

The APA's Reasoned-Explanation Rule and IRS Deficiency Notices

By Patrick J. Smith



Patrick J. Smith

Patrick J. Smith is a partner at Ivins, Phillips & Barker in Washington.

The D.C. Circuit's confirmation in *Cohen* that the Administrative Procedure Act (APA) applies to the IRS raises the question of what that application will mean. The APA's arbitrary and capricious standard for judicial review of agency action incorporates a requirement that agencies provide contemporaneous reasoned explanations for their actions, which clearly applies to IRS regulations. This report contends that the APA's reasoned explanation requirement also applies to IRS deficiency notices. Pre-APA case law held that IRS deficiency notices need not contain any explanation, but this conclusion has not been reexamined in light of the act's arbitrary and capricious standard. The pre-APA conclusion that IRS deficiency notices need no explanation cannot stand when reconsidered in light of the APA's reasoned explanation requirement.

The APA's arbitrary and capricious standard for judicial review of agency action incorporates a requirement that agencies provide contemporaneous reasoned explanations for their actions, which clearly applies to IRS regulations. This report contends that the APA's reasoned explanation requirement also applies to IRS deficiency notices. Pre-APA case law held that IRS deficiency notices need not contain any explanation, but this conclusion has not been reexamined in light of the act's arbitrary and capricious standard. The pre-APA conclusion that IRS deficiency notices need no explanation cannot stand when reconsidered in light of the APA's reasoned explanation requirement.

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Introduction

The D.C. Circuit's *en banc* decision in *Cohen v. United States*¹ confirmed that the Administrative Procedure Act (APA) applies to the IRS no less than to any other federal agency,² relying in part on the Supreme Court's more general holding in *Mayo Foundation for Medical Education and Research v. United States*³ that there is no basis for creating a special set of administrative law rules for tax cases different from the rules that apply for federal agencies other than the IRS.⁴ This aspect of *Cohen* raises the issue of what consequences result from applying the APA to the IRS. The APA's arbitrary and capricious standard for judicial review of agency action is one area in which applying the APA to the IRS has consequences.⁵

There can be no doubt that the APA's arbitrary and capricious standard applies to judicial review of IRS regulations, when validity of the regulations is challenged by taxpayers either in refund suits or in Tax Court proceedings.⁶ Somewhat less clear is the potential application of the APA's arbitrary and capricious standard to IRS actions *other than* the issuance of regulations.

Cohen involves a challenge under the APA's arbitrary and capricious standard to an IRS notice that established a procedure for refunding a tax the IRS acknowledged had been collected improperly. However, that challenge is also based on the position that because of its content, the notice was, in effect, substantive rulemaking. In any event, the D.C. Circuit's *en banc Cohen* decision did not address the issue of precisely *how* the APA applies to the IRS, other than to hold that the IRS has no exemption from application of the APA; thus, for purposes of the specific issue in *Cohen*, it is subject

¹650 F.3d 717 (D.C. Cir. 2011), *Doc 2011-14478*, 2011 TNT 128-14.

²See Patrick J. Smith, "D.C. Circuit: 'The IRS Is Not Special,'" *Tax Notes*, Aug. 29, 2011, p. 907, *Doc 2011-17230*, or 2011 TNT 168-7.

³131 S. Ct. 704 (2011), *Doc 2011-609*, 2011 TNT 8-10.

⁴See Smith, "Life After Mayo: Silver Linings," *Tax Notes*, June 20, 2011, p. 1251, *Doc 2011-10520*, or 2011 TNT 119-2.

⁵5 U.S.C. section 706(2)(A).

⁶See Smith, "Mannella, State Farm, and the Arbitrary and Capricious Standard," *Tax Notes*, Apr. 25, 2011, p. 387, *Doc 2011-6811*, or 2011 TNT 80-6; Smith, "Life After Mayo," *supra* note 4, at 1256-1257.

to free-standing suit under the APA, outside the normal proceedings of refund suits and Tax Court deficiency proceedings if those normal proceedings do not provide an adequate remedy and a free-standing suit under the APA is not barred by the Anti-Injunction Act or the Declaratory Judgment Act.⁷

The APA arbitrary and capricious standard requires agencies, including the IRS, to provide reasoned explanations for their actions.⁸ This principle clearly applies in judicial review of IRS regulations, but I focus in this report on its application to the IRS in contexts *other than* the issuance of regulations.

The most common form of IRS action that can be subject to judicial review is the issuance of a deficiency notice.⁹ If a taxpayer wishes to obtain judicial review of an IRS deficiency notice without first paying the tax and suing for a refund in either district court or the Court of Federal Claims, the taxpayer may file a petition in the Tax Court within 90 days.¹⁰

The specific question this report addresses is whether deficiency notices are subject to the arbitrary and capricious standard's reasoned-explanation requirement. Case law addressing what content must be included in a deficiency notice under section 6212(a), based on decisions from the 1930s, holds that the IRS is not required to provide *any* explanation of the reasons for its determination that a deficiency exists. However, this case law seems to be in conflict with the Supreme Court's

holding in *State Farm*¹¹ that under the APA's arbitrary and capricious standard, agencies are required to provide reasoned explanations for their actions at the time the decision to take a particular action is made.¹²

Although *State Farm* applied the APA's arbitrary and capricious standard in the context of agency rulemaking, it is clear that neither the APA arbitrary and capricious standard nor *State Farm* is limited to agency action that takes the form of rulemaking.¹³ Thus, the reasoned-explanation requirement set forth in *State Farm* as one of the requirements imposed on agency decision-making by the APA arbitrary and capricious standard is likewise not limited to rulemaking.

However, no case holding that an explanation is not required in a deficiency notice has addressed whether an explanation is required under *State Farm* and the APA's arbitrary and capricious standard. These cases have instead addressed only what content is required in a deficiency notice under the relevant provisions of the code, and the relevant provisions of the code are considerably less demanding in this respect than the APA's arbitrary and capricious standard. The question remains whether the reasoning supporting the result reached in these cases can be reconciled with the application of the APA's reasoned-explanation requirement.

A separate body of case law addresses how the APA applies in other respects in Tax Court deficiency proceedings. This body of case law likewise does not consider how the APA's arbitrary and capricious standard might apply to deficiency notices, but instead principally addresses whether Tax Court proceedings are limited to the administrative record created at the IRS or are instead properly conducted using trials *de novo*.

⁷See Smith, "The IRS Is Not Special," *supra* note 2.

⁸See Smith, "Mannella," *supra* note 6, at 390-391. In that article, I pointed out that IRS regulations are particularly vulnerable to challenge under the arbitrary and capricious standard's reasoned-explanation rule because the preambles to IRS regulations generally do not offer any explanation why the particular rules were adopted. The lack of explanations is in fact specifically authorized in a provision of the Internal Revenue Manual. IRM section 32.1.5.4.7.3.1 provides: "In the Explanation of Provisions section, the drafting team should describe the substantive provisions of the regulation in clear, concise, plain language without restating particular rules contained in the regulatory text. *It is not necessary to justify the rules that are being proposed or adopted or alternatives that were considered*" (emphasis added). Thus the IRS's instructions to its personnel who are responsible for drafting regulations specifically states that it is acceptable to draft preambles in a manner that violates the APA's arbitrary and capricious standard.

⁹Section 6212(a) provides that "if the Secretary determines that there is a deficiency in respect of any tax imposed by subtitles A or B or chapter 41, 42, 43, or 44 he is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail."

¹⁰Section 6213(a) provides in part that "within 90 days . . . after the notice of deficiency authorized in section 6212 is mailed . . . the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency."

¹¹*Motor Vehicle Manufacturers Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983).

¹²*Id.* at 43 ("The agency must . . . articulate a satisfactory explanation for its action"); *id.* at 48-49 ("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") (citations omitted).

¹³For example, *FCC v. Fox Television Stations Inc.*, 129 S. Ct. 1800 (2009), did not involve rulemaking, yet there was no suggestion in the case that the APA's arbitrary and capricious standard and its reasoned-explanation rule were inapplicable for that reason. See also *Judulang v. Holder*, No. 10-694 (U.S. 2011) and *Town of Barnstable v. FAA*, 659 F.3d 28, 34, 36 (D.C. Cir. 2011) (applying APA reasoned explanation rule in a case not involving rulemaking). *Judulang* also confirmed that the APA's arbitrary and capricious standard is equivalent to the second step of the two-step test for determining the validity of agency regulations set forth in *Chevron*.

