The APA's Arbitrary and Capricious Standard and IRS Regulations

By Patrick J. Smith


Patrick J. Smith

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

This report expands on comments he made at the American Tax Policy Institute's March 1 conference, "Tax Law and Administrative Law: The Implications of *Mayo Foundation v. United States*," held in Washington. Smith would like to thank professor Ellen Aprill of Loyola School of Law, Los Angeles, for organizing the conference and for inviting him to participate, and the other panelists for their enlightening and thoughtful presentations.

The Supreme Court's *Mayo* decision and the D.C. Circuit's *Cohen* decision have made clear that principles of administrative law generally, and the Administrative Procedure Act (APA) in particular, apply to tax law and the IRS just as they do to all other federal agencies. The APA's arbitrary and capricious standard provides a powerful but seldom-used tool for taxpayers in challenging IRS regulations, because the IRS seems unaware of the requirements imposed by the standard and even instructs its personnel to draft preambles to regulations in a way that is inconsistent with what the standard requires.

Table of Contents

Introduction

When the Supreme Court held at the beginning of 2011 in *Mayo Foundation for Medical Education and Research v. United States*[1] that the validity of IRS regulations must be evaluated using the same two-step test (enunciated in *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*[2]) that applies to regulations issued by all other federal agencies, the Court was actually applying a more general conclusion — that tax law and the IRS are subject to the same administrative law principles that govern judicial review of agency action for all other federal agencies.

> We are not inclined to carve out an approach to administrative review good for tax law only. To the contrary, we have expressly "[r]ecogniz[ed] the importance of maintaining a uniform approach to judicial review of administrative action."[3]

Although *Mayo* did not cite the judicial review provisions of the Administrative Procedure Act (APA) in announcing this general principle, it quoted an APA case to express this principle.[4] Moreover, six months after *Mayo*, the D.C. Circuit in an *en banc* opinion, *Cohen v. United States*,[5] relying in part on *Mayo*, explicitly confirmed that the judicial review provisions of the APA apply to the review of actions by the IRS just as they apply to the judicial review of actions by all other federal agencies: "The IRS is not special in this regard; no exception exists shielding it — unlike the rest of the Federal Government — from suit under the APA."[6]

Mayo's more specific holding that the *Chevron* two-step test applies in evaluating the validity of

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[1]131 S. Ct. 704 (2011), *Doc 2011-609*, *2011 TNT 8-10*.
[2]467 U.S. 837 (1984).
[3]131 S. Ct. at 713 (alterations in original).
[4]*Dickinson v. Zurko*, 527 U.S. 150 (1999) (quoted at 131 S. Ct. 713).
[5]650 F.3d 717 (D.C. Cir. 2011) (*en banc*), *Doc 2011-14478*, *2011 TNT 128-14*. For a discussion of *Cohen*, see 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*.
[6]650 F.3d 717, at 723; *id.* at 736 ("There may be good policy reasons to exempt IRS action from judicial review. Revenue protection is one. But Congress has not made that call. And we are in no position to usurp that choice on the basis of ripeness. *Cf. Mayo Found. for Med. Educ. & Res. v. United States*, 131 S. Ct. 704, 713 (2011)").

IRS regulations was generally viewed as unfavorable for taxpayers because this test was considered more deferential to agencies than the multi-factor, tax-specific test it replaced.[7] In contrast, however, *Mayo*'s more general holding that the IRS is subject to the same administrative law principles governing judicial review of agency action that apply for all other agencies benefits taxpayers because these general administrative law principles, including the judicial review provisions of the APA, had seldom been invoked by taxpayers in challenges to IRS action.

The APA's arbitrary and capricious standard[8] has rarely been used by taxpayers in challenging IRS actions,[9] even though outside the tax world, most litigated challenges to agency action are based at least partly on an alleged agency violation of this standard. The importance of the arbitrary and capricious standard has been further increased by a recent Supreme Court decision. In an immigration case decided in December 2011, the Court for the first time explicitly confirmed that step two of the *Chevron* two-step test is equivalent to the APA's arbitrary and capricious standard.

In *Judulang v. Holder*,[10] the Court held that a policy adopted by the Board of Immigration Appeals in applying one of the provisions of the immigration statute violated the APA's arbitrary and capricious standard. The Court said the case should be decided under the APA's arbitrary and capricious standard rather than under *Chevron* step two:

> The Government urges us instead to analyze this case under the second step of the test we announced in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), to govern judicial review of an agency's statutory interpretations. *Were we to do so, our analysis would be the same*, because under *Chevron* step two, we ask whether an agency interpretation is ''arbitrary or capricious in substance.'' *Mayo Foundation for Medical Ed. and Research v. United States*, 131 S.Ct. 704, 711 (2011).[11]

Although the applicability of the APA's arbitrary and capricious standard to challenges of IRS action, including IRS regulations, was clear even without *Judulang*'s confirmation of equivalence between this standard and *Chevron* step two, this equivalence not only enhances the substantial importance of the arbitrary and capricious standard but also increases the force of *Chevron* step two for challenges to agency action. Before this explicit statement of equivalence, the general view was that to succeed in a challenge to a regulation under the *Chevron* two-step test, it was almost always necessary to prevail at step one, because the significant discretion given to agencies at step two made the challenger's chances of success remote.

