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Light on the Mayo: Recent Developments May Diminish the Impact of *Mayo Foundation* on Judicial Deference to Tax Regulations

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Treasury regulations that require controlled entities that are parties to research cost-sharing arrangements to share of equity compensation costs allocable to research personnel have been controversial for twenty years. Therefore, I was not surprised when the Tax Court invalidated the regulations in 2015. That is, I was not surprised until I read the court's decision and discovered the reason for the invalidation. The court wielded an administrative law doctrine that had surfaced in a tax case a few years earlier.[1] The earlier case concerned a very technical tax accounting issue and generated relatively little attention.[2] The more recent case, however, implicated billions of dollars in taxes and concerned the very visible issue of tax base erosion.[3] Moreover, because it was the second case in recent years to apply an administrative law doctrine unfamiliar to the tax area, the Treasury should be concerned.

The Treasury scored a major victory in 2011 when the Supreme Court held that its regulations are entitled to the same standard of review applicable to regulations issued by other agencies.[4] Last year, however, the Court refused to defer to the Treasury in its third decision concerning the Patient Protection and Affordable Care Act.[5] That decision should have raised some concern for the Treasury. This decision and the two aforementioned decisions provide taxpayers fodder with which to challenge the validity of tax regulations. The Treasury's victory in 2011 may have been, to some extent, pyrrhic.

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1. *See infra* notes 196-217 and accompanying text.
2. *See infra* notes 196-201 and accompanying text.
3. *See infra* notes 230-95 and accompanying text; *See also* Richard Rubin, *Alphabet Is in Line As Winner in IRS Case*, WALL ST. J. Feb. 29, 2016, at B6 (reporting that the court's decision could save Google's parent company at least $3.5 billion in federal income taxes).
4. *See infra* notes 74-76 and accompanying text.
5. *See infra* notes 96-141 and accompanying text.

Part I of this article briefly describes the developments that led to the passage of the Administrative Procedure Act, a statute enacted to rein in the growing power and influence of administrative agencies. This part also discusses Treasury rulemaking and the agency's rather cavalier relationship with the Administrative Procedure Act. The Treasury long had asserted that regulations issued pursuant to a general statutory grant of authority were not subject to the Administrative Procedure Act. Moreover, the increased complexity of the tax code over the past thirty years led the Treasury to more frequently issue regulations in temporary form without the niceties of formal Notice and Comment procedures and to issue substantive, often controversial rules, informally.

As a consequence, Treasury actions were not always afforded the same level of deference enjoyed by other agencies' actions. Part II discusses the standards of review that the courts applied to Treasury regulations. This had been an area of considerable confusion after the Supreme Court's landmark *Chevron* decision for almost three decades. This part reviews the standards of review that existed pre-*Chevron* and the confusion regarding *Chevron's* application to tax regulations. In 2011, the Court clarified that tax regulations are reviewable under the standards applicable to regulations in general, firmly rejecting any notions of tax exceptionalism.

As a result, Treasury regulations are *pari passu* with other regulations and are entitled to *Chevron* deference to the same extent as other regulations. At the time, this result was considered an unmitigated victory for the Treasury because less deferential standards of review would no longer apply to certain tax regulations. However, in light of recent developments the Treasury's victory may have been a mixed blessing. Part III of this article discusses the Court's decision in *King v. Burwell*. This highly publicized—and politicized—case concerned the interpretation of the tax credit provisions of the Patient Protection and Affordable Care Act. The Court agreed with the Treasury's position on the issue but it did so without deferring to the agency. In so doing, the Court raised some interesting possibilities with respect to taxpayer challenges to Treasury authority.

Part III describes a more troublesome development for the Treasury. Approximately one year before *Chevron,* the Court set forth another landmark administrative law doctrine in its *State Farm* decision. That decision held that, pursuant to the Administrative Procedure Act, agencies must articulate the reasons for their regulatory choices and such choices must be reasonably connected to the facts found by the agencies. *State Farm* has not been applied by the Court to any tax regulations and this doctrine was—for all intents and purposes—ignored by the tax bar. However, two courts, invoking *State Farm*, recently have invalidated Treasury regulations. This Part III analyzes and critiques these cases.

Many scholars and practitioners believe that *Chevron* and *State Farm* are inseparable because the latter is incorporated into the former. However, I disagree and believe that *State Farm*—in many circumstances—provides independent grounds with which to challenge tax regulations.

TREASURY RULEMAKING: A CASUAL RELATIONSHIP WITH THE ADMINISTRATIVE PROCEDURE ACT

The days when our economy operated largely without the watchful eyes of a vast federal bureaucracy upon it are long gone and it is difficult to imagine things otherwise.[6] However, the federal government had limited involvement in our nation's economic affairs for almost half of its history. The administrative state was spawned and grew, in part, as a counterweight to the growth in power of business enterprises. Not surprisingly, it did not take much time for the counterweight to need its own counterweight. A sea change in the Supreme Court's interpretation of the Constitution and the exigencies of World War II led to concerns that administrative agencies had accumulated too much power and too often wielded that power in inappropriate ways. As a result, Congress enacted major reform legislation after the war. In the seven decades since, the Treasury has operated in its own regulatory environment, subjecting itself to the rules by which agencies in general, operate in some, but not all, cases.

THE GROWTH OF THE ADMINISTRATIVE STATE

The importance of the federal government's role in the nation's economic affairs increased in response to the industrialization of the economy during the nineteenth century and to the post-Civil War need to protect the newly acquired rights of African-Americans. The Progressive movement inserted, rather fitfully thanks to *Lochner*,[7] the public sector in theretofore private matters. The creation of the Interstate Commerce

6. One study reports that in 2015 Congress enacted 114 statutes and the regulatory agencies issued 3,410 regulations. The direct and indirect cost of compliance with regulatory burdens was estimated to be almost $1.9 trillion, or almost $15,000 per household; *See* Clyde Wayne Crews, Jr., *Ten Thousand Commandments*, COMPETITIVE ENTER. INST. (2016), https://cei.org/sites/default/files/Wayne%20Crews%20-%20Ten%20Thousand%20Commandments%202016%20-%20May%204%202 016.pdf.

7. *See* Lochner v. New York, 198 U.S. 45 (1905) (holding that a New York statute regulating the hours of bakers was an unconstitutional infringement on the right and liberty to contract). The *Lochner* era is considered to have closed with the Court's decision in West Coast Hotel Co. v. Parrish, 300 U.S. 379 (1937), a decision that upheld the constitutionality of Washington state's minimum wage law and overturned an earlier precedent to the contrary, Adkins v. Children's Hospital, 261 U.S. 525 (1923).

Commission in 1887 marked the birth of what would become an immense federal bureaucracy and the Progressive period resulted in the increased regulation of railroads, the institution of occupational licensing, and the enactment of the Sherman Antitrust Act.[8] The Supreme Court's initial resistance to expansive federal powers over economic matters, manifested most dramatically in *Dagenhart*,[9] eventually succumbed to the onslaught of New Deal legislation.[10] The alphabet soup of agencies to which we are now beholden came into existence and, not surprisingly, grew both in number and power. The passage of the Administrative Procedure Act in 1946 was the result of objections to the increasing power of executive branch agencies, particularly during World War II, the waning popularity of the Democratic Party, and the realization by reform proponents that procedural safeguards were necessary in the face of the courts' reluctance to rein in the agencies.[11]

A detailed analysis of the Administrative Procedure Act is beyond the scope of this work. The Act's purposes are to inform the public about agencies' procedures, rules, and organization; provide the public with the opportunity to participate in the rule making process; establish standards for the promulgation of rules and adjudicating disputes; and set forth the scope of judicial review of agencies' actions.[12] Except for military, foreign affairs, and certain managerial, personnel, and other matters not relevant here, the Act requires that notice and comment procedures be adhered to in the promulgation of proposed regulations.[13] However, the notice and comments requirements do not apply to interpretive rules, general

8. *See generally* LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 439–66 (2d. ed. 1985).

9. Hammer v. Dagenhart, 247 U.S. 251 (1918) (holding that compliance with child-labor standards was beyond the reach of Congress's power to regulate interstate commerce).

10. The Court's narrow interpretation of the commerce power came to an end with its decision in the seminal case of N.L.R.B. v. Jones & Laughlin Steel Corp., 301 U.S. 1 (1937)(upholding the constitutionality of the National Labor Relations Act of 1935). Any doubts as to the extent of the federal commerce power were laid to rest several years later in Wickard v. Filburn., 317 U.S. 111 (1942)(holding that Congress' power to regulate interstate commerce includes the power to regulate activity that has an indirect effect on such commerce).

11. Ch. 324, 60 Stat. 237 (1946) (codified at 5 U.S.C. §§ 551–59, 701–706 (2016)); Anthony W. Mongone, Note, *Business Roundtable: A New Level of Judicial Scrutiny and its Implications in a Post-Dodd-Frank World*, 2012 COLUM. BUS. L. REV. 746, 770–85 (2012).

12. ATTORNEY GENERAL'S MANUAL ON THE ADMINISTRATIVE PROCEDURE ACT 9 (Wm. W. Gaunt & Sons 1973), *available at* http://archive.law.fsu.edu/library/admin/attorneygenerals manual.pdf.

13. 5 U.S.C. §§ 553(a)-(b) (2016). In general, final regulations may not take effect within 30 days after notice is given. However, this requirement is inapplicable to regulations that relieve burdens on those persons subject to the regulations. 5 U.S.C. § 553(d)(1)(2016). Tax regulations that are favorable to taxpayers may be insulated from taxpayer challenges due to lack of standing. *See infra* note 36 and accompanying text. Not all taxpayer-friendly regulations will be so insulated, however. For example, standing was no barrier to challenges to Treasury regulations that interpreted the availability of tax credits provided by the Patient Protection and Affordable Care Act in a manner favorable to taxpayers because the availability of tax credits to some taxpayers triggered particularized burdens on other taxpayers. *See infra* notes 113, 117 and accompanying text.

statements of policy, or rules of agency organization, procedure, or practice.[14] Moreover, an agency may dispense with notice and comment if the agency finds, with good cause, that notice and comment procedures are impractical, unnecessary, or contrary to the public interest.[15]

Treasury Rulemaking

The Treasury has exhibited a degree of cognitive dissonance with respect to the applicability of certain provisions of the Administrative Procedure Act to its rulemaking actions.[16] The Treasury derives its regulatory authority from two sources. First, Congress may delegate it the authority to issue rules and regulations to carry out the provisions of a specific statute within the statute itself. The extent of the regulatory authority granted to the Treasury in this manner typically is phrased in broad language that authorizes the Treasury to prescribe regulations as may be necessary and appropriate to carry out the statutory provisions in question although it is not uncommon for Congress to reference specific provisions within the statute indicating its expectation that regulations will be forthcoming with respect to those provisions.[17] A second source of regulatory authority is Internal Revenue Code (I.R.C.) section 7805(a) which delegates general regulatory authority to the Treasury for the enforcement of the I.R.C.[18]

The Treasury took the position that regulations issued under the latter delegation of authority were interpretative and, therefore, not subject to the

14. 5 U.S.C. § 553(b)(2016).

15. *Id.* An agency that invokes the good cause exception must set forth its reasons for doing so. 5 U.S.C. § 553(b)(B)(2016). The Attorney General's Manual and the courts have interpreted the good cause exception to apply in cases when timely guidance is critical and the notice and comments requirement would impose an impediment to such timely guidance, minor rules with little public interest, and the somewhat unusual case in which notice and comment would be counterproductive. *See* Kristin E. Hickman, *A Problem of Remedy: Responding to Treasury's (Lack of) Compliance with the Administrative Procedure Act Rulemaking Requirements*, 76 GEO. WASH. L. REV. 1153, 1782 (2008).

16. The Internal Revenue Code (I.R.C.) delegates regulatory authority to the Secretary of the Treasury. The Internal Revenue Service (I.R.S.), however, has a significant role in the drafting of regulations. *See id.* at 1154, n.3.

17. *See e.g.*, I.R.C. §§ 263A(i), 409A(e), 469(l)(CCH 2016).

18. I.R.C. § 7805(a)(CCH 2016). With certain exceptions, proposed, temporary, or final regulations cannot have retroactive effect. I.R.C. § 7805(b)(CCH 2016). Temporary regulations must also be issued in the form of proposed regulations and expire within three years of their issuance. I.R.C. § 7805(e)(CCH 2016). All published proposed and temporary regulations must be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact that such regulations will have on small business. The Treasury must consider comments from the Chief Counsel for Advocacy of the Small Business Administration and discuss any response to such comments in the preamble to final regulations. I.R.C. § 7805(f)(CCH 2016).

notice and comment provisions of the Administrative Procedure Act.[19] This distinction has been criticized by several commentators and discounted by the courts.[20] Congress exhibited a modicum of concern with this practice and expressly required the Treasury to comply with the provisions of the Regulatory Flexibility Act regardless of whether the regulations are legislative or interpretative.[21] Moreover, as the tax law became more complex, particularly after the enactment of the Tax Reform Act of 1986, the Treasury came to rely on the issuance of temporary regulations which are binding upon taxpayers without any opportunity for pre-promulgation comment by interested parties.[22] Congress took notice and enacted I.R.C. section 7805(e) in 1988 mandating that temporary regulations be issued contemporaneously with a Notice of Proposed Rulemaking and that such temporary regulations expire within three years.[23]

The I.R.S. regularly engages in informal rulemaking through the issuance of revenue rulings and notices, neither of which are subject to the Administrative Procedure Act.[24] Revenue rulings are official, published

19. *See* Hickman, *supra* note 15, at 1158, n.16 (citing a study that found, in 232 regulatory projects studied, the notice and comment requirement was explicitly disclaimed in almost 92 percent of such projects).

20. *See e.g*., Mayo Found. for Med. Educ. and Research v. United States, 562 U.S. 44, 55–58 (2011) (applying the same standard of deference to regulations issued under a general grant of authority that is applied to other regulations); Chevron U.S.A., Inc. v. Natural Res. Def. Council, 467 U.S. 837, 844 (1984) (stating that oftentimes legislative delegations are implicit); Swallows Holding, Ltd. v. Comm'r, 515 F.3d 162, 168–69 (3d Cir. 2008)(holding that regulations promulgated pursuant to I.R.C. § 7805 have the force of law); Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack of)Compliance with the Administrative Procedure Act Rulemaking Requirements*, 82 NOTRE DAME L. REV. 1727, 1760–73) (2007); *S8ee also ABA Section of Taxation Report of the Task Force on Judicial Deference* [*hereinafter ABA Task Force Report*], 57 TAX LAW. 717 (2004).

21. *See* 5 U.S.C. § 603(a)(2016).

22. *See* Michael Asimov, *Public Participation in the Adoption of Temporary Tax Regulations*, 44 TAX LAW. 343, 343 (1991). *See also* Hickman, *supra* note 15, at 1160. In a study conducted by Professor Hickman, the Treasury frequently asserted that the provisions of the Administrative Procedure Act did not apply to regulations, whether temporary or final, due to the good cause exception. *See* Hickman, *supra* note 20, at 1749–51. Treasury's invocation of the good cause exception has been met with skepticism. *See id.* at 1782–86.

23. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6232(a), 102 Stat. 3342, 3734–35 (1988) (codified at I.R.C. § 7805(e)). Recently, the Treasury issued temporary and proposed regulations to hinder inversion and post-inversion transactions pursuant to which a domestic corporation relocates its domicile in a low tax jurisdiction but maintains significant operations in the country of its former domicile. *See generally* Temp. Treas. Reg. §§ 1.304-7T; 1,367(a)-3T; 1.367(b)-4T; 1.956-2T;1,7701(l)-4T;1.7874-1T-4T; 1.7874-6T-12T, 81 Fed. Reg. 20857 (April 8, 2016). The issuance of these regulations reportedly scuttled the pending Pfizer-Allergan merger, as well as other pending transactions. *See* Katie Thomas & Chad Bray, *Pfizer Weighs Split as Allergan Deal Collapses*, N.Y. TIMES, April 7, 2016, at B1; Domenic Chopping & Ben Tita, *Tax Inversion Rules Complicate Crane Deal*, WALL ST. J., April 28, 2016, at B3(reporting that the new rules could derail a merger between Terex Corp. and Konecranes Oyj).

24. The I.R.S. issues guidance in a number of forms including Revenue Procedures, Private Letter Rulings, and Technical Advice Memoranda. A discussion of other forms of guidance is beyond

interpretations of the tax law applicable to a particular set of facts and are designed to both promote the uniform application of the tax laws and to assist in taxpayers' compliance with such laws.[25] As explicitly noted in the weekly Internal Revenue Bulletins in which the rulings are published, rulings do not have the force and effect of regulations although they may be used as precedent by taxpayers. Rulings are designed to apply the law to a specific set of facts and, to that extent, can be fairly described as interpretative. Notices often are used to provide guidance pending the issuance of a ruling or proposed regulations and frequently contain substantive interpretations of the tax law.[26] Notices, in benign form, provide taxpayers with much needed guidance pending the conclusion of formal rulemaking. However, they also have been used to advance controversial positions without any opportunity for public comment. Notice 2008-83 is a particularly good example of such use.

Congress has long restricted the ability of corporate acquirers to utilize the net operating losses of acquisition targets.[27] Under current law, if a corporate ownership change, as defined by the statute, occurs then I.R.C. section 382(a) limits the amount of the taxable income for any post-change taxable year that may be offset by pre-change losses.[28]

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the scope of this article. *See* Internal Revenue Service, *Understanding IRS Guidance-A Brief Primer, available at* https://www.irs.gov/uac/understanding-irs-guidance-a-brief-primer.

25. *See* Rev. Proc. 2003-1, 2003-1 C.B.1 (Jan. 2003); Rev. Proc. 89-14, 1989-1 C.B. 814, 814–15 (Jan. 1989).

26. *See* Internal Revenue Service, *Understanding IRS Guidance-A Brief Primer, supra* note 24. The status of Notices relative to Revenue Rulings with respect to the deference that a court will afford them is not clear. *Compare* Constantino v. TRW, Inc., 13 F.3d 969, 980–81 (6th Cir. 1994)(stating that Revenue Rulings are entitled to greater deference) with Phillips Petroleum Co. v. Comm'r, 101 T.C. 78, 99 (1993)(stating that Revenue Rulings and Notices are entitled to equal deference). In some cases a Notice will expressly state that it may be relied upon by taxpayers as if it were a Revenue Ruling. *See e.g.,* Notice 89-99, 1989-2 C.B. 422 (July 1989).

27. Congress attempted to restrict the ability of taxpayers to traffic net operating losses over 70 years ago. Section 129 of the Revenue Act of 1943 denied certain tax benefits, including deductions, if, among other transactions, any person acquired control of a corporation and the principal purpose of such acquisition was the evasion or avoidance of federal income tax. Revenue Act of 1943, Pub. L. No. 78-235, § 129, 58 Stat. 21, 47 (1944).

28. The I.R.C. § 382 limitation is equal to the value of the loss corporation multiplied by the long-term tax-exempt rate. I.R.C. § 382(b)(1)(CCH 2016). The long-term tax–exempt rate is the highest of the adjusted Federal long-term rates in effect during the three month period ending in the calendar month in which the ownership change occurs adjusted for differences between long-term taxable and tax exempt rates. I.R.C. § 382(f)(CCH 2016). The Federal long-term rate is a rate published monthly by the I.R.S. that is determined by the average market yield on outstanding marketable obligations of the United States with maturities in excess of nine years. *See* I.R.S. § 1274(d)(1)(CCH 2016). A business continuity requirement is also imposed under § 382. In the event that the business enterprise of the old loss corporation is not continued at all times during the two year period beginning on the date of the ownership change, the § 382 limitation is zero. I.R.C. § 382(c)(1)(CCH 2016). An ownership change occurs in one of two ways. First, an ownership change occurs if the percentage of stock owned by one or more five percent shareholders increases by more than fifty percentage points over the lowest percentage held by such shareholders during a three year testing period. I.R.C. §§ 382(g); 382(i)(1); 382(k)(7)(CCH 2016). Changes in the percentage ownership

Consequently, once the statutory threshold change in ownership occurs, net operating losses that arose prior to the ownership change are available to offset only a limited amount of taxable income in any taxable year. If the corporation has net unrealized built-in losses in its assets on the date of the ownership change then the losses subsequently recognized on those assets during the five year period following the ownership change date are subject to the same limitations as if such recognized losses were pre-change net operating losses.[29] In effect, the I.R.C. section 382 limitation will apply to losses that would have been included in the net operating losses subject to I.R.C. section 382 had they been recognized prior to the ownership change.

