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THE IMPACT OF AGENCY PROCEDURES AND JUDICIAL REVIEW ON TAX REFORM

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THE IMPACT OF AGENCY PROCEDURES AND JUDICIAL REVIEW ON TAX REFORM

Ellen P. Aprill

This paper discusses hurdles that the IRS and Treasury would face following tax reform in their efforts to respond quickly with guidance that courts will uphold. These hurdles include the impact of the Tax Anti-Injunction Act and the Declaratory Relief Act, heightened interest in the course of tax litigation regarding compliance by the IRS and Treasury with the Administrative Procedure Act, and provisions enacted in 1988 and 1996 limiting temporary and retroactive regulations. The paper then outlines several approaches Congress could consider to mitigate possible untoward consequences.

Keywords: tax reform, notice-and-comment, temporary regulations, good cause exception

JEL Codes: H20, K23, K34

I. INTRODUCTION

Should we see major tax reform, taxpayers will clamor for guidance from the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) regarding new provisions,¹ as they did after passage of the Tax Reform Act of 1986. Indeed, the greater the extent of reform, the greater the need for guidance. Treasury and the IRS will feel compelled to issue guidance as quickly as possible. If so, they are unlikely to rely on regulations subject to time and resource consuming notice-and-comment by the public. Instead, they will look to guidance not subject to pre-issuance notice-and-comment — temporary regulations in particular, as was the case after the 1986 Act, along with revenue rulings, revenue procedures, and notices.

¹ Hickman (2007, p. 1979) notes, “The Treasury Department and the IRS jointly issue Treasury regulations interpreting the Internal Revenue Code, and Treasury’s Office of Tax Policy is significantly involved in reviewing and drafting Treasury regulations. Historically, however, the Office of Chief Counsel of the IRS has performed the function of initially drafting most Treasury regulations.”

This administrative response to major tax reform in the 21st century, however, will face hurdles unknown at the time of the 1986 Act, hurdles that could constrain the ability of the IRS and Treasury to issue guidance that courts will uphold. One is heightened interest in the course of tax litigation regarding compliance by the IRS and Treasury with the Administrative Procedure Act (APA), particularly its requirement for public notice-and-comment in connection with proposed regulations. A second relates to a set of provisions enacted in 1988 and 1996 limiting temporary and retroactive regulations. Moreover, the Tax Anti-Injunction Act (AIA) and the Declaratory Judgment Act (DJA) have the effect of postponing challenges to tax guidance until enforcement of administrative guidance has taken place.

All of these considerations could affect the effectiveness of guidance issued after tax reform. This article will examine them in reverse order before discussing actions Congress might take in connection with tax reform to mitigate possible untoward consequences.

II. TAX ANTI-INJUNCTION ACT AND DECLARATORY JUDGMENT ACT

Enacted in 1867, the AIA provides in § 7421 of the Internal Revenue Code that “no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed.” The Supreme Court has stated, “The manifest purpose of § 7421(a) is to permit the United States to assess and collect taxes alleged to be due without judicial intervention, and to require that the legal right to the disputed sums be determined in a suit for refund.”² The Court has further explained that the provision reflected “appropriate concern about the ... danger that a multitude of spurious suits, or even suits with possible merit, would so interrupt the free flow of revenues as to jeopardize the Nation’s fiscal stability.”³

The DJA, which became law in 1935, authorizes declaratory relief — which is a judgment of a court setting forth the rights, duties, and obligations of parties in a dispute without ordering any action by any party — except, as specified in an amendment passed in 1936, “with respect to Federal taxes.”⁴ One appellate court has explained that the tax exception “serves a critical but limiting purpose” in stripping “courts of jurisdiction to circumvent the AIA by providing declaratory relief in cases ‘restraining the assessment or collection of any tax.’”⁵ For the most part, courts treat the reach of the AIA and DJA as coterminous, as discussed by Hickman (2008).

