Nevertheless, the taxpayer was the prevailing party in the trial court, and it is clear from one of the *Chenery* decisions that a trial court decision can be affirmed on any basis that properly supports that court's result. The first *Chenery* decision contrasted the principle it articulated for judicial review of agency action with the established principle for the affirmance of trial court holdings:

> In confining our review to a judgment upon the validity of the grounds upon which the Commission itself based its action, we do not disturb the settled rule that, in reviewing the decision of a lower court, it must be affirmed if the result is correct ''although the lower court relied upon a wrong ground or gave a wrong reason.''[42]

Application to Other Cases

The principles expressed in Judge Ambro's dissent in *Mannella* obviously have relevance in the tax context well beyond the specific question of

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[34]1 Richard J. Pierce Jr., *Administrative Law Treatise*, section 3.6 at 219 (5th ed. 2010).

[35]129 S.Ct. 1800 (2009).

[36]*Id.* at 1810.

[37]*Id.* at 1811.

[38]*Id.* at 1814.

[39]*Id.* at 1810.

[40]Letter dated Jan. 31, 2011, *Coulter v. Commissioner*, No. 10-680 (2d Cir.); letter dated Jan. 31, 2011, *Jones v. Commissioner*, No. 10-1985 (4th Cir.); letter dated Jan. 31, 2011, *Buckner v. Commissioner*, No. 10-2056 (6th Cir.); Reply Brief for the Appellant at 23, *Payne v. Commissioner*, No. 10-72855 (9th Cir. Mar. 8, 2011).

[41]Brief for the Appellee at 45-46, *Jones v. Commissioner*, No. 10-1985 (4th Cir. Dec. 7, 2010) (citing Smith, ''*Mayo* and *Chenery*,'' *supra* note 18; and Stack, *supra* note 24).

[42]*Chenery I*, 318 U.S. at 88.

whether the two-year limit for section 6015(f) claims is valid. They potentially apply in any case in which the preamble to proposed or final tax regulations does not provide the type of explanation of the agency reasoning that the arbitrary and capricious standard and *State Farm* require.

In this regard, it is far more common for the preambles to include detailed descriptions of how the provisions in the regulations operate than to provide explanations of why the IRS and Treasury adopted the particular provisions they did. While an explanation of those reasons is sometimes given, more often it is not.

An explanation of how the provisions of proposed and final regulations operate while undoubtedly useful to taxpayers and their advisers is no substitute for the very different type of explanation required by the arbitrary and capricious standard. Moreover, the type of explanation required by the arbitrary and capricious standard would be useful not only to courts in evaluating the validity of the regulations, but also to taxpayers and their advisers in understanding the meaning of the rules that have been adopted, entirely apart from any possible challenges to those rules.

Even though the preambles would seem to provide an opening to a challenge based on the agencies' inadequate explanations of their reasons for adopting the particular rules in the regulations, *State Farm* and the arbitrary and capricious standard are rarely cited in tax cases. This is presumably another example of ''tax myopia.''[43] *State Farm* has been cited in only a handful of Tax Court cases, primarily in a series of cases in the early to mid-1990s that dealt with a change in the regulations regarding the interaction between net operating loss carrybacks and a bad-debt deduction for a special category of taxpayers.[44]

It is to be hoped that the focus on administrative law issues within the tax community that has been prompted by the Supreme Court's *Mayo* decision, the various court cases dealing with the regulations treating overstated basis as producing an omission from gross income, and the cases dealing with the two-year limit on section 6015(f) claims will draw attention to the potential for challenging tax regulations under *State Farm* and the arbitrary and capricious standard. As noted in *Mayo*, there is no reason tax law should not be subject to the same administrative law principles that apply in every other area.[45]

Conclusion

Judge Ambro's dissent in *Mannella* provides additional powerful reasons why the two-year limit applied by regulation to claims for relief under section 6015(f) should be invalidated. It relies on well-established principles of administrative law that agency action can be upheld by the courts only on the basis of the reasons for the action that were