Notice 2008-83 was released on September 30, 2008 and its operative provision interpreted the statutory built-in loss provision as it applied to banks as follows:

> For purposes of section 382(h), any deduction properly allowed after an ownership change (as defined in section 382(g)) to a bank with respect to losses on loans or bad debts (including any deduction for a reasonable reserve for bad debts) shall not be treated as a built-in loss or a deduction that is attributable to periods before the change date.[30]

This notice was issued in the midst of the financial crisis and mitigated the effect of the statutory rules on the acquirers of failing banks by overriding the statutory stricture that bad debt deductions, after an ownership change, were presumptively net recognized built-in losses unless the corporation carried its burden of proof to show otherwise.[31] The notice was

of five percent shareholders are termed "owner shifts." I.R.C. § 382(g)(2)(CCH 2016). Alternatively, an ownership change occurs due to certain tax-free reorganizations that result in a more that fifty percentage point increase in the stock held by five percent or more shareholders over the lowest percentage of stock held by such shareholders during a three year testing period. I.R.C. §§ 382(g); 382(i)(1); 382(k)(7)(CCH 2016). These transactions are termed "equity structure shifts." I.R.C. § 383(g)(3)(2016).

29. I.R.C. §§ 382(h)(1)(B); 382(h)(7)(CCH 2016). A net unrealized built-in loss is the excess of the adjusted tax basis of the assets of the corporation over the fair market value of such assets on the change date. I.R.C. § 382(h)(3)(A)(i)(CCH 2016). Any deduction which is properly taken into account during the five year recognition period is treated as a recognized built-in loss if such deduction is attributable to the periods before the change date. I.R.C. § 382(h)(6)(B)(CCH 2016). Therefore, depreciation, amortization, and bad debt deductions, may be treated as recognized built-in losses to the extent that such depreciation or amortization is attributable to assets whose tax basis exceeded their fair market value on the change date or to the extent that a bad debt deduction is taken on a receivable that had already gone bad as of the change date. The statute provides a *de minimis* rule that ignores unrealized built-in losses if such losses are minimal. I.R.C. § 382(h)(3)(B)(CCH 2016). Special rules apply in the event that the corporation has net unrealized built-in gains, as opposed to losses, on the date of the ownership change. *See* I.R.C. § 382(h)(1)(A)(CCH 2016).

30. Notice 2008-83, 2008-2 C.B 905.

31. Notice 2008-83 was a major factor in both the acquisition of Wachovia Bank by Well Fargo and the acquisition of National City Bank by PNC Financial. *See* Eric Dash & Jonathan D. Glater, *Citigroup Says Judge's Order Suspends Wachovia Deal*, N.Y. TIMES Oct. 5, 2008, at A35; Eric Dash,

immediately criticized as a bailout for the banking industry.[32] As one prominent Wall Street tax authority observed "[i]t couldn't be clearer if they had taken out an ad."[33] Senators Schumer of New York and Grassley of Iowa publicly questioned the propriety of the notice and the latter requested an internal Treasury review of the circumstances surrounding its issuance.[34] Congress overturned the notice with the passage of the American Recovery and Reinvestment Act of 2009, albeit prospectively.[35] Unfortunately, taxpayers to whom the notice did not apply would have encountered an insurmountable obstacle in challenging the legality of the notice—standing.[36] Had the I.R.S.'s position been subjected to public

PNC Gets National City in Latest Bank Acquisition, N.Y. TIMES Oct. 24, 2008 at A4; *See also* ANDREW ROSS SORKIN, TOO BIG TO FAIL (Penguin Books 2011) (reporting on effect that Notice 2008-83 had on the Wachovia acquisition); FIN. CRISIS INQUIRY COMM., THE FINANCIAL CRISIS INQUIRY REP. (2011) (reporting that, according to Federal Deposit Insurance Corp. chairwoman Sheila Bair, Notice 2008-83 was a significant factor in the Wells Fargo's acquisition of Wachovia). The Financial Crisis Inquiry Commission was created by the Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 5, 123 Stat. 1617, 1625–31 (2009), to examine the causes of the 2008 financial crisis.

32. *See e.g.*, Jesse Drucker, *Obscure Tax Breaks Increase the Cost of Financial Rescue*, WALL ST. J., Oct. 18, 2008, at A3; Amit R. Paley, *A Quiet Windfall for U.S. Banks: With Attention on Bailout Debate, Treasury Made Change to Tax Policy*, WASH. POST Nov. 10, 2008, at A01 (describing the reaction of several tax lawyers to the Notice).

33. Joe Nocera, *So When Will Banks Give Loans?*, N.Y. TIMES Oct. 25, 2008, at B1 (quoting Robert Willens).

34. Press Release, Senator Charles E. Schumer, Schumer Seeks Answers from IRS, Treasury on Tax Code Change that Subsidizes Bank Acquisitions (Oct. 30, 2008), *available at* http://schumer.senate.gov/SchumerWebsite/pressroom/record.cfm?id=304737; Press Release, Senator Chuck Grassley, Ranking Member, United States Committee on Finance, Grassley Seeks Inspector General Review of Treasury Bank Merger Move (Nov. 14, 2008), *available at* http://finance/senate.gov/pressGpress/2008/prg111408c.pdf. The Treasury's inspector general admitted that a legitimate argument could be made that the I.R.S. exceeded its authority in issuing the notice. *See* THE FINANCIAL CRISIS INQUIRY REP., *supra* note 31, at 371.

35. Pub. L. No. 111-5, § 1261, 123 Stat. 115, 342–43 (2009). Section 1261(a) of the legislation stated Congress' findings as follows:

> The delegation of authority to the Secretary of the Treasury under section 382(m) of the Internal Revenue Code of 1986 does not authorize the Secretary to provide exemptions or special rules that are restricted to particular industries or classes of taxpayers.
> Internal Revenue Service Notice 2008-83 is inconsistent with the congressional intent in enacting such section 382(m).
> The legal authority to prescribe Internal Revenue Service Notice 2008-83 is doubtful. *Id.*

The legislation applied only to transactions that occurred after January 16, 2009. *Id.* Moreover, the notice would remain in effect for ownership changes that occurred pursuant to contracts and certain written agreements that were entered into on or before January 16, 2009. *Id.*

36. Frothingham v. Mellon, 262 U.S. 447, 478–89 (1923) (explaining that federal taxpayer standing jurisprudence had its genesis in the 1923. In that case, a taxpayer alleged that federal expenditures under a statute increased her tax bill in violation of due process and the Court denied the taxpayer standing because the effect of the expenditures on her federal tax liability was "too remote, fluctuating, and uncertain" and that "her interest in moneys of the Treasury" was "shared with millions of others"); *Id*. at 487 (illustrating that according to the Court, federal judicial power can be invoked by a party upon a showing "not only that the statute is invalid, but that he has sustained some direct injury as a result of its enforcement, and not merely that he suffers in some indefinite way in common with people generally"); *Id*. at 488 (explaining that the Court has been similarly unreceptive to suits brought

comment the public outcry could very well have prompted Congress to take action *before*, not *after*, its provisions became applicable to any bank acquisitions.

The Treasury's cavalier approach to rulemaking came with a price. For decades it was unclear whether Treasury regulations issued after notice and comment were entitled to the deference enjoyed by regulations issued by other agencies or whether such regulations were entitled to some lesser degree of deference.

I. JUDICIAL DEFERENCE TO TREASURY REGULATIONS

Treasury regulations have enjoyed varying level of judicial deference. The notion that tax regulations should be treated differently than other types of regulations by the courts had many proponents. Calls for such tax exceptionalism were rooted in both Treasury practice and in the ostensible peculiarities of the tax law. The Court's landmark decision, over three decades ago, regarding deference to agency action sowed confusion as to whether that decision applied to all Treasury regulations—a confusion that was finally eliminated by the Court in 2011.

A. Pre-*Chevron*

Judicial deference to agency interpretations of statutes is long-standing and, at least initially, had prudential roots. In *Skidmore v, Swift & Co.*, the Court acknowledged the limitations, in terms of both resources and expertise, on the judicial branch, that place agencies in a favored position to interpret congressional enactments.[37] Under *Skidmore*, the deference that an agency's actions warrants depends upon the thoroughness of the

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by members of Congress that allege an institutional injury but have allowed allegations of personal injury to proceed). *See generally* Raines v. Byrd, 521 U.S. 811, 818–19 (1997); Powell v. McCormack, 395 U.S. 486, 514–22 (1969). *See also* Shays v. FEC, 414 F. 3d 76, 88–90 (D.C. Cir. 2005); U.S. House of Representatives v. Miers, 558 F. Supp. 2d 53, 55, 68 (D.D.C. 2008)(concluding that legislators may have standing to challenge executive action in the absence of a particularized individual harm if they have undertaken the challenge in a representational capacity. In a recent federal district court case a committee of the House of Representatives had standing to enforce a subpoena issued by the committee to a member of the executive branch). *See also* INS v. Chadha, 462 U.S. 919, 939 (1983) (stating, in dicta, that ". . . Congress is the proper party to defend the validity of a statute when an agency of government, as a defendant charged with enforcing the statute agrees with plaintiffs that the statute is inapplicable or unconstitutional"); United States v. Windsor, 133 S. Ct. 2675, 2686 (2013) (highlighting the case that struck down the Defense of Marriage Act, the Bipartisan Litigation Advisory Group (BLAG) of the House of Representatives petitioned to intervene to defend the statute as an interested party after being notified by the Attorney General that the Department of Justice would not defend the statute's constitutionality. The Court found it unnecessary to determine whether BLAG had standing its own right but Justices Alito and Thomas believed that BLAG did have standing to defend the statute and would maintain the standing of a member of Congress to defend the constitutionality of any statute provided that the member has the institutional imprimatur to do so); *Id*. at 2686, 2688.

37. 323 U.S. 134, 138–40 (1944).

agency's deliberations, the validity of its reasoning, its consistency with earlier and later pronouncements, and other factors which provide the agency with the power to persuade.[38] *Skidmore* deference is vague and offers judges tremendous flexibility in the degree to which they choose to pay respect to agency decisions. Justice Scalia believed that *Skidmore* deference was no deference at all.[39]

In 1979, the Court applied a multi-factor test to determine whether Treasury regulations issued under the general authority of I.R.C. section 7805(a) were a permissible interpretation of a statute.[40] Under this test—the so called *National Muffler* test—the Court examined whether the regulations in question were a contemporaneous construction of the statute promulgated with the awareness of congressional intent; the length of time that the regulations were in effect; the degree of reliance placed on the regulations by affected parties; the consistency of the agency's position; and the degree of scrutiny given the regulations by Congress during subsequent re-enactments of the statute.[41] The Court later applied this test in two cases decided not long after its *National Muffler* decision and, in both cases, noted that less deference is owed to Treasury interpretations issued pursuant to I.R.C. section 7805.[42]

B. *Chevron*

The seminal case of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc*. was decided in 1984 and has sowed confusion for the tax bar for three decades.[43] Under *Chevron*, if the statute that is the subject of the agency action does not directly address the precise question at issue then a very deferential standard of review is applied to agency action that had been subject to notice and comment.[44] Under that standard, agency action will not be disturbed unless it is found to be arbitrary, capricious in substance, or manifestly contrary to the statute.[45] This test, the lapidary *Chevron* two-step test, is more deferential than the *National Muffler* test in several respects. For example, under *Chevron,* whether the agency's action is consistent with its previous position on the matter at hand and whether the regulation had been issued contemporaneously with the statute are not

38. *Id.* at 140.
39. *See* United States v. Mead, 533 U.S. 218, 219 (2001) (Scalia, J., dissenting).
40. Nat'l Muffler Dealers Ass'n v. United States, 440 U.S. 472 (1979).
41. *Id.* at 477.
42. *See* United States v. Vogel Fertilizer Co., 455 U.S. 16, 24 (1982); Rowan Cos. v. United States, 452 U.S. 247, 253 (1981).
43. 467 U.S. 837 (1984).
44. *Id.* at 842–43.
45. *See* United States v. Mead, 533 U.S. at 277.

relevant to the level of deference due the agency.[46] Moreover, the Court has held that *Chevron* deference is owed to regulations that are contrary to previous judicial holdings regarding the meaning of statutory terms.[47]

Chevron mandated deference to agency interpretations when its conditions were met and was premised, like *Skidmore*, on prudential grounds. The modern administrative state demands that agencies possess specialized knowledge beyond the "ordinary knowledge" possessed by the courts.[48] Justice Ginsburg reiterated the prudential rationale for judicial deference to agency action in a more recent case. "The expert agency is surely better equipped to do the job than individual judges issuing ad hoc, case by case injunctions. Federal judges lack the scientific, economic, and technological resources an agency can utilize in coping with issues of this order."[49]

In addition to prudential concerns, *Chevron* also rested on the notion of congressional intent and the concomitant political accountability that follows.[50] Judicial deference to agency action is warranted because "[t]he power of an administrative agency to administer a congressionally created . . . program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress."[51] Thus, deference was owed to an agency regardless of whether Congress explicitly delegated interpretative power to the agency or whether that delegation was implicit. The two rationales for deference, expertise and political accountability, are not always compatible with each other. Technocratic expertise, dispassionately wielded, appears to rest uncomfortably with political accountability and the horse trading that comes with such accountability. It stands to reason that political considerations often will countermand technical considerations—a point made by critics of administrative power. Such critics, including the House of Representatives, question the political legitimacy of agency actions because

46. *See* Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 1001 n.4 (2005) (stating that lack of consistency does not undermine the case for deference); Cent. Laborers' Pension Fund v. Heinz, 541 U.S. 739, 748 (2004) (deferring to a regulation that upset a longstanding agency position to the contrary); Smiley v. Citibank, 517 U.S. 735, 740–41 (1996) (applying *Chevron* deference to a regulations issued approximately a century after the enactment of the statute). A recent study of the application of *Chevron* at the Circuit Court level found that agencies prevail in disputes at a significantly higher rate than they do when the courts review an issue de novo or apply a less deferential standard of review. *See* Kent Barnett & Christopher J. Walker, *Chevron in the Circuit Courts* (July 2016) (unpublished manuscript), *available at* http://ssrn.com/abstract=2808848.

47. *See* Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 545 U.S. at 982.

48. *Chevron U.S.A., Inc*., 467 U.S. at 844.

49. Am. Elec. Power Co., Inc. v. Conn., 564 U.S. 410, 428 (2011).

50. *See infra* note 94 and accompanying text.

51. *Chevron U.S.A., Inc.*, 467 U.S. at 843.

of the inordinate influence that the regulated constituency often exerts over the regulator.[52]

Ostensibly, *Chevron* has a constitutional dimension in that fealty to congressional intent pays respect to separation of powers and to the notion that policy debates are best resolved by the political branches. For several reasons, however, the link between the Constitution and *Chevron* should be considered tenuous at best. First, if deference is constitutionally mandated then it begs the question of why it took so long for the Court to say so. Second, deference to agency interpretations invites sweeping delegations of authority from Congress to agencies, delegations which themselves may either violate separation of powers principles or come close to doing so.[53] Third, to underpin *Chevron* on the Constitution putatively renders any explicit statutory provision that rejects or limits judicial deference, including certain provisions of the Administrative Procedure Act, unconstitutional.[54] Fourth, *Chevron* itself, in the resolution of its step one,

52. The House of Representatives passed the Separation of Powers Restoration Act of 2016, H.R. 4768, 114th Cong. (2016) which would require a de novo judicial review of all relevant questions of law and agency rules. There are several reasons for the oft-held perception of industry dominance over regulators including resource disparities, political influence, informational disparities, and the proverbial revolving door between agencies and their regulated constituents. *See* David J. Arkush, *Direct Republicanism in the Administrative Process*, 81 GEO. WASH. L. REV. 1458, 1473-75 (2013).

53. Congress cannot delegate its Article I legislative powers. *See* Field v. Clark, 143 U. S. 649, 692 (1892). Broad delegations of regulatory authority to agencies call into question whether a delegation is so broad that it constitutes an impermissible delegation by Congress of its legislative authority. The Court has applied an "intelligible principle" test to determine whether a congressional delegation is too broad. In Mistretta v. United States, 488 U.S. 361, 372–73 (1989), the Court succinctly described this test.

> Applying this "intelligible principle" test to congressional delegations, our jurisprudence has been driven by a practical understanding that in our increasingly complex society, replete with ever changing and more technical problems, Congress simply cannot do its job absent an ability to delegate power under broad general directives . . . . Accordingly, this Court has deemed it "constitutionally sufficient" if Congress clearly delineates the general policy, the public agency which is to apply it, and the boundaries of this delegated authority.

The Administrative Procedure Act precludes judicial review of actions committed to agency discretion by law. *See* 5 U.S.C. § 701(2) (2016). The Court has held that this exception is to be construed narrowly, applicable in the rare instances where the statutory terms are so broad that there is no law to apply. *See* Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 410–11 (1971). The non-delegation doctrine set forth in *Mistretta* appears to be in tension with the "no law to apply" standard set forth in *Overton Park*. *See* Viktoria Lovei, *Revealing the True Definition of APA § 701(a)(2) by Reconciling "No Law to Apply" with the Nondelegation Doctrine*, 73 U. CHI. L. REV. 1047 (2006).

54. For example, the Freedom of Information Act mandates a *de novo* review of government actions to withhold records from the public. *See generally* Margaret B. Kwoka, *Deference, Chenery, and FOIA*, 73 MD. L. REV. 1060 (2014). The Administrative Procedure Act provides a number of rules regarding judicial review of agency rules and actions, including a provision that requires a court to decide all relevant questions of law and to interpret statutory provisions and the meaning or applicability of the terms of agency action. *See* 5 U.S.C. § 706 (2016). If *Chevron* was constitutionally required then any conflict it has created with provisions of the Administrative Procedure Act is not problematic. However, critics of *Chevron* do not make this assertion and instead explain away any

does not remove the judiciary from policy debates and instead often requires the judiciary to immerse itself in policy matters. Whether or not Congress has spoken clearly on an issue often turns on the judiciary's evaluation of a statute's underlying policy or policies.[55] Finally, statutes contain gaps for a number of reasons not all of which reflect a congressional desire to punt the issues to an agency.[56] In such circumstances *Chevron* deference represents nothing more than the ceding of power by the judicial branch to the executive branch for prudential reasons.[57]

seeming conflict between *Chevron* and the Administrative Procedure Act on policy grounds or, alternatively, on the notion that Congress's delegation of authority to an agency evidences a congressional intent for the courts to defer to an agency. This latter explanation is problematic because the Administrative Procedure Act cannot be overridden by another statute unless the other statute does so expressly. *See* 5 U.S.C. § 559(2016). *See generally* Patrick J. Smith, *Chevron's Conflict with the Administrative Procedure Act*, 31 VA. TAX REV. 813, 816–22 (2013); Cass R. Sunstein, *Beyond Marbury: The Executive's Power to Say What the Law Is*, 115 YALE L.J. 2580, 2585-91 (2006); John F. Duffy, *Administrative Common Law in Judicial Review*, 77 TEX. L. REV. 113, 189–203 (1998). Note that the language of § 706 of the Administrative Procedure Act also appears to conflict with the deference that the courts provide to agency interpretations of their own regulations pursuant to the standards set forth in Auer v. Robbins, 519 U.S. 452 (1991). Under *Auer*, an agency's interpretation of an ambiguous regulation is given controlling weight unless such interpretation is inconsistent with the regulation or statute or is plainly erroneous. *Id.* at 461. *Auer* deference is not due an agency if its interpretation is not the result of fair and considered judgment, conflicts with a prior interpretation, or represents a convenient litigating position or a post-hoc rationalization. *See* Christopher v. SmithKline Beecham Corp., 132 S. Ct. 2156, 2166 (2012) (citations omitted). The Court, in United States v. Haggar Apparel Co., 526 U.S. 380 (1999), stated that it saw no incongruity between a court's *de novo* review of both an agency's determination of facts and its application of the law to those facts and a court's deference to an agency's interpretation of the law. *Id.* at 391. In a recent case, the Fourth Circuit upheld the Department of Education's interpretation of its regulations under Title IX of the Civil Rights Act of 1964 that such regulations required schools to treat transgender students consistent with their gender identity. The Department's interpretation—promulgated in an opinion letter issued by its Office of Civil Rights—was entitled to deference under *Auer*. *See* Grimm v. Gloucester Cty. Sch. Bd., 2016 U.S. APP. LEXIS 7026 (4th Cir. 2016). An interesting issue is whether deference is appropriate for agency claims of preemption. If *Chevron* indeed is firmly rooted in the separation of powers then preemption claims would implicate a conflict between the two structural pillars of the Constitution, separation of powers and federalism. For an interesting discussion of deference in such circumstances *see* William W. Buzbee, *Does the Earth Belong to the Living? Property and Environmental Law Perspectives on the Rights of Future Generations: Preemption Hard Look Review, Regulatory Interaction, and the Quest for Stewardship and Intergenerational Equity*, 77 GEO WASH. L. REV. 1521 (2009). The House of Representatives passed a bill in 2016 that would require a court to undertake a de novo review of agency rules. *See supra* note 52.