Although this case law contains dictum suggesting the APA does not apply to Tax Court proceedings, the actual holdings of these cases apply the much narrower principle that Tax Court deficiency proceedings are conducted using trials *de novo* rather than being limited to a consideration of the administrative record. This would not be the case under currently controlling Supreme Court authority in most other situations involving judicial review of agency action. This narrower principle regarding the use of trials *de novo* is entirely compatible with the conclusion that the APA in general applies to Tax Court deficiency proceedings.

More specifically, the application of the arbitrary and capricious standard to deficiency notices is consistent with the conclusion that Tax Court deficiency proceedings are properly conducted as trials *de novo*, because both modes of review are specifically set forth in section 706(2) of the APA concerning standards of judicial review of agency action, and it is clear that — with one limited exception that does not apply here — the standards of review in section 706(2) are cumulative rather than mutually exclusive. This report contends that the reasoning in the relevant case law supporting the conclusion that no explanation is required in deficiency notices under the relevant provisions of the code cannot sustain the conclusion that no explanation is required when the APA's arbitrary and capricious standard is brought to bear on the issue.

The significant effect that administrative law can have on tax law is evidenced by instances in which general administrative law principles are applied to tax issues for the first time and the result supports a reversal of long-established tax principles. There have been repeated calls for an end to "tax myopia."¹⁴ Perhaps that time has finally arrived, thanks in part to *Mayo*.

Overview of the APA

The APA, enacted in 1946, is codified in two separate groups of provisions in Title 5 of the U.S. Code, sections 551 to 559 and sections 701 to 706. The first group of provisions imposes requirements directly concerning agency procedures. The second group concerns judicial review of agency actions. These judicial review provisions impose additional requirements on agency action indirectly through the scope of review provisions in 5 U.S.C. section 706.

¹⁴See, e.g., Paul L. Caron, "Tax Myopia, or Mamas Don't Let Your Babies Grow Up To Be Tax Lawyers," 14 *Va. Tax Rev.* 517 (1994); Kristin E. Hickman, "The Need for *Mead*: Rejecting Tax Exceptionalism in Judicial Deference," 90 *Minn. L. Rev.* 1537 (2006).

Title 5 U.S.C. section 551 provides definitions that apply for purposes of the first group of provisions.¹⁵ Section 553 provides requirements relating to the use of notice and comment procedures in agency rulemaking. The rulemaking requirements in section 553 are clearly applicable to the issuance of tax regulations.¹⁶ Section 554 provides rules relating to any agency "adjudication required by statute to be determined on the record after opportunity for an agency hearing," with some specified exceptions. There is no such requirement in the Internal Revenue Code for deficiency notices, so this provision is not directly relevant for Tax Court deficiency proceedings. However, one of the exceptions in section 554 is for "a matter subject to a subsequent trial of the law and the facts *de novo* in a court."

Title 5 U.S.C. section 556 provides rules relating to agency hearings concerning matters required by either section 553 or section 554 to be conducted on the record. Because neither IRS rulemaking nor IRS deficiency determinations are required to be conducted on the record, this section is not directly relevant here. Section 557 provides rules relating to agency decisions after hearings required to be conducted under section 556.

Title 5 U.S.C. section 559 contains two extremely important provisions relating to the effect of (1) the APA on requirements that are more stringent than those in the APA and that either existed before the enactment of the APA or are prescribed outside the APA and (2) later legislation on the requirements of the APA. Under the first of these two provisions, the provisions of the APA "do not limit or repeal additional requirements imposed by statute or otherwise recognized by law." The second important provision in section 559 states that a "subsequent statute may not be held to supersede or modify" the requirements of the APA "except to the extent that it does so expressly."¹⁷

The APA's second group of sections, relating to judicial review of agency action, are more directly relevant to the current issue than the provisions in the first group of sections, other than section 559. Title 5 U.S.C. section 701(a) provides in part that the judicial review sections apply "according to the

¹⁵U.S.C. section 552 currently consists for the most part of the later enacted Freedom of Information Act.

¹⁶However, there is an ongoing issue whether the IRS's practice of issuing temporary regulations without prior notice and comment violates section 553.

¹⁷In connection with the issue of whether the IRS's practice of issuing temporary regulations without prior notice and comment violates section 553 of the APA, the IRS argues that the specific references to temporary regulations in section 7805(e) override section 553 of the APA. This argument is not likely to prevail in light of the second rule in section 559.

provisions thereof, except to the extent that — (1) statutes preclude judicial review; or (2) agency action is committed to agency discretion by law.” Section 702, headed “Right of review,” provides in part that a “person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review thereof.”

Title 5 U.S.C. sections 703 and 704 deal with the form of judicial review and the nature of agency action that is subject to judicial review. Title 5 U.S.C. section 706 sets forth six different standards of review courts are to apply in reviewing agency action. These standards of review include both the arbitrary and capricious standard and the use of trials *de novo*. This section is of central importance to the issue addressed in this report.

Trials De Novo in Tax Court

A significant body of case law exists addressing the relationship between the APA and Tax Court proceedings. Although this case law does not specifically address the potential applicability of the APA’s arbitrary and capricious standard to deficiency notices, it does address whether deficiency proceedings in the Tax Court should be limited to consideration of material in the administrative record or should be conducted as trials *de novo*.

Supreme Court precedent generally requires trial courts to consider only material in the administrative record in most situations in which courts review agency action. But the case law addressing the relationship between the APA and Tax Court proceedings concludes that Tax Court deficiency proceedings are properly conducted as trials *de novo*, that they are not limited to the administrative record, and that this conclusion is consistent with the APA.

One important issue is whether applying the APA’s reasoned explanation requirement to deficiency notices could be inconsistent with the conclusion that Tax Court deficiency proceedings are conducted as trials *de novo*. Although there is dictum in some opinions erroneously suggesting the APA has *no application* to Tax Court deficiency proceedings, the reasoning supporting the conclusion that Tax Court deficiency proceedings are conducted as trials *de novo* is not inconsistent with the conclusion that the APA’s arbitrary and capricious standard applies to IRS deficiency notices.

The cases containing the most thorough consideration of the application of the APA to Tax Court proceedings have been brought under section 6015(e), reviewing IRS denials of innocent spouse

relief under section 6015(f),¹⁸ specifically *Ewing v. Commissioner*¹⁹ and *Porter v. Commissioner*.²⁰ The conclusions reached in these Tax Court decisions on this point were endorsed by the Eleventh Circuit in *Commissioner v. Neal*.²¹ Both Tax Court decisions were reviewed *en banc*, and in both cases, there were multiple opinions (one concurrence and two dissents in *Ewing* and four concurrences and one dissent in *Porter*).

Although the Tax Court’s jurisdiction over these innocent spouse cases under section 6015(e) is separate from the Tax Court’s general jurisdiction over deficiency proceedings under sections 6213(a) and 6214(a), the analysis in these cases of how the APA applies to innocent spouse proceedings began by considering how the APA applies in Tax Court deficiency proceedings.

The issue in both cases was whether, in determining if a taxpayer was entitled to innocent spouse relief, the Tax Court may properly consider at trial evidence that was not included in the administrative record. The IRS argued in both cases that under the APA, courts reviewing agency action are ordinarily limited to review of the administrative record. But in both cases, the court held that proceedings under section 6015(e) to review innocent spouse relief determinations under section 6015(f) are not restricted to consideration of material in the administrative record.

The court concluded in both cases that this “record rule” does not apply to section 6015(e) proceedings because it was well-established that in deficiency proceedings the Tax Court conducts a trial *de novo*. The court held it was reasonable to conclude that when Congress gave the Tax Court separate jurisdiction under section 6015(e) to review innocent spouse determinations, Congress’s intention was that the same *de novo* approach would apply in innocent spouse proceedings as in deficiency proceedings.

Although there was some dissent in these cases from the conclusion that a trial *de novo* is the proper approach under section 6015(e) in section 6015(f) cases, there was no dissent from the conclusion that a trial *de novo* is the proper approach in deficiency

¹⁸For discussion of the provisions of section 6015(f), see Smith, “Gaps in the Seventh Circuit’s Reasoning in *Lantz*,” *Tax Notes*, Sept. 27, 2010, p. 1375, Doc 2010-18745, or 2010 TNT 186-19; and Smith, “*Mannella*,” *supra* note 6.

