Mayo and *Chenery*: Too Much of a Shift in Rationale?

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Mayo, soon to be heard in oral argument before the Supreme Court, presents several issues, some that are specific to the particular statutory provision at issue and others that have considerably broader importance. One the parties have not addressed is the application of the *Chenery* rule to the shift in rationale relating to legislative history as between the preamble to the proposed regulations and the government's position in the Supreme Court. Because of this shift, the taxpayers should prevail even if the Court decides all other issues in favor of the government.

Introduction

The Supreme Court is scheduled to hear oral argument on November 8, 2010, in *Mayo Foundation for Medical Education and Research v. United States*.[1] The case raises two issues of considerably more importance than the particular issue of statutory construction presented. Those two issues are (1) whether the validity of a tax regulation issued under the general authority of section 7805(a), rather than under more specific authority granted by the particular code section at issue, is evaluated under the framework established by *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*,[2] or instead under the principles set forth in *National Muffler Dealers Ass'n v. United States*,[3] and (2) whether the Eighth Circuit was correct in holding that ''when the context is a provision of the Internal Revenue Code, a Treasury Regulation interpreting

[1]Sup. Ct. Dkt. No. 09-837. The court of appeals decision is reported at 568 F.3d 675 (8th Cir. 2009), *Doc 2009-13439, 2009 TNT 112-75*.

[2]467 U.S. 837 (1984).

[3]440 U.S. 472 (1979). Neither the Eighth Circuit opinion nor the taxpayer's brief in the Supreme Court acknowledged this issue, but instead assumed that the two standards could be harmonized. At the time this article was being written, the government's brief had not yet been filed. For a discussion of this issue, see Brief of Tax Professor Carlton M. Smith as *Amicus Curiae* In Support of the Petitioners, No. 09-837 (U.S. Aug. 2010); Kristin E. Hickman, ''The Need for *Mead*: Rejecting Tax Exceptionalism in Judicial Deference,'' 90 *Minn. L. Rev.* 1537 (2006). After this article was completed, the government filed its merits brief, in which it argues ''*National Muffler* has been superseded by *Chevron*.'' Brief for the United States, No. 09-837, at 18, 50 (U.S. Sept. 27, 2010). Professor Hickman filed an *amicus* brief supporting the government on this point. *See* brief of *Amicus Curiae* Kristin E. Hickman In Support of Respondent, No. 09-837 (U.S. Oct. 4, 2010).

the words is nearly always appropriate,''[4] because ''words . . . that may have a common or plain meaning in other contexts''[5] do not have a common or plain meaning in the context of a provision in the code.

The purpose of this article is to discuss a third issue that the parties have not so far addressed. Even if the Court holds that *Chevron* applies to tax regulations issued under section 7805(a), and that the question of the proper interpretation of the statutory provision at issue cannot be resolved under *Chevron* step one,[6] but must instead be resolved under *Chevron* step two[7] — whether because the Court agrees with the Eighth Circuit's views regarding the inherent ambiguity of any provision in the code, or because the Court concludes congressional intent regarding the meaning of the specific provision at issue is not clear — the taxpayers should still prevail.

The third issue involves the general principle of administrative law established by the Court in its two *Chenery* decisions in the 1940s that agency action can be upheld only on the basis articulated by the agency at the time it made its decision.[8] The combination of circumstances in *Mayo* presents a clear case for application of the *Chenery* rule. In the preamble to the proposed regulations at issue in *Mayo*, the IRS relied on a reading of the legislative and statutory history that was later rejected by three of the courts of appeals that addressed the issue after the issuance of the regulations. The IRS's reading also differed from the reading adopted by the Eighth Circuit and has been substantially deemphasized by the government in its arguments to the Supreme Court in favor of the reading adopted by the Eighth Circuit.

Background

Section 3121(b)(10) provides an exception from FICA taxes for ''service performed in the employ of . . . a school, college, or university . . . if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university.'' Before the amendments to the regulations that are at issue in this case, the regulations interpreting that exception had, since soon after the exception was first enacted in 1939, provided that whether an individual qualified for the student exception would be determined ''on the basis of the relationship of such employee with the organization for which the services are performed'' and whether the services are performed ''as an incident to and for the purpose of pursuing a course of study.''