55. *See infra* notes 126-31 and accompanying text for a discussion of this issue in the context of the Supreme Court's recent decision regarding the availability of tax credits to purchasers of health insurance on the Federal Exchange established under the Patient Protection and Affordable Care Act.

56. *See infra* notes 145-46 and accompanying text.

57. Two scholars have asserted that the President has the constitutional authority to gap-fill statutory provisions. *See* Jack Goldsmith & John F. Manning, *The President's Completion Power*, 115 YALE L.J. 2280, 2282 (2006). If so, then *Chevron* need not be supported on congressional delegation grounds. Moreover, the refusal to invoke *Chevron* for "extraordinary" issues that belie Congress's intent to delegate could not be justified because the executive branch's authority is not predicated on such intent. *See infra* notes 93-95 and accompanying text for a discussion of *Chevron* in the context of "extraordinary" issues.

Scholars have debated whether the two steps of the *Chevron* test are redundant. Stephenson and Vermeule assert that "the single question is whether the agency's construction is permissible as a matter of statutory interpretation; the two *Chevron* steps both ask the question, just in different ways. As a result, the two steps are mutually convertible."[58] To be sure, an agency interpretation that is contrary to Congress's express intent cannot be considered a reasonable interpretation. However, in such cases there is one and only one interpretation that is reasonable. The counterargument to Stephenson and Vermeule was compelling made by Richard Re who asserted that *Chevron* step one provides the answer to the question of whether Congress left only one permissible interpretation of a statute or more than one.[59] If, under *Chevron* step one, a genuine statutory ambiguity exists, then *Chevron* step two defers to any number of interpretations, so long as they are reasonable.[60]

In addition to the question of whether the two *Chevron* steps should be collapsed into one step, a question whose answer had significant implications for tax regulations persisted concerning *Chevron's* applicability to implicit delegations of authority. Five years prior to the *Chevron* decision, *National Muffler* set forth the standard by which courts were to determine whether and to what extent to defer to Treasury regulations issued under I.R.C. section 7805(a).[61] After *Chevron*, the continuing vitality of the *National Muffler* standard was unclear due to a distinction between explicit and implicit delegations seemingly made by *Chevron* itself.

> If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. Sometimes the legislative delegation to an agency on a particular question is implicit rather than explicit. In such a case, a court may not substitute its own

58. Matthew C. Stephenson & Adrian Vermeule, *Chevron Has Only One Step*, 95 VA. L. REV. 597, 599 (2009).

59. Richard M. Re, *Should Chevron Have Two Steps?*, 89 IND. L.J. 605, 610–16 (2014).

60. *Id.* Recasting *Chevron* step one as an inquiry into whether Congress mandated a particular interpretation avoids the confusion that the Court has created in assessing whether Congress intended to delegate authority over a particularly important issue. In reality, such an inquiry resolves *Chevron* step one—the Congress had one particular result in mind and, therefore, no ambiguity existed. The Court's approach has been to find a statutory ambiguity, determine that the issue is too important for Congress to have delegated to an agency, and then proceed to find that there is a clear congressional intent on the matter after all. As discussed later in this article, this is precisely what the Court did in *King v. Burwell*. *See infra* notes 142-45 and accompanying text.

61. *See supra* notes 40-42 and accompanying text.

> construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.[62]

Some commentators, including the American Bar Association, believed that *Chevron* set forth two separate step twos—an arbitrary, capricious, manifestly contrary to the statute test for regulations promulgated under explicit congressional delegations of authority and a less deferential reasonable interpretation standard for regulations promulgated under implicit congressional delegations of authority.[63] Consequently, the deference afforded to regulations issued pursuant to I.R.C. section 7805(a) by *National Muffler* is appropriate after *Chevron*.[64] *United States v. Mead* is a case well known for the Court's post-*Chevron* application of the less deferential *Skidmore* standard of review to informal rules, in this case a customs service ruling.[65] Thus, the Court made explicit that the *Skidmore* standard survived *Chevron* at least with respect to informal rule making.[66] *Mead* is also interpreted by some, but not all, commentators as reinforcing the distinction made by *Chevron* between the level of deference to be given regulations issued pursuant to explicit and implicit delegations of authority.[67]

If indeed the *Chevron* Court intended to create Step 2A, applicable to regulations issued under explicit delegations, and Step 2B, applicable to regulations issued under implicit delegations, then it left no guidance as to the application of the standards it set forth. For example, whether a delegation is explicit or implicit often is not clear. Many specific statutory provisions are extremely complex, implicate a number of issues, and contain a broad delegation of authority to issue regulations without limiting that authority to any specific provision or provisions in the statute in

62. *Chevron U.S.A., Inc*., 467 U.S. at 843–44.

63. *See* Mark E. Berg, *Judicial Deference to Tax Regulations: A Reconsideration in Light of National Cable, Swallows Holding, and Other Developments*, 61 TAX LAW 480, 495 (2008); *ABA Task Force Report*, *supra* note 20, at 739.

64. *Id*. at 794.

65. *See* United States v. Mead, 533 U.S. at 232–36; *see also* Christensen v. Harris Cnty, 529 U.S. 576, 587 (2000)(stating that *Skidmore* deference is applicable to informal agency actions such as opinion letters, manuals, guidelines, and policy statements); Nelson v. Comm'r, 568 F.3d 662, 665 (8th Cir. 2009)(applying *Skidmore* deference to revenue rulings); Kornman & Assoc., Inc., v. United States, 527 F.3d 443, 452–57 (5th Cir. 2008)(concluding that Revenue Rulings are entitled to *Skidmore* deference); *but see* Tualatin Valley Builders Supply, Inc. v. United States, 522 F.3d 937, 948 (9th Cir. 2008) (O'Scannlain, J., concurring)(concluding that *Chevron* deference was appropriate for a Revenue Procedure). The Department of Justice has indicated that it will not argue for the application of *Chevron* deference to Revenue Rulings and Revenue Procedures. *See infra* note 87 and accompanying text.

66. United States v. Mead, 533 U.S. at 234–35.

67. *See* Berg, *supra* note 63, at 494–95; *ABA Task Force Report*, *supra* note 20, at 739. However, *Mead* contains language that supports the opposite conclusion. *See* Leandra Lederman, *The Fight Over "Fighting Regs" and Judicial Deference in Tax Litigation*, 92 BOSTON. U. L. REV. 643, 660–61 (2012).

question.[68] In many respects, such authority resembles the authority granted by I.R.C. section 7805(a). In addition, the questions of how, and to what degree, the reasonableness standard is less deferential that the arbitrary, capricious, manifestly contrary to the statute standard were not answered. Is it even possible that an administrative interpretation can be unreasonable if such interpretation is not arbitrary, capricious, or manifestly contrary to the statute? Most likely, the Court in both *Chevron* and *Mead* used such terms interchangeably and simply was making clear that both explicit and implicit delegations of regulatory authority by Congress trigger coterminous levels of deference. In my opinion, the Court put this issue to rest in 2011.[69]

After *Chevron*, the Court continued to apply the *National Muffler* test to Treasury regulations issued under I.R.C. section 7805, albeit somewhat inconsistently and without clear guidance on either the effect that *Chevron* had on the applicability of this test or on how this test differed from *Chevron's* two step standard.[70] As a result, confusion and contradiction emanated from the lower courts and the Tax Court as to whether *Chevron* replaced *National Muffler*, whether they are in fact similar, and when to apply one standard versus the other.[71] Critics of the application of *Chevron* to tax regulations asserted a sort of tax exceptionalism pursuant to which a lesser standard of deference was justified for tax regulations. Such exceptionalism was warranted because of the inherent advantages enjoyed by the I.R.S. over taxpayers, the severity of tax penalties, the sweeping reach of the revenue collection function, and the particular importance of agency expertise in administering statutes with the complexity of the tax code.[72] Moreover, unlike other agencies, Treasury actions often are

68. *See supra* notes 17-18 and accompanying text.

69. *See infra* notes 79-83 and accompanying text.

70. *See* Berg, *supra* note 63, at 497; Kristen E. Hickman, *The Need for Mead: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537, 1579–86 (2006).

71. Berg, *supra note* 63, at 500–16 (discussing several Circuit Court cases and Tax Court cases). In one case, the Tax Court stated that the *National Muffler* standard "had not been changed by *Chevron*, but has merely been restated in a practical two-part test with possibly subtle distinctions as to the role of legislative history and the degree of deference to be accorded to a regulation." Cent. Pa. Savings Ass'n & Subs. v. Comm'r, 104 T.C. 384, 392 (1995). According to the Court, the *National Muffler* and *Chevron* standards are not similar. *See infra* note 78.

72. *See ABA Task Force Report*, *supra* note 20, at 723–25. The idea of tax exceptionalism is not universally held. *See* Hickman, *supra* note 70, at 1592–98. The notion that tax law is somehow exceptional and that standards of deference should be adjusted accordingly is, in part, a result of the silo effect—the propensity of agencies to develop their own bureaucratic eccentricities. The Treasury itself has practiced its own brand of tax exceptionalism and, therefore, it is not surprising that the tax bar has sought to counter with its own call for tax exceptionalism. *See supra* notes 19-26 and accompanying text; Richard E. Levy & Robert L. Glickman, *Agency-Specific Precedents*, 89 TEX. L. REV. 499, 510–26 (2011).

insulated from taxpayer challenge due to the inability of taxpayers to maintain standing or by the application of the Anti-Injunction Act.[73]

C. *Mayo*

In 2011 the Court decided *Mayo Foundation for Medical Education and Research v. United States* and held that the *Chevron* standard applied to all Treasury regulations issued after notice and comment.[74] Rejecting any notions of tax exceptionalism, the Court acknowledged that the administrative landscape had changed over the years and that no special rules were warranted for tax regulations.[75] Accordingly, tax regulations are entitled to *Chevron* deference regardless of their source of authority.[76]

Mayo presented the question of whether physicians who serve as medical residents were entitled to a student exemption from certain federal payroll taxes. The I.R.S. promulgated a regulation pursuant to the general grant of authority under I.R.C. section 7805 that denied medical residents an exemption from the applicable payroll taxes. The Court upheld the

73. *See supra* note 36 and accompanying text for a discussion of taxpayers standing. The Anti-Injunction Act prohibits any "suit for the purpose of restraining the assessment or collection of any tax . . . in any court by any person, whether or not such person is the person against whom such tax was assessed." I.R.C. § 7421(a)(CCH 2016). In effect, § 7421 requires that taxpayers resolve their tax disputes in a suit for refund and provides legislative notice of the "[g]overnment's need to assess and collect taxes as expeditiously as possible with a minimum of preenforcement judicial interference." Hibbs v. Winn, 542 U.S. 88, 103 (2004). This statute is a significant burden if the regulations have a particularly large negative impact on pending transactions, such as the recently issued tax inversion rules. There are several exceptions to the statute's prohibition including the ability of a federal district court to issue an injunction to prevent irreparable harm to the property rights of others in the context of a levy or sale of property by the I.R.S. *See* I.R.C. § 7426(b)(CCH 2016). Moreover, third parties are expressly provided standing to vindicate an interest in property that has been wrongfully levied. I.R.C. § 7426(a)(CCH 2016). Exceptions to the statute are also provided for collection activities undertaken in certain cases that involve innocent-spouse relief or undertaken during the pendency of a Tax Court proceeding challenging federal liens and levies. *See* I.R.C. §§ 6015(e)(1)(B)(2); 6330(e)(CCH 2016). The Court has held that proceedings whose success would have the effect of increasing tax revenue are not barred by the Anti-Injunction Act. Hibbs v. Winn, 542 U.S. at 102–12. *See also* E. Ky. Welfare Rights Org. v. Simon, 506 F.2d 1278, 1283–85 (D.C. Cir. 1974). The Court also has recognized two common law exceptions to the Anti-Injunction Act. First, a pre-enforcement challenge will be countenanced if the government could not prevail under any circumstances and the taxpayer would suffer irreparable harm from enforcement action. *See* Enoch v. Williams Packing & Navigation Co., 370 U.S. 1, 7 (1962). Second, a preenforcement action is permitted if, under the circumstances, no other legal remedy is available. *See* South Carolina v. Regan, 465 U.S. 367, 378, 380–81 (1984). Whether an exaction is a tax, subject to the Anti-Injunction Act, or a penalty was at issue in the Court's landmark decision upholding the constitutionality of the Patient Protection and Affordable Care Act. *See infra* note 107. The D.C. Circuit recently held that the Anti-Injunction Act precluded a taxpayer challenge to certain income reporting requirements imposed on U.S. banks by Treasury regulations. *See* Fla. Bankers Ass'n v. U. S. Dep't of the Treasury, 799 F.3d 1065 (D.C. Cir. 2015), *cert. denied* 2016 U.S. LEXIS 3683 (June 6, 2016).

74. 562 U.S. 44 (2011).

75. *Id.* at 56–57.

76. *Id.* at 57–58.

regulation under the *Chevron* standard.[77] The Court forcefully rejected the notion that tax regulations are somehow entitled to less deference than the regulatory action of other agencies.

> . . . *Mayo* has not advanced any justification for applying a less deferential standard of review to Treasury Department regulations than we apply to the rules of any other agency. In the absence of such justification, 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" . . . . Filling in gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation at least as complex as the ones other agencies must make in administering their statutes . . . . We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to *Chevron* to the same extent as our review of other regulations.[78]

The Court, in my opinion, also put to rest the belief that *Chevron* set forth two versions of its step two, one version applicable to regulations promulgated pursuant to explicit congressional delegations of authority and another version for regulations issued pursuant to implicit congressional delegations of authority.[79] The Court appeared to consider the two formulations of step two as interchangeable. After concluding that the statute's ambiguity allowed it to proceed to step two of *Chevron*, the Court stated that "such an ambiguity would lead us inexorably to *Chevron* step two, under which we may not disturb an agency rule unless it is '[arbitrary or capricious in substance, or manifestly contrary to the statute.]'"[80] The Court, after explaining at length why *Chevron* deference was appropriate in this case, then applied step two by inquiring whether the regulation in question was a '"reasonable interpretation"' of the statute.[81]

The Court's opinion also called into question just what constitutes an explicit or implicit delegation of authority and whether such a distinction matters. The Court stated that the regulation at issue in the case was issued "pursuant to the explicit authorization" set forth in I.R.C. section 7805(a) and that such "express congressional authorizations" indicate that *Chevron*

77. *Id.* at 58–60.

78. *Id.* at 55–56. The Court also made clear the distinction between the *Chevron* and *National Muffler* standards and why the former is significantly more deferential than the latter. *Id.* at 54–55.

79. *See supra* notes 63-67 and accompanying text.

80. Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. at 53 (citations omitted).

81. *Id.* at 58.

deference is warranted. If indeed I.R.C. section 7805 provides explicit authorization for Treasury rule-making, then it is difficult to conceive of any Treasury regulation that would be issued under any authority other than explicit authority.

However, in *King v. Burwell* the Court stated that if a statutory ambiguity constitutes any delegation of authority then it constitutes "an implicit delegation from Congress to the agency to fill in the statutory gaps."[82] Because *Chevron* deference is predicated on the existence of a statutory ambiguity, if one takes *King v. Burwell* at face value then all *Chevron* deference is reserved for regulations issued under implicit grants of congressional authority. *Mayo* and *King v. Burwell* are irreconcilable in this respect. Under *Mayo*, all regulations, whether they are issued under the authority provided by I.R.C. section 7805 or under the authority of a substantive I.R.C. section, represent action taken pursuant to an explicit grant of authority from Congress. In contrast, under *King v. Burwell* any agency authority to resolve a statutory ambiguity is a result of an implicit grant of authority to the agency by Congress. The Court made clear in *King* that the intent of Congress is the determining factor in whether deference to an agency's action is warranted.[83] The inconsistency between *Mayo* and *King v. Burwell* in the Court's categorization of authority indicates that whether regulatory authority is made explicit or implicit is not important.

Chevron left a number of issues—tax and otherwise—unresolved and *Mayo* did not resolve all deference questions with respect to Treasury actions.[84] For example, whether *Chevron* deference is predicated on the issuance of regulations after notice and comment is not clear. *Mayo* hinted that notice and comment is a prerequisite for *Chevron* deference but did not say so categorically. "The Department issued the full-time employee rule only after notice-and- comment procedures, . . . again a consideration identified in our precedents as a 'significant' sign that a rule merits *Chevron* deference."[85] Thus, whether temporary Treasury regulations are entitled to *Chevron* deference is unlikely and, if not, whether *National*

82. King v. Burwell, 135 S.Ct. 2480, 2488 (2015) (quoting FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 159 (2000)). *See infra* note 129 and accompanying text for a discussion of the Court's decision that *Chevron* deference was not warranted in this case.

83. *See infra* note 128 and accompanying text.

84. Two scholars posed 14 questions that they believe *Chevron* left unanswered in addition to the basic question of whether there are certain subject matters for which deference is not appropriate. *See* Thomas W. Merrill & Kristin E. Hickman, *Chevron's Domain*, 89 GEO. L.J. 833, 849–52 (2001).

85. Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. at 57–58 (citing Mead v. United States, 533 U.S. at 230–31, and Long Island Care at Home, Ltd. v. Coke, 351 U.S. 158,173–74 (2007)).

Muffler or *Skidmore* deference should apply is unclear.[86] Informal actions, such as revenue rulings and notices appear to warrant, after *Mead*, *Skidmore* deference—an opinion that is shared by the government. The Department of Justice has stated that it will not argue that *Chevron* deference applies to revenue rulings or revenue procedures.[87]

After *Mayo*, the deference to which Treasury regulations issued after notice and comment are entitled no longer depends upon their source of authority. *Mayo*, therefore, was a win for the Treasury because, assuming that *Chevron* step one is met, *Chevron* and not *Skidmore*, *National Muffler*, or some other less deferential test will be applied to test the validity of Treasury regulations. Whether this result is desirable as a policy matter depends on whether one believes in tax exceptionalism, whether *Mayo* will embolden the Treasury to exercise its interpretative authority more aggressively, and whether it will provide impetus for the Treasury to submit to notice and comment procedures more frequently.[88]

86 The Seventh Circuit, however, indicated that it would apply *Chevron* deference to temporary regulations, at least those that have been replaced by nearly identical final regulations issued after notice and comment.