¹⁹122 T.C. 32 (2004), Doc 2004-1771, 2004 TNT 19-20, *rev’d and vacated*, 439 F.3d 1009 (9th Cir. 2006), Doc 2006-3915, 2006 TNT 40-8.

²⁰130 T.C. 115 (2008), Doc 2008-10827, 2008 TNT 96-12.

²¹557 F.3d 1262 (11th Cir. 2009), Doc 2009-2978, 2009 TNT 26-14.

cases.²² The various opinions in these two cases, when taken together, provide a comprehensive discussion of the reasons why that conclusion is consistent with the APA. It is that analysis that is relevant for purposes of the present discussion.

The opinions in these cases that concluded that a trial *de novo* is appropriate for Tax Court deficiency proceedings have come to a number of common conclusions. The first point supporting the conclusion that deficiency proceedings in the Tax Court are properly based on a trial *de novo* is that in the list of six standards of review set forth in section 706(2) of the APA, the sixth standard (section 706(2)(F)) specifically contemplates that in some circumstances a court reviewing agency action will conduct a trial *de novo*. Under this standard of review, “the reviewing court shall . . . hold unlawful and set aside agency action, findings, and conclusions found to be . . . unwarranted by the facts to the extent that the facts are subject to a trial *de novo* by the reviewing court.”

Similarly, 5 U.S.C. section 554(a)(1), dealing with agency adjudications, likewise contemplates that under some circumstances, matters initially decided by an agency will be “subject to a subsequent trial of the law and the facts *de novo* in a court.” Section 554(a)(1) provides as follows:

a. This section applies, according to the provisions thereof, in every case of adjudication required by statute to be determined on the record after opportunity for an agency hearing, except to the extent that there is involved

. . . .

1. a matter subject to a subsequent trial of the law and the facts *de novo* in a court.

Although 5 U.S.C. section 554(a) would not apply to the issuance of a deficiency notice because this action is not required by statute to be conducted on the record after opportunity for an agency hearing, the exception in section 554(a)(1) for “a matter subject to a subsequent trial of the law and the facts *de novo* in a court” confirms the general conclusion that in some circumstances, judicial review of agency action takes the form of a trial *de novo*.

However, neither 5 U.S.C. section 706(2)(F) nor 5 U.S.C. section 554(a)(1) nor any other provision of the APA specifically prescribes the circumstances under which a trial *de novo* will be required or permitted. Thus, under currently applicable Supreme Court authority, the determination of when a

trial *de novo* is appropriate for reviewing agency action is made under legal principles outside the text of the APA.

The second point supporting the propriety of trials *de novo* in Tax Court deficiency proceedings relates to section 559 of the APA, which states that the provisions of the APA “do not limit or repeal additional requirements imposed by statute or otherwise recognized by law.” Although none of the opinions in *Ewing* or *Porter* discussed the Supreme Court’s decision in *Dickinson v. Zurko*,²³ that decision is highly relevant to the application of section 559.

The issue in *Zurko* was whether judicial review of decisions by the Patent and Trademark Office under a “clearly erroneous” standard was “recognized by law” when the APA was enacted so as to be applicable as a more stringent “additional requirement” under 5 U.S.C. section 559 in lieu of the less demanding standard that would otherwise be applicable under the APA. The Court concluded it was not sufficiently clear that the “clearly erroneous” standard was recognized as the applicable standard in 1946 when the APA was enacted in the context of judicial review of decisions by the Patent and Trademark Office to warrant application of section 559.

In contrast, as discussed in various opinions in *Ewing* and *Porter*, it seems clear that the application of *de novo* review in Tax Court deficiency proceedings was well-established in 1946 so as to warrant application of the 5 U.S.C. section 559 exception for “additional requirements . . . recognized by law.” Another important point distinguishing the issue in *Zurko* from the issue relating to trials *de novo* in Tax Court deficiency proceedings is that the alternative “clearly erroneous” standard that was rejected in *Zurko* is not specifically contemplated by the APA, whereas the use of trials *de novo* is specifically contemplated by 5 U.S.C. section 706(2)(F).

The third point supporting the use of trials *de novo* in Tax Court deficiency proceedings is that both sections 703 and 704 of the APA contemplate that in many cases, judicial review of agency action will occur in proceedings established outside the provisions of the APA itself. Section 703 provides in part that “the form of proceeding for judicial review is the special statutory review proceeding relevant to the subject matter in a court specified by statute or, in the absence or inadequacy thereof, any applicable form of legal action.” Clearly, a Tax Court deficiency proceeding is “the special statutory review proceeding relevant to the subject matter in a

²²Currently pending in the Supreme Court is a case addressing the somewhat analogous issue of when, in district court challenges to denials of a patent application by the Patent and Trademark Office, new evidence may be introduced that was not presented to the PTO. See *Kappos v. Hyatt*, No. 10-1219 (U.S.).

²³527 U.S. 150 (1999).

court specified by statute” for the review of IRS deficiency determinations.

Title 5 U.S.C. section 704 provides in part that “agency action made reviewable by statute and final agency action for which there is no other adequate remedy in a court are subject to judicial review.” IRS deficiency determinations clearly represent “agency action made reviewable by statute” in light of the provisions in the Internal Revenue Code providing for Tax Court review of IRS deficiency determinations.

Read in conjunction with 5 U.S.C. section 559, these provisions confirm that law outside the APA that provides for agency review of agency action is not disturbed by the APA, particularly when that extra-APA law provides review that is more stringent than required by the provisions of the APA itself.²⁴

As discussed in *Ewing* and *Porter*, the committee reports on the APA provide specific support for the conclusion that it was intended that under the APA, Tax Court deficiency proceedings would be conducted as trials *de novo*. The sections of the committee reports drafted by the Senate Judiciary and the House Judiciary committees dealing with the trial *de novo* standard of review in 5 U.S.C. section 706(2)(F) contain nearly identical language relating to the applicability of trials *de novo* in both Tax Court deficiency proceedings and district court refund suits:

In other cases, the test is whether there has been a statutory administrative hearing of the facts which is adequate and exclusive for purposes of review. Thus, where adjudications such as tax assessments are not made upon an administrative hearing and record, contests may involve a trial of the facts in the Tax Court or the United States district courts.²⁵

Finally, there are code provisions dealing with Tax Court procedure that specifically contemplate the Tax Court will conduct trials *de novo*. Section 7453 provides that “the proceedings of the Tax Court shall be conducted . . . in accordance with the rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia.” Rules of evidence would not be neces-

sary in proceedings not involving factual findings. Section 7459(b) provides that “the Tax Court shall report in writing all its findings of fact, opinions, and memorandum opinions.” It would make no sense to require a written report of “findings of fact” if the Tax Court did not have the authority to make “findings of fact.”

The foregoing considerations, particularly when taken in combination, leave no doubt that the use of trials *de novo* in Tax Court deficiency proceedings is proper and entirely compatible with the provisions of the APA. However, some of the opinions in *Ewing* and *Porter* include overly broad statements that go beyond the conclusion that trials *de novo* are proper and assert that the APA *has no application* to deficiency proceedings in the Tax Court. These overly broad statements in *Ewing* and *Porter* are based on similarly overbroad statements in the much earlier Fourth Circuit opinion *O’Dwyer v. Commissioner*.²⁶

Nevertheless, the conclusion that deficiency proceedings in the Tax Court are not limited to the administrative record is not equivalent to the conclusion that the APA has no application to those proceedings.²⁷ It is unnecessary to conclude the APA has no application to deficiency proceedings in order to conclude those proceedings are not limited to the administrative record, and the conclusion that deficiency proceedings involve a trial *de novo* does not lead to the conclusion that the APA has no application to deficiency proceedings.

This is particularly true because 5 U.S.C. section 706(2)(F) specifically contemplates the use of trials *de novo* in judicial review of agency action in some circumstances, and because 5 U.S.C. sections 703 and 704 specifically contemplate that the judicial review of agency action to which sections 701 through 706 apply will in many cases occur in proceedings established outside the APA itself.