² See *Enochs v. Williams Packing & Nav. Co.*, 370 U.S. 1, 7 (1962). In *National Federation of Independent Business v. Sebelius*, slip opinion, U.S. Supreme Court No. 11–393 (June 28, 2012), the Supreme Court held that, because Congress labeled as a penalty and not as a tax the payment to the IRS required from individuals not complying with the Affordable Care Act’s individual mandate to purchase health insurance, the AIA did not bar the suit. Nonetheless, the Court also held that the penalty is a tax for constitutional purposes. The choice of a statutory label “does not, however, control whether an exaction is within Congress’s constitutional power to tax.” (Opinion of the Court, at 33).

³ See *Alexander v. “Americans United” Inc.*, 416 U.S. 752, 769 (1974).

⁴ U.S.C. Title 28, “Creation of Remedy,” § 2201(a).

⁵ See *Cohen v. United States*, 650 F.3d 717, 729 (2011).

In general, three courts — the United States District Courts, the United States Court of Claims, and the United States Tax Court — hear claims at the trial level in connection with federal taxes, as discussed by Lederman (2012).⁶ In any of these courts, the taxpayer can challenge a regulation or ruling that is a basis for the IRS's position.

These three courts follow two distinct litigation paths, as explained further by Lederman (2012). Under the Tucker Act of 1976, taxpayers can bring suit in the District Court and Court of Federal Claims only for refund actions.⁷ That is, to litigate in these courts, a taxpayer must pay the taxes the IRS alleges to be due, file a refund claim that is disallowed by the IRS (or waive disallowance), and timely file a refund suit in one of these courts.

Different rules apply to the Tax Court, which is known as the “deficiency” forum; taxpayers may bring suit there without paying the taxes the IRS alleges to be due.⁸ To sue in Tax Court, the taxpayer must have received a notice of deficiency from the IRS. Having received this a notice of deficiency, the taxpayer generally has 90 days following the mailing of the notice to petition the Tax Court. If the taxpayer petitions the Tax Court, § 6213(a) of the Internal Revenue Code provides that the IRS cannot assess any deficiency determined by the Tax Court until after the Tax Court's decision becomes final due.

As a result of the AIA and DJA, challenges to administrative action by the IRS and Treasury follow a different time line from challenges to guidance issued by other administrative agencies. For other agencies, pre-enforcement actions are common. In many areas of administrative law, pre-enforcement challenges to final regulations have become the norm.⁹ As O'Reilly (2012, p. 305, 309–310) explains in his administrative law treatise:¹⁰

Pre-enforcement injunction action sometimes are begun the very day that an agency rule is promulgated, with a request that the implementation of the rule be enjoined and that the court stay the effective date of the ruling pending outcome of the litigation ... The typical remedial action is revision of the rule on remand. When a declaratory judgment invalidating a rule is issued, the matter is sent back to the agency for reconsideration, often with instructions for specific activity or a schedule for compliance.

Pre-enforcement challenges can include allegations of failure to comply with the APA, for reasons discussed below. Section 706(2)(d) of the APA instructs reviewing courts to invalidate agency action that fails to observe “processes required by law.”

⁶ In addition to these three courts, bankruptcy courts can hear tax claims in connection with a bankruptcy.

⁷ U.S.C. Title 28, “Creation of Remedy,” §1346(a)(1) and §1491(a)(1).

⁸ The Tax Court has jurisdiction over a variety of types of actions, some of which do not involve an actual tax deficiency. In a few specified situations, such as the status and classification of an organization under § 501(c)(3), the Tax Court has statutory authority to issue declaratory judgments. See § 7428 of the Internal Revenue Code.

⁹ See *Abbott Labs v. Gardner*, 387 U.S. 136, 154 (1967).

¹⁰ Courts do sometimes remand a regulation without vacating it. See Rodriguez (2004), *Checkosky v. SEC*, 23 F.3d 452, 466 (D.C. Cir. 1994).