In 1998 the Eighth Circuit held that the student exception in the Social Security Act, which is identical to the student exception in section 3121(b)(10), is applicable to medical residents, who have received their medical degree but are pursuing a specialization at a university hospital.[9] In response to that decision, the IRS issued proposed regulations modifying the rules for when the student exception is applicable.[10] Among the proposed changes was a rule that the student exception does not apply to any individual who regularly works 40 hours or more per week. In the final regulations, many of the rules that had been included in the proposed regulations were made less rigid, but the 40-hour-per-week rule was retained.[11]

After the release of those regulations, the courts of appeals in four different circuits, in cases dealing with time periods before the effective date of the amendments to the regulations, rejected the IRS position that medical residents could categorically be excluded from qualifying for the student exception. Those four circuits all concluded that the IRS

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[4]568 F.3d at 680.

[5]*Id.* at 679.

[6]''If a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect.'' 467 U.S. at 843 n.9.

[7]''If the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.'' 467 U.S. at 843.

[8]*See SEC v. Chenery Corp.*, 318 U.S. 80, 87-88, 92, 94 (1943); *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947). (''When the case was here before, we emphasized a simple but fundamental rule of administrative law. That rule is to the effect that a reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the agency.'') I discussed the *Chenery* rule in a previous article. *See* Patrick J. Smith, ''Omissions from Gross Income and the *Chenery* Rule,'' *Tax Notes*, Aug. 16, 2010, p. 763, *Doc 2010-16074*, or *2010 TNT 158-3*. For recent cases applying the *Chenery* principle, see, *e.g.*, *Comcast Corp. v. FCC*, 600 F.3d 642, 660 (D.C. Cir. 2010); *Southern California Edison Co. v. FERC*, 603 F.3d 996, 1001 (D.C. Cir. 2010); *Riffin v. Surface Transportation Board*, 592 F.3d 195, 198 (D.C. Cir. 2010); *American Equity Investment Life Insurance Co. v. SEC*, 572 F.3d 923, 934 (D.C. Cir. 2009); *Landstar Express America, Inc. v. Federal Maritime Commission*, 569 F.3d 493, 499 (D.C. Cir. 2009); *American Farm Bureau Federation v. EPA*, 559 F.3d 512, 522 (D.C. Cir. 2009); *GHS Health Maintenance Organization, Inc. v. United States*, 536 F.3d 1293, 1302 (Fed. Cir. 2008); *Oregon Natural Desert Association v. Bureau of Land Management*, 531 F.3d 1114, 1141 (9th Cir. 2008); *Hasan v. Department of Labor*, 545 F.3d 248, 251 (3d Cir. 2008); *Parker v. Astrue*, 597 F.3d 920, 922, 925 (7th Cir. 2010); *Carpio v. Holder*, 592 F.3d 1091, 1103 (10th Cir. 2010).

[9]*Minnesota v. Apfel*, 151 F.3d 742 (8th Cir. 1998), *Doc 98-22259, 98 TNT 134-22*.

[10]REG-156421-03 (Feb. 25, 2004), *Doc 2004-3783, 2004 TNT 37-15*.

[11]T.D. 9167 (Dec. 21, 2004), *Doc 2004-24024, 2004 TNT 245-7*.

position was in conflict with the statutory provision. As discussed below, three of the circuits also rejected the IRS arguments based on the statutory and legislative history. In the first case to be decided under the amendments to the regulations, the Eighth Circuit held that the 40-hour-per-week rule was a valid interpretation of the statute.

IRS Reading of Legislative History

In the preamble to the proposed regulations, as support for the rule that under no circumstances will an individual working 40 hours or more per week qualify for the *student exception*, the IRS relied on the statutory and legislative history relating to a *separate statutory exception* for *medical interns*.[12] That provision excepted ''service performed as an intern in the employ of a hospital by an individual who has completed a 4 year course in a medical school chartered or approved pursuant to State law.''

The exception for medical interns was first enacted in 1939 and was carried over as section 3121(b)(13) of the 1954 code. The exception for medical interns was repealed in 1965. The preamble to the proposed regulations quoted from the committee reports on both the 1939 enactment and the 1965 repeal of this *medical intern* exception in support of the position that the *student* exception should not apply to medical *residents*.