Moreover, the conclusion that the APA applies to Tax Court deficiency proceedings does not mean the Tax Court is subject to greater constraints in its review of IRS deficiency determinations than would be the case if the APA did not apply. What it means instead is that *the IRS, not the Tax Court*, is subject to greater constraints through application of the APA to IRS deficiency determinations than would be the case if the APA did not apply. This is the point of 5 U.S.C. section 559. Section 559 makes clear that the

²⁴See, e.g., *Bowen v. Massachusetts*, 487 U.S. 879, 903 (1988) (“When Congress enacted the APA to provide a general authorization for review of agency action in the district courts, it did not intend that general grant of jurisdiction to duplicate the previously established special statutory procedures relating to specific agencies”).

²⁵S. Rep. No. 79-752 (1945), reprinted in *Administrative Procedure Act: Legislative History, 1944-1946*, at 214; see also H.R. Rep. No. 79-1980 (1946), reprinted in *Administrative Procedure Act: Legislative History, 1944-1946*, at 279.

²⁶266 F.2d 575, 580 (4th Cir. 1959) (Tax Court is not a “reviewing court” within the meaning of section 706 of the APA: “We agree that the Tax Court is not subject to the Administrative Procedure Act”).

²⁷Tax Court Judges James S. Halpern and Mark V. Holmes reached similar conclusions in their dissenting opinion in *Ewing*, 122 T.C. at 59-61 (Halpern and Holmes, JJ., dissenting).

purpose of the APA is to impose *additional* restrictions on agency action, but not to *eliminate* any restrictions that would apply to agency actions apart from the APA that are in any way more restrictive than the requirements imposed by the APA itself.

Overton Park

Although the various considerations supporting the conclusion that trials *de novo* in Tax Court deficiency proceedings are consistent with the APA are compelling, it should be noted that the state of the law regarding when trials *de novo* are appropriate in judicial review of agency action under the APA is far from satisfactory. This situation results from the fact that the Supreme Court decision that continues to guide the law in this area did an unsatisfactory job of supporting its conclusions.

The background to this Supreme Court decision begins with the fact that both the Senate Judiciary and the House Judiciary committees' reports on the APA clearly indicated that the use of trials *de novo* in judicial review of agency actions would occur whenever the relevant statute did not require the agency action to be made on the basis of a hearing and record. When agency action is required by statute to be made on the basis of a hearing and record, the "substantial evidence" standard of review in 5 U.S.C. section 706(2)(E) applies, rather than the trial *de novo* standard of review set forth in 5 U.S.C. section 706(2)(F).

The House Judiciary Committee report stated in part as follows concerning the provisions in 5 U.S.C. section 706(2)(F) relating to trials *de novo*:

The sixth category, respecting the establishment of facts upon trial *de novo*, would require the reviewing court to determine the facts in any case of adjudication not subject to sections 7 and 8 or otherwise required to be reviewed exclusively on the record of a statutory agency hearing. It would also require the judicial determination of facts in connection with rule making or any other conceivable form of agency action to the extent that the facts were relevant to any pertinent issues of law presented. . . . *In short, where a rule or order is not required by statute to be made after opportunity for agency hearing and to be reviewed solely upon the record thereof, the facts pertinent to any relevant question of law must be tried and determined de novo by the reviewing court respecting either the validity or application of such rule or order — because facts necessary to the determination of any relevant question of law must be determined of record somewhere and, if*

Congress has not provided that an agency shall do so then the record must be made in court.²⁸

It is hard to miss the clear principle expressed in this quotation from the committee report. However, the Attorney General's Manual on the APA (Attorney General's Manual),²⁹ which was prepared shortly after the enactment of the APA, contended that both committee reports were simply mistaken in stating that a trial *de novo* is required in judicial review of agency action whenever the agency action is not required by statute to be made on the basis of a hearing and record.³⁰

The Attorney General's Manual contended the committee reports were mistakenly reflecting an early draft of the legislation in which the rule described in the committee reports was explicitly provided. The Attorney General's Manual contended that the fact that this provision had been dropped from the enacted legislation meant the committee reports were wrong.

The Supreme Court has cited the Attorney General's Manual on other issues as a legitimate tool in interpreting the APA,³¹ although it is hard to see how

²⁸H.R. Rep. No. 79-1980 (1946), reprinted in *Administrative Procedure Act: Legislative History, 1944-1946*, at 279-280 (emphasis added); see also S. Rep. No. 79-252 (1945), reprinted in *Administrative Procedure Act: Legislative History, 1944-1946*, at 214. The references to sections 7 and 8 in the quoted passage refer to the original section numbers for the APA as it was originally enacted. What was originally section 7 is now section 556 and what was originally section 8 is now section 557. This same long paragraph in each committee report also contained the explicit references to Tax Court proceedings referred to earlier.

²⁹*Attorney General's Manual on the Administrative Procedure Act* (1947).

³⁰*Id.* at 109.

³¹The principal citation on this point is the landmark administrative law decision in *Vermont Yankee Nuclear Power Corp. v. Nat. Res. Def. Council Inc.*, 435 U.S. 519 (1978), which described the Attorney General's Manual as "a contemporaneous interpretation previously given some deference by this Court because of the role played by the Department of Justice in drafting the legislation." *Id.* at 546. The problem with this description is that the two previous decisions cited in support of this proposition had nothing to do with either the APA or the Attorney General's Manual. One of the two cited decisions, *Power Reactor Dev. Co. v. Int'l Union of Elec., Radio and Machine Workers*, 367 U.S. 396 (1961), involved the Atomic Energy Act of 1954, and the discussion on the cited page, *id.* at 408, deferred to the position of the Atomic Energy Commission on the point at issue. The second cited decision, *United States v. Zucca*, 351 U.S. 91 (1956), related to the Immigration and Nationality Act of 1952. At least this case, in contrast to *Power Reactor*, related to deference given to the Attorney General, although neither case relates to the APA. Here, in connection with a much earlier immigration statute, dating to 1906, the Court deferred to a position expressed by the Attorney General "shortly after its enactment." *Id.* at 96. "In such circumstances, a contemporaneous construction of a statute by the officer charged with its enforcement is entitled to great weight." However, in contrast, the Justice

(Footnote continued on next page.)

that reliance is consistent with current understanding of the proper use of extrinsic materials in statutory interpretation or with current understanding of when deference to agency positions is appropriate. The Attorney General's Manual was written after the APA was enacted, in contrast to the congressional committee reports, and the use of post-enactment legislative history is generally disfavored. The Justice Department is not responsible for the enforcement of the APA, in contrast to the types of situations in which deference to agency interpretations is granted under *Chevron USA Inc. v. Natural Resources Defense Council Inc.*³² The Attorney General's Manual was not produced using any type of formal administrative procedures, in contrast to the usual types of situations in which *Chevron* applies under *United States v. Mead Corp.*³³ And the Justice Department is scarcely a neutral or unbiased party on issues concerning the scope of judicial review of agency action when it serves as the legal representative of agencies defending judicial challenges to agency action.³⁴

Although one might expect that this conflict between both committee reports and the Attorney General's Manual would lead the Supreme Court to carefully consider the question of when trials *de*

Department is in no way "charged with . . . enforcement" of the APA. Giving everyone involved the benefit of the doubt, presumably this clearly erroneous description in *Vermont Yankee* of these two prior cases represents an instance of what journalistic corrections often describe as an "editing error." However, the erroneous citation of these two earlier cases was repeated without any correction, along with the language from *Vermont Yankee*, in *Chrysler Corp. v. Brown*, 441 U.S. 281, 302 n.31 (1979). See also, e.g., *Steadman v. SEC*, 450 U.S. 91, 102 n.22 (1981) (quoting *Vermont Yankee* on this point); *Darby v. Cisneros*, 509 U.S. 137, 148 n.10 (1993) (repeating the language from *Vermont Yankee*); *Norton v. Utah Wilderness Alliance*, 542 U.S. 55, 63 (2004) (describing the Attorney General's Manual as "a document whose reasoning we have sometimes found persuasive").

³²467 U.S. 837, 842 (1984) (*Chevron* applies "when a court reviews an agency's construction of the statute which it administers").

³³533 U.S. 218, 230 (2001) ("It is fair to assume generally that Congress contemplates administrative action with the effect of law when it provides for a relatively formal administrative procedure tending to foster the fairness and deliberation that should underlie a pronouncement of such force").