> This temporary regulation, which was issued without notice and comment at the same time as an identical proposed regulation, purports to offer taxpayers guidance by resolving an open question and stating definitively that in the case of a disposition of property, an overstatement of basis can lead to an omission from gross income. This temporary regulation has since been replaced by a nearly identical final regulation, issued after a notice and comment period. T.D. 9511 (eff. Dec. 14, 2010), 75 Fed. Reg. 78, 897. Because we find that *Colony* is not controlling, we need not reach this issue. However, we would have been inclined to grant the temporary regulation *Chevron* deference, just as we would be inclined to grant such deference to T.D. 9511. We have previously given deference to interpretive Treasury regulations issued with notice-and-comment procedures, *see* Kikalos v. Comm'r of Internal Revenue, 190 F.3d 791, 795 (7th Cir. 1999); Bankers Life & Casualty Co. v. United States, 142 F.3d 973, 979–84 (7th Cir. 1998), and the Supreme Court has stated that the absence of notice-and-comment procedures is not dispositive to the finding of *Chevron* deference. Barnhart v. Walton, 535 U.S. 212, 222, 122 S. Ct. 1265, 152 L.Ed.2d 330 (2002).

See Beard v. Comm'r, 633 F.3d 616, 623 (7th Cir. 2011). It is not clear whether proposed regulations are entitled to any deference whatsoever although the Court has indicated that such regulations are not so entitled. In rejecting the taxpayer's reliance on proposed regulations the Court stated that ". . . we find these proposed regulations to be of little consequence given that they were nothing more than mere proposals." Boeing Co. v. United States, 537 U.S. 437, 453 n.13 (2003).

87. *See* Marie Sapirie, *DOJ Won't Argue for Chevron Deference for Revenue Rulings and Procedures, Official Say*s, 131 TAX NOTES 674 (May 16, 2011).

88. *See* Steve R. Johnson, *Preserving Fairness in Tax Administration in the Mayo Era*, 32 VA. TAX REV. 269, 275–78, 289–98 (2012)(setting forth the benefits of the *Mayo* decision but cautioning that *Mayo*, when combined with *Brand X*, *Auer*, and other doctrines could lead to Treasury overreach). *See supra* notes 46, 54 and accompanying text for a discussion of *Brand X* and *Auer*. A recent study of the Circuit Courts' application of Chevron found that Chevron is invoked somewhat less frequently in tax cases but, when invoked, the Treasury's win rate is relatively high. *See* Barnett & Walker, *supra* note 46, at 48, Table 2.

II. *MAYO* DIMINISHED? THE EXTRAORDINARY ISSUE AND *STATE FARM*

Two recent developments call into question whether *Mayo* has provided a veritable carte blanche to the Treasury to interpret the I.R.C. First, the Supreme Court, in the third of its trilogy of cases involving the Patient Protection and Affordable Care Act, refused to apply *Chevron* to the Treasury regulations at issue in that case.[89] The Court's rationale for its refusal to defer to the Treasury was not altogether convincing but the Court's decision nonetheless could provide support for taxpayer assertions that deference to the Treasury is unwarranted. Second, another fundamental but different administrative law doctrine recently has appeared on the tax landscape—the *State Farm* doctrine.[90] Two recent cases applied this doctrine to invalidate Treasury regulations.[91] Perhaps it was inevitable that the *Mayo* Court's refusal to provide special treatment for Treasury regulations would lead to the application of other administrative law doctrines that, up to that time, were ignored in the tax context. *Mayo* may very well turn out to be a mixed blessing for the Treasury.

A. *King v. Burwell* and the Extraordinary Issue

On occasion, the Court seemingly interjects an extra step into the *Chevron* analysis. The Court proceeds to discover a statutory ambiguity but then inquires whether the ambiguity implicates an issue of such importance—an extraordinary case—that it is unlikely that Congress would have implicitly delegated authority to an agency to resolve the issue. Despite the Court's rhetoric, what the Court appears to do in these cases is apply a more searching inquiry in resolving *Chevron* step one.

For example, whether the FDA had the authority to regulate tobacco products was the issue before the Court in *FDA v. Brown & Williamson Tobacco Corp*.[92] The Court, after twenty-three pages of explanation,

89. *See infra* notes 127–30 and accompanying text. The first in the trilogy of cases was Nat'l Fed. of Ind. Bus. v. Sebelius 132 S.Ct. 2566 (2012). In that case, the Court upheld the statute's requirement that individuals obtain health insurance coverage or face financial penalties. The Court, despite holding that enactment of this provision did not fall within the Commerce Power, believed that it was within Congress's power to tax and spend. *Id.* at 2577. In that same case the Court struck down, on federalism grounds, the parts of the legislation that expanded Medicaid coverage. *Id.* at 2606–07. The second case in the trilogy was Burwell v. Hobby Lobby Stores, Inc., 134 S.Ct. 2751(2014). The Court held that, pursuant to the Religious Freedom Restoration Act, the statute's requirement to provide certain contraceptive coverage could not be enforced against three closely held corporations.

90. *See infra* notes 159-95 and accompanying text.

91. *See infra* notes 196-295 and accompanying text.

92. 529 U.S. 120 (2000).

concluded that Congress did not intend to authorize the FDA to regulate tobacco products.[93]

> Finally, our inquiry into whether Congress has directly spoken to the precise question at issue is shaped, at least in some measure, by the nature of the question presented. Deference under *Chevron* to an agency's construction of a statute that it administers is premised on the theory that a statute's ambiguity constitutes an implicit delegation from Congress to the agency to fill in the statutory gaps. *See Chevron*, 467 U. S., at 844. In extraordinary cases, however, there may be reason to hesitate before concluding that Congress has intended such an implicit delegation.[94]

The Court went on to quote from a law review article written by Justice Breyer before he was confirmed to the Court. "A court may also ask whether the legal question is an important one. Congress is more likely to have focused upon, and answered, major questions, while leaving interstitial matters to answer themselves in the course of the statute's daily administration."[95]

As the Court exhaustively documented, Congress's intent was clear. Therefore, there was no longer any ambiguity and whether or not the issue presented was extraordinary should have been irrelevant. Step one of *Chevron* was not met and, as a consequence, step two is not applicable. The Court's reasoning in the FDA case recently was parroted in the Court's most recent ObamaCare decision, *King v. Burwell*.[96] At issue in this case was whether federal tax credits are available to individual enrollees in the Federal Exchange. The Patient Protection and Affordable Care Act established the American Health Benefit Exchanges [hereinafter Exchanges], governmental or non-profit entities that, among other functions, serve as insurance marketplaces in which individuals have the ability to comparison shop for insurance products.[97] Each state must create and operate an Exchange that offers insurance for purchase by individuals and employees of small employers.[98] A state may opt out of creating and operating an Exchange in which case the Exchange will be established by

93. *Id.* at 133–56.

94. *Id.* at 159.

95. *Id*. (quoting Breyer, *Judicial Review of Questions of Law and Policy*, 38 ADMIN. L. REV. 363, 370 (1986)).

96. 135 S.Ct. 2480 (2015).

97. Patient Protection and Affordable Care Act, Pub. L. No. 111-148, §1311, 124 Stat. at 173 (codified at 41 U.S.C. § 18031(d)(1)–(4)(2016)).

98. *Id.*, § 1311(b), 124 Stat. at 173 (codified at 42 U.S.C. § 18031(2016)). After 2016, states have the option of allowing large employers to participate in the Exchanges. *Id*., § 1312(f)(2)(B), 124 Stat, at 184 (codified at 42 U.S.C. § 18032(2016)). Under certain circumstances, a state may participate in a multi-state regional Exchange or establish subsidiary Exchanges to operate within a state. *Id*., § 1311(f), 124 Stat. at 179 (codified at 42 U.S.C. § 18031(2016)). *See also* 45 C.F.R. § 155.140 (2013).

the federal government.[99] Thirteen states and the District of Columbia have established Exchanges.[100]

The Act added section 5000A to the Internal Revenue Code.[101] This provision, commonly referred to as the individual mandate, is designed to minimize adverse selection in light of the insurance market reforms that were part of the legislation.[102] The individual mandate requires that an applicable individual maintain minimum essential coverage for herself and any dependents who are also applicable individuals each month beginning after 2013.[103] Failure to maintain such coverage for one or more months results in the imposition of a shared responsibility payment, a penalty that is included with a taxpayer's income tax return for the taxable year which includes the month that such failure occurred.[104]

A significant number of individuals obtain health insurance through their employers, a delivery mechanism that had its genesis as a mechanism

99. Patient Protection and Affordable Care Act, § 1321(c), 124 Stat. at 186 (codified at 42 U.S.C. § 18041 (2016)). These Exchanges may be operated exclusively by the Department of Health and Human Services or in partnership with the state with authority over the operation of the Exchange residing within the Department of Health and Human Services. *See* Bernadette Fernandez & Annie L. Mach, Health Insurance Exchanges Under the Patient Protection and Affordable Care Act (ACA), Cong. Res. Serv. 12-13 (Jan. 31, 2013). Seven Exchanges operate under this model. Four states operate federally supported Exchanges. These Exchanges are operated by state authorities through the use of federal information technology infrastructure. *See* State Health Insurance Marketplace Types, 2016, http://kff.org/health-reform/state-indicator/state-health-insurance-marketplace-types/.

100. *See id.*

101. Patient Protection and Affordable Care Act, §§1501(b); 10106(b)(1), 124 Stat. at 244–49,909–10 (2010)(codified as amended at I.R.C. § 5000A (CCH 2016). The penalty amount imposed by the statute was amended shortly thereafter by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, §1002, 124 Stat.1029, 1032–33 (2010) (codified at I.R.C. § 5000A(CCH 2016)). This provision survived a constitutional challenge when the Court upheld it under Congress's taxing power despite holding that its enactment exceeded Congress's power to regulate interstate commerce. *See supra* note 89.

102. Among the insurance market reforms instituted by the legislation are community rating and guarantee issue requirements. Insurers may not price discriminate on any basis except age, family size, smoking, and geographic areas. Consequently, insurers can neither deny coverage to those individuals with pre-existing medical conditions nor price their coverage to account for such pre-existing conditions. *See* Patient Protection and Affordable Care Act, §1201, 124 Stat. at 155 (codified at 42 U.S.C. §§ 300gg-1, 300gg-3(2016)). Adverse selection refers to the propensity of those most in need of insurance to purchase it while those individuals with little or no perceived need of insurance—the young and healthy, for example—forego its purchase. Adverse selection reduces the number of no or low claim customers needed by the insurers to keep premiums affordable.

103. I.R.C. § 5000A(a)(CCH 2016). The term "applicable individual" excludes individuals who qualify for statutorily defined religious conscience or health ministry exemptions, individuals who are not citizens or nationals of, or legal aliens present in, the United States, or who are incarcerated. I.R.C. § 5000A(d)(CCH 2016). Individuals whose required contribution exceeds eight percent of household income, very low income individuals, and members of Indian tribes are not subject to the penalty. I.R.C. § 5000A(e)(1)–(3)(CCH 2016).

104. I.R.C. § 5000A(b)(1)–(2)(CCH 2016). The requirement to maintain minimum essential coverage is variously met through, among other means, Medicare or Medicaid coverage, individual insurance policies, or eligible employer-sponsored group health plans or insurance coverage. I.R.C. § 5000A(f)(CCH 2016).

to avoid wage controls during World War II and that is aided and abetted by income tax subsidies,[105] I.R.C. section 4980H was added by the Patient Protection and Affordable Care Act to prevent employers from free riding on the statute's tax credits and subsidies by not offering adequate health insurance coverage to their employees.[106] This provision imposes an exaction on certain employers if they either do not offer insurance coverage to their employees or offer coverage that is deemed inadequate under the statute.[107] An assessable payment is imposed on employers with an average of fifty or more full time or full time equivalent employees if such employers fail to offer affordable minimum essential health care coverage to their full time employees and one or more such employees qualify for the tax credit or premium subsidies.[108] In addition, an excise tax is imposed in the amount of $100 per day for each affected individual if the

105. *See* Thomas C. Buchmueller & Alan C. Monheit, *Employer-Sponsored Health Insurance and the Promise of Health Insurance Reform* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 14389, 2009). The system has been subject to much criticism by economists because, among other things, it provides greater subsidies to higher income individuals, masks the true cost of coverage to the insured resulting in the overconsumption of medical care, and distorts labor market mobility due to lack of portability. *See id.* at 8–14. The portability issue has been addressed to a very limited extent by the Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, 100 Stat. 82 (1986), under which, in general, employers with twenty or more full time equivalent employees must offer medical coverage for a period of eigthteen months to an employee or covered family member after a qualifying event. Among qualifying events are voluntary or involuntary termination of employment, divorce, death, and disability. The employee must pay for the cost of coverage plus an allowable administrative fee.

106. Patient Protection and Affordable Care Act, §§ 1513, 10106(e), 124 Stat. at 253–56, 910–11 (codified as amended in I.R.C. § 4980H (CCH 2016)). *See infra* notes 110–16 and accompanying text for a discussion of the tax credit.

107. I.R.C. § 4980H (CCH 2016). A federal district upheld the constitutionality of the employer mandates but its decision was vacated by the Fourth Circuit due to the application of the Ant-Injunction Act, discussed at *supra* note 73. *See* Liberty Univ., Inc. v. Geithner, 753 F. Supp. 2d 611 (W.D. Va., 2010), *vacated*, Liberty Univ., Inc. v. Geithner, 671 F.3d 391 (4th Cir. 2011). The Court later held that the individual mandate was a tax for constitutional purposes but that it was a penalty for purposes of the Anti-Injunction Act. Nat'l Fed. of Ind. Bus. v. Sebelius, 132 S.Ct. at 2594. In light of its holding in *Sebelius,* the Supreme Court granted certiorari and remanded the case back to the Fourth Circuit. Liberty Univ. v. Geithner, 133 S. Ct. 679 (2012). The Fourth Circuit then upheld the constitutionality of the employer mandate. Liberty Univ., Inc. v. Lew, 733 F.3d 72 (4th Cir., 2013) *cert. denied* Liberty Univ., Inc. v. Lew, 134 S.Ct. 683 (2013).

108. I.R.C. §§ 4980H(a)(1); 4980H(c)(2)(A)(CCH 2016). A full-time employee is defined as an employee who is employed an average of at least 30 hours per week. I.R.C. § 4980H(c)(4)(A) (CCH 2016). Full-time equivalent employees are a combination of employees, none of whom are full-time employees, who are counted as full-time employees for purposes of determining whether an employer is an applicable large employer. *See* Treas. Reg. § 54.49809H-1(a)(22) (2015). The full time equivalency rules apply only for the purposes of determining whether an employer employs an average of 50 or more full time employees and not for the purpose of determining the penalty amount. I.R.C. § 4980H(c)(2)(E)(CCH 2016). Failure to offer such coverage results in the imposition of a penalty up to $ 2,000 per annum for each full time employee in excess of thirty if no coverage is provided and one employee qualifies for a premium tax credit or cost sharing subsidy. I.R.C. §§ 4980H(a); 4980H(c)(1)(CCH 2016). The maximum annual penalty amount is $3,000 if unaffordable coverage is offered. I.R.C. §§ 4980H(a)(1); 4980H(b)(1)(CCH 2016).

group health plan does not conform to the requirements of the Patient Protection and Affordable Care Act.[109]

The legislation, through the enactment of I.R.C. section 36B, provides tax credits to individuals and families whose income is below a certain threshold and who pay premiums for insurance through an Exchange established by the State under section 1311 of the Patient Protection and Affordable Care Act.[110] The credit is designed to subsidize health insurance coverage for taxpayers whose income does not exceed 400 percent of the poverty line for a family of the size involved.[111] In general, the credit is the lesser of the premium cost or the excess of the premium cost of a baseline plan over a percentage, which increases as the taxpayer's household income approaches 400 percent of the poverty line, of the taxpayer's household income.[112]

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109. *See* I.R.C. §§ 4980D(a)–(b); 9815(CCH 2016). The excise tax imposed by § 4980D predates the enactment of Patient Protection and Affordable Care Act. The excise tax is triggered by the failure of a plan to conform to the requirements of chapter 100 of the Internal Revenue Code. I.R.C. § 4980(a)(CCH 2016). I.R.C. § 9815 was added to chapter 100 by the Patient Protection and Affordable Care Act to incorporate its changes into chapter 100. *See* Patient Protection and Affordable Care Act, § 1563(f), 124 Stat. at 270 (as redesignated by Patient Protection and Affordable Care Act § 10107(b)(1), 124 Stat. at 911). Plans cannot exclude coverage of preexisting conditions, must not, in general, impose lifetime or annual limits on the dollar amount of benefits, must offer coverage to dependent children under the age of twenty-six, and provide coverage of preventive services. *See generally* Temp. Treas. Reg. §§ 54.9815-2704T(2010) 54.9815-2711T(2010); 54.9815-2713T(2012); 54.9815-2714T(2010). The application of both section 4980H and the excise tax were at issue in the Court's recent holding that closely-held corporations are protected by the Religious Freedom Restoration Act. *See* Burwell v. Hobby Lobby Stores, Inc., 134 S. Ct. 2751, 2768, 2777–78, 2780–81 (2014).

110. I.R.C. §§ 36B(a); 36B(c)(2)(A)(CCH 2016). An individual who is covered under any eligible employer-sponsored plan or who is offered health insurance coverage through an eligible employer-sponsored plan under which the employee's required contribution with respect to the plan does not exceed 9.5 percent of the applicable taxpayer's income and which covers at least 60 percent of total benefit costs are not eligible for the credit. I.R.C. § 36B(c)(2)(CCH 2016). A taxpayer also is ineligible for the credit is she is offered minimum essential coverage other than such coverage through the individual market. I.R.C. § 36B(c)(2)(B)(CCH 2016). Advance payments of the credits may be made in the form of reductions to the monthly insurance premiums and such advance payments reduce the amount of the credit under § 36B. I.R.C. § 36B(f)(1)(CCH 2016). In the event that advances exceed the credit amount to which the taxpayer is entitled the excess amount advanced increases the income tax owed by the taxpayer subject to certain limitations based on the level of the taxpayer's household income. I.R.C. § 36B(f)(2)(CCH 2016); Treas. Reg. § 1.36B-4 (2012).

111. I.R.C. § 36B(c)(1)(CCH 2016).

112. I.R.C. § 36B(b)(B)–(C)(CCH 2016). The applicable percentage varies from a minimum of 2 percent to a maximum of 9.5 percent subject to adjustment to account for the possibility that health insurance costs increase faster than the rate of income growth. Additional adjustments are to be made beginning in 2019 if premium cost increases exceed the growth in the consumer price index and the subsidies exceed a certain level of gross domestic product. *See* I.R.C. § 36B(b)(3)(A)(CCH 2016). Household income is the sum of the adjusted gross income, with certain modifications, of all individuals who were taken into account in determining the taxpayer's family size and were required to file a tax return for the taxable year. *See* I.R.C. § 36B(d)(2)(CCH 2016). The federal poverty line is the most recently published poverty guideline as of the first day of the regular enrollment period for coverage through an Exchange for the calendar year. Treas. Reg. § 1.36B-1(h)(2012).

The allowance of a tax credit can trigger the applicability of the individual mandate with respect to the individual entitled to the credit because the credit reduces such individual's required contribution for purposes of determining whether insurance coverage is affordable by such individual and, therefore, mandated.[113] In addition, the attainment of a credit or cost sharing reduction by one employee triggers the penalty imposed on employers by I.R.C. section 4980H.[114]

On its face, I.R.C. section 36B limits eligibility for tax credits to taxpayers who are enrolled in State Exchanges.[115] However, regulations were issued pursuant to which participants in the Federal Exchange would also qualify for the credit.[116] Virginia did not establish an Exchange and its residents may purchase health insurance through HealthCare.gov, the Federal Exchange. Several Virginia residents challenged the validity of the regulations that entitled qualified enrollees on Federal Exchanges to a tax credit because the availability of such credit rendered their insurance costs affordable under the statute thereby subjecting them to the individual mandate.[117] The Fourth Circuit applied *Chevron* and unanimously affirmed the district court's holding that the Treasury regulations were within the Treasury's authority.[118] The court held that the statutory language did not unambiguously reveal the intent of Congress with respect to the availability of tax credits for individuals enrolled on the Federal Exchange.[119] The court then proceeded to *Chevron* step two.[120] According to the court, the Treasury regulations were a permissible interpretation of the statute because the objectives of the Patient Protection and Affordable Care Act

113. I.R.C. § 5000A(e)(1)(B)(ii)(CCH 2016).

114. *See supra* note 108 and accompanying text.

