Challenging Tax Regulations: Are *Altera* and *Direct Marketing* Game Changers?

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Pat Smith, Ivins, Phillips & Barker

Jud Judkins, Baker & McKenzie

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Background on the Administrative Procedure Act

- Enacted in 1946 in response to substantial growth in number and size of federal agencies during 1930s and World War II
- Contains two sets of provisions relevant for challenges to agency regulations: (1) notice-and-comment rulemaking requirements in 5 U.S.C. § 553; (2) provisions relating to judicial review of agency action in 5 U.S.C. § § 701-706
- Notice-and-comment rulemaking requirements will be discussed in connection with *Altera* decision
- One of the provisions relating to judicial review, section 706(2)(A) states that "The reviewing court shall ... hold unlawful and set aside agency action ... found to be ... arbitrary, capricious, an abuse of discretion, or not in accordance with law."
- This is referred to as the "arbitrary and capricious standard"
- The landmark Supreme Court case interpreting the arbitrary and capricious standard is the 1983 decision in *State Farm*, 463 U.S. 29 (1983)
- *State Farm* held, among other things, that the agency must "articulate a satisfactory explanation for its action"

Background on the Administrative Procedure Act cont'd

- *State Farm* also reiterated the principle that had been established in the Supreme Court's two earlier decisions in *Chenery* (1943 and 1947) that agency action, when challenged in court, can be upheld only on the basis of the rationale that the agency relied on in making the decisions
- Under *Chenery*, agency action cannot be upheld based on "*post hoc* rationalizations" put forward for the first time by the lawyers defending the agency action against the court challenge
- For challenges to regulations issued by agencies other than IRS and Treasury, the challenge is almost always based in whole or in part on claim that the agency violated the arbitrary and capricious standard
- In contrast, for challenges to tax regulations, the arbitrary and capricious standard has very seldom been invoked
- There have been only two cases in which a court has invalidated a tax regulation based on a violation of the arbitrary and capricious standard
- The first was *Dominion Resources*, a 2012 decision by the Federal Circuit
- The second was the Tax Court's recent *Altera* decision
- After *Altera*, however, it is certain that taxpayers will begin using the arbitrary and capricious standard to challenge other tax regulations

Altera – The Rule at Issue

- A proposed Treasury regulation in 2002 required parties in a cost-sharing arrangement to share the costs of stock-based compensation ("SBC")
- Commentators provided facts and evidence that unrelated parties did not and would not share SBC
  - Publicly available agreements
  - Reports by economic experts
  - Government contracts
  - The absence of contrary evidence
- Treasury promulgated a final rule in 2003 that was substantially identical to the proposed rule

Altera – The Rulemaking Process

- Treasury & the IRS stated in the preamble to the Final Rule that "[i]t has also been determined that section 553(b) of the [APA] does not apply to these regulations."
  - IRM 32.1.5.4.7.5.1 (2011): "[M]ost IRS/Treasury regulations will be interpretative regulations because they fill gaps in legislation or have a prior existence in the law."
- 5 U.S.C. § 553
  - Notice of Proposed Rulemaking
  - Written Comments
  - Statement of Basis and Purpose
  - Exceptions
    - Good Cause
    - Interpretive Rules
- The Tax Court concluded that "APA sec. 553 applies to the final rule." Slip op. at 43.

Altera – Legislative v. Interpretive Rules

- To identify legislative rules, courts commonly apply the test in *American Mining Congress v. Mine Safety & Health Administration*, 995 F.2d 1106 (D.C. Cir. 1993)
    1. Whether in the absence of the rule there would not be an adequate legislative basis for enforcement action or other agency action to confer benefits or ensure the performance of duties.
    2. Whether the agency has explicitly invoked its general legislative authority.
    3. Whether the rule effectively amends a prior legislative rule.
- The Tax Court applied the Ninth Circuit's version of that multi-part test.