³⁴For a forceful characterization of the Attorney General's Manual as an unreliable and biased document, particularly regarding the judicial review provisions, see John F. Duffy, "Administrative Common Law in Judicial Review," 77 *Tex. L. Rev.* 113, 119, 133 (1998) ("The Attorney General's Manual was a 'highly political document designed to minimize the impact of the new statute on executive agencies'; 'The Attorney General's Manual was a post-hoc attempt 'to create a record' that would influence future reviewing courts in interpreting that compromise," that is, the compromise reflected in the enactment of the APA). Duffy argues that for various reasons, including the influence of the Attorney General's Manual, courts have been very slow to give full effect to the APA's provisions relating to judicial review of agency action.

novo are appropriate in judicial review of agency action under the APA, the Court's analysis in *Citizens to Preserve Overton Park Inc. v. Volpe*³⁵ was lacking, at least as presented in the published opinion.

The Court's opinion in *Overton Park* included no discussion of the conflict between the committee reports and the Attorney General's Manual, no acknowledgment that the committee reports took an opposing position on the issue than the one announced in the opinion, and no acknowledgment of the position or analysis expressed in the Attorney General's Manual. Rather, the opinion included a conclusory statement of a rule (contrary to the rule described in the committee reports), supported only by a citation to the House Judiciary Committee report (that did not even cite to a particular page) to the effect that trials *de novo* would be appropriate in only two narrowly circumscribed situations:

De novo review of whether the Secretary's decision was "unwarranted by the facts" is authorized by section 706(2)(F) in only two circumstances. First, such *de novo* review is authorized when the action is adjudicatory in nature and the agency factfinding procedures are inadequate. And, there may be independent judicial factfinding when issues that were not before the agency are raised in a proceeding to enforce nonadjudicatory agency action. H. R. Rep. No. 1980, 79th Cong., 2d Sess.³⁶

The foregoing represents the entirety of the discussion of this point in *Overton Park*, and yet it is this discussion that courts continue to rely on as the undisputed and unquestioned law on the issue of when trials *de novo* are appropriate in judicial review of agency action under the APA.³⁷ It might

³⁵401 U.S. 402 (1971).

³⁶*Id.* at 415.

³⁷See Gordon G. Young, "Judicial Review of Informal Agency Action on the Fiftieth Anniversary of the APA: The Alleged Demise and Actual Status of *Overton Park*'s Requirement of Judicial Review 'On the Record,'" 10 *Admin. L. J. Am. U.* 179, 211, 212 (1996) ("The Committee Report . . . is more easily read as suggesting that all informal administrative action should be reviewed not on the record before the agency, but *de novo*, on a record made in the reviewing court's proceedings"; "The Supreme Court has, in effect, stood the original meaning of the APA on its head in this respect"). For a more general criticism of some of the Supreme Court's decisions on the APA, see Robert A. Anthony, "The Supreme Court and the APA: Sometimes They Just Don't Get It," 10 *Admin. L. J. Am. U.* 1 (1996). Subsequent Supreme Court decisions cite the holding in *Overton Park* on this point as settled law, despite the unsatisfactory justification for this holding. See, e.g., *Camp v. Pitts*, 411 U.S. 138, 141-142 (1973). Likewise, court of appeals decisions typically merely cite *Overton Park* for this proposition without any discussion. The Fifth Circuit's decision in *Sierra Club v. Peterson*, 185 F.3d 349 (5th Cir.

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be the case that the analysis in the Attorney General's Manual on this point was correct, and that the statements in both committee reports to the effect that trials *de novo* were the default rule in the absence of specific statutory evidence to the contrary were incorrect.

However, the Supreme Court in *Overton Park* did not engage in the analysis set forth in the Attorney General's Manual. Instead, the Court referred only generally to the House Judiciary Committee report as the sole support for the conclusion that trials *de novo* are applicable only in two narrowly limited sets of circumstances, despite the committee report having taken a much different position on this issue from the rule announced in *Overton Park*. It seems hard to imagine that the Supreme Court, in deciding *Overton Park*, overlooked the passages in the committee reports cited above, and it is disconcerting to think the Court reached its decision on trials *de novo* based purely on a policy decision grounded in a reluctance to burden the judicial system with an obligation to conduct trials *de novo* in large numbers of cases rather than on the basis of an attempt to determine congressional intent.

This poor justification for the holding in *Overton Park* on such a fundamental administrative law issue leaves this area of the law in an unsatisfactory place that clearly warrants more careful reconsideration by the Supreme Court. The principle that the force of *stare decisis* is particularly strong in cases of statutory interpretation should not apply for such a foundational statute as the APA. Nevertheless, as discussed above, the conclusion that Tax Court deficiency proceedings are properly conducted as trials *de novo* is sufficiently strongly grounded that it is not put at risk by the otherwise unsatisfactory state of the law in this area.³⁸

1999), is unusual in its explicit recognition that *Overton Park* completely changed the law in this regard:

While the early years of the APA witnessed many such trials [*de novo*] where a full administrative hearing had not taken place, the Supreme Court's decision in *Citizens to Preserve Overton Park v. Volpe*, 401 U.S. 402 (1971), drastically changed this practice. *Overton Park* eliminated *de novo* review in all cases except those [covered by the two specific exceptions recognized in *Overton Park*]. As a result of *Overton Park*, however, *de novo* review of agency adjudications has virtually ceased to exist.

185 F.3d at 367-368 (some citations omitted).

³⁸Another Supreme Court decision that is sometimes cited in support of the principle that judicial review of agency action under the APA is normally limited to review of the administrative record, rather than through a trial *de novo*, is *United States v. Carlo Bianchi & Co.*, 373 U.S. 709, 715 (1963). "Indeed, in cases where Congress has simply provided for review, without setting forth the standards to be used or the procedures to be followed, this Court has held that consideration is to be confined to the administrative record and that no *de novo* proceeding may be

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APA Judicial Review Standards 'Cumulative'

Thus, the conclusion that Tax Court deficiency proceedings are properly conducted using trials *de novo* is entirely consistent with the provisions of the APA. The next question is whether the APA's arbitrary and capricious standard is applicable to the IRS action that is reviewed in Tax Court deficiency proceedings, namely, the issuance by the IRS of a deficiency notice, and whether any inconsistency exists between the conclusion that Tax Court deficiency proceedings are properly conducted as trials *de novo* and the application of the APA's arbitrary and capricious standard to deficiency proceedings.

Title 5 U.S.C. section 706(2) lists six different standards for the scope of review by a court of agency action:

To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall —

....

1. hold unlawful and set aside agency action, findings, and conclusions found to be —

A. arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;

B. contrary to constitutional right, power, privilege, or immunity;

C. in excess of statutory jurisdiction, authority, or limitations, or short of statutory right;

D. without observance of procedure required by law;

E. unsupported by substantial evidence in a case subject to sections 556 and 557 of this title or otherwise reviewed on the record of an agency hearing provided by statute; or

F. unwarranted by the facts to the extent that the facts are subject to trial *de novo* by the reviewing court.

An important issue that is relevant to the question of what standards of review apply in Tax Court deficiency proceedings is the relationship among

held." The problem with reliance on this decision as being relevant to the APA is that the statute at issue in the case was not the APA, the majority opinion did not apply the APA, and the cases cited in support of the statement quoted above predated the APA.

these six different standards of review. In this regard, it is clear that Tax Court deficiency proceedings are subject to the standard of review set forth in 5 U.S.C. section 706(2)(F), under which the reviewing court will “hold unlawful and set aside agency action, findings, and conclusions found to be . . . unwarranted by the facts to the extent that the facts are subject to trial *de novo* by the reviewing court.” However, the issue is whether the applicability of the “trial *de novo*” standard set forth in section 706(2)(F) to Tax Court deficiency proceedings means the other standards of review set forth in section 706(2), and in particular, the arbitrary and capricious standard set forth in section 706(2)(A), are thereby inapplicable.