In contrast to challenges to guidance from other agencies, because challenges to tax guidance will take place, with rare exceptions, after notice of deficiency or assessment of taxes, they occur only after enforcement of the provision has occurred. Most taxpayers affected by the guidance have complied with it. Judicial invalidation of tax guidance thus has an enormous effect on the tax system as already in effect.

That is, reliance by taxpayers complicates the consequences of judicial invalidation and may affect judicial willingness to invalidate tax rules, although courts do invalidate tax regulations, as described by Lederman (2012). For taxpayers who do not challenge an IRS ruling, even a decision that would be favorable to them can impose burdens. These taxpayers will have organized their affairs and structured transactions on the assumption that the guidance is valid. And, of course, a decision invalidating a tax rule raises problems for taxpayers on the side of a transaction for whom the IRS guidance had been favorable.

As noted earlier, tax challenges arise in an enforcement context. As a result, as noted by Hickman (2008, p. 1164), they “typically revolve around the IRS conclusions about the application of the laws to the circumstances of a particular taxpayer, rather than merely disputing more generally the substantive or procedural validity of a regulation.”¹¹ That is, taxpayers and courts have not to date generally characterized the challenge as broadly as do challengers to other agency guidance.

If, as argued below, recent developments in administrative law as applied to tax increase the likelihood of judicial invalidation of regulations promulgated after tax reform but such invalidation takes place only after enforcement of the regulation, the consequences for administration of a reformed tax system would be significant.

III. SECTION 7805

In the 1980s, the IRS and Treasury increased the number of temporary regulations issued, largely in response to the quantity of tax legislation. Congress failed, as it does so often, to see its own responsibility for the problem it identified. Nonetheless, Congress became concerned about the number of temporary regulations remaining on the books for several years that also lacked any indication as to when or whether Treasury and the IRS might finalize them with public notice-and-comment, as discussed in the literature (Asimow, 1991; Vasquez, 2003). So great was Congressional concern that Congress considered language that would eliminate the ability of the tax agencies to issue any proposed and final regulations alleging that the regulations were interpretive rules, a category of the APA that does not require notice-and-comment, as discussed by Asimow (1991). Ultimately, in 1988 Congress, as part of the Technical and Miscellaneous Revenue Act of 1988, specified in § 7805(e) of the Internal Revenue Code that any temporary regulation should also be issued as a proposed regulation and that any temporary regulation would expire within three years of the date of its issuance.

¹¹ Hickman (2008) also discusses two additional considerations, standing and ripeness, that could affect pre-enforcement challenge to tax guidance. Those considerations are beyond the scope of this article.

To date, the provisions of § 7805(e) have not appeared to have posed a problem for the IRS and Treasury, as discussed by Asimow (1999). In her recent study of tax regulations over a three-year period from 2003 through 2005, Hickman (2007) found that 36.2 percent of all regulations issued were temporary regulations accompanied by proposed regulations with requests for comment. As a result of § 7805(e), however, should the IRS and Treasury issue a large number of temporary regulations shortly after adoption of a major tax reform, the agencies will face the burden of responding to comments and finalizing all these regulations at a time when guidance may not have been issued on all aspects of the new law. To quote Asimow (1991, p. 370), given that the shelf life of a temporary regulation is now three years, “[a] large number of temporary regulations may fall from the shelf at about the same time. That would require the Treasury to adopt final regulations before it is ready to do so or to repromulgate the rule and start all over again.”¹² Moreover, issuing immediately effective temporary regulations along with proposed regulations that are open to notice-and-comment raises serious issues under administrative law, as discussed below.