115. *See supra* note 110 and accompanying text.

116. *See* Treas. Reg. §§ 1.36B-1(k)(2012)(defining Exchange by reference to 45 C.F.R. § 155.20); 1.36B-2(a)(2012)(providing eligibility for credit by enrollment in an Exchange); 45 C.F.R. § 155.20(2012)(stating that the term Exchange refers to State Exchanges, regional Exchanges, subsidiary Exchanges, *and a Federally-facilitated Exchange*)(emphasis added).

117. *See supra* note 113 and accompanying text.

118. King v. Burwell, 759 F.3d 358 (4th Cir. 2014), *aff'g* King v. Sebelius, 977 F.Supp. 2d 415 (E.D. Va. 2014).

119. *Id.* at 369. The language of I.R.C. § 36B referred only to Exchanges established by a State, but the court refused to "'confine itself to examining a particular statutory provision in isolation.'" *Id*. at 368 (quoting Nat'l Ass'n of Home Builders v. Defenders of Wildlife, 551 U.S. 644, 666 (2007)). The court believed that § 1311, the provision authorizing State exchanges, § 1321, the provision authorizing the Federal Exchange, and a definitional provision of the Act could plausibly be read to treat the Federal Exchange as an Exchange established by a State. *Id.* at 369. The court also found that two other statutory provisions were irreconcilable with the appellants' assertion that I.R.C. § 36B denies the availability of credits to taxpayers enrolled on the Federal Exchange. *See id.* at 369–71. Moreover, the court found little guidance in the legislative history of the statute. Despite the fact that several floor statements by Senators indicated that all taxpayers would have access to the credits, such statements could have been made under the assumption that all states would establish Exchanges and that the denial of credits to taxpayers enrolled in the Federal Exchange would induce states to establish their own Exchanges. *Id.* at 371–72.

120. *Id.* at 372.

are to increase the number of Americans covered by health insurance and to decrease the cost of health care.[121] Therefore, the broad availability of tax credits to subsidize the cost of health insurance is congruent with the statute's objectives.[122]

A similar challenge to the Treasury regulations was brought before the D.C. Circuit by individual appellants who resided in states that did not establish Exchanges.[123] In a 2-1 decision, the court reversed the district court's judgment that upheld the validity of the regulations.[124] Unlike the Fourth Circuit, the court found no need to proceed to *Chevron* step two because it believed that Congress did speak directly to the precise question at issue and that tax credits are available only for enrollees in State Exchanges as the statutory language of section 36B made clear.[125]

The Court, in *King v. Burwell*, affirmed the judgment of the Fourth Circuit and held that enrollees on the Federal Exchange are entitled to tax credits.[126] Justice Roberts, writing for the Court, briefly reviewed the economic underpinnings of the legislation, took notice of unsuccessful efforts by various states to expand individuals' access to health insurance coverage, and contrasted those efforts with the efforts of states that achieved success in expanding health insurance coverage.[127]

Unlike the Fourth Circuit, the Court did not believe that the Treasury regulations were entitled to *Chevron* deference. According to the Court, the deference afforded administrative agencies in their interpretations of

121. *Id.* at 373–74.

122. *Id.* at 374–75.

123. Halbig v. Burwell, 758 F.3d 390, 393 (D.C. Cir. 2014), *rev'g* Halbig v. Sebelius, 27 F.Supp. 3d 1 (D.D.C., 2014). The decision of the court was vacated and a rehearing *en banc* was granted. Halbig v. Burwell, 2014 U.S. App. LEXIS 17099 (Sept. 4, 2014). However, the case subsequently was held in abeyance pending the decision of the Supreme Court. Halbig v. Burwell, 2014 U.S. App. LEXIS 23434 (Nov. 12, 2014).

124. *See* Halbig v. Burwell, 758 F.3d at 399.

125. According to the court, the Federal Exchange is equivalent to State Exchanges in certain respects but it differs from State Exchanges in one crucial respect—it is not established by a State as required by the language of I.R.C. § 36B. *Id.* at 400. Section 1321 of the Patient Protection and Affordable Care Act, the provision that authorizes the Federal Exchange, omits any language that suggests that such Exchange should be treated as a State Exchange. *Id.* The court presumed that Congress's use of dissimilar language in different parts of a statute was intentional, rejected the government's contention that all Exchanges are, by definition, established by a State, and held that the absurdity doctrine did not apply. *Id.* at 400–402. Despite the fact that the court believed that the statutory language was unambiguous, it did proceed to examine the legislative history of the statute. In the court's opinion, the legislative history failed to provide demonstrable evidence that Congress intended to provide tax credits to eligible enrollees on all Exchanges. The court found the legislative history inconclusive in this respect and believed that a reasonable inference could be drawn that the limitation of credits to enrollees in State Exchanges was a means to incentivize states to establish their own Exchanges. *Id.* at 408. Moreover, it refused to countenance the absence of any suggestion in the legislative history that credits be so limited as evidence of an intent to the contrary because silence is not evidence that Congress meant something other than what it said. *Id.* at 408.

126. King v. Burwell, 135 S.Ct. at 2496. Justices Scalia, Thomas, and Alito dissented. *Id.*

127. *Id.* at 248–86.

statutory ambiguities under *Chevron* is premised on the notion that such ambiguities "constitute an implicit delegation from Congress to the agency to fill in the statutory gaps."[128] This implication may be unwarranted in "extraordinary cases" and, according to the Chief Justice Roberts, this was an extraordinary case.[129]

> The tax credits are among the Act's key reforms, involving billions of dollars in spending each year and affecting the price of health insurance for millions of people. Whether those credits are available on Federal Exchanges is thus a question of deep "economic and political significance" that is central to this statutory scheme; had Congress wished to assign that question to an agency, it surely would have done so expressly. . . . It is especially unlikely that Congress would have delegated this decision to the IRS, which has no expertise in crafting health insurance policy of this sort. . . . This is not a case for the IRS.[130]

Plain statutory language is enforceable according to its terms but whether such language is, in fact, plain "'may only become evident when placed in context . . . and with a view to their place in the overall statutory scheme"'[131] At this point, *King v. Burwell* degenerated into an exercise in statutory interpretation. The majority, by my count, employed three canons of statutory construction: the words of a statute must be read in context and given their place in the overall statutory scheme; federal statutes cannot be interpreted to negate their own stated purposes; and fundamental details of a regulatory scheme are not altered in vague or ancillary provisions.[132] The dissent employed its own canons to refute the majority's conclusion: the plain and obvious meaning of a statute is preferable to other meanings; it is presumed that lawmakers use words in their natural and ordinary

128. *Id.* at 2488 (quoting FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 159 (2000)).

129. *Id.* at 2488–89 (citing FDA v. Brown & Williamson Tobacco Corp., 529 U.S. at 159).

130. *Id.* at 2489 (citations omitted).

131. *Id.* (quoting FDA v. Brown & Williamson Tobacco Corp., 529 U.S. at 132–33).

132. *Id.* at 2489, 2493, 2495. The Court examined the definitional provisions of the statute and, similar to the Fourth Circuit, found that the most natural meaning of the definitional provisions would result in no qualified individuals for the Federal Exchange and that such Exchange would not be an Exchange at all—results clearly not contemplated by the statute. *Id.* at 2490–91. Moreover, unless the Federal Exchange is deemed established under the same statutory provision as State Exchanges, none of the statutory requirements are applicable to the Federal Exchange. *Id.* at 2491. In addition, the Court agreed with the Fourth Circuit that the information reporting requirements imposed on the Federal Exchange made little sense if tax credits were not available to enrollees in such Exchange. *Id.* at 2491–92. Apparently, the importance of contextual analysis -the first canon noted—to Chief Justice Roberts and Justice Kennedy varies from case to case. Ironically, in another case that involved the Patient Protection and Affordable Care Act, both the Chief Justice and Justice Kennedy placed significant emphasis on the Dictionary Act's definition of "person" in reaching the conclusion that the Religious Freedom Restoration Act was applicable to closely-held corporations. Burwell v. Hobby Lobby Stores, Inc., 134 S. Ct. at 2768–70.

signification; lawmakers do not use terms that have no operation at all; and specific terms govern over general terms.[133]

The enlistment of these tools by both the majority and the dissent was made for one purpose—to answer the question of whether Congress intended for tax credits to be available to enrollees on the Federal Exchange.[134] The Court found it possible to interpret the language of I.R.C. section 36B either to limit tax credits to enrollees in State Exchanges or to permit enrollees on both State and the Federal Exchange to qualify for tax credits.[135] The Court examined the broader structure of the legislation to clarify the ambiguity in favor of the government.[136]

The dissenting opinion, authored by Justice Scalia, asserted that Congress could not have "come up with a clearer way to limit tax credits to State Exchanges than to use the words 'established by the State.'"[137] Conceding that context always is a relevant consideration in statutory interpretation, Justice Scalia stated that context "is a tool for understanding the terms of the law, not an excuse for rewriting them."[138] Moreover, the dissent disagreed that the statutory language evidenced the intent to treat

133. King v. Burwell, 135 S. Ct. at 2497–2500 (Scalia, J., dissenting).

134. It has been suggested that this case also concerned two broader issues—the manner in which legislation is drafted and debated and the appropriateness of increasing the compliance burden on an already overburdened I.R.S. *See* Armando Gomez, *Why Should Tax Lawyers Care About King v. Burwell?*, 2015 COLUM. J. TAX L.-TAX MATTERS 4, 5 (2015). Whether or not the Court could have, or should have, considered those issues is beyond the scope of this work.

135. King v. Burwell, 135 S.Ct. at 2491. The Court noted that its preference for the avoidance of surplusage is not an absolute rule and rejected the notion that if Congress intended the tax credits to be available for qualified individuals enrolled on all Exchanges then the words "established by the State" would have been unnecessary. *Id.* at 2492. The legislation was poorly drafted due, in large part, to the political machinations that were employed in order to secure its passage. *Id.* Accordingly, the Court found that the phrase "an Exchange established by the State" to be ambiguous. *Id.*

136. According to the Court, a limitation of tax credits to enrollees on State Exchanges would "likely create the very 'death spirals' that Congress designed the Act to avoid." *Id*. at 2492–93. Such an interpretation would run counter to the canon that federal statutes cannot be interpreted to negate their own stated purpose. *Id.* at 2493 (quoting N.Y. State Dep't. of Soc. Servs. v. Dublino, 413 U.S. 405, 419–20 (1973)). The Court, rejecting the assertion that Congress believed that the limitation of tax credits to enrollees in State Exchanges would entice the states to establish Exchanges, believed that the establishment of a Federal Exchange evidenced that Congress contemplated state reluctance to cooperate and established the Federal Exchange as a fallback in the event of such state reluctance. *Id*. at 2494. Finally, the Court delved into the intricacies of § 36B and noted that the denial of tax credits, if such credits are to be denied, becomes evident only after delving into a "sub-sub-sub section" of the statute. *Id*. at 2495. Due to the fundamental importance of the tax credits to the overall statutory scheme, the Court believed that a congressional intent to deny such credits would have been made known in a prominent way and not buried in the interstices of the statute. *Id.*

137. *Id*. at 2497 (Scalia, J., dissenting).

138. *Id.* Justice Scalia did not believe that the phrase "established by the State" was surplusage. Redundant language is commonly used by lawmakers but the majority violated a virtually absolute principle of statutory construction by rendering the phrase in question a nullity. *Id.* at 2498. Because this language was repeated seven times throughout the statute but not throughout the entire statute, common sense dictates that the use of a phrase in some cases and another phrase in other cases indicates that the two phrases have contrasting meanings. *Id*. at 2498–99.

the Federal and State Exchanges as equivalent and that the majority's interpretation rendered various statutory provisions nonsensical.[139] Justice Scalia was unmoved by the majority's reliance on the legislation's design and purpose. The notion that the health insurance market would be destabilized by the lack of tax subsidies to enrollees in the Federal Exchange, if true, is not proof that the statute does not mean what it says but is just a flaw in the law.[140] Justice Scalia accused the majority of ignoring other competing purposes. The legislation evidences the congressional desire for state participation in the establishment and management of Exchanges and a holding contrary to the majority's would encourage states to establish their own Exchanges thereby achieving the market reforms desired with active state participation.[141]

1. Analysis and Critique

The Court came to the conclusion that Congress intended to make tax credits available to enrollees in the Federal Exchange. At that point, there is no ambiguity, *Chevron* step one is failed, and that should have been the end of the inquiry. In *Chevron*, the Court noted that ". . . [i]f this choice represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute, we should not disturb it unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned."[142] The Court failed to explain how an accommodation that Congress would not have sanctioned could ever be a "reasonable accommodation of conflicting policies that were committed to the agency's care."

Jonathan Adler and Michael Cannon, the authors who gave prominence to the issue in *King v. Burwell*, stated the following:

139. Several provisions of the legislation mandated state officials to undertake certain tasks related to the administration of Exchanges. The dissent questioned how a state official possibly could undertake those tasks for an Exchange that is operated by the federal government. *Id.* at 2499. Even if it were true that Congress intended to equate the two types of Exchanges in general, for the specific purpose of the tax credits the two types of Exchanges are not equivalent. *Id.* at 2500. The dissent found nothing unusual in the fact that the limitation of tax credits to enrollees in State Exchanges is found in a formula, rather than a definitional, provision. Such drafting is common in the I.R.C. *Id.* at 2501–02 (providing several examples of such drafting).

140. *Id.* at 2503. Moreover, this flaw existed, without dispute, in the long-term care insurance program established by the legislation and in the general insurance market in the Federal Territories. *Id.* Whether or not the statute was the result of Congress's lack of due care and deliberation was of no moment to the dissent. It is not the role of the Court to amend a law that says what Congress did not intend to say or "to make everything come out right when Congress does not do its job properly." *Id*. at 2506.

141. *Id.* at 2504.

142. Chevron U.S.A., Inc. v. Nat. Res. Def. Council, 467 U.S. at 845 (quoting United States v. Shimer, 367 U. S. 374, 382–83 (1961)).

> Suppose, however, the IRS was able to convince a reviewing court that the PPACA is ambiguous on whether it limits tax credits to state-based Exchanges. The IRS would also need to demonstrate that this ambiguity was evidence of an implicit delegation of authority to interpret the statute in a way that would authorize the creation of new tax credits, new entitlement spending, and new taxes on employers and individuals beyond the purview of the traditional legislative appropriations process. This is not the sort of authority one should lightly presume Congress delegated to an agency. To paraphrase the Supreme Court, Congress does not hide such "elephants in mouseholes."[143]

If Congress does not hide "elephants in mouseholes" then there should be no ambiguity that would justify Treasury's action. Again, either the issue was committed to the agency's care or it was not. Clarity of statutory language is, of course, the best evidence of whether or not a statute evidences a congressional intent with respect to the issue in question. If I.R.C. section 36B stated that tax credits are available to eligible individuals enrolled on "any Exchange," or, alternatively, "an Exchange established by a State (but not the Federal government or any instrumentality therefor)" then the intent of Congress would have been manifested clearly. Unfortunately, Congress often does not manifest its intent in so obvious a manner. Chief Justice Roberts stated that the meaning of the term "established by the State" was ambiguous but then proceeded to explain why Congress intended for such term to encompass the Federal Exchange.[144] Ambiguity of language should not be confused with ambiguity of intent. Congressional intent can be gleaned from extraneous sources as the Court did in *FDA v. Brown & Williamson Tobacco Corp.*, a case in which it exhaustively examined other congressional actions to determine that Congress did not intend to provide the FDA with regulatory authority over tobacco.[145]

The importance of the issue, whether to an overall regulatory scheme, to the economy, or to some other matter of import may be—and perhaps should be—a factor in the courts' inquiry with respect to congressional intent but it should not be treated as conclusive evidence of Congress's intent. Common sense dictates that the more central that the resolution of a seeming ambiguity is to a regulatory scheme the more likely it is that the legislature intended a particular result. However, Congress may have given no thought at all to the matter for one of two reasons. First, the matter may implicate the application of a statutory requirement to one of many possible

143. Jonathan H. Adler & Michael F. Cannon, *Taxation Without Representation: The Illegal IRS Rule to Expand Tax Credits Under the PPACA*, 23 HEALTH MATRIX 119, 180 (2013) (quoting Whitman v. Am. Trucking Ass'ns, 531 U.S. 457, 468 (2001)).

144. *See supra* notes 135–36 and accompanying text.

145. *See* FDA v. Brown & Williamson Tobacco Corp., 592 U.S. at 133–56.

fact patterns potentially covered by the rule and Congress intended an agency to deal with such specifics. It is precisely these situations that justify *Chevron* deference because the regulatory agencies have the policy and technical expertise to deal with such situations and the flexibility to alter their positions as circumstances warrant.

Second, Congress may not have contemplated the issue at all and the issue's importance casts doubt on Congress's intent to delegate its resolution to an agency. Such a situation may arise, for example, as a result of technological, legal, or social developments not contemplated by Congress at the time the legislation was enacted. In such circumstances, the courts should invalidate the regulations in question and leave the matter for Congress to resolve. Neither *FDA v. Brown & Williamson* nor *King v. Burwell* presented a case in which Congress gave no thought to a matter of extraordinary importance. In both cases, the Court was able to glean Congress's intent with the respect to the issue presented. Both cases were—in reality—decided at *Chevron* step one.

Whether an issue's importance negates congressional delegation is itself a difficult issue.[146] *King v. Burwell* would appear to be an easy case in this respect because qualification for tax credits is critical to the operation of the health care reforms advanced by the statute and presented an issue that was contemplated by Congress. Yet, the Court and the Fourth Circuit court came to opposite conclusions about whether Congress implicitly delegated authority to the I.R.S.[147] Less than a decade ago, the Sixth and Second Circuits upheld the so-called "check-the box" regulations that were issued ten years previously.[148] These regulations dealt with the classification of an entity for tax purposes.[149] For decades, the

146. Assume that the phrase "established by the State but not by the federal government or any instrumentality thereof)" replaced the language presently found in I.R.C. § 36B and that neither the statute nor its legislative history made mention of the possibility that states and the federal government could partner to operate an Exchange. Assume further that the Treasury Department issued regulations that defined an Exchange "established by the State (but not by the federal government or any instrumentality thereof)" to include Exchanges that were operated by states in partnership with the Department of Health and Human Services. This regulation would satisfy both the policy goal of insurance affordability and the policy goal of state participation. If Congress contemplated that states would either form an Exchange or would not participate at all then the possibility of a federal-state partnership in operating an Exchange would not have occurred to Congress at the time the legislation was deliberated and enacted. However, if a great number of states chose to partner with the Department of Health and Human Services then the importance of this issue to the overall statutory scheme would be significant. It is unclear how a court would determine whether this issue is of such import to negate the implication that Congress intended the Treasury Department to deal with it.

147. *See* King v. Burwell, 759 F.3d at 373. The Court had indicated, in Smiley v. Citibank, 517 U.S. 735 (1996), that conflicting interpretations of a statute by courts—in this case, the Supreme Courts of New Jersey and California—provides strong evidence of statutory ambiguity. Intuitively, the same inference should be drawn by conflicting interpretations of a statute by the Circuit Courts.

148. *See* Littriello v. United States, 448 F.3d 372 (6th Cir. 2007), *cert. denied* 552 U.S. 1186 (2008); McNamee v. Dep't of the Treasury, 488 F.3d 100 (2d Cir. 2007).