Judulang's explicit confirmation of equivalence between the arbitrary and capricious standard and *Chevron* step two changes the likelihood of success for challenges to regulations, because the likelihood that a challenge will prevail under the arbitrary and capricious standard is considerably higher than under *Chevron* step two. The likelihood of success under an arbitrary and capricious challenge had been approximately the same as the likelihood of success under the *Chevron* two-step test *as a whole*, before *Judulang*'s explicit confirmation of equivalence between the arbitrary and capricious standard and *Chevron* step two.

Judulang's confirmation of the equivalence between *Chevron* step two and the arbitrary and capricious standard not only makes judicial decisions interpreting and applying the arbitrary and capricious standard relevant under *Chevron* step two, but it also makes decisions interpreting and applying *Chevron* step two relevant under the arbitrary and capricious standard. Although in most instances decisions interpreting the arbitrary and capricious standard have provided more useful tools for challenging agency action than decisions under *Chevron* step two, there are also some instances when decisions under *Chevron* step two have provided useful tools for challenges. After *Judulang*, both sets of decisions should be freely available for use under either the arbitrary and capricious standard or under *Chevron* step two.

The APA's arbitrary and capricious standard provides a powerful tool for taxpayers to use in

[7] *See National Muffler Dealers Ass'n Inc. v. United States*, 440 U.S. 472, 477 (1979). For a different view on whether *National Muffler* was less deferential than *Chevron*, 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*; and Johnson, ''Preserving Fairness in Tax Administration in the *Mayo* Era,'' *Va. Tax Rev.* (forthcoming).

[8] 5 U.S.C. section 706(2)(A) (''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'').

[9] For a discussion of the relatively few tax cases where this standard has been invoked, see Patrick J. 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*, at n.44.

[10] 132 S. Ct. 476 (2011).

[11] *Id.* at 483, n.7 (some citations omitted; emphasis added). The similarity of *Chevron* step two and the arbitrary and capricious standard had been recognized, for example, by the D.C. Circuit before *Judulang*. *See*, *e.g.*, *Shays v. FEC*, 414 F.3d 76, 96-97 (D.C. Cir. 2005).

challenging IRS regulations, especially after *Judulang*. IRS regulations are particularly vulnerable to challenge under the arbitrary and capricious standard, compared with regulations issued by other agencies, because of the IRS's apparent lack of awareness of the need to comply with this standard in issuing regulations, which has led to IRS behavior that resembles open defiance of the standard.

I have previously discussed the application of the APA's arbitrary and capricious standard to IRS regulations in contexts in which the focus was not exclusively on the general applicability of this standard to IRS regulations, but the subject is sufficiently important to warrant revisiting in more detail, especially after *Judulang*.[12] This report does not attempt to discuss everything that could be said about applying the arbitrary and capricious standard to IRS regulations, but it is a start.

The importance of the arbitrary and capricious standard in evaluating the validity of IRS regulations was shown by the Federal Circuit's recent decision in *Dominion Resources, Inc. v. United States*,[13] issued after this report was completed. In that case, the court held that a provision in the interest capitalization regulations under section 263A was invalid under the arbitrary and capricious standard, because the IRS had failed to explain in the preamble to the regulations the reasons for adopting the rule that was at issue.

General Content of the Standard

The Supreme Court explained the meaning of the arbitrary and capricious standard in *Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co.*[14] The Court said an agency must satisfy two basic requirements to avoid violating this standard. First, the agency must engage in "reasoned decisionmaking."[15] Second, "the agency must . . . articulate a satisfactory explanation for its action."[16] The "agency must cogently explain why it has exercised its discretion in a given manner."[17]

This explanation of the reasons for the agency's action must be provided by the agency itself when it makes its decision, rather than by the agency's attorneys when the agency's action is challenged in court:

> The courts may not accept appellate counsel's *post hoc* rationalizations for agency action. It is well established that an agency's action must be upheld, if at all, on the basis articulated by the agency itself. *SEC v. Chenery Corp.*, 332 U.S. [194], at 196 [(1947)].[18]

Likewise, the reviewing court may not supply a rationale that the agency failed to supply when it made its decision:

> 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).[19]

However, the reasoned-explanation requirement is excused, or deemed satisfied, if the reason for the agency's action is obvious: "We will 'uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned.'"[20]

The second requirement imposed by the arbitrary and capricious standard — that the agency must provide a reasoned explanation for its decision when the decision is made — is a mechanism for enforcing the first requirement: that the agency must engage in reasoned decision-making. Without a contemporaneous explanation by the agency of the reasons why the agency made the decision to adopt a particular rule, a reviewing court does not have the ability to evaluate whether the agency satisfied the requirement for reasoned decision-making.