IRS Reading Rejected by Three Circuits

In the court of appeals decisions following the issuance of the regulations, three circuits rejected the IRS's conclusion that the statutory and legislative history relating to the *intern* exception provided any support for the conclusion that medical *residents* should not qualify for the *student* exception. The courts based their decisions on the significant differences in the scope of the two exceptions, most importantly the fact that the *student* exception applies only to work performed for a ''school, college, or university,'' whereas the *medical intern* exception applied to work performed for a hospital, regardless of whether the hospital had any connection to a school, college, or university. The first of those court of appeals decisions was *United States v. Mount Sinai Medical Center of Florida, Inc.*[13]

The Eleventh Circuit's rejection of the IRS reliance on the repeal of the medical intern exception included the following discussion:

> The government devotes a substantial portion of its brief to analyzing the student exemption's relation to the now-repealed intern exemption. The government notes that Congress repealed the FICA exemption for medical interns in 1965. It contends that repeal of the intern exemption evidences Congress's intent to bring all young doctors-in-training within the scope of Social Security coverage, and, hence, FICA taxation. The government asserts it would be highly incongruous for Congress to have repealed the intern exemption for those pursuing a one-year course of post-M.D. training, and yet continue to exempt the services of medical residents and fellows, who are pursuing several years of training after receiving their M.D. degrees.
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> The government's arguments with respect to the FICA scheme and the history of the separate intern exemption are unavailing. . . . The fact that Congress repealed the entirely separate intern exemption in 1965 is irrelevant to the question of whether residents may qualify for the student exemption under the plain language of the statute. Second, the district court's contention — that a plain reading of the student exemption would have rendered the intern exemption superfluous — ignores an important difference between the two exemptions. The student exemption relies, in part, on the identities of the employees and employers to define the scope of the exemption, whereas the intern exemption applied to a type of service. The intern exemption would have been superfluous only if an intern were *always* a ''student'' and a ''hospital'' were always a ''school, college, or university.'' Although all interns may be students, not all hospitals are schools, colleges, or universities. As a result, interpreting the student exemption according to its plain language does not render the former intern exemption superfluous.[14]

In *University of Chicago Hospitals v. United States*,[15] the Seventh Circuit rejected the IRS reading of the statutory and legislative history for reasons similar to those of the Eleventh Circuit:

> The government's argument proceeds from inferences about the statutory and legislative history of the student exception *and* the intern exception. That is, the government maintains that the Treasury Regulation must be read in light of the legislative history of the student and intern exceptions, which establishes (so the argument goes) that Congress intended to categorically exclude medical residents from

[12]69 *Fed. Reg.* at 8,608.

[13]486 F.3d 1248 (11th Cir. 2007), *Doc 2007-12257, 2007 TNT 98-14*.

[14]*Id.* at 1252-1253.

[15]545 F.3d 564 (7th Cir. 2008), *Doc 2008-20287, 2008 TNT 186-17*.

> eligibility for the student exception. This legislative history, the government concludes, demonstrates that the Treasury Regulation — and the case-specific tests it specifies — does not apply to medical residents.
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> The student exception was enacted in 1939 as an amendment to the 1935 Social Security Act, and at that time Congress also enacted a specific FICA exception for medical interns. . . . The intern exception established a categorical FICA exemption for services rendered by medical interns.
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> In 1965 Congress repealed the intern exception. The government cites certain statements in House and Senate Reports reflecting congressional concern about Social Security coverage for ''young doctors'' and their families. The government views the legislative history surrounding the repeal of the intern exception as broadly establishing congressional intent regarding medical residents, who are also ''young doctors.'' The government contends that the repeal of the per se exception for interns must be understood to mean that Congress intended both interns *and* medical residents to be per se ineligible for the student exception.
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> This argument relies on non sequiturs. The student exception was wholly unaffected by the repeal of the intern exception, and the repeal of the intern exception implied nothing about whether either interns *or* residents might bring themselves under the student exception.[16]

In *United States v. Memorial Sloan-Kettering Cancer Center*,[17] the Second Circuit reached similar conclusions:

