

# Separation of Powers: What Do Recent Court Cases Mean for the IRS's Exercise of Regulatory Authority?

National Tax Association  
53<sup>rd</sup> Annual Spring Symposium  
May 11, 2023

This panel is co-sponsored by the American Tax Policy Institute

Special thanks to Jud Judkins and his fellow panelists at the DC Bar Conference on January 25, 2023 for use of some of their slides on this topic.

# Panelists

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# Agenda

- Administrative Procedure Act
- *Chevron* Deference
- Major Questions Doctrine
- Constitutional Questions
- IRS Appeals Consideration of Validity Challenges

# Factors Influencing U.S. Tax Law

- Factors influencing the making of U.S. tax law include:
  - Policy
  - Process
    - Legislation
    - Administrative Guidance
  - Politics
- This panel focuses on the process of administrative guidance

# Questions about the Exercise of Regulatory Authority by the Executive Branch

- There is an increasing number of cases in which taxpayers have made assertions, many successful, that the Treasury Department has exceeded its authority in issuing administrative guidance, including regulations, either because the process for promulgating the guidance failed to satisfy the requirements of the Administrative Procedure Act (APA), or because the substance of the regulations failed to satisfy the standard for judicial deference under the U.S. Supreme Court's *Chevron* decision
- The federal judiciary is increasingly concerned that the federal executive branch is exercising administrative power contrary to the statutes enacted by Congress

# Notice-and-Comment Rulemaking: General APA Requirements

- 5 U.S.C. § 553
- Purposes
  - Notice and comment gives affected parties fair warning of potential changes in the law and opportunity to be heard on those changes, and it affords the agency a chance to avoid errors and make a more informed decision
- General Requirements
  - Notice of proposed rulemaking
  - Written comments
  - Concise and general statement of basis and purpose
  - Rule effective 30 days after publication
- Hearing (not required but often provided)

# Notice-and-Comment Rulemaking: Legislative and Interpretive Rules

- Exceptions within 5 U.S.C. § 553
  - “Interpretive” rules
  - Procedural rules
  - Policy statements
  - The “good cause” exception
- Legislative rules
  - Have the force and effect of law
  - Impose new rights or duties
  - Change the legal status of regulated parties
- Interpretive rules articulate what an agency thinks a statute means or remind parties of pre-existing duties

# Judicial Review of Agency Action

- 5 U.S.C. § 706(2) – Three Bases for Setting Aside Rules
  - Contrary to Statute
  - Arbitrary or Capricious
  - Procedurally Defective



# APA Challenge to Micro-Captive Insurance Notice

- Notice 2007-83 designates as listed transactions certain employee benefit plans that feature cash-value insurance policies
- The Notice was set aside in *Mann Construction* (6<sup>th</sup> Cir. 2022) because of the IRS's failure to issue the Notice under notice-and-comment procedures
- Taxpayers have been unsuccessful in obtaining nationwide injunctions against enforcement of notices of this type imposing reporting requirements

# APA Challenges Regarding Syndicated Conservation Easements

- There are dueling appellate court opinions (*Hewitt* (11<sup>th</sup> Cir. 2021) and *Oakbrook* (6<sup>th</sup> Cir. 2022)) as to whether the IRS failed to respond to “significant comments” when in 1986 it finalized a regulation about deductions for charitable contributions of conservation easements
- I.R.C. § 170(h)(2)(C) requires the contribution of an easement to be in perpetuity in order to obtain a charitable deduction
- The issue was the regulation’s interpretation of what it means to be in perpetuity, in particular what a deed needs to say about the allocation of proceeds if there is a judicial extinguishment of the conservation easement
- The U.S. Supreme Court declined to resolve the conflict between the appellate courts, perhaps because the IRS could have prevailed in *Oakbrook* on an alternative theory
- The Tax Court held for the taxpayer on a similar issue (*Green Valley Investors* (2022)) involving the obligation to report conservation easements (Notice 2017-10), and a government appeal is likely

# IRS Response to APA Litigation Losses

- In December 2022, the IRS issued proposed regulations identifying certain syndicated conservation easements as listed transactions
- In April 2023, the IRS issued proposed regulations identifying certain micro-captive insurance transactions as listed transactions, and certain other micro-captive transactions as transactions of interest, another type of reportable transaction
- In April 2023, the IRS issued Notice 2023-30, setting forth “safe harbor deed language” in response to uncertainty around what a deed needs to say about the allocation of proceeds if there is a judicial extinguishment of a conservation easement

# Validity of Temporary Regulations

- Good-cause exception to notice-and-comment rulemaking
  - 5 U.S.C. § 553(b)(3)(B) provides an exception to the APA's rulemaking requirements if the agency for good cause finds that notice-and-comment procedures are impracticable, unnecessary, or contrary to the public interest
  - I.R.C. § 7805(e) pertains to temporary regulations and requires:
    - The IRS to contemporaneously issue temporary regulations as proposed regulations subject to notice and comment; and
    - That the temporary regulations expire within three years of issuance