When one of the standards of review in 5 U.S.C. section 706(2) is applicable in a particular type of judicial review of agency action, it does not necessarily follow that *none of the other* standards of review in section 706(2)(A) can apply to that type of judicial review. One relevant aspect of *Overton Park* is much more firmly grounded in the actual text of the APA than the case’s holding on when trials *de novo* are appropriate. *Overton Park* made clear that the first four standards set forth in 5 U.S.C. sections 706(2)(A), (B), (C), and (D) are applicable *in all cases* of judicial review of agency action:

In all cases agency action must be set aside if the action was “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law” or if the action failed to meet statutory, procedural, or constitutional requirements. 5 U.S.C. sections 706(2)(A), (B), (C), (D).³⁹

In contrast, the standards set forth in 5 U.S.C. sections 706(2)(E) (“substantial evidence”) and (F) (“trial *de novo*”) apply only in specifically described separate sets of circumstances.⁴⁰ The standards in sections 706(2)(E) and (F) are mutually exclusive of one another, but these are the only standards of review in section 706(2) that have this relationship. The D.C. Circuit recently reiterated that “the arbitrary and capricious standard governs review of *all* proceedings that are subject to challenge under the APA.”⁴¹

More specifically, in *Bowman Transportation Inc. v. Arkansas-Best Freight System Inc.*,⁴² the Supreme Court held that the same court review of a particular agency action could be subject to both the “substantial evidence” standard of review in sec-

tion 706(2)(E) and the arbitrary and capricious standard of review in section 706(2)(A): “The District Court properly concluded that, though an agency’s finding may be supported by substantial evidence . . . it may nonetheless reflect arbitrary and capricious action.”⁴³

Moreover, in an opinion written while he was a judge on the D.C. Circuit, Supreme Court Justice Antonin Scalia expressed the same point, namely that the standards of review set forth in 5 U.S.C. section 706(2) “are cumulative” rather than mutually exclusive:

The “scope of review” provisions of the APA, 5 U.S.C. section 706(2), are cumulative. Thus, an agency action which is supported by the required substantial evidence may in another regard be “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law” — for example, because it is an abrupt and unexplained departure from agency precedent. Paragraph (A) of subsection 706(2) — the “arbitrary or capricious” provision — is a catchall, picking up administrative misconduct not covered by the other more specific paragraphs.⁴⁴

Although both the foregoing passage by Justice Scalia and the Supreme Court opinion in *Bowman Transportation* use the same example of a particular instance of judicial review of agency action applying both the “substantial evidence” standard of 5 U.S.C. section 706(2)(E) and the arbitrary and capricious standard of section 706(2)(A), the same principle should also apply in cases in which judicial review of agency action is subject to the “trial *de novo*” standard of section 706(2)(F) rather than the “substantial evidence” standard of section 706(2)(E). Thus, it should be no less true that a particular instance of judicial review of agency action could be subject to both the “trial *de novo*” standard of section 706(2)(F) and the arbitrary and capricious standard of section 706(2)(A).⁴⁵

³⁹*Id.* at 284.

⁴⁴*Ass’n of Data Processing Serv. Org. Inc. v. Bd. of Governors of the Federal Reserve System*, 745 F.2d 677, 683 (D.C. Cir. 1984) (Scalia, J.). See also, e.g., *Olenhouse v. Commodity Credit Corp.*, 42 F.3d 1560, 1575 n.25 (10th Cir. 1994) (citing this passage in *Ass’n of Data Processing*).

⁴⁵See Richard J. Pierce Jr., Volume 2 *Administrative Law Treatise*, section 11.4 at 1022 (“Since APA section 706 requires courts to review all agency actions through application of the arbitrary and capricious test, all actions must satisfy the reasoned decision-making component of that test independent of the adequacy of the agency’s evidentiary support for its findings”).

³⁹401 U.S. at 413-414 (emphasis added).

⁴⁰*Id.* at 414.

⁴¹*Menkes v. Dept. of Homeland Security*, 637 F.3d 319, 329 (D.C. Cir. 2011) (emphasis in original).

⁴²419 U.S. 281 (1974).

Likewise, it should also be no less true that an agency action might violate the arbitrary and capricious standard even though the action might otherwise be upheld under a trial *de novo* standard of review. Clearly the general standards set forth in 5 U.S.C. section 706(2)(B), (C), and (D) would be applicable in trials *de novo*, so the same conclusion should also apply regarding the arbitrary and capricious standard in section 706(2)(A).

This does not mean that conclusions of law or fact by the IRS would be upheld in deficiency proceedings merely because those conclusions satisfied the arbitrary and capricious standard, without the need for a trial *de novo*. Title 5 U.S.C. section 559 makes clear that the APA does not supplant more restrictive requirements that were already in place when the APA was enacted in 1946, and the Tax Court's well-established trial *de novo* approach for deficiency proceedings that was in place in 1946 required the court to apply *de novo* review to both facts and law. Also, the introductory language in section 706 specifically provides that "the reviewing court shall decide all relevant questions of law."

Application of the arbitrary and capricious standard in Tax Court deficiency proceedings would provide an *additional* potential basis on which the IRS deficiency determination could be *overturned*, not a basis on which the IRS deficiency determination could be *upheld* in situations in which that determination *would not* be upheld under the Tax Court's trial *de novo* approach but for application of the arbitrary and capricious standard. Thus, for the IRS to prevail in a Tax Court deficiency proceeding, the IRS would need to prevail *not only* under the arbitrary and capricious standard, *but also* under a trial *de novo* review.

Case Law on Deficiency Notices

Another consideration in determining whether the APA's reasoned-explanation requirement applies to IRS deficiency notices is the substantial body of case law holding that a deficiency notice is not required to contain *any explanation* of how the deficiency was determined and that a deficiency notice is sufficient if it contains nothing more than (1) a statement that the IRS has determined there is a deficiency, (2) the amount of the deficiency, (3) the identity of the taxpayer, and (4) the year to which the deficiency relates. Most of the cases contain no analysis but instead simply cite earlier cases that asserted and applied the same principles.⁴⁶

⁴⁶The line of citations in many of these cases can be traced back to *Commissioner v. Stewart*, 186 F.2d 239, 241 (6th Cir. 1951). Although this case postdates the APA, all of the cases it relies on precede the APA. For prior commentary on the case law relating

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The cases in which these principles were originally established predate the APA and were apparently based on the fact that the terms of the predecessor provisions to section 6212(a) did not require any type of explanation.⁴⁷ Similarly, section 6212(a) requires no such explanation.

However, none of the cases asserting and applying these principles after the enactment of the APA contain any analysis of the potential impact of the APA's arbitrary and capricious standard on the issue of whether a deficiency notice must contain an explanation of the reasons supporting the IRS determination that a deficiency exists. Because none of the cases holding that deficiency notices are not required to contain any explanation addresses the potential application of the APA arbitrary and capricious standard, they are not controlling if the APA were to be raised.

Two post-APA Ninth Circuit decisions contain more extensive discussions of the foregoing principles relating to the content of deficiency notices than is usual, but with no consideration of the possible effect of the APA's arbitrary and capricious standard. In *Scar v. Commissioner*,⁴⁸ the Ninth Circuit held section 6212(a) was violated when the notice of deficiency on its face showed the purported deficiency determination was based on information relating to a tax shelter that was completely unrelated to the taxpayers against whom the deficiency was asserted.

The majority noted "section 6212(a) 'authorize[s]' the sending of a deficiency notice '[i]f the Secretary determines that there is a deficiency.'"⁴⁹ The majority quoted from two early decisions of the Board of Tax Appeals pointing out that the word "determines" has a meaning that is relevant in the application of section 6212(a). "By its very definition and etymology the word 'determination' irresistibly connotes consideration, resolution, conclusion, and judgment"⁵⁰:

The statute clearly contemplates that before notifying a taxpayer of a deficiency and hence

to the content of deficiency notices, see, e.g., Mary Ferrari, "'Was Blind, But Now I See' ('Or What's Behind the Notice of Deficiency and Why Won't the Tax Court Look?)" 55 *Alb. L. Rev.* 407 (1991); Leandra Lederman, "'Civilizing Tax Procedure: Applying General Federal Learning to Statutory Notices of Deficiency,'" 30 *U.C. Davis L. Rev.* 183 (1996).

⁴⁷See, e.g., *Olsen v. Helvering*, 88 F.2d 650, 651 (2d Cir. 1937); *Commissioner v. Forest Glen Creamery Co.*, 98 F.2d 968, 971 (7th Cir. 1938); *Ventura Consol. Oil Fields v. Rogan*, 86 F.2d 149, 153 (9th Cir. 1936); *Commissioner v. New York Trust Co.*, 54 F.2d 463, 465-466 (2d Cir. 1931).

⁴⁸814 F.2d 1363 (9th Cir. 1987).

⁴⁹*Id.* at 1368 (emphasis in original).