> The Government argues that the coexistence of the student exception and the intern exception demonstrates that Congress did not believe that medical interns would fall within the scope of the student exception, and that, *a fortiori*, medical residents — who are even further removed from enrollment in medical school classroom studies — would not fall within the student exception either. According to the Government, if medical interns and medical residents were eligible for the student exception, the intern exception would have been surplusage.
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> According to the Government, the enactment of the intern exception — which reflects a determination that interns (and, *a fortiori*, residents) are ineligible for the student exception — combined with the repeal of the intern exception — which reflects a determination that interns (and, *a fortiori*, residents) should be covered by the FICA tax — demonstrate a congressional determination that medical residents are ineligible for the student exception. Thus, if we find the statute ambiguous and look to legislative history, the Government believes we will find the legislative history to require a ruling in its favor.
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> We disagree. The Government is correct in pointing out that traditional rules of construction, such as the *expressio unius* canon and the rule against surplusage, suggest that in 1939 and 1965, Congress did not believe that medical interns were categorically *eligible* for the student exception. But it does not follow that Congress considered medical residents to be categorically *ineligible* for that exception. *See Mount Sinai*, 486 F.3d at 1253. (''The student exemption relies, in part, on the identities of the employees and employers to define the scope of the exemption, whereas the intern exemption applied to a type of service. The intern exemption would have been superfluous only if an intern were always a 'student' and a 'hospital' were always a 'school, college, or university.' Although all interns may be students, not all hospitals are schools, colleges, or universities.'')
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> Congress has not defined the term ''student'' such that a post-graduate doctor could *never* be eligible for the exception. As the Eleventh Circuit held, ''the student exception was wholly unaffected by the repeal of the intern exception, and the repeal of the intern exception implied nothing about whether either interns or residents might bring themselves under the student exception.'' *Univ of Chi. Hosps.*, 545 F.3d 569. We will not infer from a sequence of legislative events occurring more than forty years ago that Congress intended today's medical residents to be categorically ineligible for the student exception.[18]

In the other court of appeals decision following the issuance of the regulations, the Sixth Circuit

[16]*Id.* at 568-569 (footnotes omitted; citations omitted).
[17]563 F.3d 19 (2d Cir. 2009), *Doc 2009-6657, 2009 TNT 56-7*.
[18]*Id.* at 28, 29-30 (emphasis in original).

rejected the IRS position without addressing any arguments based on statutory or legislative history.[19]

Change in Approach in the Eighth Circuit

After the resounding rejection by three different circuits of any reliance on the history of the medical intern exception, a different approach was taken in the Eighth Circuit. Rather than referring to statements in the committee reports relating to the *medical intern exception*, the court referred instead to statements in the committee reports relating to the *student exception itself*, which suggested the exception was meant to apply to part-time work.[20] The committee report statements on the *student exception* were not quoted in the section of the preamble to the proposed regulations discussing the full-time employer rule, which instead focused, in its discussion of legislative history, on the statutory history and committee report statements relating to the *medical intern exception*.[21]

That change in focus relating to the legislative history was accompanied by a change in the outcome of the case. The Eighth Circuit, in contrast to the other four circuits, agreed with the government that an exclusion based solely on the number of hours worked was consistent with the statutory provision. In its brief in the Supreme Court opposing the granting of certiorari, the government similarly focused exclusively on the committee report material cited in the Eighth Circuit opinion relating to the *student* exception, with no mention of the *intern* exception.[22]

The problem with that change in approach is that this is precisely what the *Chenery* principle forbids. The agency's *appellate counsel* is relying on a different rationale in defending the agency's action than the rationale that was relied on *by the agency itself* at the time the agency made its decision.

Application of *Chenery*

If the Court agrees with the taxpayers that the 40-hour-per-week rule is in conflict with the statutory provision, the *Chenery* violation is moot. However, if the Court concludes that congressional intent on the issue is not clear, it will be necessary for the Court to address the choice between *Chevron* and *National Muffler*. If the Court concludes that *Chevron* has supplanted *National Muffler*, this decision will dispose of most of the taxpayer's arguments that the 40-hour-per-week rule is not reasonable, because those arguments were based on application of the *National Muffler* factors. Thus, if the resolution of the case turns on an application of step two of *Chevron*, the *Chenery* violation would become quite relevant.

It might be argued that *Chenery* should not be applied to affect consideration by a court of aspects of statutory and legislative history. That argument would have force if the issue turned on the application of *Chevron step one*, since step one is a question of pure statutory construction, in which the agency's position is given no special weight.[23] However, the Eighth Circuit considered legislative history at *step two*, not step one, and the government does not contend that the case should be decided in its favor at *step one*, but rather argues that the Eighth Circuit properly held that the case should be decided at *step two* rather than step one.

Once the issue becomes one of applying step two of the *Chevron* framework, rather than step one, it is hard to see why *Chenery* should not be given full force and effect, even when that means holding the agency to its reliance on particular aspects of the

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[19]*United States v. Detroit Medical Center*, 557 F.3d 412 (6th Cir. 2009), *Doc 2009-4255, 2009 TNT 37-16*.

[20]568 F.3d at 681-682.

[21]The section of the preamble discussing student status included general statements that congressional intent was that the student exception was limited to part-time work, but did not include quotations or citations to committee reports in support of that position. 69 *Fed. Reg.* at 8,607.