Moreover, if the agency has not complied with the reasoned-explanation requirement, this noncompliance suggests an increased likelihood that the agency has not engaged in the type of reasoned decision-making process that would withstand

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[12]I have previously discussed the application of the APA's arbitrary and capricious standard to the IRS, but those discussions have occurred either in the context of a specific controversy about a particular regulation, see Smith, "*Mannella*," *supra*; or in the context of the more general principle from *Mayo* that the IRS is subject to the same administrative law principles relating to judicial review of agency action that are applicable for all other agencies. *See* Smith, "Life After *Mayo*: Silver Linings," *Tax Notes*, June 20, 2011, p. 1251, *Doc 2011-10520*, or *2011 TNT 119-2*; or in the context of the application of the arbitrary and capricious standard to IRS action other than regulations, see Smith, "The APA's Reasoned-Explanation Rule and IRS Deficiency Notices," *Tax Notes*, Jan. 16, 2012, p. 331, *Doc 2011-24403*, or *2012 TNT 11-10*.

[13]No. 2011-5087 (Fed. Cir. May 31, 2012), *Doc 2012-11709, 2012 TNT 106-16*. Two of my partners and I represented the taxpayer in this case.

[14]463 U.S. 29 (1983).

[15]*Id.* at 52.

[16]*Id.* at 43.

[17]*Id.* at 48.

[18]*Id.* at 50 (some citations omitted).

[19]*Id.* at 43.

[20]*Id.* However, some court of appeals decisions hold that "mere silence" is not enough to make it possible to discern the agency's path. *See, e.g., Pacific Coast Federation of Fishermen's Associations v. United States Bureau of Reclamation*, 426 F.3d 1082, 1091 (9th Cir. 2005) ("Although 'a decision of less than ideal clarity' may be upheld 'if the agency's path may reasonably be discerned,' we cannot infer an agency's reasoning from mere silence") (some internal quotation marks omitted).

scrutiny under the arbitrary and capricious standard. If an agency understands that courts reviewing the regulations the agency promulgates will enforce the reasoned-explanation requirement, it is more likely to engage in the requisite reasoned decision-making process. Requiring the agency to explain the reasoning for a decision makes it more likely that the reasoning required by the arbitrary and capricious standard will actually take place.

Judulang's confirmation of the equivalence between *Chevron* step two and the arbitrary and capricious standard resolves an anomaly that would otherwise exist between the standards that apply to agency positions evaluated under the *Chevron* two-step test and the standards that apply to agency positions that do not qualify for evaluation under the *Chevron* test but are evaluated instead under the much less deferential standard in *Skidmore v. Swift & Co*.[21] Under *Skidmore*, the key factor determining the amount of weight given to an agency position is the quality of the agency's reasoning supporting its position.[22] This factor is similar to the reasoned decision-making requirement under the arbitrary and capricious standard.

Before *Judulang*, for agency positions evaluated not under *Skidmore* but under the more deferential *Chevron* standard, many judicial decisions applied *Chevron* step two in a way that made it seem that the quality of the agency's reasoning in reaching its position did not matter and that only the reasonableness of the result reached by the agency mattered.[23] It obviously would not make sense for greater deference to be given under *Chevron* step two to agency positions that are not subject to a reasoned decision-making requirement than is given to agency positions that are evaluated, under *Skidmore*, on the basis of the quality of their reasoning. *Judulang* has the salutary effect of eliminating that anomaly, so now it is clear that the quality of the agency's reasoning is no less important under *Chevron* step two than under *Skidmore*.

Application to IRS Regulations

Regulations issued by the IRS are particularly vulnerable to challenge under the arbitrary and capricious standard because the IRS's preambles to its regulations do not ordinarily provide the type of explanation for adopting the rules in the regulations that the arbitrary and capricious standard requires. Instead, preambles to IRS regulations typically explain how the rules operate.

A challenge to an IRS regulation under the arbitrary and capricious standard is more likely to be based on the reasoned-explanation requirement than on the reasoned decision-making requirement, because the IRS's general practice of not explaining the reasons for its rules makes it impossible for a court or a challenger to evaluate whether the agency has satisfied the reasoned decision-making requirement.

One rationale for the IRS preambles' failure to explain why particular rules are adopted in the regulations is that an Internal Revenue Manual provision dealing with drafting regulations and preambles explicitly instructs IRS personnel that "it is not necessary to justify the rules that are being proposed or adopted or alternatives that were considered."[24] This statement essentially instructs IRS employees to draft preambles in a way that violates the arbitrary and capricious standard.