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[43]*See* Paul L. Caron, ''Tax Myopia, or Mamas Don't Let Your Babies Grow Up to Be Tax Lawyers,'' 14 *Va. Tax Rev.* 517 (1994). In a previous article, I described tax myopia as ''the insularity of the tax community in mistakenly believing that developments in the law outside of tax have no potential relevance for tax and can therefore be ignored.'' Smith, ''Omissions From Gross Income and Retroactivity,'' *Tax Notes*, Apr. 4, 2011, p. 57, *Doc 2011-4748, 2011 TNT 65-7*. *See also* Richard E. Levy and Robert L. Glicksman, ''Agency-Specific Precedents,'' 89 *Tex. L. Rev.* 499 (2011) (discussing the ''silo effect'' in which particular agencies and the parties and professional advisors who are focused on those agencies tend to ignore developments in the law that do not relate directly to the particular agency).

[44]The first decision in this series, *Pacific First Federal Savings Bank v. Commissioner*, 94 T.C. 101 (1990), held the change in the regulations invalid without any reference to *State Farm* or the arbitrary and capricious standard. In *Peoples Federal Savings & Loan Ass'n v. Commissioner*, 948 F.2d 289 (6th Cir. 1991), an appeal of a Tax Court decision that had applied the holding of *Pacific First*, the Sixth Circuit reversed the Tax Court, holding the

(Footnote continued in next column.)

change in the regulations valid under *Chevron*. The taxpayers in that case argued that the IRS and Treasury had not provided the explanation required by *State Farm* and the arbitrary and capricious standard, but the Sixth Circuit held there had been a sufficient explanation. 948 F.2d at 303.

In *Georgia Federal Bank v. Commissioner*, 98 T.C. 105 (1992), the Tax Court, in a reviewed opinion, considered the Sixth Circuit decision but decided to adhere to the Tax Court's prior position, concluding, after an analysis that included citations to *State Farm*, that the explanation accompanying the change in the regulations was not ''a cogent, persuasive explanation.'' 98 T.C. at 118.

In 1992 the Ninth Circuit reversed the Tax Court's decision in *Pacific First*. 961 F.2d 800 (9th Cir. 1992). On remand, 101 T.C. 117 (1993), *Doc 93-8197*, *93 TNT 158-6*, the Tax Court addressed the separate question whether the change in the regulations had properly been made retroactive, and it concluded, after an analysis that included citations to *State Farm*, that the retroactive effect of the change was proper. In 1994 the Seventh Circuit reversed a Tax Court decision on the issue of the validity of the change in the regulations. *Bell Federal Savings & Loan Ass'n v. Commissioner*, 40 F.3d 224 (7th Cir. 1994), *Doc 94-10505*, *94 TNT 229-11*.

In *Central Pennsylvania Savings Ass'n v. Commissioner*, 104 T.C. 384 (1995), the Tax Court, in a reviewed opinion, considered the issue once again, and concluded that it should accede to the decisions of the courts of appeals that had reversed prior Tax Court decisions on the issue. The majority opinion did not cite *State Farm*.

For a recent tax decision in which *State Farm* and the arbitrary and capricious standard were raised, see the Court of Federal Claims decision in *Dominion Resources Inc. v. United States*, No. 08-195T (Fed. Cl. Feb. 25, 2011), *Doc 2011-4145*, *2011 TNT 40-11*. Because I am one of the attorneys who represented the taxpayer in *Dominion Resources*, a discussion of that case (or other pending cases presenting this issue in which I am involved) is inappropriate.

[45]131 S.Ct. at 713 (''We are not inclined to carve out an approach to administrative review good for tax law only.'').

articulated by the agency when it made its decision. As Judge Ambro correctly points out, in the absence of any explanation, the reviewing court is unable to determine whether the agency's decision-making was reasoned and reasonable, as required by both step two of *Chevron* and by the APA's arbitrary and capricious standard as interpreted in *State Farm*. Moreover, the principles relied on by Judge Ambro have potential application for tax regulations far beyond the specific issue of the validity of the two-year time limit on claims for relief under section 6015(f).