Altera – The Administrative Record

- The Record Rule: Judicial review of agency action is limited to the administrative record. *Camp v. Pitts*, 411 U.S. 138, 142 (1973) ("the focal point for judicial review should be the administrative record already in existence").
- Contents of the Administrative Record
  - Notices pertaining to the rulemaking
  - Comments submitted during the rulemaking
  - Transcripts or recordings of oral presentations
  - Reports of agency officials or outside advisors
  - Any other material considered by the agency during the rulemaking

Altera – *Chevron* Step 2 and *State Farm*

- The Tax Court: "*Chevron* step 2 incorporates the reasoned decisionmaking standard of *State Farm*." Slip op. at 47-48.
- 5 U.S.C. § 706(2)(A): "The reviewing court shall . . . hold unlawful and set aside agency action . . . found to be . . . arbitrary, capricious, an abuse of discretion, or not in accordance with law."
- "Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *State Farm*, 463 U.S. 29, 43 (1983).
- The Tax Court: "The Final Rule Must Satisfy *State Farm*'s Reasoned Decisionmaking Standard." Slip op. at 43.

Altera – Four Separate Grounds of Invalidity

The Tax Court invalidated the 2003 Final Rule under the APA and the reasoned decisionmaking requirement described in *State Farm*

1. The Rule had no basis in fact because Treasury "fail[ed] to engage in any fact finding."
2. Treasury did not articulate a rational connection between the facts found and the choice made.
3. The failure to respond to comments "frustrate[d] [the court's] review of the final rule and was prejudicial to affected entities."
4. The Final Rule was contrary to all of the evidence.

Implications of *Altera* for challenges to other regulations

- Clearest implication is that challenges to other regulations will be made based on the arbitrary and capricious standard
- For challenges to other regulations under section 482, the Tax Court's strong emphasis on the factual nature of the inquiry under section 482 will provide a tool to challenge other provisions that were not based on factual inquiry by IRS and Treasury or do not permit a factual inquiry in the application of the provision
- For challenges to regulations relating to Code provisions other than section 482, the Tax Court's strong emphasis on the failure of the IRS and Treasury to adequately address and deal with comments submitted on proposed regulations may cause taxpayers to focus on how comments were dealt with
- However, the strong emphasis in the *Altera* decision on how the IRS and Treasury dealt with comments should not obscure the fact that outside of tax, the usual basis for an arbitrary and capricious challenge is that the agency failed to provide an explanation of the reasoning behind its decision

Implications of *Altera* for challenges to other regulations cont'd

- In this regard, as the *Altera* decision noted in a parenthetical, the section of the Internal Revenue Manual dealing with the drafting of preambles stated explicitly, until very recently, that it was not necessary to justify the rules that were being proposed or adopted
- As a result of this policy expressed until very recently in the Internal Revenue Manual, many tax regulations that have been issued in the past by the IRS and Treasury are vulnerable to challenge under the arbitrary and capricious standard based on the failure of the preambles to explain the reasoning that was used in the decision as to what rules to adopt

The Anti-Injunction Act and the Supreme Court's *Direct Marketing* Decision

- For challenges to the validity of regulations issued by agencies other than the IRS and Treasury, standard way to bring such challenges is for challenges to be brought immediately after the regulations are issued, without the regulation having been applied to the party bringing the challenge
- In many cases, the substantive statute authorizing the agency to issue regulations also specifically authorizes such immediate challenges, often directly in a Court of Appeals rather than in federal district court
- In any case where there is no such explicit judicial review provision, parties wishing to bring immediate challenges to newly issued regulations may bring immediate challenges in federal district court under the judicial review provisions of the APA
- The Supreme Court's 1967 decision in *Abbott Laboratories v. Gardner*, 387 U.S. 136 (1967), held that such "pre-enforcement" challenges were generally authorized under the APA
- In contrast, for tax regulations issued by the IRS and Treasury, the traditional view has been that such pre-enforcement challenges are generally barred by the Anti-Injunction Act, section 7421(a) of the Code
- The Anti-Injunction Act provides, with a list of specific exceptions, that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person."