## Validity of Temporary Regulations (cont'd)

- In *Liberty Global* (2022), a federal District Court in Colorado invalidated a temporary regulation on the theory that the IRS failed to comply with the notice-and-comment requirement of the APA, and “good cause” did not exist to issue a temporary regulation because the IRS had seven months to issue a final regulation
- Because seven months seems an inadequate period of time to issue a proposed regulation, receive public comments, hold a public hearing, and issue a final regulation, the government is likely to appeal the case

# Necessity of Responding to Significant Comments Will Continue to Generate Controversy

- In *3M Company* (2023), in a reviewed 346-page opinion, the Tax Court judges differed on the question whether the IRS had adequately responded to comments in 1994 when it issued the transfer-pricing regulation at issue in this case
- Query: should tax disputes be determined by reference to whether certain public comments were “significant” enough to be discussed specifically by the IRS in preambles to final regulations?

# Judicial Deference

- *Chevron* deference: regulatory interpretations of statutes (discussed later)
- *Auer* deference: agency interpretations of regulations (clarified by *Kisor* (2019))
  - Following application of the traditional tools of statutory construction, the court must find that the regulation is genuinely ambiguous
  - The agency's interpretation must fall within the bounds of reasonable interpretation
  - The regulatory interpretation must be the agency's authoritative or official position
  - The agency's interpretation must implicate its substantive expertise
  - An agency's reading of a rule must reflect its fair and considered judgment, rather than a convenient litigating position or a new interpretation that creates unfair surprise to regulated parties
- *Skidmore* deference: typically applies to subregulatory guidance
  - "The weight of such a judgment in a particular case 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 which give it power to persuade, if lacking power to control."

# *Chevron* Deference

- In *Chevron* (1984), the U.S. Supreme Court set forth a two-step framework for judicial review of an agency's interpretation of a statute that the agency is charged with administering
- In *Mayo Foundation* (2011), the U.S. Supreme Court stated that the principles in *Chevron* apply with full force in the tax context
- In step one of the *Chevron* analysis, if a court determines that Congress has directly spoken to the precise question at issue, then that is the end of the matter
- If a court determines that Congress has not directly spoken to the question at issue, a court will proceed to step two, under which courts generally defer to a reasonable agency interpretation of the statutory text



## *Chevron* Deference (cont'd)

- The *Chevron* test at first glance appears to be relatively straightforward, but in actuality the two-step rule is ambiguous in many ways and how courts apply the two-step rule varies
  - For example, it is unclear whether or how legislative history is relevant to *Chevron* step one
- A court might do a statutory analysis and determine that a statute is clear, invalidating an agency's regulatory interpretation, whereas another court might do a similar statutory analysis and determine that the statute is ambiguous, necessitating resort to *Chevron* step two, generally resulting in deferral to the agency's interpretation of the statute
  - In *FedEx* (2023), a federal District Court in Tennessee, after a lengthy statutory analysis, concluded that a tax statute was clear and invalidated a regulation, even though the court's conclusion appeared to be contrary to appropriate tax policy

## *Chevron* Deference (cont'd)

- Furthermore, the *Chevron* case itself has been heavily criticized by Justices of the U.S. Supreme Court, who think that the *Chevron* test allows too much discretion to federal agencies and that federal agencies have overstepped their proper authority in their interpretation of Congress's statutes
- In particular, see Justice Gorsuch's dissent to the denial of certiorari in *Buffington* (2022), in which he expressed his view that *Chevron* allows too much deference to agencies in rulemaking
- Justice Gorsuch believes that courts have abdicated their responsibility to exercise independent judgment about the law's meaning
- The Supreme Court has decided to revisit the *Chevron* doctrine in *Loper Bright Enterprises*

# Major Questions Doctrine

- *West Virginia v. EPA* (2022)
  - Held that the EPA's Clean Power Plan was not within the agency's authority under § 111(d) of the Clean Air Act
  - A "clear statement" from Congress is necessary in order for a court to conclude that Congress intended to delegate authority to EPA to establish carbon emissions caps based on a generation shifting approach and promulgate a regulation of such "vast economic and political significance"
  - The majority opinion did not mention *Chevron* and made it clear that the major questions doctrine is independent from *Chevron*
  - In his concurrence, Justice Gorsuch explains that the major questions doctrine is a way of enforcing the non-delegation doctrine, which holds that legislative powers vested in Congress by the Constitution cannot be delegated by Congress to administrative agencies
  - Courts have historically avoided the nondelegation doctrine because of the difficulty inherent in distinguishing permissible executive policy from exercises of legislative power. Nondelegation appears to have only been upheld by the Court in *Panama Refining* and *Schechter Poultry* (both in 1935)

# Major Questions Doctrine

- *King v. Burwell* (2015)
  - The case involved a regulation interpreting the Affordable Care Act
  - The U.S. Supreme Court did not apply *Chevron* deference because courts should not defer to agency statutory interpretations that concern questions of “vast economic or political significance”
  - Courts, not administrative agencies, are supposed to interpret “major” legal questions