But this instruction in the IRM does not justify or excuse the resulting violations of the arbitrary and capricious standard. Moreover, the instruction may increase the chance that a reviewing court will be receptive to a challenge to an IRS regulation based on an asserted violation of the reasoned-explanation requirement.

When a challenge to an IRS regulation is based on the absence of any IRS explanation of the reasons for adopting the rules at issue, the party challenging the regulation can benefit by identifying for the court various possible alternative lines of reasoning the IRS may have used to reach the conclusion to adopt the particular rules. If some of these alternative lines of reasoning can be shown to be improper, because, for example, they conflict with specific statutory provisions, identifying these possible rationales will help show that the lack of explanation is improper, because this lack of explanation makes it impossible to know if the rules were based on valid or invalid reasoning.

Moreover, although it is not unusual for litigated challenges to agency action outside the tax world to

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[21]323 U.S. 134 (1944). *United States v. Mead Corp.*, 533 U.S. 218 (2001), made clear that those agency positions that do not qualify for evaluation under *Chevron* are evaluated instead under *Skidmore*. *Id.* at 221, 228, 234-238.

[22]Under *Skidmore*, the weight given to an agency position "will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors [that] give it power to persuade, if lacking power to control." 323 U.S. at 140.

[23]Although *Chevron* identified as one of the factors supporting giving deference to the agency in that case the fact that "the agency considered the matter in a detailed and reasoned fashion," 467 U.S. at 865, and cited *Skidmore* in support of the relevance of this factor, this identification occurred in a part of the opinion that is at some distance from the passages that are normally quoted, and many court opinions applying *Chevron* step two seem to have overlooked this aspect.

[24]IRM section 32.1.5.4.7.3(1).

be based exclusively on the lack of any agency explanation, until these challenges become more common in tax cases, it would be prudent for a challenge to an IRS regulation to not only be based on an arbitrary and capricious challenge due to the lack of explanation, but also to include a *Chevron* step-one challenge, asserting that the challenged rule conflicts with relevant statutory provisions. The two types of challenges can reinforce one another, because the arguments in support of them will often overlap: The arbitrary and capricious challenge asserts not only the lack of any explanation but also that some of the possible explanations would reveal improper reasoning.

The requirement that an agency consider comments submitted during the course of a rulemaking is imposed by the APA's notice and comment requirements, not by the arbitrary and capricious standard, and the IRS generally complies with the requirement to discuss the comments that have been submitted in the preambles to final regulations.[25] When the suggestions made in comments have been rejected, the IRS's preambles sometimes explain the reasons for the rejection, as required by the arbitrary and capricious standard. Often, however, the IRS's preamble simply notes that the suggestion was rejected, without providing any explanation. Failure to explain the reason for rejecting a suggestion made in comments would provide a basis for challenge under the arbitrary and capricious standard.

Challenges to Reasoning

Because IRS preambles to regulations ordinarily do not explain why the IRS decided to adopt the particular rules in the regulations, a challenge to an IRS regulation under the arbitrary and capricious standard ordinarily will be based on this lack of explanation, rather than on the quality of the IRS's reasoning in adopting the rule. Occasionally, however, the IRS's preambles to regulations provide the type of explanation required to satisfy one of the two basic requirements of the arbitrary and capricious standard.

In those cases, a challenge under the arbitrary and capricious standard must be based on a challenge to the quality of the reasoning that is disclosed by the preamble's explanation. Although the meaning of the reasoned-explanation requirement is straightforward and essentially self-explanatory, the meaning of the reasoned decision-making requirement may not be so immediately apparent.

A court decision responding to a challenge based on an asserted violation of the arbitrary and capricious standard will almost invariably begin by quoting *State Farm*'s admonition that "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."[26] But this admonition does not mean the agency can do whatever it wants, even if the agency explains the reasons for its decision.

Instead, *State Farm* explained that when a court reviews the quality of the agency's reasoning under the arbitrary and capricious standard, the court "must 'consider whether the [agency's] decision was based on a consideration of the relevant factors.'"[27] "Normally, an agency rule would be arbitrary and capricious if the agency relied on factors [that] Congress has not intended it to consider [or] entirely failed to consider an important aspect of the problem."[28]

However, *State Farm*'s guidance that the agency must consider the factors that Congress wanted the agency to consider and must not consider factors that Congress did not want the agency to consider does not resolve most cases, particularly because there will almost always be a dispute about what factors Congress wanted to be considered and what factors it did not want considered. Fortunately, it is not necessary for a party challenging agency action under the arbitrary and capricious standard to be able to bring shortcomings in the agency's reasoning within the scope of these specific considerations identified by *State Farm* in order for such a challenge to prevail.