The Anti-Injunction Act and the Supreme Court's *Direct Marketing* Decision, cont'd

- The view that the Anti-Injunction Act bars direct immediate APA challenges to tax regulations is based on two 1974 Supreme Court decisions, *Bob Jones University v. Simon*, 416 U.S. 725 (1974), and *Alexander v. "Americans United" Inc.*, 416 U.S. 752 (1974)
- Both cases involved district court challenges to IRS revocations of an organization's tax-exempt status
- The Supreme Court held the Anti-Injunction Act barred the suits, based in part on the fact that success in the suits would affect the ability of contributors to the organizations to claim tax deductions for their contributions
- The general view has been that what these two cases mean is that whenever a district court suit against the IRS, other than a tax refund suit, would, if successful have an adverse effect on the amount of tax revenue received by the government, the Anti-Injunction Act bars the suit
- Based on this view, in order to challenge the validity of a tax regulation, a taxpayer had to engage in a transaction that would be subject to the regulation and either apply the regulation and sue for a refund or not apply the regulation, have the IRS assert a deficiency, and challenge the IRS position either in Tax Court or in tax refund litigation

The Anti-Injunction Act and the Supreme Court's *Direct Marketing* Decision, cont'd

- These traditional routes for challenging tax regulations had at least two disadvantages compared to the direct, immediate district court APA challenges permitted for challenges to regulations issued by other federal agencies
- First, the timing of a judicial resolution of the challenge would be considerably delayed by the need to have the regulation applied to the taxpayer making the challenge before the challenge could be brought
- Second, if the challenge failed, the taxpayer making the challenge would be burdened with the adverse tax consequences of having engaged in a transaction to which the challenged regulation applied in order to be able to bring the challenge
- The Supreme Court's decision in March of this year in *Direct Marketing Association v. Brohl*, 135 S. Ct. 1124 (2015), suggested that the tradition broad view of the scope of the Anti-Injunction Act may be incorrect
- *Direct Marketing* did not deal directly with the Anti-Injunction Act, but rather with a parallel provision imposing similar limitations on federal district court suits relating to taxes imposed by the states, the Tax Injunction Act, 28 U.S.C. § 1341
- The Tax Injunction Act provides that "The district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law"

The Anti-Injunction Act and the Supreme Court's *Direct Marketing* Decision, cont'd

- *Direct Marketing* was a challenge to a Colorado statute requiring out-of-state retailers who were not required to collect sales tax on sales to Colorado residents to file information returns with the state providing details on these sales and to notify the customers of their obligation to pay use tax on the sales
- Colorado argued the suit was barred by the Tax Injunction Act because success in the suit would have a negative effect on the state's ability to collect use tax
- The Supreme Court unanimously held the suit was not barred
- In reaching this conclusion, the Court relied on the close parallels between the Tax Injunction Act and the Anti-Injunction Act, and on the fact that the Tax Injunction Act was modeled on the Anti-Injunction Act
- The Court relied on the narrow, technical meanings the terms "assessment," "levy," and "collection" have in the Internal Revenue Code
- The Court held that in the Internal Revenue Code these terms refer to specific, narrowly defined stages in the overall revenue raising process, and that information reporting of the type at issue in the case was an earlier stage in that process
- The Court rejected the view expressed by the Tenth Circuit in the case that "restrain" should be given a broad meaning basically equivalent to "inhibit"
- Thus, the Court rejected the broad view that the Tax Injunction Act prohibits any federal district court suit that could, if successful, have an adverse effect on the amount of tax revenue collected by a state

The Anti-Injunction Act and the Supreme Court's *Direct Marketing* Decision, cont'd