Provisions of § 7805 enacted in 1996 as part of the Taxpayer Bill of Rights 2 to address retroactive regulations also bear on issuance of tax regulations in response to tax reform. The House Ways and Means Committee (U.S. House of Representatives, 1996, p. 44) explained the reason for these provisions by explaining that “Congress believed that it is generally inappropriate for Treasury to issue retroactive regulations.” Nonetheless, Congress provided exceptions to permit retroactive regulations in specified circumstances. Section 7805(b)(1) of the Internal Revenue Code explicitly permits final regulations to apply retroactively to the earliest of (1) “the date on which such regulation is filed with the Federal Register”; (2) the date on which the Federal Register published “any proposed or temporary regulation to which such final regulation relates”; or (3) “[t]he date on which any notice substantially describing the expected contents of any temporary, proposed or final regulation is issued to the public.” While these provisions give the IRS and Treasury the ability to issue retroactive regulations, uncertainty would surround the content of the law until issuance of a binding retroactive regulation, since neither notices nor proposed regulations have the force of law, as discussed by Salem, Aprill, and Galler (2004). Moreover, the final regulation could differ from that proposed or described as a result of comments from the public. Given the Congressional purpose of limiting retroactive regulations in enacting § 7805(b)(1), Asimow (1991, p. 350) notes that a practice of adopting “proposed regulations together with a statement that the final regulations would be retroactive to the date of publication of the proposed regulation ... should be reserved for exceptional situations.”

Under § 7805(b)(2) of the Internal Revenue Code, a provision that is likely to be particularly important in the context of any tax reform, the three limitations on retroactivity listed in § 7805(b)(1) do “not apply to regulations filed or issued within 18

¹² Asimow (1999, p. 739) observed that a sunset could force an agency to allocate resources away from projects with higher priority or to adopt a final rule without changes, “even though modifications would be appropriate in light of public comments or actual administrative experience.”

months of the date of the enactment of the statutory provision to which the regulation relates.” In the context of major tax reform, however, a safe harbor of 18 months for issuing regulations with retroactive effect may be far from adequate.

The provisions of § 7805, which did not exist at the time of the 1986 Tax Reform Act, thus pose opportunities and challenges should tax reform be enacted.

IV. TAX AND ADMINISTRATIVE LAW

A. Tax Exceptionalism

For many years, courts and tax professionals treated tax agencies differently from other administrative agencies when it came to the application of general principles of administrative law — a state of affairs known as “tax exceptionalism.” Tax exceptionalism has been ascribed to a number of factors. They include the insular nature of the tax bar, the lack of knowledge of administrative law within the IRS after a restructuring in 1988, and the establishment of the Treasury Department and its procedures long before that of the many administrative agencies established by the New Deal, as discussed in the literature (Hickman, 2008; Zaring, 2010). Tax exceptionalism, however, is fading.

Under the doctrine of tax exceptionalism, for example, courts for many years used a specific Supreme Court tax precedent, *National Muffler Dealers Ass’n v. U.S.*,¹³ rather than *Chevron U.S.A. Inc. v. NRDC, Inc.*,¹⁴ the Supreme Court case applied in the case of administrative agencies generally, to determine the level of judicial deference given to the decisions of administrative agencies in reviewing tax guidance. The greater the degree of judicial deference, the more likely that courts will uphold agency guidance, and *National Muffler* has been read as less deferential than *Chevron*.¹⁵

In *Mayo Foundation for Medical Education and Research v. United States*,¹⁶ however, the Supreme Court upheld a regulation involving the social security tax under the Federal Insurance Contribution Act to medical students promulgated under the general authority of § 7805(a),¹⁷ by applying the more deferential test of *Chevron*, rather than the tests of *National Muffler*. The Court (*Mayo*, p. 713) wrote that, absent a justification to do so, “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.”¹⁸ This quotation seems to reject tax exceptionalism generally, not just for the degree of deference given to tax guidance.

¹³ See *National Muffler Dealers Ass’n v. U.S.*, 440 U.S. 472 (1979).

¹⁴ See *Chevron U.S.A. Inc. v. NRDC, Inc.*, 467 U.S. 837 (1984).

¹⁵ For further discussion of doctrines of judicial deference, see Lederman (2012).

¹⁶ See *Mayo Foundation for Medical Education and Research v. United States*, 131 S.Ct. 704 (2011).

¹⁷ As discussed further below, § 7805(a) of the Internal Revenue Code grants the Secretary authority to develop “all needful rules and regulations for the enforcement of” the Internal Revenue Code.

