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WNTS Insight

Supreme Court decision addresses deference accorded tax regulations

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The U.S. Supreme Court, while construing final Treasury regulations relating to the payment of FICA tax by medical residents, recently concluded that the proper standard of deference when reviewing Treasury regulations is the highly deferential *Chevron* standard, rather than the less deferential *National Muffler* standard. (*Mayo Foundation for Medical Education and Research v. United States*) The degree of deference accorded to agency regulations has been the subject of significant litigation for more than 50 years.

Background

The *Chevron* standard, announced in the Supreme Court's 1984 decision in *Chevron USA Inc. v. Natural Resources Defense Council*, employs a two-part framework in analyzing the deference to be given to agency rules. First, a court is to determine whether Congress directly addressed the precise issue. If so, the court, and the agency, must give effect to the unambiguously expressed intent of Congress. If Congress has not directly addressed that precise issue, regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. Thus, a court may not substitute its own construction of a statutory provision for the agency's reasonable interpretation of the statute.

In contrast, the standard articulated by the Supreme Court in its 1979 decision in *National Muffler Dealers Ass'n v. United States* considers multiple factors in determining whether to defer to an agency interpretation. These factors include whether the regulation was substantially contemporaneous with the statute, the length of time the regulation has been in effect, the reliance placed on the regulation, the consistency of the agency's interpretation, and the degree of scrutiny exercised by Congress in subsequent statutory re-enactments. This standard affords less deference to the agency's interpretation of the statute than the *Chevron* standard.

The *Mayo* decision

The Supreme Court acknowledged that before deciding *Mayo*, it had cited both *Chevron* and *National Muffler* in reviewing Treasury regulations. However, the Court concluded that there is no justification for applying a less deferential standard of review to Treasury regulations than is applied to interpretations of other agencies. As a result, the Court held unanimously that the principles of *Chevron* apply with full force in the tax context.

Observations: The heightened level of deference may change the balance of power between taxpayers and the IRS as to the proper interpretation of statutory provisions. Also, the IRS may seek to invoke the Mayo decision with respect to the deference to be accorded less formal guidance such as revenue procedures or revenue rulings. At least one Department of Justice official has stated that he believes revenue procedures also are entitled to *Chevron* deference under the *Mayo* rationale.

Potential limits on reach of *Mayo*

The potential scope of the *Mayo* decision remains uncertain. Three circuit-level cases, all decided after the January 11 Supreme Court decision in *Mayo* and all interpreting the same statutory provision and underlying regulations, may provide insight on potential boundaries that still may constrain agency authority.

In September 2009, after the government lost six-year statute of limitations arguments in the Federal and Ninth circuits, the IRS issued temporary and proposed regulations under section 6501(e) to provide a six-year limitations period for assessing tax deficiencies when the taxpayer overstated its basis in sold assets, thereby understating gross income for the sale. The government then filed motions for reconsideration in some cases and appealed other cases based on the authority of the temporary regulation. In the last few weeks, three circuits -- the Seventh, Fourth, and Fifth -- have ruled in these cases.

In *Beard v. Commissioner*, the Seventh Circuit found that the six-year

period of limitations applied to the overstatement of basis but stated, in *dicta*, that it would have been inclined to grant *Chevron* deference to the temporary regulations notwithstanding the fact that they were issued without notice and comment.

The Fourth Circuit later decided *Home Concrete & Supply, LLC v. United States*, coming to a contrary conclusion. First, the Fourth Circuit held that, prior to the regulations, the six-year period did not apply in the case of overstated basis. Second, the court concluded that the attempt to hold open, or perhaps reopen, the statute of limitation for any cases that had not become final prior to the issuance of the temporary regulations was contrary to the unambiguous intent of Congress to close the statute of limitations within six years of the return being filed absent fraud. The court refused to defer to the temporary regulations and apply them retroactively, noting that regulations making substantive changes, as opposed to mere clarifications, could not be applied retroactively. The court also stated that, because the Supreme Court has declared the statute in question to be unambiguous, the regulations are not entitled to *Chevron* deference. In a concurring opinion, Judge Harvie Wilkinson stated, "agencies are not a law unto themselves," and noted that the case appeared "to pass the point where the beneficial application of agency expertise gives way to a lack of accountability and a risk of arbitrariness."

Most recently, in *Burks v. United States*, the Fifth Circuit concluded that the statute is unambiguous and does not apply to overstated basis. Because the statute is clear, the regulations are irrelevant under *Chevron*. Finally, the court stated, in *dicta*, that it would not have deferred to the regulations under *Chevron* even if the statute were ambiguous because the regulations "are an unreasonable interpretation of settled law." In a footnote, the court noted the *Mayo* case involved final regulations. Accordingly, the court stated it was unclear whether *Mayo* applied to temporary regulations that were not subject to notice and comment. The footnote further stated the issuance of nearly identical final regulations, after notice and comment, was not an acceptable substitute for pre-promulgation notice and comment.

These three cases reflect that courts are not in agreement on whether temporary regulations, which are frequently issued, should be accorded *Chevron* deference. It is unclear whether other courts will concur with the Fifth Circuit that subsequent adoption of final regulations does not serve to insulate temporary regulations from review.

Observation: Five similar cases that address the regulations under section 6501(e) are poised to be decided by four other circuits in the next several months. These cases may further illuminate what boundaries, if any, may be placed on how tax guidance must be issued to be entitled to *Chevron* deference.

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