More generally, the reasoned decision-making requirement means the agency's reasoning must make sense. The agency's conclusion must follow

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[25] *See* IRM section 32.1.5.4.7.3(2) ("The drafting team should address the public comments submitted in writing and the oral comments presented at the public hearing on the NPRM (generally, including late comments). . . . The drafting team should explain why the agency found some comments persuasive, and others not, in issuing the final regulations").

[26] 463 U.S. at 43.

[27] *Id.*

[28] *Id. See also, e.g., Montana Wilderness Association v. McAllister*, 666 F.3d 549, 561 (9th Cir. 2011) ("We hold that the travel plan improperly ignores the impact of increased volume of motorized and mechanized use on current users' ability to seek quiet and solitude in the study area. Because the Service entirely failed to consider this important aspect of its duty to maintain the study area's 1977 wilderness character, its decision is arbitrary and capricious"); *Newton-Nations v. Betlach*, 660 F.3d 370, 381-382 (9th Cir. 2011) ("There is little, if any, evidence that the Secretary considered the factors section 1315 requires her to consider before granting Arizona's waiver. Thus, the Secretary's decision was arbitrary and capricious within the meaning of the APA insofar as it 'entirely failed to consider an important aspect of the problem'").

from its premises, and the premises must be reasonable.[29] If those requirements are not met, the arbitrary and capricious standard has been violated.

One example of a type of flawed agency reasoning that can form the basis for a challenge under the arbitrary and capricious standard is a failure by the agency to consider alternative approaches to the one the agency adopted.[30] Although the agency is not required to consider every conceivable alternative,[31] the failure to consider an alternative, which may have been brought to the agency's attention or may be obvious for other reasons, or a failure by the agency to explain the reasons for rejecting the alternative, could violate the arbitrary and capricious standard.[32]

Another example of a defect in agency reasoning that will ordinarily be considered a violation of the arbitrary and capricious standard is internal inconsistency in the rules themselves or in the agency's reasoning in support of the rules.[33] For example, the rules might treat the same situation inconsistently in separate cases for purposes of applying different aspects of the rules without providing justification for this differential treatment.

Here is another example of flawed agency reasoning: If the agency concluded that the rule it had adopted was compelled by the statute, but the court concludes, under a *Chevron* step-one analysis, that the statute does not compel the result the agency reached, the agency's result is likely to be rejected because its reason for reaching that result was incorrect. The D.C. Circuit has applied this principle in an important line of cases.[34] Although these D.C. Circuit cases nominally represent an application of *Chevron* step two, the equivalence between *Chevron* step two and the arbitrary and capricious standard that has been confirmed by *Judulang* makes the principle applied in these cases an equally good example of a type of agency reasoning that is likely to be rejected under the arbitrary and capricious standard.

A recent article by Randy J. Kozel and Jeffrey A. Pojanowski addressed the type of agency reasoning that was rejected in these D.C. Circuit cases. Discussing the standards for judicial review of changes

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[29]"The agency must . . . articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'" 463 U.S. at 43. *See also*, *e.g.*, *New England Health Care Employees Union v. NLRB*, 448 F.3d 189, 196 (2d Cir. 2006) ("In sum, the Board erred because it failed to acknowledge the natural and logical implications of the facts it credited and the analytic framework it adopted"); *Northwest Coalition for Alternatives to Pesticides v. EPA*, 544 F.3d 1043, 1052 (9th Cir. 2008) ("In sum, the Final Order does not provide enough information to demonstrate a rational connection between the factors that the EPA examined and the conclusions it reached"); *Oregon Natural Resources Council v. Allen*, 476 F.3d 1031, 1037 (9th Cir. 2007) ("Because there is no rational connection between the authorization of take and the scope of the underlying proposed action, we conclude that the Incidental Take Statement is arbitrary and capricious"); *Center for Biological Diversity v. Department of the Interior*, 623 F.3d 633, 650 (9th Cir. 2010) ("We hold further that the conclusion in the ROD that the proposed land exchange is in the 'public interest' within the meaning of FLPMA was arbitrary and capricious because it was based on the BLM's flawed assumption"); *Western Watersheds Project v. Kraayenbrink*, 632 F.3d 472, 494-495 (9th Cir. 2010) ("The BLM has failed to consider relevant factors, failed to articulate a rational connection between the facts put forth by agency experts and the choices made, and changed course from current policy without a reasoned explanation. . . . Therefore, we conclude that . . . its conclusion in the Final EIS that the proposed action would have no significant environmental impact is arbitrary and capricious under the APA").

[30]463 U.S. at 46 ("The first and most obvious reason for finding the rescission arbitrary and capricious is that NHTSA apparently gave no consideration whatsoever to modifying the Standard"); *id.* at 48 ("At the very least this alternative way of achieving the objectives of the Act should have been addressed and adequate reasons given for its abandonment"); *id.* at 50 ("Not having discussed the possibility, the agency submitted no reasons at all").