149. *See generally* Treas. Reg. §§ 301.7701-1, *et. seq*. (1996).

classification of an entity as a corporation or a partnership for tax purposes was determined by the examination of certain attributes of the entity in question.[150] The emergence of limited liability companies (LLCs) during the 1990s magnified the importance of entity classification because the LLC form provided taxpayers with an extremely flexible non-corporate vehicle with which to limit the personal liability exposure of the entity's owners. The Treasury regulations completely discarded the previous entity classification rules and adopted a system whereby noncorporate entities elect whether they would be taxed as corporations or partnerships.[151]

Both the Sixth and Second Circuits upheld the regulations under *Chevron*.[152] The classification of an entity has enormous tax consequences. The regulations certainly simplified tax administration and reduced the risk of tax litigation. Perhaps the emergence of LLCs warranted such simplification. Equally plausible, however, is that the Treasury regulations would spell the virtual death knell of the corporate form for non-publicly traded entities.[153] Neither circuit court considered the possibility that Congress would not have a delegated such a critical matter to the Treasury.

King v. Burwell could undermine the equipoise that *Mayo* provided between the I.R.S. and other federal agencies.[154] According to the Court, it was unlikely that Congress delegated the authority to establish a qualification for tax subsidies, a matter central to the operation of Patient Protection and Affordable Care Act, to the I.R.S.[155] Chief Justice Roberts stated that the delegation of such a matter to the I.R.S. was even more unlikely given its lack of expertise in health care policy.[156] Because agency expertise is one factor that supports *Chevron* deference, this statement should trouble the Treasury.[157] Tax legislation often serves policy goals unrelated to revenue collection. Federal housing, education, health care, and retirement security policy goals are aided, in part, through the tax

150. *See generally* Treas. Reg. §§ 301.7701-1, *et. seq.* (1960); Morrissey v. Comm'r, 296 U.S. 344 (1935); United States v. Kintner, 216 F.2d 418 (9th Cir. 1954).

151. *See* Treas. Reg. §§ 301.7701-3(a)-(b)(2006). Non-corporate entities owned by one person elect to be taxed as corporations or to be disregarded. Entities incorporated under a federal or state statute, insurance companies and banks, entities wholly owned by a State or political subdivision thereof or a foreign government, and certain foreign entities are treated as corporations. *See* Treas. Reg. § 301.7701-2(b)(2012).

152. Littriello v. United States, 448 F.3d at 378; McNamee v. Dep't of the Treasury, 488 F.3d at 105. I offer no opinion on whether *Chevron* was applied properly in these cases.

153. Publicly traded entities, except for entities who generate at least 90 percent of their gross income from certain passive sources, are treated as corporations regardless of the entities' legal form. *See generally* I.R.C. § 7704(CCH 2016).

154. *See supra* notes 74-76 and accompanying text.

155. *See supra* notes 129-30 and accompanying text.

156. *Id*.

157. *See supra* notes 48-49 and accompanying text.

system.[158] Will I.R.S. lack of expertise in these areas somehow subject its regulations to greater scrutiny? At a minimum, such a statement provides fodder for taxpayers to challenge Treasury regulations.

B.The *State Farm* Doctrine

The Administrative Procedure Act permits a court to invalidate agency actions that are arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.[159] One year before *Chevron* the Court decided the seminal case concerning the Act's arbitrary and capricious standard, *Motor Vehicle Manufacturers Association of the United States, Inc. v. State Farm Mutual Automobile Insurance Co*.[160] The National Traffic and Motor Vehicle Safety Act of 1966, enacted to reduce automobile accidents and the deaths and injuries that ensued from such accidents, directed the Secretary of Transportation to issue practical and objective motor vehicle safety standards.[161] The statute also directed the Secretary to consider all relevant safety data and the reasonableness and practicality of proposed safety standards and whether such standards will contribute to carrying out the purpose of the statute.[162] Between 1967 and 1978 the Department of Transportation issued several standards, at first simply requiring automobile manufacturers to install seatbelts and later requiring full passive front seat occupant restraint systems—automatic seatbelts or airbags—in model year 1984 vehicles.[163] In 1981, the

158. *See e.g*., I.R.C. §§ 25A (providing a credit for certain educational expenses); 36 (providing a credit for first time homebuyers); 105 (providing an exclusion for employer provided medical insurance); 213 (providing a deduction for medical and dental expenses); 401–09 (providing tax deferred retirement vehicles)(CCH 2016).

159. 5 U.S.C. § 706(2)(A)(2016). Courts may also set aside agency action that are contrary to constitutional right, power, privilege, or immunity; in excess of statutory jurisdiction, authority, or limitations, or short of statutory right; taken without observance of required procedure; decisions in certain hearings that are unsupported by substantial evidence; or unwarranted by the facts to the extent that the facts are subject to a trial *de novo*. *See* 5 U.S.C. §§ 706(2)(B)-(F)(2016). Unless a statute provides otherwise only final agency actions are reviewable by a court. *See* 5 U.S.C. § 704(2016). In general, a person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review. 5 U.S.C. § 702(2016). However, agency actions are not subject to judicial review if a statute precludes such review or the action is committed to agency discretion by law. 5 U.S.C. §§ 701(1)-(2)(2016). *See supra* note 52 for a discussion of actions committed to agency discretion and the non-delegation doctrine.

160. 463 U.S. 29 (1983).

161. *Id.* at 33.

162. *Id.* at 33–34.

163. *Id.* at 34–37. Originally, passive restraints were required in all vehicles manufactured after August 15, 1975. In the two years preceding the effective date of the passive restraint requirement vehicles could be manufactured with passive restraint or shoulder belts coupled with an ignition lock. The shoulder belt/ignition lock option was selected by most manufacturers but the unpopularity of this feature led Congress to amend the statute in 1974 to foreclose this option. The effective date was later postponed for approximately one year and then suspended pending the outcome of a demonstration

Department ordered a one year delay in the new standard and later proposed a rescission of the standard. Ultimately, the Department rescinded the standard.[164]

The Department of Transportation asserted that it no longer found that passive restraints would yield significant safety benefits. The agency assumed that airbags would be installed in sixty percent of new cars and that the remaining forty percent would comply with the standard through the installation of automatic seat belts.[165] Instead, the vehicle manufactures planned to meet the standard through the installation of automatic seat belts in approximately ninety-nine percent of new cars.[166] Most automatic seat belts could be disengaged with relative ease. As a result, the agency believed that the costs to comply with the standard would be unreasonable in light of the minimal safety benefits to be derived from its imposition.[167] In addition, the agency believed that the imposition of an expensive, yet ineffective, standard would negatively affect public attitudes toward vehicle safety thereby hindering future agency safety initiatives.[168]

State Farm and an automobile insurance trade group challenged the rescission of the standard and the D.C. Circuit held that the agency's rescission of the safety standard was not supported by clear and convincing reasons because there was insufficient evidence to support the agency's conclusion regarding seat belt use and because the agency failed to give due consideration to either a requirement to install non-detachable seat belts or a requirement to install airbags.[169] The Court agreed with the D.C. Circuit that rescission of a regulation is reviewable under the arbitrary and capricious standard but it held so in more sweeping terms. According to the Court, "the revocation of an extant regulations is substantially different than a failure to act" and such a change in course obligates an agency "to supply a reasoned analysis for the change beyond that which may be

project. Finally, a new Secretary of Transportation had the Department of Transportation issue the new standard in 1978. The standard was to be phased in first with large cars in model year 1982 and then to all cars by model year 1984. *Id.* at 37.

164. *Id.* at 38.

165. *Id.*

166. *Id.*

167. *Id.* at 39.

168. *Id.*

169. *Id.* at 39–40. The court held that the rescission was reviewable under the arbitrary and capricious standard and that such rescission was not analogous to a failure to issue regulations. The Administrative Procedure Act authorizes a court to compel agency action that has unlawfully withheld or unreasonably delayed. 5 U.S.C. § 706(1)(2016). However, the courts are much more reluctant to compel agency action than they are to invalidate actions once such actions are taken. In general, courts will compel action only if they find that the agency has a clear, nondiscretionary duty to act. Moreover, many forms of agency inaction are considered committed to agency discretion by law or are not deemed final agency action, and therefore, unreviewable. Eric Biber, *Two Sides of the Same Coin: Judicial Review of Administrative Agency Action and Inaction,* 26 VA. ENVTL. L.J. 461, 465–66 (2008).

required when an agency does not act in the first instance."[170] The Court, however, disagreed with the lower court that this particular rescission was subject to a heightened standard of review due to congressional action. The standard of review, in this case the arbitrary and capricious standard, is neither enlarged nor diminished by subsequent congressional action.[171]

The Court noted that the arbitrary and capricious standard is narrow and does not invite a court to substitute its judgment for that of the agency.[172] However, an agency must articulate a satisfactory explanation for its action and there must be a rational connection between the facts found and the agency's action.[173] According to the Court, an agency rule is arbitrary and capricious if the agency: 1) relied on factors that Congress did not intend it to consider; 2) entirely failed to consider an important aspect of the issue in question; 3) offered an explanation that is counterfactual; or 4) offered an explanation that is so implausible that it belies a difference of opinion or agency expertise.[174] An agency's reasoning may be discerned by a court if its reasoning is opaque.[175] However, the Court, citing *SEC v. Chenery Corp*, stated that the judiciary cannot make up for agency deficiencies nor provide a reasoned basis for an agency's action that has not been advanced by the agency itself.[176]

The Court held that the rescission of the passive restraint requirement was arbitrary and capricious. With respect to air bags, the Court held that the Department of Transportation's belief that detachable seat belts would prove ineffective, even if proven true, in no way provides a rational basis for rescinding the airbag requirement.[177] The Court found that the Department of Transportation gave no consideration to amending the standard to mandate airbags in light of its position that detachable seat belts are not effective.[178] The agency's assertions that airbags create difficulties in the production of small cars and that public reaction to mandatory airbags would be negative were, according to the Court, *post hoc* rationalizations.[179] *Chenery* mandates that agency action, if it is to be sustained, be based on the reasons articulated by the agency when it took action.[180]

170. Motor Vehicle Mfg. Ass'n of the U.S. v. State Farm Mut. Auto. Ins. Co., 463 U.S. at 41–42.
171. *Id.* at 44–45.
172. *Id.* at 43.
173. *Id.* (citing Burlington Truck Lines, Inv. v. United States, 371 U.S. 156, 168 (1962)).
174. *Id.*
175. *Id.*
176. *Id.* (citing SEC v. Chenery Corp., 332 U.S. 194, 196 (1947)).
177. *Id.* at 48–49.
178. *Id.* at 50.
179. *Id*.
180. *Id*. (citing Burlington Truck Lines, Inv. v. United States, 371 U.S. at 168; SEC v. Chenery Corp. 332 U.S. at 196; Am. Textile Mfrs. Inst., Inc. v. Donovan, 452 U.S. 490, 539 (1981)).

With respect to automatic seatbelts, the Court held that the agency failed to consider evidence regarding the effect that detachable seat belts would have on vehicle safety. The Court acknowledged that agencies often operate in the face of uncertainty, that no evidence in direct support of a conclusion may be available, and that policy conclusions may be the result of judgments drawn from facts and probabilities.[181] However, an agency must do more than merely recite "substantial uncertainty" as its rationale for an action.[182] Instead, it must rationally connect the facts found with the choice made and justify why it is rescinding a rule before searching for further evidence.[183] The Court found the Department of Transportation's reliance on test data and manual seat belt usage data to be inadequate and, in certain respects, misplaced.[184] The Court also held that the agency did not adequately consider a "continuous passive" seat belt option as a solution to the problems posed by automatic seat belts.[185]

1. Is *State Farm* Distinct from *Chevron*?

In many respects, *State Farm's* "hard look" review of agency action is difficult to extricate from the *Chevron* two step test. If an agency came to an action based on factors that Congress did not intend the agency to consider then such action apparently would fail *Chevron* step one because Congress left no ambiguity for the agency to act upon—at least with respect to the factors that Congress prohibited. In most cases, the application of *State Farm* and *Chevron* step two will lead to similar conclusions. For example, if agency justification for an action is counterfactual or implausible then that action is unlikely to pass muster under *Chevron* step two. Likewise, if the agency entirely failed to consider an important aspect of the issue in question then whatever action was taken by the agency is unlikely to satisfy *Chevron* step two. The American Bar Association and several scholars have argued that the arbitrary and capricious standard should be incorporated into *Chevron* step two because both tests involve similar inquiries and that the discernment of a conceptual distinction between the two standards is difficult.[186] I agree that *Chevron* and *State Farm* may be inextricable when *Chevron* step two is failed. I am not convinced, however, that the failure to meet the *State Farm* standard is a sufficient condition for the failure of *Chevron* step two.

It is possible to discern a distinction between *State Farm* and *Chevron.* The latter inquires whether an agency has reasonably interpreted the law

181. *Id*. at 51–52.
182. *Id.* at 52.
183. *Id.*
184. *Id.* at 52–54.
185. *Id.* at 55.
186. David Zaring, *Reasonable Agencies*, 96 VA. L. REV. 135, 162 –63 (2010).

while the former inquires whether the agency has articulated a reasonable factual and/or policy basis for its actions. The law versus facts distinction between the two tests implies, somewhat counterintuitively, that the courts are more likely to defer to an agency's interpretation of law than to an agency's factual and policy conclusions. This point was made by Justice Breyer.[187] In many, if not most, cases, both *State Farm* and *Chevron* will yield the same result. However, the tests are not identical. While *Chevron* rests on notions of agency expertise and congressional intent, *State Farm* has other justifications, including the imposition of discipline on agency decisions, the legitimization of agency action, and enablement of judicial review.[188] *State Farm* more appropriately should be seen as an additional hurdle for agencies to jump after they have cleared *Chevron* step two.

Assuming that the requisite statutory gap exists *Chevron* step two prohibits agency actions that are either arbitrary and capricious in substance or contrary to the statute.[189] As discussed earlier, if *Chevron* step one does not yield a mandatory result then *Chevron* step two permits any number of alternatives so long as those alternatives are reasonable. *State Farm* inquires why the agency chose a particular alternative among the possible permissible alternatives and examines if the reasons articulated by the agency make sense in light of the factual record and congressional policy preferences. It is conceivable that an agency choose a course of action that, in substance, does no violence to the statute yet is not adequately justified by the agency.

In fact, *State Farm* itself and *Mayo* provide examples of this possibility. In *State Farm*, the statute in question provided the Department of Transportation with significant latitude to take action to improve motor vehicle safety.[190] Had the Department of Transportation issued a rule that mandated only passive seat belts, only air bags, seat belts for certain cars and air bags for others, or manual seat belts with an interlock or buzzer feature, I imagine that *Chevron* step two would have sanctioned each of these alternatives. Each of these alternatives appears to be reasonable under the statutory mandate. At this point, *State Farm* requires the agency to articulate the facts to support the choice it made. In *Mayo*, Treasury regulations required that medical residents be subject to payroll taxes.[191] The Court found that the I.R.C. did not address the issue of student-workers

187. Thomas J. Miles & Cass R. Sunstein, *The Real World of Arbitrariness Review*, 75 U. CHI. L. REV. 761, 765 (citing Stephen Breyer, *Judicial Review of Questions of Law and Policy*, 38 ADMIN. L. REV. 363, 394 (1986)).

188. *See* Jodi L. Short, *The Political Turn in American Administrative Law: Power, Rationality, and Reasons*, 61 DUKE L.J. 1811, 1820–23 (2012).

189. *See supra* note 60 and accompanying text.

190. *See supra* note 161 and accompanying text.

191. *See supra* note 77 and accompanying text.

thereby *Chevron* step one was met.[192] The regulations in question addressed the status of such individuals on the basis of hours worked as opposed to the primary purpose of the work.[193] Determining full-time employment status on the basis of hours worked is neither arbitrary or capricious in substance nor contrary to the statute. The Treasury articulated satisfactory reasons for its choice of hours worked as the critical variable in determining full-time employment status.[194] Had the Treasury failed to provide reasons for its choice the regulations in question would have been invalidated under *State Farm* but not under *Chevron*.

Chevron step two is, or should be, applied in the abstract. Does the statute permit this action? If the answer to this question is no then *State Farm* is inapplicable. If the answer to this question is yes, then *State Farm* takes a hard look at the reasons behind the action. The fact that the failure of *Chevron* step two inevitably will result in the failure of the *State Farm* test does not mean that the opposite is true. *Chevron* step two may be met yet *State Farm* may be violated.

For a tax attorney, State Farm meant insurance and not part of her administrative law tool kit. Unlike *Chevron*, *National Muffler*, *Skidmore*, and, more recently, *Mayo* the *State Farm* case garnered little attention from the tax bar. The Supreme Court has never examined tax regulations under the *State Farm* standard.[195] Recently, *State Farm* has surfaced in two tax cases. In one case, the court applied both *Chevron* and *State Farm* to invalidate a Treasury regulation. In the other, a case with significant financial ramifications for multinational enterprises, the court invalidated a Treasury regulation under *State Farm*.

2. *State Farm* and Tax Regulations

a. Dominion Resources

I.R.C. section 263A, the uniform capitalization rules, sets forth rules for the capitalization of costs attributable to real or personal property produced by a taxpayer and to real or personal property acquired by a taxpayer for resale.[196] Under the statute, both direct and indirect costs are

192. *See* Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. at 52–53.

193. *See id.* at 50.

194. The Treasury justified its actions on the basis of administrative efficiency and the policy underlying the Social Security Act. *See id.* at 59–60.

195. Two scholars recently examined all Supreme Court decisions between 1983 and 2014 that involved an arbitrary and capricious holding. Their compilation included one tax case, *Mayo.* *See* Jacob Gersen & Adrian Vermeule, *Thin Rationality Review*, 114 MICH. L. REV. 1355, 1407–12 (2016). However, the Court did not review the Treasury regulation at issue in that case under *State Farm*. *See supra* notes 74–81 and accompanying text.

196. I.R.C. § 263A(a)–(b)(CCH 2016).

subject to capitalization.[197] Interest costs incurred during the production period and allocable to real property and certain personal property with a long useful life are subject to capitalization.[198] In determining the amount of interest expense required to be capitalized interest on any debt that is directly attributable to production expenditures with respect to a property are assigned to that property.[199] In addition, interest on any other debt is assigned to property under production to the extent that such debt could have been reduced if the production expenditures had not been incurred.[200] Thus, interest expense directly incurred by reason of production is capitalizable, such as interest on a construction loan. Moreover, if production is financed by equity, internal cash flow, asset sales, or some other non-debt source of funds, then interest expense on any debt is capitalizable under the theory—or fiction—that, but the production expenditures, debt unrelated to production could have been paid down.

The Treasury issued regulations that defined production expenditures, in the case of the purchase of property for further production, to include not only the costs of acquisition of the property and the improvements thereto but also the adjusted basis of other property that is temporarily idled by the production.[201] This has the effect of adding to the total production expenditures and thereby increasing the amount of interest that must be capitalized. In *Dominion Resources v. United States*, the validity of the regulation was challenged and the Court of Federal Claims applied *Chevron* and granted the government's motion for summary judgment.[202] The Federal Circuit reversed the decision of the Court of Federal Claims and held that the regulation in question failed both *Chevron* step two and the *State Farm* test.[203]

The court concurred with the lower court that the statute's definition of production expenditures was opaque, circular, and did not speak directly to the issue at hand.[204] Accordingly, *Chevron* step one was satisfied.[205] The court, however, did not believe that the inclusion of the basis of idled property in the production costs for which interest must be capitalized was

197. I.R.C. § 263A(a)(2)(CCH 2016).

198. I.R.C. §§ 263A(f)(1); 263A(f)(4)(A)(CCH 2016). The interest capitalization rules also apply to property whose estimated production period exceeds two years or whose estimated production period exceeds one year and whose cost exceeds $1,000,000. I.R.C. § 263A(f)(1)(B)(ii)–(iii)(CCH 2016).

199. I.R.C. § 263A(f)(2)(A)(1)(CCH 2016).

200. I.R.C. § 263A(f)(2)(A)(2)(CCH 2016).

201. *See* Treas. Reg. § 1.263A-11(e)(1)(ii)(B)(1994).