¹⁸ See *Dickinson v. Zurko*, 527 U.S. 150, 154 (1999).

Recently, compliance by the IRS with the APA has also received renewed judicial scrutiny. In *Cohen*, the D.C. Circuit *en banc* (that is, sitting as a whole and not in a three-judge panel), held that the court could hear taxpayers' challenge on grounds of failure to engage in notice-and-comment rulemaking as required by the APA to a notice setting forth procedures to claim a refund for certain telephone excise taxes. In *Cohen*, the court found that there was no need for the challengers to file a refund suit and that neither the Anti-Injunction Act nor the Declaratory Judgment Act was applicable when the challenge was to the legality of refund procedures established and the process by which they were established. The Court could identify no judicial exception for the IRS from the APA. The DC Circuit thus permitted a challenge to a notice to go forward on the grounds of failure to follow APA notice-and-comment requirements. Upon remand, the District Court determined that the notice was binding, that failure to provide notice-and-comment violated the APA and that the failure did not constitute harmless error. The District Court vacated the notice prospectively.¹⁹

Very recently, in *Dominion Resources, Inc. v. U.S.*,²⁰ the Court of Appeals for the Federal Circuit invalidated Treasury Regulation §1.263A-11(e)(1)(ii)(B), a regulation requiring capitalization of interest to be determined by including the adjusted basis for property temporarily withdrawn from service. The Court had two bases for its decision. First, it concluded that the regulation was not a reasonable interpretation of the statute. Second, it looked to the APA and found that the regulation failed the "arbitrary and capricious" test of APA § 706(2) by failing to provide a reasoned explanation when it promulgated the regulation, as required by the important administrative law case *Motor Vehicles Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto Ins. Co.*²¹ Commentators on the case predict that the requirements of the APA under the arbitrary and capricious standard will be increasingly litigated, as discussed in Tax Analysts (2012).

As these three cases suggest, it seems likely that administrative law principles in general and the APA in particular will become increasingly important in tax litigation.

B. The APA and Notice-and-Comment Rulemaking Requirements

The APA emerged from the New Deal as the "bill of rights for the new regulatory state," striking a balance "between promoting individuals' rights and maintaining agencies' policy-making flexibility," (Shepherd, 1996, p. 1558). The procedures for notice-and-comment rulemaking are considered the key achievement of the APA, as discussed by Shepherd (1996). These provisions require that, in general, agencies anticipating adoption of a regulation give notice of the regulation as proposed, invite public comments, consider the comments, and then adopt a final regulation that includes

¹⁹ United States District Court of Columbia, 2012 U.S. Dist. Lexis 49716, "In Re: Long-Distance Telephone Service Federal Excise Tax Refund Litigation – MDL, 2798," http://www.gpo.gov/fdsys/pkg/USCOURTS-dcd-1_07-mc-00014.

²⁰ See *Dominion Resources, Inc. v. U.S.*, 2011-5087 (May 31, 2012).

²¹ See *Motor Vehicles Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983).

a statement of the regulation's basis and purpose as well as the agency's response to material comments.²²

More precisely, § 553 of the APA requires public notice-and-comment for what it calls legislative rules. Legislative rules are understood as regulations that have the force of law and impose duties and obligations on affected parties, as discussed by Hickman (2007).²³ Legislative rules stand in contrast to interpretive rules, which do not so bind the public, but instead give an agency's view of matters under its jurisdiction.

Notice-and-comment, as one court has explained, "reintroduce[s] public participation and fairness to affected parties after governmental authority has been delegated to unrepresentative agencies."²⁴ The Supreme Court has written, "In enacting the APA, Congress made a judgment that notions of fairness and informed administrative decisionmaking require that agency decisions be made only after affording interested persons notice and an opportunity to comment."²⁵ As discussed by Asimow (1991, 1999), notice and comment procedures serve fundamental purposes of democracy as well as improve the regulatory product by bringing to regulators' attention considerations that might be missed.