[31]*Id.* at 51 ("It is true that rulemaking 'cannot be found wanting simply because the agency failed to include every alternative device and thought conceivable by the mind of man . . . regardless of how uncommon or unknown that alternative may have been'") (alterations in original).

[32]*See*, *e.g.*, *Chamber of Commerce of the United States v. SEC*, 412 F.3d 133, 145 (D.C. Cir. 2005) ("In sum, the disclosure alternative was neither frivolous nor out of bounds and the Commission therefore had an obligation to consider it").

[33]*See*, *e.g.*, *Business Roundtable v. SEC*, 647 F.3d 1144, 1153 (D.C. Cir. 2011) ("We also agree with the petitioners that the Commission's discussion of the estimated frequency of nominations under Rule 14a-11 is internally inconsistent and therefore arbitrary"); *Portland Cement Association v. EPA*, 665 F.3d 177, 187 (D.C. Cir. 2011) ("Basing its decision on a premise the agency itself has already planned to disrupt is arbitrary and capricious"); *Jupiter Energy Corp. v. FERC*, 407 F.3d 346, 361 (5th Cir. 2005) ("The Commission's decision is fatally flawed by the inconsistency of having the putative point where gathering ends and transportation begins upstream from a gathering pipeline"); *Sorenson Communications Inc. v. FCC*, 567 F.3d 1215, 1221-1222 (10th Cir. 2009) ("The FCC's justification is inconsistent with the logic of a price cap-based compensation system"); *Center for Biological Diversity v. National Highway Traffic Safety Administration*, 538 F.3d 1172, 1208 (9th Cir. 2008) ("NHTSA's new focus on the purpose for which automobiles are manufactured conflicts with its earlier assertion"). *See also*, *e.g.*, *Westar Energy Inc. v. FERC*, 473 F.3d 1239, 1241 (D.C. Cir. 2007) ("A fundamental norm of administrative procedure requires an agency to treat like cases alike").

[34]*See*, *e.g.*, *United States Postal Service v. Postal Regulatory Commission*, 640 F.3d 1263, 1266-1267, 1268 (D.C. Cir. 2011); *Secretary of Labor v. National Cement Co.*, 494 F.3d 1066, 1073, 1074-1075 (D.C. Cir. 2007); *Peter Pan Bus Lines v. Federal Motor Carrier Safety Administration*, 471 F.3d 1350, 1352, 1354 (D.C. Cir. 2006); *PDK Laboratories Inc. v. DEA*, 362 F.3d 786, 797-798 (D.C. Cir. 2004); *Arizona v. Thompson*, 281 F.3d 248, 254, 259 (D.C. Cir. 2002); *Transitional Hospitals Corp. v. Shalala*, 222 F.3d 1019, 1029 (D.C. Cir. 2000); *Alarm Industry Communications Committee v. FCC*, 131 F.3d 1066, 1072 (D.C. Cir. 1997); *Prill v. NLRB*, 755 F.2d 941, 956-957 (D.C. Cir. 1985).

in agency position, the article identifies a useful distinction between two different types of agency reasoning and argues that the standard of review should vary based on which of these two types of reasoning the agency used in reaching its decision.[35] One type of agency reasoning focuses exclusively on interpreting the statutory provision using standard principles of statutory construction.[36] This type of reasoning could be called interpretative reasoning.[37] The second type of agency reasoning focuses on making policy choices in the absence of clear statutory direction[38]; this type could be called policy-based reasoning.[39]

Kozel and Pojanowski suggest that when an agency engages in interpretative reasoning in adopting a change in position, the agency's changed position should be given no deference, and that deference should be given only when an agency bases a change in position on policy-based reasoning. Moreover, as Kozel and Pojanowski recognize, the distinction between these two types of agency reasoning applies to more than just agency changes in position that are the focus of their article and is equally applicable when an agency adopts a position for the first time.[40] *Chevron* clearly supports the principle that policy-based choices by the agency receive deference.[41]

Although Kozel and Pojanowski do not make this connection, their conclusion that interpretative reasoning by an agency should be given no deference is illustrated by the type of case described above, in which the agency's explanation discloses that it concluded, based on interpretative reasoning, that its result was compelled by the statute, but the reviewing court concludes that under *Chevron* step one, congressional intent is unclear and on that basis, the agency's reasoning and result should be rejected. The line of D.C. Circuit cases referred to above that apply this principle concludes that when an agency erroneously believes its interpretation of a statutory provision is compelled by the statute, the agency is not making the type of policy-based judgment that receives deference under *Chevron* step two.[42]

The distinction between interpretative reasoning and policy-based reasoning is something for those considering challenges to IRS regulations based on the arbitrary and capricious standard to consider as one possible element of the challenges.