202. Dominion Res., Inc. v. United States, 97 Fed. Cl. 239 (2011), *rev'd*, 681 F.3d 1313 (Fed. Cir. 2012). The court upheld the regulation despite its finding of several internal inconsistencies within the regulations and its belief that the regulation's interpretation of the statute stretched the bounds of reasonableness. *See id.* at 257.

203. Dominion Res., Inc. v. United States, 681 F.3d 1313, 1314 (Fed. Cir. 2012), *rev'd,* 97 Fed. Cl. 239 (2011).

204. *Dominion Res.*, 681 F.3d at 1317

205. *Id.*

a reasonable interpretation of the statute. The court examined the statute's language and its legislative history and concluded, for three reasons, that the rule did not implement the avoided cost principal in a sensible manner.[206]

First, the court noted that the premise of the avoided cost rule is that debt could have been reduced had production expenditures not been incurred. However, no such reduction in debt could have occurred with respect to the basis of an existing, yet idled facility.[207] The cost of the idled property cannot be an avoided cost because such cost had already been incurred prior to production.[208] The Treasury's position makes sense only if one assumes that the idled facility could have been sold and the sale proceeds used to pay down debt. This assumption belies reality because such a sale obviates the very reason for any improvement to the property.[209]

Second, the court proceeded to parse the statutory language and held that the plain meaning of production expenditures is an amount actually expended or spent.[210] Moreover, the statute determined the amount of interest to be capitalized based on the amount of debt that could have been reduced had no production expenditures been incurred. The basis of existing property is not an amount that is incurred by a taxpayer.[211] Finally, the court concluded that the Treasury regulation could lead to absurd results. The adjusted basis of idled property bears little relation to the cost of improvements. Consequently, the same improvement could result in significantly different amounts of interest capitalized.[212] Dominion's two improvements were comparable in cost yet the regulations required vastly different amounts of interest to be capitalized solely because the adjusted basis of the two idled properties that were improved differed by over $100 million.[213]

The court further held that the regulation was arbitrary and capricious under *State Farm* because the Treasury offered no rationale when it issued the notice that provided guidance on the forthcoming regulation or when it issued the regulation in either proposed or final form.[214] The court believed that Court of Federal Claims erroneously concluded that the Treasury's reasoning was murky yet discernable.[215] Moreover, the fact that the Treasury announced its position in advance is not sufficient to satisfy its

206. *Id.* at 1318.
207. *Id.*
208. *Id.*
209. *Id.* at 1318–19.
210. *Id.* at 1318.
211. *Id.*
212. *Id.*
213. *Id.*
214. *Id.* at 1319.
215. *Id*.

obligation under *State Farm*.[216] *State Farm* is rarely applied in tax cases and *Dominion Resources* was the first appellate decision that invoked it to invalidate tax regulations.[217]

1. Analysis and Critique

The Federal Circuit's application of *Chevron* and *State Farm* is somewhat puzzling. The court held that *Chevron* step one was met. However, one its reasons for rejecting the regulation under *Chevron* step two was the court's belief that the statutory language plainly did not contemplate the Treasury's interpretation.[218] If so, then I fail to see how *Chevron* step one was met. If the meaning of the terms "expended," "spent," and "incurred" are plain then the statute does speak to the precise issue at hand. Moreover, having held that the regulations failed *Chevron* step two, there was no need for the court to delve into *State Farm*. Based on the court's *Chevron* analysis any Treasury explanation for its position would have been irrelevant.

Judge Clevenger's concurrence, in my opinion, nicely draws a distinction between *Chevron* step two and *State Farm*. He agreed that the Treasury proffered no reasonable explanation for its interpretation of the avoided cost rule and, therefore, the regulation should be invalidated under *State Farm*.[219] However, he did not believe that the regulation should have been invalidated under *Chevron* step two.[220] Noting that the avoided cost rule is a fiction, the judge articulated several reasons why the Treasury's position merited serious consideration.[221] For example, the idling of a facility does result in the incurrence of costs—lost revenue, for example.[222] Moreover, the regulation minimizes the opportunity for tax evasion. The basis of purchased property that has never been placed in service and improved is subject to interest capitalization. The regulation at issue prevents a taxpayer from temporarily placing such a property in service to avoid interest capitalization.[223]

216. *Id.*

217. In Manella v. Comm'r, 631 F.3d 115 (3d Cir. 2011), the court upheld the validity of a Treasury regulation under *Chevron*. The dissent quoted from *State Farm* but the quote was used to support the argument that *Chenery* precluded the court from considering the Treasury's assertions in this case. *See id.* at 127 (Ambro, J. dissenting). See *supra* notes 176, 180 for a discussion of *Chenery*. *State Farm* surfaced in a number of Tax Court cases over twenty years ago. *See* Patrick J. Smith, *Manella, State Farm, and the Arbitrary and Capricious Standard*, 131 No. 4, TAX NOTES 387, 393 n.44 (2011).

218. *See supra* note 210-11 and accompanying text.

219. *Dominion Res.*, 681 F.3d at 1320 (Clevenger, J. concurring).

220. *Id.* at 1321.

221. *Id.*

222. *Id.* at 1321–22.

223. *Id.* at 1322.

Judge Clevenger correctly noted that the majority's application of *Chevron* "creates a binding rule (at least in this circuit) that the government can never re-promulgate its associated-property rule for property temporarily withdrawn from service, no matter how well-formed its reasoning."[224] Therein lies the distinction between *Chevron* and *State Farm*. If a regulation fails *Chevron* step two then *State Farm* is not relevant anymore because no explanation can turn an unreasonable position into a reasonable one. As previously discussed, *Chevron* step two should permit any agency interpretation of a statute that is reasonable in the abstract.[225] At that point, the agency must articulate its reasons for why its particular interpretation was advanced.

Admittedly, in circumstances that do not involve statutory interpretation the determination of whether an agency action is permissible in the abstract cannot be ascertained without examining the factual basis for the action.[226] In such circumstances, *Chevron* and *State Farm* are joined quite firmly.[227] In a deportation case, Justice Kagan conceded that the Court would have reached the same conclusion whether it reviewed a Board of Immigration Appeals' action under *Chevron* step two or *State Farm*. She also stated ". . . that the more apt analytic framework in this case is standard 'arbitrary [or] capricious' review under the APA. The BIA's comparable-grounds policy . . . is not an interpretation of any statutory language . . . ."[228] However, a statutory interpretation that requires no empirical data for support, as was the case in *Mayo*, or a statutory interpretation for which no reasoned explanation is articulated, as was the case in *State Farm* and, according to Judge Clevenger, in *Dominion Resources*, very well may be permissible in the abstract.[229]

224. *Id.* at 1322–23. *See* Christopher J. Walker, *The Ordinary Remand Rule and the Judicial Toolbox for Agency Dialogue*, 82 GEO. WASH. L. REV. 1553 (discussing the circumstances in which a court will or will not remand a matter to an agency for further consideration); *See also* Allied-Signal, Inc. v. U.S. Nuclear Reg. Comm'n, 988 F. 2d 146, 150-51 (D.C. Cir. 1993) (holding that in certain circumstances, remand without vacatur is appropriate).

225. *See supra* notes 186-95 and accompanying text.

226. For example, assume that a statute requires that compensation must be reasonable to be deductible and that reasonableness is to be determined based on compensation paid for comparable work in comparable circumstances. If the Treasury issued a regulation that determined reasonableness based on some metric such as profit, revenue, or some other such variable then whether this regulation is a permissible interpretation of the statute depends on whether the factual data supports that such a rule approximates comparable pay standards. If not, it is not a permissible interpretation but this cannot be determined until a hard look review of the Treasury's reasoning takes place.

227. *See e.g.*, Judulang v. Holder, 132 S. Ct. 476, 484 n.7 (2011) (stating that the application of *Chevron* step two to a deportation action would have yielded the same result as the Court's application of *State Farm* when the agency's discretion was not exercised in a reasonable manner).

228. *Id.*

229. *See supra* notes 177-85, 219 and accompanying text.

a. Altera

The taxation of U.S. based multinational entities has garnered significant attention in recent years. Depending on one's point of view, U.S. corporations are improperly shifting taxable income to foreign subsidiaries domiciled in low or no tax jurisdictions or are understandably doing their best to avoid the taxation of world-wide income at draconian tax rates.[230] Although recent attention has been focused on the creative tax planning techniques of Apple, Google, and other prominent companies or on corporate acquisitions which result in a foreign situs for the parent company—so-called inversion—the prevention of improper income shifting by U.S. corporations has been a long-standing tax policy.[231] In general, transactions between related entities are respected provided their terms are at arm's length.

I.R.C. section 482 seeks to determine the "true taxable income" of a controlled taxpayer by putting such taxpayer in "tax parity with an uncontrolled taxpayer."[232] This provision grants the I.R.S. broad authority to distribute, apportion, or allocate gross income, deductions, credits, and allowances among controlled taxpayers as is necessary in order to prevent tax evasion or to clearly reflect the income of such entities.[233] Treasury regulations implement this statutory mandate by means of the "arm's length" standard, under which the result of a transaction among controlled taxpayers is compared to the result that would have arisen had the same transaction occurred among uncontrolled taxpayers.[234] The regulations are lengthy and complex and deal with various transactions among controlled taxpayers, including the transfer of property, loans, and leases of property.[235]

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230. *See e.g.*, Nelson D. Schwartz & Brian X. Chen, *Apple Hits Tax Tension Head-On: Testimony by Cook Eases the Concerns of Some Senators*, N.Y. TIMES May 22, 2013, at B1. *See also* Chris William Sanchirico, *As American As Apple Inc.: International Tax and Ownership Nationality*, 68 TAX L. REV. 207 (2015).

231. *See* Charles Duhigg & David Kosieniewski, *Inquiry Into Tech Giants' Tax Strategies Nears End*, N.Y. TIMES Jan. 4, 2013, at B1; Charles Duhigg & David Kosieniewski, *How Apple Sidesteps Billions in Taxes*, N.Y. TIMES Apr. 29, 2012, at A1.

232. Treas. Reg. § 1.482-1(a)(1)(2015); Comm'r v. First Sec. Bank, 405 U.S. 394, 400 (1972). A controlled taxpayer is a taxpayer directly or indirectly owned or controlled by the same interests. A controlled taxpayer also includes a taxpayer that owns or controls other taxpayers. Treas. Reg. § 1.482-1(i)(5)(2015). For this purpose, control is broadly defined. *See* Treas. Reg. § 1.482–1(i)(4)(2015).

233. I.R.C. § 482 (2016).

234. Treas. Reg. § 1.482-1(b)(1)(2012).

235. Various methodologies are employed under the regulations for determining the arm's-length standard in a transaction involving the transfer of tangible property, including the comparable uncontrolled price method, the resale price method, the cost plus method, the comparable profits method, and the profits split method. *See generally* Treas. Reg. § 1.482-3(a)(1995). The methodologies employed for determining the arm's-length standard with respect to transactions involving the transfer of intangible property are the comparable uncontrolled transaction method, the comparable profits method, and the profits split method. The regulations also allow for unspecified

In the case of a transfer or license of intangible property the statute requires that the income with respect to such transfer or license be commensurate with the income attributable to the intangible.[236] The commensurate with income standard for transfers and licenses of intangibles, enacted in 1986 due to the difficulty in determining comparable terms for such transactions, requires that the transferor retain what is referred to as a "super royalty" and allows for *ex-post* adjustments based on the income generated from the intangible in question.[237] The Treasury concluded that the commensurate with income standard did not supplant, but is consistent with, the arm's length standard.[238]

The addition of the commensurate with income standard in 1986 was not intended to prohibit the use of bona fide research and development cost-sharing arrangements.[239] However, the parties to such arrangements are required to bear a portion of all research and development costs at all stages of development regardless of the success or failure of the project.[240] The regulations contain specific rules related to the joint development of intangible property under a cost sharing arrangement entered into among controlled taxpayers.[241] Compliance with these regulations allows taxpayers to avoid the uncertainty of whether these arrangements meet the arm's-length standard.[242] In general, the parties to a qualified cost-sharing arrangement share intangible development costs in proportion to the parties' share of reasonably anticipated benefits.[243] The Treasury regulations require that stock-based compensation costs directly identified with, or reasonably allocable to, the development of intangible property be included in the cost pool subject to the cost-sharing arrangement.[244] The amount and timing of such costs are determined under the rules that govern the deductibility of such costs.[245] However, a taxpayer may elect to determine the amount and timing of the costs of stock options on publicly

methods to be utilized is such methods otherwise satisfy the arm's-length standard. *See* Treas, Reg, § 1,482-4(a)(2011). The best method under the circumstances must be selected. Treas. Reg. § 1.482-1(c)(1)(2012).

236. I.R.C. § 482 (2016).

237. *See* H.R. Rep. No. 99-426, at 423–26 (1985); Reuven S. Avi-Yonah, *Xilinx Revisited*, 126 TAX NOTES 1621 (Mar. 29, 2010); Treas. Reg. § 1.482-4(f)(2)(2011). It is not clear whether the commensurate with income standard is consistent with, or supersedes, the arm's-length standard. *See* Deborah Brubaker Burns, *Golden Apple of Discord: International Cost-Sharing Arrangements*, 15 HOUS. BUS. & TAX L.J. 55, 68 n.57–58 (2015).

238. *See* Notice 88-123, 1988-2 C.B. 458, 472 (1988).

239. H.R. Conf. Rep. No. 99-481 (Vol. II), at II-637–38 (1986).

240. *Id.*

241. *See generally* Treas. Reg. § 1.482-7 (2013).

242. Treas. Reg. § 1.482-7(a)(3)(2013). *See supra* note 235 for the methodologies employed for determining the arm's-length standard with respect to transactions involving the transfer of intangible property.

243. Treas. Reg. §§ 1.482-7(a)(1); 1.482-1(b)(2013).

244. Treas. Reg. §§ 1.482-7(d)(3)(i)-(ii)(2013).

245. Treas. Reg. § 1.482-7(d)(3)(iii)(A)(2013).

traded stock under generally accepted accounting principles as reflected in the taxpayer's audited financial statements.[246]

For tax purposes, stock grants are taxable to the recipient and deductible by the employer at the time the stock is transferable by the recipient or not subject to a substantial risk of forfeiture, whichever occurs earlier.[247] The amount of income recognized by the transferee from such a transaction is the excess of the fair market value of the property received over the amount paid by the recipient for such property.[248] Correspondingly, the transferor of the property is entitled to a compensation deduction, at the time the recipient of the property recognizes income, equal to the amount includible in the income of the recipient.[249] If, however, the stock is subject to a substantial risk of forfeiture then the income recognition and the corresponding deduction is postponed until such time that the risk of forfeiture lapses.[250] However, the recipient of restricted property may elect to accelerate the incidence of taxation to the time that the property is transferred.[251] This election also accelerates the employer's compensation deduction.[252]

With respect to compensatory stock options, income recognition and the compensation deduction are postponed until the date of exercise or disposition provided that, at the time the option is granted, it has no readily

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246. Treas. Reg. § 1.482-7(d)(3)(iii)(B)(2013).

247. I.R.C. § 83(a)(CCH 2016).

248. I.R.C. § 83(a)(1)-(2)(CCH 2016). The fair market value of the property received is determined at the time the property is transferable by the recipient or is not subject to substantial risk of forfeiture, whichever is earlier. I.R.C. § 83(a)(1)(CCH 2016). The property recipient is taxable on the appreciation that occurs between the time of grant and the time of vesting despite the fact that, at the time of grant, the employee paid full fair market value for the property. *See* Alves v. Comm'r, 734 F.2d 478 (9th Cir. 1984), *aff'g* 79 T.C. 864 (1982).

249. I.R.C. § 83(h) (CCH 2016).

250. Whether a substantial risk of forfeiture exists is a factual question based on all the facts and circumstances. Subjecting the property to continued employment is expressly deemed a substantial risk of forfeiture. *See* Treas. Reg. § 1.83-3(c)(1) (1985). Other circumstances evidencing a substantial risk of forfeiture include performance targets and certain covenants not to compete. The fact that an employee is subject to the "short-swing" profit rule of § 16(b) of the Securities Exchange Act of 1934 will cause the property to be deemed to be subject to a substantial risk of forfeiture. Treas. Reg. § 1.83-3(j)(1) (1985).

251. I.R.C. § 83(b)(CCH 2016). The election is irrevocable, except with the permission of the Commissioner. I.R.C. § 83(b)(2)(CCH 2016); Treas. Reg. § 1.83-2(f) (1978). The postponement of taxation until the lapse of vesting restrictions could expose the employee to a very large tax liability if the stock's value increases significantly between the time that the property is received and the time that such property is no longer subject to a substantial risk of forfeiture. This election is not without its risks. In a declining market the stock recipient will have recognized an amount of compensation income based on the value of the stock at the date of grant and any subsequent decline in the value of the stock will be recognized as a capital loss only upon disposition of the stock. Moreover, no loss is recognized upon the forfeiture of the shares due to the employee's failure to meet the vesting requirements. I. R.C. § 83(b)(CCH 2016). The employer, however, will recognize income on the forfeiture equal to the amount of the deduction allowed on the transfer of the forfeited property. Treas. Reg. § 1.83-6(c)(2003). The no-loss rule is inapplicable to amounts paid for the stock by the employee. *See* Treas. Reg. § 1.83-2(a)(1978).

252. I.R.C. § 83(h)(CCH 2016).

ascertainable fair market value.[253] For this purpose, an option has an ascertainable fair market value if it is actively traded on an established market or, alternatively, it is transferable by the option holder, is immediately exercisable, and the underlying property that is the subject of the option is not subject to any restriction that has a significant effect on such property's value.[254]

Under generally accepted accounting principles, a grant of restricted shares is valued at the date of grant and such amount is charged to expense over the vesting period.[255] Time-based or performance-based vesting restrictions do not, for accounting purposes, preclude a determination of the compensation amount at the time of grant. Instead, such restrictions merely affect the time over which such amount is charged to expense.[256] Implicit in the accounting treatment of share-based compensation is the notion that post-grant changes in the market value of the stock are not compensatory in nature. For accounting purposes, stock options are valued at the date of grant pursuant to one or more option pricing models.[257]

The requirement that equity-based compensation—in particular stock option compensation—be included in the cost pool subject to the cost sharing arrangement was the subject of a recent Tax Court case. Altera Corporation, a Delaware corporation, and its Cayman Island subsidiary, Altera International, entered into a technology licensing agreement and a

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253. Treas. Reg. § 1.83-7(a)(1978).

254. Treas. Reg. §§1.83-7(b)(1); 1.83-7(b)(2)(i)-(iii)(1978).

255. *See generally* SHARE-BASED PAYMENT, Statement of Fin. Acct. Standards No. 123, §§ 16,39 (Fin. Acct. Standards Bd. revised 2004). This standard conformed U.S. accounting standards with international accounting standards. *See generally* SHARE-BASED PAYMENT, Int'l Acct. Standards No. 2 (Int'l Acct. Standards Bd. 2004). Stock options are valued at the date of grant pursuant to one or more option pricing models. *See id.*, Appendix A at §§ A13-A37.

256. Restrictions that result in the forfeiture of the shares are ignored in determining the fair market value of the shares at the date of grant. *Id.* at §18. Thus, shares that are issued subject to a time-based vesting restriction are valued without consideration of the vesting restriction. Moreover, certain contingent features, such as a clawback provision, are not considered at the time of grant. Instead, such contingencies are accounted for if, and when, they occur. *Id.* at § 27. Special rules are provided if, in addition to time-based restrictions, the award also contains performance-based restrictions. The existence of performance-based restrictions does not disturb the valuation of the shares at the date of grant. However, such restrictions may impact the time over which the grant is charged to expense. *See id*. at §§ 40–49.