⁵⁰*Terminal Wine Co. v. Commissioner*, 1 B.T.A. 697, 701 (1925), quoted at 814 F.2d 1368.

before the Board can be concerned, a determination must be made by the Commissioner. This must mean a thoughtful and considered determination that the United States is entitled to an amount not yet paid.⁵¹

The Ninth Circuit majority in *Scar* concluded “the ‘determination’ requirement of section 6212(a) has substantive content”⁵²:

Section 6212(a) of the Internal Revenue Code requires the Commissioner to determine that a deficiency exists before issuing a notice of deficiency. Because the Commissioner’s purported notice of deficiency revealed on its face that no determination of tax deficiency had been made with regard to the Scars’ 1978 tax year, it did not meet the requirements of section 6212(a). Accordingly, the Tax Court should have dismissed the action for lack of jurisdiction.⁵³

A dissenting opinion in *Scar* was filed by Judge Cynthia Holcomb Hall, who had previously served as a judge on the Tax Court. Judge Hall cited “the rule that a deficiency notice need not contain any explanation whatsoever”⁵⁴:

The majority fails to grasp the function of the deficiency notice. It is nothing more than “a jurisdictional prerequisite to a taxpayer’s suit seeking the Tax Court’s redetermination of [the Commissioner’s] determination of the tax liability.” “The notice is only to advise the person who is to pay the deficiency that the Commissioner means to assess him; anything that does this unequivocally is good enough.” Nothing more is required as a predicate to Tax Court jurisdiction. . . .

Therefore, the deficiency notice is effectively the taxpayer’s “ticket” to the Tax Court. This “ticket” gives the taxpayer access to the only forum where he can litigate the relevant tax issue without first paying the tax assessed. If a properly-addressed deficiency notice states the amount of the deficiency, the taxable year involved, and notifies the taxpayer that he has 90 days from the date of mailing in which to file a petition for redetermination, then the notice is valid.⁵⁵

Hall concluded that “alternative remedies exist to protect the taxpayer’s interests besides dismissal

of the case for lack of jurisdiction,”⁵⁶ because, for example, “the presumed correctness of the Commissioner’s deficiency notice disappears if the deficiency is arbitrary or capricious, since the burden of proof then shifts to the Commissioner.”⁵⁷ Although Hall used the phrase “arbitrary or capricious” here, there is no indication this was meant as a reference to section 706(2)(A) of the APA. There was no citation to the APA, and the case authority cited in support of this proposition likewise did not cite the APA and used the phrases “arbitrary and excessive” or “arbitrary and erroneous” rather than “arbitrary or capricious.”

Two years after *Scar*, in *Clapp v. Commissioner*,⁵⁸ the Ninth Circuit held *Scar* was distinguishable, but also endorsed the principles expressed in Hall’s dissent in *Scar*:

Appellants’ argument for greater substantive review of the Commissioner’s “determination” mistakes the nature of the notice of deficiency. The notice of deficiency does not result in final liability on the part of taxpayer. If the taxpayer files a petition in the Tax Court, liability will be adjudicated prior to payment. The notice of deficiency merely hails the taxpayer into court. The Tax Court has as its purpose the redetermination of deficiencies, through a trial on the merits, following a taxpayer petition. It exercises *de novo* review. Issuing a notice of deficiency is in many ways analogous to filing a civil complaint.

It is true that the Tax Court considers the Commissioner’s determination presumptively correct, and places on the taxpayer the burden of going forward and the burden of persuasion. Yet, if the taxpayer establishes that the Commissioner’s determination is arbitrary, courts generally shift the burden onto the Commissioner, putting the Commissioner in the same position as a civil plaintiff. Given the function of the notice of deficiency, this is the proper remedy for arbitrariness. Courts do not invalidate the notice, but shift the burden to the Commissioner.

....

The existence of remedies for an inaccurate determination of deficiency makes greater substantive review of the Commissioner’s “determination” inappropriate. The courts carefully review administrative action for arbitrariness when an agency exercises final,

⁵¹*Couzens v. Commissioner*, 11 B.T.A. 1040, 1159 (1928) (quoted at 814 F.2d 1369).

⁵²814 F.2d at 1369.

⁵³*Id.* at 1370.

⁵⁴*Id.* at 1372 (Hall, J., dissenting).

⁵⁵*Id.* at 1372-1373 (citations and footnotes omitted).

⁵⁶*Id.* at 1375.

⁵⁷*Id.*

⁵⁸875 F.2d 1396 (9th Cir. 1989).

statutory decision-making authority, such as an agency rulemaking. In tax cases such as this, the Tax Court or U.S. district court review the Commissioner's decision on the merits *de novo*. Too detailed a substantive review of the Commissioner's threshold "determination," undertaken solely for purposes of exercising subject matter jurisdiction would be duplicative and burdensome on the courts and the Commissioner.⁵⁹

Although the policy-based analysis in Hall's dissent in *Scar* and in the opinion in *Clapp* is questionable, even apart from the potential application of the APA's arbitrary and capricious standard and that standard's reasoned-explanation requirement, this analysis clearly cannot stand against the application of the APA. The concept that a deficiency notice is a *benefit provided by the IRS* that is reflected in the description of a deficiency notice as a "ticket to the Tax Court" is not persuasive.⁶⁰

It is true that the ability to litigate a tax issue in the Tax Court rather than in a refund suit is often valued by taxpayers because Tax Court deficiency litigation, in contrast to refund litigation, does not require payment of the tax as a prerequisite to challenging the IRS determination. Nevertheless, it is not realistic to conclude this means the receipt of a deficiency notice from the IRS is a benefit provided to taxpayers by the IRS that excuses the IRS from including any substantive content in the deficiency notice. Giving taxpayers the ability to contest deficiency determinations in the Tax Court without first having to pay the tax is a policy decision *made by Congress* long ago, not a benefit conferred on taxpayers *by the IRS*.

The only meaningful comparison is between receiving a deficiency notice and not having to engage in any contest regarding the issue at all. Clearly, from this more realistic perspective, a deficiency notice is not in any reasonable sense a benefit provided by the IRS to the taxpayer who receives it, because the IRS cannot ordinarily assess or collect additional tax without first issuing a deficiency notice (unless the taxpayer affirmatively waives receiving one). It is not reasonable to view a defi-

ciency notice as a realistic alternative to any state of affairs other than not having to contest the issue at all.

Moreover, the fact that the Tax Court conducts a trial *de novo* is not a sufficient remedy for the failure of the IRS to provide a reasoned explanation in its deficiency notice. The burden on the taxpayer of having to engage in the costly process of a Tax Court deficiency proceeding cannot reasonably be viewed as any sort of proper remedy for the failure of the IRS to provide a reasoned explanation of its position in the deficiency notice.

In cases when that failure by the IRS might be a consequence of a failure by the taxpayer to cooperate with the IRS, an explanation of that fact in the deficiency notice might well be sufficient to satisfy the reasoned-explanation requirement. However, in cases when there has not been a lack of cooperation by the taxpayer, enforcement of a reasoned-explanation requirement would ensure that the IRS has developed a well-reasoned position before issuing a deficiency notice.

The enforcement of a reasoned-explanation requirement for deficiency notices would unquestionably result in cases that would conclude with no deficiency notice being issued, and thus the taxpayer would be spared the need to engage in a costly Tax Court deficiency proceeding but where, in the absence of an enforced reasoned-explanation requirement, a deficiency notice would have been issued. The existence of those cases makes clear that the availability of a trial *de novo* in the Tax Court is not an adequate remedy for failure by the IRS to provide a reasoned explanation in its deficiency notice.

The Tax Court has repeatedly held it will not "look behind" a deficiency notice through an examination of the procedures by which the IRS developed the deficiency notice.⁶¹ However, the enforcement of a reasoned-explanation requirement for the content of a deficiency notice would not require any "looking behind" the deficiency notice. That requirement involves nothing more than an examination of the face of the deficiency notice itself.

In any event, those policy-based considerations are irrelevant if the APA's arbitrary and capricious standard and its reasoned-explanation requirement apply to IRS deficiency notices. Moreover, those policy-based considerations are irrelevant in deciding if the arbitrary and capricious standard applies.

⁵⁹*Id.* at 1403.