Another example of flawed agency reasoning that can result in a violation of the arbitrary and capricious standard's reasoned decision-making requirement (similar to the situation in which the agency incorrectly believes its position is compelled by the statute) is when the agency incorrectly believes it is required to take certain action by committee report language but the committee report language the agency relies on is not connected to any specific statutory provision.[43]

Unlike many other agencies,[44] the IRS could not ordinarily rely on any claim of technical expertise

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[35]Randy J. Kozel and Jeffrey A. Pojanowski, ''Administrative Change,'' 59 *UCLA L. Rev.* 112 (2011).

[36]Kozel and Pojanowski define this category of agency reasoning somewhat more broadly to include the interpretation of court opinions in addition to that of statutory provisions.

[37]Kozel and Pojanowski use the term ''expository reasoning'' rather than ''interpretative reasoning,'' but their term seems to me to be unnecessarily opaque and not sufficiently self-explanatory.

[38]Kozel and Pojanowski define this category of agency reasoning somewhat more broadly to include the application of technical expertise.

[39]Kozel and Pojanowski use the term ''prescriptive reasoning'' rather than ''policy-based reasoning'' but, as with the other category, their term seems to me to be unnecessarily opaque and not sufficiently self-explanatory.

[40]*Supra* note 34, at 155.

[41]*See, e.g.*, 467 U.S. at 866 (''When a challenge to an agency construction of a statutory provision, fairly conceptualized, really centers on the wisdom of the agency's policy, rather than whether it is a reasonable choice within a gap left open by Congress, the challenge must fail'').

[42]*See, e.g.*, *PDK Laboratories*, 362 F.3d at 797-798 (''In precisely those kinds of cases, it is incumbent upon the agency not to rest simply on its parsing of the statutory language. It must bring its experience and expertise to bear in light of competing interests at stake. *See Chevron v. NRDC*, 467 U.S. at 865-866. When it does so it is entitled to deference, so long as its reading of the statute is reasonable. But it has not done so here and at this stage it is not for the court 'to choose between competing meanings'''); *Peter Pan Bus Lines*, 471 F.3d at 1354 (same); *National Cement Co.*, 494 F.3d at 1074-1075 (same); *Arizona v. Thompson*, 281 F.3d at 254, 259 (''Deference to an agency's statutory interpretation 'is only appropriate when the agency has exercised its *own* judgment,' not when it believes that interpretation is compelled by Congress''; ''As we have said before, 'an agency regulation must be declared invalid, even though the agency might be able to adopt the regulation in the exercise of its discretion, if it was not based on the [agency's] own judgment but rather on the unjustified assumption that it was Congress' judgment that such [a regulation is] desirable' or required'') (emphasis and alterations in original; some internal quotation marks omitted).

[43]*See, e.g.*, *Northwest Environmental Defense Center v. Bonneville Power Administration*, 477 F.3d 668, 682 (9th Cir. 2007) (''The case law of the Supreme Court and our court establishes that legislative history, untethered to text in an enacted statute, has no compulsive legal effect. It was thus contrary to law for BPA to conclude, from committee report language alone, that it was bound to transfer the functions of the FPC'').

[44]*See, e.g.*, *Colorado Wild v. United States Forest Service*, 435 F.3d 1204, 1216 (10th Cir. 2006) (''Under the arbitrary and capricious standard, 'our deference to the agency is greatest when reviewing technical matters within its area of expertise, particularly its choice of scientific data and statistical methodology'''); *Lands Council v. McNair*, 537 F.3d 981, 993 (9th Cir. 2008) (*en banc*) (''We are to be 'most deferential' when the agency is 'making predictions, within its [area of] special expertise, at the frontiers of science.' A number of our sister circuits agree that we are to

(Footnote continued on next page.)

relating to scientific or factual matters in defending its regulations against challenge under the arbitrary and capricious standard. The only expertise the IRS can claim is familiarity with the provisions of the Internal Revenue Code, but this is not the type of expertise that ordinarily provides the basis for claims of special deference for an agency's policy judgments.

When an agency explains the reasons for its action, and the reasons consist of more than one rationale, if the court concludes that one or more of the rationales is invalid, the court ordinarily will conclude that the arbitrary and capricious standard has been violated, unless the court has a basis for concluding that the agency would have reached the same result based exclusively on the rationale or rationales that the court concludes were proper.[45]

Bright-Line Rules vs. Complexity

One of the traditional tensions in the drafting of tax regulations is between drafting simple bright-line rules that are easy to apply but that may produce a large number of questionable results in particular cases, and drafting highly detailed, complex rules that are more likely to produce appropriate results in most cases but that may be exceedingly difficult to understand and apply because of the detail and complexity of the rules. An issue to be considered when applying the arbitrary and capricious standard to IRS regulations is whether the standard would provide a basis to challenge the IRS's judgment in particular cases regarding the use of either bright-line rules or highly complex rules. It is possible that a particular set of rules might be viewed as having gone too far in one direction or the other, and the issue is whether the arbitrary and capricious standard could provide a mechanism for policing this type of situation.