# Origin of the Major Questions Doctrine

- *MCI Telecommunications Corp. v. American Telephone & Telegraph Co.*(1994)
  - The Court held that the FCC did not have the authority to excuse certain common carriers from filing tariffs imposed under the Communications Act.
  - “Agencies only have those powers given to them by Congress and ‘enabling legislation’ is generally not an open book to which the agency [may] add pages and change the plot line.”
- *Brown & Williamson*
  - The Court held that the FDA’s authority over drugs and devices did not authorize it to regulate tobacco.
  - “Congress could not have intended to delegate [such a sweeping and consequential authority ] in so cryptic a fashion”
  - In extraordinary cases. . . there may be reason to hesitate before accepting a reading of a statute that would, under more ordinary circumstances, be upheld

# Development of the Major Questions Doctrine

- *Alabama Assn. of Realtors v. Department of Health and Human Services (2021) (per curiam)*
  - In a shadow docket decision, the Court held that the CDC could not institute a nationwide eviction moratorium in response to the COVID-19 pandemic under its authority to adopt measures necessary to prevent the spread of disease
  - The Court cited the sheer scope of the CDC's claimed authority, its unprecedented nature and the fact that Congress had failed to extend the moratorium (after previously having done so)
- *National Federation of Independent Business v. Occupational Safety and Health Administration (2022)*
  - The Court held that an OSHA mandate that most Americans working indoors either obtain a COVID-19 vaccine or undergo weekly medical testing at their own expense
  - The Court found it “telling that OSHA, in its half century of existence, had never relied on its authority to regulate occupational hazards to impose such a remarkable measure.”

# Major Questions Doctrine -- Considerations

- **When is a question a major question?**
  - Is the determination based on an absolute standard detached from the statute?  
Does the Court decide?
    - *Brown & Williamson* employs an absolute standard as determined by the Court
    - In his concurrence in *EPA vs. West Virginia*, Justice Gorsuch provides a non-exhaustive list of political, economic and structural considerations for identifying a major question
    - Under this determination, reference to the statute is less relevant. If the issue is a major question (in absolute terms) and the agency does not have a specific grant of authority, the doctrine applies

# Major Questions Doctrine -- Considerations

- **When is a question a major question?**
  - Alternatively, or in addition, should the test look to the relative importance of the question in the statutory scheme (*i.e.*, the idea that Congress does not hide elephants in mouseholes)?
    - See *King v. Burwell* where the issue (whether health insurance policies qualify for tax credits) was determined to be major because of its relative importance to the statutory framework
    - Also see the dissent in *EPA vs. West Virginia* which describes the major questions doctrine as involving cases in which “the agency strayed out of its lane, to an area where it had neither expertise nor experience.”



# Major Questions Doctrine -- Considerations

- **How does the major questions doctrine intersect with *Chevron*?**
  - Should it be considered a *Chevron* Step Zero rule: A determination that *Chevron* should not apply at all? A reversal of *Chevron*'s presumption of agency deference?
  - Should it inform *Chevron* Step One and/or Step Two (*i.e.*, the determination of whether the statute is ambiguous, or the agency's interpretation reasonable)?
  - Is the doctrine entirely separate and apart from *Chevron* (*e.g.*, a subset of the nondelegation doctrine)?
- **Separation of power considerations**
  - Does the doctrine, articulated as giving more power to Congress, actually give it less power?
    - To what extent should the modern reality of an often-dysfunctional Congress be considered?
  - As between the agency and the courts, who is best positioned to determine the agency's jurisdiction or the scope of its regulatory authority?
  - To what extent does the doctrine prevent an agency from undertaking important regulatory projects

# Constitutional Questions

- Taxpayers have challenged statutes as violating the U.S. Constitution
- For example, in *Moore* (9<sup>th</sup> Cir. 2022), the taxpayer unsuccessfully asserted that the I.R.C. § 965 mandatory repatriation tax (MRT) enacted in the 2017 Tax Cuts and Jobs Act was not permitted under the 16<sup>th</sup> Amendment (authorizing the income tax) and violated the Apportionment Clause and the Due Process Clause
- The 9<sup>th</sup> Circuit upheld the constitutionality of the MRT, which imposed an income tax on a U.S. shareholder's share of undistributed earnings of a controlled foreign corporation
- The Court held that the Constitution does not require income to be “realized” before it can be subject to income tax

# IRS Appeals Consideration of Validity Challenges

- I.R.C. § 7803(e) generally provides taxpayers with a right to resolution of disputes with the IRS Independent Office of Appeals.
- Appeals has historically been permitted to consider validity issues
- Proposed Reg. § 301.7803-2(c)(18), (19) and (20):
  - IRS Appeals may not consider a taxpayer's argument that a statute is unconstitutional, that a regulation is invalid, or that an IRS notice or revenue procedure is procedurally invalid, absent an unreviewable decision from a federal court to that effect
- Concerns raised by commenters:
  - Today, validity challenges to tax guidance under the APA present a real litigation hazard
  - The position taken in the proposed regulation undercuts the independence of Appeals
  - The position renders Appeals inconsistent with and less responsive to legal developments