The Treasury and the IRS, however, take the position that the majority of regulations, the most binding of tax guidance, do not require notice-and-comment. More specifically, Treasury and the IRS have regularly asserted that the APA § 553(b) requirements for notice- and-comment rulemaking do not apply to guidance issued pursuant to § 7805(a) of the Internal Revenue Code, the provision that grants the Secretary authority to develop "all needful rules and regulations for the enforcement of" the Internal Revenue Code.

Treasury and IRS declare that regulations promulgated under the general authority of § 7805(a) are interpretive rather than legislative. Interpretive rules present an agency's view of the correct meaning of a statute, but because they do not bind citizens, they do not require notice-and-comment under the APA. The Internal Revenue Manual provides, "Interpretative rules are not subject to the provisions of 5 United States Code (U.S.C.) [§] 553(b), (c), and (d). Although most IRS/Treasury regulations are interpretative, and therefore not subject to these provisions of the APA, the IRS usually solicits public comment when it promulgates a rule."²⁶

Hickman (2007) found that 216 of 232 regulatory projects examined claimed that APA notice-and-comment rulemaking requirements did not apply. Although the tax agencies frequently provide for notice-and-comment in connection with regulations promulgated under the general authority of § 7805(a), they claim that such procedures are not required, often stating, "It has been determined that section 553(b) of the APA (5 U.S.C. chapter 5) does not apply," (Hickman, 2007, pp. 1740–1759).

²² Administrative Procedure Act, Section 553 (b), (c).

²³ See also *American Mining Cong. V. Mine Safety & Health Admin.*, 995 F.2d 1106 (D.C. Cir. 1993).

²⁴ See *American Hospital Ass'n v. Bowen*, 834 F.2d 1037, 1044 (D.C. Cir. 1987) (quoting *Batterson v. Marshall*, 648 F.2d 694, 703 (D.C. Cir. 1980)).

²⁵ See *Chrysler Corp. v. Brown*, 441 U.S. 281, 316 (1979).

²⁶ See Internal Revenue Manual, § 32.1.5.4.7.5.1.3. The Internal Revenue Manual follows the APA in using the term "interpretative" (APA § 553(b)(3)(A)), but it is more common to use the simpler word, interpretive.

The IRS position that general authority regulations, those promulgated pursuant to § 7805(a), are interpretive and thus free of APA notice-and-comment requirements, however, does not comport with administrative law more generally; in other areas of administrative law, language like that in § 7805(a) is deemed to authorize legislative regulations, as discussed in the literature (Merrill and Watts, 2002; Cunningham and Repetti, 2004). “As a result of emphatic holdings in several non-tax cases, the general consensus now is that a general rulemaking power [like that in § 7805(a)] confers delegated power to adopt binding legislative rules,” (Asimow, 1991, p. 354).²⁷

If, as the Supreme Court in *Mayo* suggests, general principles of the administrative law, including the strictures of the APA, apply to tax, failure by the IRS to solicit public comments for regulations promulgated under § 7805 could endanger the validity of the regulations.

C. The Special Case of Temporary Regulations

Temporary IRS regulations raise the most significant and salient issues regarding compliance with the APA. Treasury and the IRS began regularly issuing temporary regulations without pre-promulgation notice-and-comment in the 1980s and the practice spiked after the Tax Reform Act of 1986, as discussed in the literature (Asimow, 1991; Hickman 2007). After 1988, as noted above, in order to comply with § 7805(e), Treasury and the IRS have adopted the practice of issuing proposed regulations and a request for comment at the same time that they issue temporary regulations. That is, the tax agencies follow what is known as “interim-final rulemaking” by issuing “interim-final regulations.” This approach consists of an agency issuing legally binding rules without notice-and-comment, but, at the same time, requesting post-promulgation public comment, with an assurance that comments will be considered and could affect replacement final rules, as discussed by Asimow (1999).