[22]Brief for the United States in Opposition at 11. As noted above, at the time this article was written, the government's merits brief had not been filed. In the section of the government's brief headed ''The legislative history supports the full-time employee rule,'' the government devotes its discussion to the legislative history relating to the student exception, with no discussion of the medical intern exception. *See* Brief for the United States, No. 09-837, at 24-27 (U.S. Sept. 27, 2010). However, in contrast to the government's brief in opposition to certiorari, which did not refer to the medical intern exception, the government's merits brief does refer to the medical intern exception, but not in the portion of the brief defending the validity of the full-time employee rule. Instead, reference to the medical intern exception appears only in the much later section of the brief responding to the taxpayers' arguments that medical residents qualify for the student exception. *See id.* at 39-42. This represents a substantial de-emphasis of the medical intern exception in comparison to the preamble to the proposed regulations and the arguments made to the courts of appeals

(Footnote continued in next column.)

prior to the Eight Circuit. Nowhere in its brief does the government acknowledge the prominence that was given to the medical intern exception in the preamble to the proposed regulations. *See*, *e.g.*, *id.* at 8-9. The government's brief contends that the preamble cited and quoted the legislative history relating to the student exception in its discussion of the full-time employee rule, but the section of the preamble the government's brief cites here is the section discussing the meaning of ''school, college, or university,'' not the section of the preamble discussing the full-time employee rule. *See id.* at 9.

[23]*See*, *e.g.*, *Bank of America NA v. FDIC*, 244 F.3d 1309, 1319 (11th Cir. 2001). (''There is no support in either *Chenery* or its progeny for the proposition that *Chenery*'s prohibition on post-hoc rationales should apply to agency arguments proffered under the first step of the *Chevron* analysis.'')

legislative history. A leading article on *Chenery* emphasizes the relationship between *Chenery* and *Chevron*:

> The clearest point of connection between *Chevron* and *Chenery* is that compliance with the *Chenery* principle operates as a condition for the agency to receive deference in *Chevron* Step Two. . . . The basic logic of this structure seems relatively clear: the deference the Court applies at Step Two is implicitly conditioned on the agency's having worked through the problem, with reason-giving as the overt expression of its exercise of discretion and expertise.
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> Thus, *Chenery* states a necessary condition for *Chevron* deference: the agency's contemporaneous reliance on the rationale for which it seeks deference.[24]

Conclusion

Under *Chenery*, the 40-hour-per-week rule should not be upheld based on aspects of the legislative history that are not the same as those that were primarily relied on by the IRS at the time it issued the rule. While applications of *Chenery* often involve situations in which the rationale offered by the agency's appellate counsel in defense of the agency's action is a rationale that was not referred to by the agency at the time it made its decision, nevertheless, a substantial change in the weight given to the factors that were referred to by the agency at the time it made its decision should also be subject to *Chenery*. When it issued the rule, the IRS clearly placed considerable weight on the history of the medical intern exception. Since the medical intern exception has now been substantially deemphasized by the government in its defense of the rule, any decision to uphold the rule would necessarily be based on a reasoning process different from the reasoning process that was relied on by the IRS when the rule was issued, and therefore is forbidden by *Chenery*.

The preamble to the proposed regulations did not indicate that the IRS would have adopted the rule based solely on its belief that congressional intent meant to limit the student exception to part-time work, even in the absence of IRS reliance on the statutory and legislative history relating to the medical intern exception. The prominence given in the preamble to the discussion of the medical intern exception suggests otherwise. Consequently, this case should be subject to the same principle that applies when an agency relies on multiple factors in reaching a decision and a court holds that some of the factors relied on by the agency are invalid. In those cases, unless it is clear that the agency would have reached the same result based solely on the factors not held invalid, *Chenery* applies.[25]

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[24]Kevin M. Stack, ''The Constitutional Foundations of *Chenery*,'' 116 *Yale L.J.* 952, 1005, 1006 (2007).

[25]*See, e.g., Williams Gas Processing-Gulf Coast Co. LP v. FERC*, 475 F.3d 319, 330 (D.C. Cir. 2006) (''When an agency relies on multiple grounds for its decision, some of which are invalid,' we may only 'sustain the decision [where] one is valid and the agency would clearly have acted on that ground even if the other were unavailable.' *Casino Airlines Inc. v. Nat'l Transp. Safety Bd.*, 439 F.3d 715, 717-18 (D.C. Cir. 2006) (internal quotation marks omitted); *see Int'l Union, United Mine Workers v. Dep't of Labor*, 358 F.3d 40, 44-45 (D.C. Cir. 2005)'') (alterations in original).