- The nature of the Court's reasoning in *Direct Marketing* strongly suggests that the Anti-Injunction Act should be given a similar narrow reading
- Under this type of narrow reading, if a taxpayer brings a direct APA district court challenge to the validity of a tax regulation without having engaged in any transaction to which the regulation would apply, the Anti-Injunction Act would not bar the challenge, because there would be no possibility for the IRS to assess a tax on the taxpayer bringing the challenge based on applying the regulation to that taxpayer
- Two D.C. Circuit cases decided this year after the *Direct Marketing* decision have addressed the impact of that decision on the Anti-Injunction Act
- The first of these was *Z Street v. Koskinen*, 791 F.3d 24 (D.C. Cir. 2015)
- This case did not involve a challenge to the validity of a tax regulation, but rather a First Amendment challenge to alleged delay by the IRS in processing an organization's tax-exemption application
- The only issue addressed by the D.C. Circuit was whether the Anti-Injunction Act barred the challenge
- The D.C. Circuit held the Anti-Injunction Act did not apply

The Anti-Injunction Act and the Supreme Court's *Direct Marketing* Decision, cont'd

- The D.C. Circuit did not rely on *Direct Marketing* in reaching this conclusion, but rather on the Supreme Court's 1984 decision in *South Carolina v. Regan*, 465 U.S. 367 (1984), which held that the Anti-Injunction Act does not apply where the party bringing the suit has no alternative judicial mechanism for making the challenge
- In dictum, however, the D.C. Circuit in *Z Street* noted that the *Direct Marketing* decision supports the conclusion that the Anti-Injunction Act does not apply in every case where a suit, if successful, could have some adverse effect on the amount of tax revenue collected by the government
- The second D.C. Circuit decision addressing *Direct Marketing* and the Anti-Injunction Act was *Florida Bankers Association v. Department of the Treasury*, 799 F.3d 1065 (D.C. Cir. 2015)
- This suit is a challenge to regulations requiring U.S. banks to file information returns with the IRS reporting on interest income earned by non-resident aliens on accounts with the banks
- The government contends that even though this interest income is not subject to tax by the U.S., nevertheless, the information reporting is necessary to enable the U.S. to comply with information sharing agreements with foreign governments
- These agreements benefit the U.S. by providing information on foreign bank accounts held by U.S. citizens

The Anti-Injunction Act and the Supreme Court's *Direct Marketing* Decision, cont'd

- The government argued that the Anti-Injunction Act barred the suit because the penalty that is imposed for non-compliance with the information reporting requirement is considered a tax for purposes of the Anti-Injunction Act
- The district court, in a decision issued before the *Direct Marketing* decision, held the Anti-Injunction Act did not apply, in part because none of the banks that were members of the bankers associations bringing the challenge had violated the reporting requirement or threatened to do so
- The D.C. Circuit, in a split decision, with the majority opinion written by Judge Kavanaugh, held the Anti-Injunction Act barred the challenge
- Judge Henderson dissented
- Judge Kavanaugh relied on the broad view that the Anti-Injunction Act applies whenever success in a suit could potentially have an adverse effect on the amount of tax revenue received by the government
- Judge Kavanaugh did not address the reasoning in *Direct Marketing*, but instead distinguished that decision based on the grounds that the penalty for non-compliance with the information reporting requirement at issue there was not considered a tax for purposes of the Tax Injunction Act

The Anti-Injunction Act and the Supreme Court's *Direct Marketing* Decision, cont'd

- Judge Henderson's dissent relied on the *Direct Marketing* decision to take the position the Anti-Injunction Act did not apply
- Judge Henderson's dissent also relied on the fact that prior D.C. Circuit cases, including *Z Street*, had rejected the very broad view of the Anti-Injunction Act applied by Judge Kavanaugh's opinion
- The plaintiffs in *Florida Bankers* filed a petition for rehearing *en banc* with the D.C. Circuit, but in a very surprising development, the D.C. Circuit denied that petition
- The plaintiffs have announced that they will file a petition for certiorari with the Supreme Court