⁶⁰The characterization of an IRS deficiency notice as a "ticket to the Tax Court" was not invented by Hall. This phrase has been used in approximately 100 cases, including one Supreme Court decision, *Commissioner v. Shapiro*, 424 U.S. 614, 630 n.12 (1976), many of them predating *Scar*. While unquestionably a memorable phrase, this characterization does not appear to have ever been defended or supported with any careful analysis.

⁶¹See, e.g., *Greenberg's Express Inc. v. Commissioner*, 62 T.C. 324, 327 (1974).

The rationale that because the Tax Court conducts a trial *de novo*, and that in particularly egregious cases the burden of proof will be shifted to the IRS, provides a justification for not requiring any explanatory content in a deficiency notice cannot be reconciled with the mandate in section 5 U.S.C. 706(2)(A) that “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” (emphasis added). The words “hold unlawful and set aside” cannot be reconciled with action by a reviewing court that falls short of “hold[ing] unlawful and set[ting] aside.”

Moreover, any attempt to apply on a blanket basis the harmless error rule found at the end of 5 U.S.C. section 706 (“due account shall be taken of the rule of prejudicial error”) on the basis that the taxpayer will learn what the IRS’s rationale is during the course of litigation cannot be reconciled with the fundamental principle incorporated in the arbitrary and capricious standard that “*post hoc* rationalizations” presented in the course of litigation over the propriety of agency action are an unacceptable substitute for the reasoned explanation the arbitrary and capricious standard requires the agency to provide at the time it takes its action.⁶²

The rationale offered by *Clapp* that “issuing a notice of deficiency is in many ways analogous to filing a civil complaint” was never sound, since a civil complaint containing the bare minimum amount of information the courts have required in a deficiency notice would be subject to being dismissed for failure to state a claim on which relief can be granted. Moreover, this rationale has become even more untenable in light of the heightened pleading requirements for complaints imposed by the Supreme Court in *Iqbal*⁶³ and *Twombly*.⁶⁴

Thus, the case law holding that IRS deficiency notices are not required to contain any explanation of the reasons supporting the deficiency determination is based ultimately on decisions predating the APA, and is likewise based solely on the provisions of the code relating to deficiency notices. None of the decisions applying this principle has ever considered the potential effect on the required content of a deficiency notice of the APA’s arbitrary and capricious standard and the reasoned-explanation requirement. When the APA is brought to bear on

the issue, the reasoning in these cases is clearly not sufficient to support the conclusion that no explanation is required.

Section 7522

An additional issue to consider is what effect the 1988 enactment of section 7522 might have had on how the APA’s arbitrary and capricious standard and that standard’s reasoned-explanation requirement applies to deficiency notices. The first sentence of section 7522(a) provides as follows:

Any notice to which this section applies shall describe the basis for, and identify the amounts (if any) of, the tax due, interest, additional amounts, additions to the tax, and assessable penalties included in such notice.

Section 7522 applies to three different categories of notices, including “any tax due notice or deficiency notice described in section 6155, 6212, or 6303,”⁶⁵ and thus applies to deficiency notices under section 6212. However, the second sentence of section 7522(a) provides as follows: “An inadequate description under the preceding sentence shall not invalidate such notice.”

Thus, although section 7522(a) requires deficiency notices, as well as other listed types of notices, to “describe the basis for” the deficiency, section 7522(a) also provides that there are no consequences for a violation of that requirement. Because of the lack of any penalty for noncompliance, it would be surprising if the enactment of section 7522 eliminated the phenomenon of deficiency notices being issued without explanations.

The issue that is relevant to the current discussion is whether this rule in section 7522(a) that there are no consequences for a violation of the section 7522(a) explanation requirement somehow nullifies the reasoned-explanation requirement of the APA’s arbitrary and capricious standard for deficiency notices. However, it is clear that because of section 559 of the APA, the enactment of section 7522 has no effect on the applicability of the APA’s arbitrary and capricious standard to deficiency notices.

Section 7522 does not refer to the APA, and thus does not satisfy 5 U.S.C. section 559’s requirement of an express statement for legislation after the APA to repeal any of its provisions. Moreover, section 7522 does not constitute the type of comprehensive regulatory scheme that the Supreme Court has held may supersede the requirements of the APA even without an express reference to it.⁶⁶ Thus, section

⁶²*State Farm*, 463 U.S. at 50 (“The courts may not accept appellate counsel’s *post hoc* rationalizations for agency action”).

⁶³*Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949-1950 (2009).

⁶⁴*Bell Atl. Corp. v. Twombly*, 550 U.S. 544 (2007).

⁶⁵Section 7522(b)(1).

⁶⁶*See Marcello v. Bonds*, 349 U.S. 302, 308-310 (1955).

7522 does not affect the applicability of the APA's reasoned-explanation rule to deficiency notices.

Is a Violation 'Jurisdictional'?

One final issue is whether a determination that an IRS deficiency notice lacks the reasoned explanation required under the APA's arbitrary and capricious standard means the Tax Court lacks jurisdiction over a deficiency proceeding, and what the consequences are of the resolution of that issue.

In a recent decision, *Napoliello v. Commissioner*,⁶⁷ the Ninth Circuit followed *Scar* and other cases in characterizing challenges to the validity of a deficiency notice as constituting challenges to the Tax Court's jurisdiction.⁶⁸ As the Ninth Circuit explained, success in that challenge would in many cases mean issuance of a new, proper deficiency notice would be barred by the statute of limitations, because an invalid deficiency notice does not suspend the running of the statute of limitations on assessment.⁶⁹

There is some question whether it is correct to say that if a deficiency notice is invalid the Tax Court lacks jurisdiction over the case, even though that has been the traditional formulation. In recent years, the Supreme Court has repeatedly emphasized that there has been a tendency on the part of courts, including the Supreme Court itself, to characterize statutory prerequisites to bringing suit as representing "jurisdictional" requirements without properly analyzing whether the requirements are genuinely jurisdictional. The Court has repeatedly characterized those decisions as "drive-by jurisdictional rulings" that carry no weight.⁷⁰

No such careful analysis has taken place regarding the issue of whether an invalid deficiency notice represents a jurisdictional defect. However, one factor that may weigh in favor of jurisdictional status is the fact that in contrast to the situation with refund suits, there is no provision in Title 28 of the U.S. Code granting the Tax Court jurisdiction over

deficiency proceedings. Instead, the only possible jurisdiction-granting provisions for Tax Court deficiency proceedings are in sections 6212, 6213, and 6214.

For this reason, it may be the case that an invalid deficiency notice does give rise to a jurisdictional issue. However, it is not necessarily the case that an invalid deficiency notice must attain the level of a jurisdictional defect to have significant consequences. As discussed above, 5 U.S.C. section 706(2)(A) requires that a reviewing court must "hold unlawful and set aside" agency action that violates the arbitrary and capricious standard.

A deficiency notice that is held "unlawful and set aside" because it violates the arbitrary and capricious standard would be invalid without regard to whether the violation of the arbitrary and capricious standard represented a jurisdictional violation. A statutory requirement for being in court can be mandatory without being jurisdictional. Thus, even if a determination that a deficiency notice violates the APA's arbitrary and capricious standard for lack of a reasoned explanation does not represent a jurisdictional defect, it should still have the same effect on issues such as the running of the statute of limitations against the IRS.

Conclusion

The APA's arbitrary and capricious standard applies to review in the Tax Court of IRS deficiency determinations. Under that standard, an agency must provide a reasoned explanation for its decisions at the time the decisions are made. The absence of the required reasoned explanation in an IRS deficiency notice requires a determination that the deficiency notice is invalid.

From a broader perspective, the fact that application of the APA to an issue of tax procedure that has seemed settled since the 1930s produces a result that is different from that settled answer illustrates the potential power of bringing the APA and general principles of administrative law to bear on tax issues that have not previously been considered from that perspective. It is clear that *Mayo's* unambiguous endorsement of the principle that the IRS is subject to the same administrative law principles that apply to all other federal agencies has been instrumental in making it possible to reach these conclusions.

⁶⁷655 F.3d 1060 (9th Cir. 2011), *Doc 2011-18098*, 2011 TNT 165-10.

⁶⁸*Id.* at 1063.

⁶⁹*Id.*

⁷⁰See Smith, "Is the Anti-Injunction Act Jurisdictional?" *Tax Notes*, Nov. 28, 2011, p. 1093, *Doc 2011-22319*, or 2011 TNT 229-7; Smith, "Life After *Mayo*," *supra* note 4, at 1258-1259.

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