257. *See id.,* Appendix A at §§ A13–A37. Prior to the effective date of this accounting standard, compensation expense with respect to stock options was measured by the difference between the market price of the stock underlying the option and the exercise price of the option. As a result, no reported compensation expense for at-the-money or out-of-the money stock options resulted. ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES, Accounting Principles Bd. Opinion No. 25, § 10a (Am. Inst. of Certified Pub. Accts. 1972). Later, the Financial Accounting Standards Board issued new rules that, effective until 2005, encouraged the expensing of stock options at the time of grant but allowed corporations to account for the grants under existing rules provided that additional footnote disclosures were made. *See generally* ACCOUNTING FOR STOCK-BASED COMPENSATION: TRANSITION AND DISCLOSURE, Statement of Fin. Acct. Standards No. 148, (Fin. Acct. Standards Bd. 2002); ACCOUNTING FOR STOCK-BASED COMPENSATION, Statement of Fin. Acct. Standards No. 123 (Fin. Acct. Standards Bd. 1995).

research and development cost-sharing agreement.[258] Certain employees of Altera Corporation who performed research and development activities were compensated, in part, with stock options and other forms of equity-based compensation.[259] The costs associated with this compensation were not included in the cost pool under the corporation's cost-sharing arrangement with its foreign subsidiary.[260] The I.R.S. issued notices of deficiency to Altera Corporation for each of its taxable years 2004-2007 that allocated, in total, approximately $80,000,000 in income from Altera International to Altera Corporation.[261] This income was allocated pursuant to I.R.C. section 482 and the Treasury regulation noted above as a result of the addition to the cost pool subject to the cost-sharing arrangement between the companies of the equity-based compensation paid to research and development personnel.[262]

The Tax Court discussed its decision in an earlier case, *Xilinx, Inc. v. Commissioner*, that invalidated a previous version of the regulation at issue and the Ninth Circuit's affirmance of its decision.[263] In that case, the Tax Court invalidated the cost-sharing regulation because it was inconsistent with the arm's length standard.[264] The evidence indicated that unrelated parties did not include equity-based compensation in the cost pool subject to cost-sharing.[265] In its affirmance, the Ninth Circuit held that the arm's length standard was irreconcilable with the requirement to include all costs, including equity-based compensation, in the cost pool subject to a cost-sharing arrangement.[266] According to the Court, the regulations created an ambiguity and—based on the dominant purpose of the regulations—the arm's length standard overrides the regulations that require the inclusion of equity-based compensation in the cost pool.[267] The court did not cite or refer to *State Farm* but Judge Fisher, in concurrence, conceded that the Treasury's position was theoretically plausible but that its position warranted no deference because the Treasury had not clearly articulated the rationale for its position.[268]

Written comments were submitted to the Treasury and testimony given at a public hearing by several prominent law and accounting firms, trade associations, and academics regarding the regulation at issue in

258. Altera Corp. v. Comm'r, 145 T.C. No. 3, 2015 U.S. Tax Ct. LEXIS 31, at *2 (2015).
259. *Id.* at *3–4.
260. *Id.* at *4.
261. *Id.*
262. *Id.*
263. *Id.* at *16–21.
264. *See* Xilinx, Inc. v. Comm'r, 125 T.C. 37, 56–62 (2005).
265. *Id.* at 58–62.
266. Xilinx, Inc. v. Comm'r, 598 F.3d 1191, 1196 (9th Cir. 2010).
267. *Id.* at 1196–97.
268. *Id.* at 1198 (Fisher, J., concurring).

Altera.[269] The comments and testimony asserted that no contracts between unrelated parties included equity-based compensation in the cost pool subject to cost-sharing.[270] A survey of members of the American Electronics Association and model contract provisions used in the petroleum industry provided further support that such costs are not subject to cost-sharing between unrelated parties primarily because such costs are speculative, uncertain, and outside the control of the compensating party.[271] In contrast, the Treasury produced no empirical evidence in support of its position and did not attempt to do so.[272] Instead, the Treasury supported its position in the rather lengthy preamble to the regulations with the assertion that comparable transactions for high profit intangibles are not available because transactions between unrelated parties do not share enough characteristics with transactions among controlled parties.[273] The Treasury's explanation echoed, to a significant extent, the reasoning set forth in the legislative history of the statute that enacted the commensurate with income standard.[274]

Despite its acknowledgement that the Supreme Court had never applied *State Farm* to tax regulations, the court held that *State Farm* provided the appropriate standard of review.[275] The Treasury argued that *Chevron* supplied the appropriate standard of review in this case because the interpretation of I.R.C. section 482 requires no empirical evidence.[276] The court, however, concluded that whether the regulation complied with the arm's length standard, which always require an analysis of comparable unrelated party transactions, is an empirical question and is in no way dependent on statutory interpretation.[277] Accordingly, *State Farm* provides "the more apt analytic framework."[278] The court went on to note that whether it applied *State Farm* or *Chevron* in this case was immaterial because the former is incorporated into the latter.[279]

The regulations failed to meet the *State Farm* standard in four ways. First, the regulations lacked any basis in fact because the Treasury was unable to produce any evidence that unrelated parties share equity

269. Altera Corp. v. Comm'r, 145 T.C. No. 3, 2015 U.S. Tax Ct. LEXIS 31, at *23–24.

270. *Id.* at *24–25.

271. *Id.* at *24–27. Commentators also noted that the federal procurement regulations prohibit the inclusion of equity compensation in the cost-pool subject to federal government reimbursement. Additionally, two economists argued that compensatory stock options do not result in any cost to the grantor of the options. *See id*. at *26–27 (citing 48 C.F.R. § 31.205-6(i)(2013)).

272. *Id.*at *28–29.

273. *Id.* at *29–34.

274. *Id.* at *31.

275. *Id.* at *45-46, 49.

276. *Id.* at *46.

277. *Id*. at *47, 49 (citing Xilinx v. Comm'r, 125 T.C. at 53–55).

278. *Id*. at *49 (quoting Judulang v. Holder, 132 S. Ct. at 483).

279. *Id*. at *50 (citing Judulang v. Holder, 132 S. Ct. at 483).

compensation costs.[280] The court dismissed the Treasury's attempt to justify the rule under the commensurate with income standard because this standard, by the Treasury's own admission, is consistent with the arm's length standard and, in any event, the Treasury did not rely exclusively on that standard.[281] Moreover, the court was not persuaded by the Treasury's assertion that scant empirical evidence exists for certain propositions. According to the court, the evidence produced that contradicted the Treasury's position and the evidence produced in *Xilinx* belied this assertion.[282] Moreover, the Treasury could not have rationally concluded that scant evidence was available because it never attempted to marshal any empirical evidence.[283]

Second, the court held that there was no rational connection with the regulations and the facts found by the Treasury.[284] If the Treasury was correct in its belief that cost-sharing arrangements for the development of high-profit intangibles have no unrelated party counterparts, then the regulation should have distinguished between cost-sharing arrangements for the development of such intangibles and those arrangements for the development of other intangibles.[285] Instead, the regulations apply its requirements to all cost-sharing arrangements. Support for a uniform rule on the ground of administrative convenience was not sufficient because the Treasury did not articulate this reason for the rule.[286] Moreover, even if this rationale was articulated, the Treasury provided no facts to determine whether the rule is justified by its purported administrative benefits.[287]

Third, the court believed that the Treasury failed to adequately respond to the comments it received concerning the regulations.[288] In many respects, this failure is closely related to the court's first objection to the regulations. The lack of any empirical evidence in support of the Treasury's position relegated the Treasury's response to the comments it received as mere assertions to the contrary.[289] Finally, the court held that the regulations are contrary to the evidence.[290] The credibility of the evidence marshaled against the regulation was not called into question and no evidence to the contrary was presented.[291]

280. *Id.* at *59.
281. *Id.* at *51–54.
282. *Id.* at *55–57.
283. *Id.* at *57.
284. *Id.* at *62.
285. *Id*. at *59–60.
286. *Id.* at *61.
287. *Id.*
288. *Id.* at *69–70.
289. *Id.* at *68–70.
290. *Id.* at *70–71.
291. *Id.*

The court dismissed the Treasury's argument that the regulation should be upheld under the harmless error rule despite any deficiencies in the agency's reasoning.[292] The court was not persuaded by the Treasury's assertions that it had sufficient alternative reasons for its position and that subsequent developments in financial reporting evidenced that its position is settled policy.[293] The Treasury never indicated that it was prepared to rely on any reasons other than the arm's length standard as a basis for its adoption of the regulation and, due to treaty obligations, it was not clear that the agency would have underpinned the rule on something other than the arm's length standard.[294] With respect to subsequent financial reporting development the court held that such developments were not relevant because the Treasury itself disavowed financial reporting standards in promulgating the rule and, in any event, *Chenery* precludes reliance on *ex post* developments.[295]

1. Analysis and Critique

Although searching judicial scrutiny of the actions of tax authorities, I imagine, would be welcome by most taxpayers, the Tax Court's decision is perplexing in several respects. First, the court reviewed the Treasury regulation at issue against the arm's length standard as if that standard is set forth in a statute, which it is not. The arm's length standard is itself a creature of Treasury regulations.[296] Consequently, the court's application of the various standards of review was inapt. Second, the court refused to accept administrative convenience as a reasoned justification for the regulation without supporting evidence.[297] This runs counter to the Supreme Court's decision in *Mayo* and has created confusion as to whether a naked assertion of administrative convenience will be countenanced as justification for other regulations. Finally, given the nature and purpose of the cost-sharing regulations it appears that the Treasury provided a lucid and reasoned justification despite its failure to muster supporting empirical data.

The cost-sharing regulations implemented the statutory mandates that allocations of various tax items clearly reflect income and that the income with respect to transfers or licenses of intangible assets be commensurate with the income attributable to the intangibles.[298] Clearly, the statutory

292. The harmless error rule is based on § 706 of the Administrative Procedure Act and allows a court to upheld an agency action if the agency's mistake was not outcome determinative. *See id* at *42.

293. *Id.* at *71–74.

294. *Id.* at *72–73.

295. *Id.* at *73–74.

296. *See supra* note 234 and accompanying text.

297. *See supra* notes 286-87 and accompanying text.

298. *See supra* notes 232-36 and accompanying text.

language is sufficiently ambiguous to pass *Chevron* step one. The court reviewed the regulations against the arm's length standard which, in the court's opinion, always requires an examination of comparable unrelated party transactions.[299] Accordingly, the court believed that *Chevron* step two would have yielded the same result that the application of *State Farm* yielded.[300] However, even if one concedes that the court was correct that the arm's length standard always requires the use of comparable transactions, the cost-sharing regulations conflicted with a regulation and not a statutory mandate. *Chevron* step two should not have been implicated on this basis. Instead, *Auer* provides the more appropriate standard of review.[301]

The court pointedly noted that the regulation in no way was predicated on the Treasury's interpretation of a statute.[302] Instead, the Treasury was required to show whether unrelated parties share equity-based compensation and this was an empirical question. Accordingly, *State Farm* supplied the appropriate standard of review.[303] However, the cost-sharing regulations interpreted the commensurate with income standard and its relationship to the arm's length standard.[304] In effect, the Treasury was interpreting both the statute and its own regulations. *Chevron* step two should have been applied to determine whether the regulations permissibly construed the commensurate with income standard and *Auer* should have been applied to determine whether the regulations were permissible in light of the long-standing regulatory-based arm's length standard. The legislative history of the commensurate with income standard stated that cost-sharing arrangements were permissible if such arrangements provided for a sharing of all costs.[305] In light of the legislative history, the inclusion of equity compensation costs in the cost pool is, in my opinion, a reasonable interpretation of the commensurate with income standard and, therefore, *Chevron* step two is satisfied. I also believe that the inclusion of equity-based compensation in the cost pool is not plainly inconsistent with the arm's length standard and, therefore, the regulation should pass muster under *Auer*. At this point, *State Farm* requires that the rule chosen by the Treasury have adequate justification.

The Treasury asserted that the requirement that all cost-sharing arrangements include equity-based compensation in the cost pool was based, in part, on administrative convenience.[306] The court required more

299. *See supra* note 277 and accompanying text.
300. *See supra* note 279 and accompanying text.
301. *See supra* note 54.
302. *See supra* note 277 and accompanying text.
303. *See supra* note 278 and accompanying text.
304. *See supra* notes 273-74 and accompanying text.
305. *See supra* notes 239-40 and accompanying text.
306. *See supra* notes 286-87 and accompanying text.

from the Treasury than a categorical assertion, insisting that the Treasury provide data to support this justification.[307] Administrative convenience is a common justification for bright-line rules and common sense dictates that bright-line rules are administrable with relative ease. For example, in *Mayo*, the Court accepted the Treasury's explanation that the rule that subjects medical residents to payroll taxes was based, in part, on administrative convenience.[308] The Court did not inquire whether a categorical exemption for medical residents would have yielded similar, or perhaps, greater administrative benefits. For that matter, the Court did not examine any supporting data for the Treasury's assertion that the broad purposes of the Social Security program were served by a rule that broadened the program's coverage. It is quite possible that, after a long career as a physician, a person's social security benefits are unaffected by whether she was subject to tax as a medical resident. *Chevron* does not require that the best policy alternative be chosen, only a permissible one. Neither does *State Farm*.

The most problematic aspect of the Tax Court's opinion is that it failed to understand the nature of the transactions governed by, and the purpose of, the cost-sharing regulations. As a result, the evidence it required from the Treasury to satisfy *State Farm* was impossible to produce. In many respects, the arm's length standard is a fiction and, in the case of high-profit intangible assets, is a fiction. The use of comparable transactions to ascertain whether transactions between controlled entities clearly reflect income assumes that transactions between unrelated parties and transactions among controlled group members share similar economic attributes. Controlled groups have collective assets—management, information systems, sources of financing, institutional memory, brand equity, and culture, for example—that lead such groups to enter into transactions that would not be offered to anyone outside the group.[309] Moreover, the transactional approach of the arm's length standard often fails to properly source the parties' allocable share of non-routine, or residual, profits.[310]

The arm's length standard may be adequate to allocate profits among controlled group members with respect to the sale of routine goods and services that have little or no potential to generate residual profits. However, this standard is not well-suited to a post-industrial economy in which the creation and use intangible assets is central to wealth creation.

307. *See supra* note 287 and accompanying text.

308. *See* Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. at 59.

309. *See* Ilan Benshalom, *Sourcing the "Unsourceable": The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions*, 26 VA. TAX REV. 631, 642–45 (2007).

310. *See* Bret Well & Cym Lowell, *Tax Base Erosion: Reformation of Section 482's Arm's Length Standard*, 15 FLA. TAX REV. 737, 745–65 (discussing one-sided and two-sided pricing methodologies and the deficiencies in the former methodology).

Intangible assets are often specialized, are efficiently deployed only in the context of a controlled group, and require exclusivity to protect market share.[311] As a result, comparable transactions do not exist.

The Tax Court, in the absence of evidence that unrelated parties share equity compensation costs, invalidated the regulations' requirement that related parties share such costs. *State Farm* requires that the Treasury provide a reasoned explanation for the adoption of the rule in question. The preamble to the regulations explained that comparable transactions do not exist for the sharing of research of development costs with respect to high-profit intangibles and that the regulations attempt to clearly reflect income among related parties in the absence of such comparable transactions.[312] The explanation put forth echoed the legislative history of the commensurate with income standard.[313] As discussed above, the Tax Court insisted that the *sine qua non* of the arm's length standard is comparable transactions.[314] If one assumes that the court's interpretation of the arm's length standard is the correct one—a dubious assumption—then such an interpretation fails to cover situations in which no comparable transactions exist. This was the basis of the Treasury's adoption of the rule and was explained as such. The Supreme Court, in upholding the Federal Communications Commission's repeal of its long-standing "fleeting expletives" safe harbor, deferred to the agency's intuition and noted that "there are some propositions for which scant empirical evidence can be marshalled . . . ."[315] Agency intuition forms part of what two scholars referred to a "tacit expertise" and often influences agency decisions.[316] This "tacit expertise" is developed through experience. The Treasury has grappled with tax base erosion for a long-time and its expertise informed the belief that unrelated transactions are not comparable to research and development arrangements among controlled entities.

The court's rigidity with respect to evidence of comparable cost-sharing arrangements is all the more perplexing because the cost-sharing regulations themselves are a safe harbor and deviate from the terms to which unrelated parties would ostensibly agree. As discussed above, the cost-sharing regulations were designed as a response to the administrative burdens and regulatory uncertainty imposed by I.R.C. section 482.[317] Adherence to the regulatory requirements provides taxpayers with the assurance that their resultant profit splits will go undisturbed. Taxpayers are free to ignore the cost-sharing regulations and take their chances under

311. *See* Benshalom, *supra* note 309, at 645–47.
312. *See supra* note 273 and accompanying text.
313. *See supra* note 274 and accompanying text.
314. *See supra* note 277 and accompanying text.
315. FCC v. Fox Television Stations, Inc. 129 S.Ct. 1800, 1813 (2009).
316. *See* Gersen & Vermeule, *supra* note 195, at 1396–1401.
317. *See supra* note 242 and accompanying text.

the other rules set forth in the regulations. The cost-sharing regulations contain several provisions whose incorporation into an arm's length agreement would be unlikely. For example, the regulations require that a party to a cost-sharing agreement provide payment for pre-existing research and platform rights and require adjustments if the actual benefits derived deviate from projected results to a certain extent.[318] Moreover, costs are funded by the parties in proportion to the benefits they expect to derive from the research and development effort.[319] In contrast to the profit-split method described elsewhere in the regulations, the cost-sharing regulations focus solely on funding and make no allowance for expertise and know-how.[320] Moreover, this approach assumes that the funding parties bear commensurate financial risks which may or may not be true in a controlled group setting.[321]

Dominion Resources and *Altera* may very well motivate taxpayers to take their scrutiny of tax regulations beyond *Chevron*. A tax regulation that appears to be a permissible interpretation of an ambiguous statute may nonetheless be inadequately justified by the Treasury. Regulations that are accompanied by explanations that recite the operation of rules unaccompanied by the reasons for the rules, that justify bright-line rules on the grounds of administrative convenience in a conclusory manner, that do not address comments that object to the rules in question, and that fail to explain why alternative approaches were dismissed are particularly vulnerable. *Mayo* made clear that tax regulations are not exceptional and, consequently, it should not come as a surprise that administrative law principles long applicable to other agencies have surfaced in tax cases. Whether or not the Treasury adjusts its rulemaking procedures probably depends on the regularity with which *State Farm* appears on the tax landscape and whether the courts invalidate regulations that don't pass muster or simply remand without vacatur.

318. *See* Treas. Reg. §§ 1.482-7(g); 1.482-7(f)(3)(2013). Valuation of preexisting research and platform rights poses its own difficulties. *See* Deepa Seetharaman, *IRS Sues Facebook Over Irish Transfer*, WALL ST. J. July 8, 2016, at B4 (reporting on the dispute between the I.R.S. and Facebook over the valuation of certain intangible assets transferred to its Irish subsidiary).

319. *See supra* note 243 and accompanying text.

320. *See generally* Treas. Reg. § 1.482-6(b)(2009). This provisions states that "[t]he relative value of each controlled taxpayer's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity . . . ."

321. *See* Benshalom, *supra* note 309, at 660–61. *See also* Debra Brubaker Burns, *Golden Apple of Discord: International Cost-Sharing Arrangements*, 15 HOUS. BUS. & TAX L.J. 55 (2015) (discussing the application of the cost-sharing regulations to Apple, Inc.).

CONCLUSION

From a procedural standpoint, Treasury rulemaking has been subject to much criticism. The agency too often has skirted the requirements of the Administrative Procedure Act and its behavior led to much confusion regarding the level of judicial deference to which its actions were entitled. *Mayo* made clear that Treasury regulations were entitled to the same deference as that enjoyed by other agency regulations. At the time, *Mayo* was interpreted as an unmitigated victory for the Treasury. *King v. Burwell*, however, provides taxpayers with two arguments with which to challenge the agency's entitlement to *Chevron* deference—the extraordinary issue and the Treasury's lack of expertise. Moreover, as two recent tax cases illustrate, the equipoise that *Mayo* created between Treasury and other agency regulations has introduced the *State Farm* doctrine to tax rulemaking. As a result, the Treasury may be forced to provide more reasoned justifications for its actions than it has been accustomed to providing.