It seems more likely that the arbitrary and capricious standard could be invoked successfully to challenge the use of a bright-line rule that could be shown to produce too many inappropriate results in particular cases than that the standard could be successfully invoked to challenge a set of rules on the basis of their excessive detail and complexity. Nevertheless, one problem with using highly complex, highly detailed rules in IRS regulations is that IRS regulations of this type are much more likely to attempt to provide a specific rule to cover every imaginable situation in which taxpayers might otherwise be able to obtain what would be viewed as an inappropriately favorable result. Those regulations are much less likely to make a comparable effort to provide a specific rule to cover every imaginable situation in which taxpayers would otherwise receive what would be viewed as an inappropriately unfavorable result. Whether the arbitrary and capricious standard could be successfully invoked to challenge the results in those cases is an open question.

Notice and Comment Compared

Apart from the arbitrary and capricious standard, the other APA provision that can be used to challenge IRS regulations is the notice and comment requirement in section 553.[46] The arbitrary and capricious standard provides a much more broadly applicable tool for challenging IRS regulations than the notice and comment requirement.

The IRS's principal failing regarding the APA notice and comment requirement is the IRS's use of temporary regulations in situations in which none of the exceptions of the notice and comment requirement is applicable. IRS temporary regulations are almost always issued without prior notice and comment.

Although the Service's misuse of temporary regulations is widespread, the IRS ordinarily follows proper notice and comment procedures in issuing regulations other than temporary regulations. The IRS's principal failing regarding regulations under the arbitrary and capricious standard is that the preambles to its regulations ordinarily do not explain the reasons for adopting the rules in the regulations, which is required to satisfy the arbitrary and capricious standard.

The Service's failure to explain the reasons for the rules adopted in its regulations is much more widespread than its use of temporary regulations

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conduct a 'particularly deferential review' of an 'agency's predictive judgments about areas that are within the agency's field of discretion and expertise . . . as long as they are reasonable'") (citations omitted; alterations in original); *In re Operation of Missouri River System Litigation*, 421 F.3d 618, 628 (8th Cir. 2005) ("When the resolution of the dispute involves primarily issues of fact and analysis of the relevant information requires a high level of technical expertise, we must defer to the informed discretion of the responsible federal agencies") (internal quotation marks omitted).

[45]*See, e.g.*, *National Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831, 839 (D.C. Cir. 2006) ("An important corollary is that where FERC has relied on multiple rationales (and has not done so in the alternative), and we conclude that at least one of the rationales is deficient, we will ordinarily vacate the order unless we are certain that FERC would have adopted it even absent the flawed rationale").

[46]*See, e.g.*, Kristin E. Hickman, "Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance With Administrative Procedure Act Rulemaking Requirements," 82 *Notre Dame L. Rev.* 1727 (2007).

and thus provides a much more widely available basis for challenging IRS regulations than the IRS's noncompliance with the notice and comment requirement in issuing temporary regulations. Moreover, although the APA notice and comment requirement may have some applicability to IRS documents other than temporary regulations, such as the notice that was challenged in *Cohen*, the arbitrary and capricious standard will ordinarily also be available as a basis for challenge in these cases, as *Cohen* illustrates.

Fox Television

In *FCC v. Fox Television Stations Inc.*, 129 S. Ct. 1800 (2009), the Supreme Court resolved two important issues relating to the application of the arbitrary and capricious standard. First, *Fox Television* explicitly answered the question whether the standard imposes a more demanding level of judicial review in a case in which the agency changes its position than in a case in which the agency adopts a position on a particular issue for the first time. The Court's answer on this question was that the level of judicial scrutiny under the arbitrary and capricious standard is no different in these two cases.

By its explicit resolution of the first issue, the Court also implicitly resolved a second issue, namely whether the arbitrary and capricious standard applies *only* to agency changes in position and *not at all* to agency positions adopted for the first time. By clarifying that the level of judicial review under the arbitrary and capricious standard is the same for both types of situations, the Court also left no doubt that the application of the standard is not limited to agency changes in position, but is also equally applicable to agency positions adopted for the first time.

Conclusion

The APA's arbitrary and capricious standard provides a powerful tool that can be used in challenging IRS regulations, particularly after *Judulang*'s confirmation that this standard and *Chevron* step two are equivalent. IRS regulations are especially vulnerable to challenge under the arbitrary and capricious standard, because the IRS seems to be unaware that this standard requires that agencies must explain the reasons for their rules when they issue regulations. However, taxpayers have seldom invoked this standard in challenging IRS regulations. Presumably this will begin to change, with the attention that *Mayo* has brought to the applicability in the tax world of general administrative law principles. The Federal Circuit's recent *Dominion Resources* decision shows that this change is beginning to take place.