Interim-final regulations provoke serious questions as to their validity. As one court has observed, “[C]itizens will recognize that the agency is less likely to pay attention to their views after a rule is in place, and therefore the public is less likely to participate vigorously in comment.”²⁸ In tax, smaller taxpayers, already unlikely to participate in the rulemaking process, may be particularly unwilling to offer comments on interim-final regulations.

Asimow (1999, p. 716) offers a counter-argument: “[I]nterim-final rules may elicit *more and better comments* than proposed rules since a rule that has already gone into effect may be taken more seriously by the persons affected by it than one that may never go into effect or will not go into effect for a long time,” (emphasis in original). Hickman (2007, pp. 1758–59) reports of her examination of tax regulations issued in 2003, 2004, and 2005, “[i]n at least 31 of the 96 projects in which Treasury received negative comments or suggestions for changes, Treasury received such input after issuing

²⁷ See Hickman (2007, p. 1763, n. 140, and p. 1764, n. 143).

²⁸ See *Levesque v. Block*, 723 F.2d 175, 187–88 (1st Cir. 1983).

temporary regulations; but Treasury received no comments whatsoever for 17 projects in which it issued temporary regulations.” Moreover, as Asimow (1999, p. 716) notes, the majority of staff members he interviewed believed “that agencies are less responsive to comments on interim-final rules than on proposed rules.”

The now defunct Administrative Conference of the United States (1995, p. 43112) has written, “Courts generally have not allowed post-promulgation comment as an alternative to the prepromulgation notice-and-comment process in situations where no exemption is justified.” Courts that have invalidated final regulations that follow this interim-final procedure worry that allowing agencies to cure procedural failures in promulgating temporary regulations by post-promulgation notice-and-comment undermines the notice-and-comment requirement, opening the door for an agency to “negate at will the Congressional decision that notice and an opportunity for comment must precede promulgation.”²⁹ Tax Court Judges Halpern and Holmes have concluded, “Giving the public a chance to comment only after making the regulations effective does not comply with the APA.”³⁰

Not all courts have invalidated such regulations. Some have accepted the final regulation if there is a finding that the agency demonstrated an “open mind” regarding comments made in the course of adopting final regulations.³¹ Asimow (1999, p. 726) would urge courts to go further: “So long as the agency meets normal APA standards by giving consideration to material public comments, it should not matter that the request for comments accompanied an invalidly-adopted interim rule.”³² That is, he argues that a final regulation could be valid based on notice-and-comment after adoption of the interim regulation, even if the interim regulation is invalid for failing to satisfy the notice-and-comment requirement.

Other courts have not demonstrated concern about failure to meet the APA good cause exception in promulgating interim-final rules. As a practical matter, by the time a dispute reaches a court, the regulation at issue has usually become final, after notice-and-comment, and courts may consider the substantive validity of the final regulation, not its procedural validity as a result of its origin as a temporary regulation. For example, in the recent Supreme Court case of *United States v. Home Concrete and*

²⁹ See *Sharon Steel Corp. v. EPA*, 597 F.2d 377, 381 (3d Cir. 1979). See also *Natural Res. Def. Council, Inc. v. EPA*, 683 F.2d 752, 768 (3d Cir. 1982). See, e.g., *Air Transp. Ass’n of Am. v. Dep’t of Trans.*, 900 F.2d 369, 379–80 (D.C. Cir. 1990), which invalidated a rule despite post-promulgation notice-and-comment.

³⁰ See *Intermountain Ins. Services v. CIR*, 134 T.C. 211, 247 (2010) (Halpern and Holmes, JJ. concurring in the result only), and *rev’d* 650 F.3d 691 (D.C. Cir. 2011). Judges Halpern and Holmes argued that the temporary regulations at issue in the case were invalid for failure to go through notice-and-comment. The regulations addressed the statute of limitations issue involved in *Home Concrete*, but at the time of the Tax Court case only temporary regulations were in effect. The Supreme Court vacated the Circuit Court decision in *Intermountain Ins. Services* and remanded for further consideration in light of *Home Concrete*, U.S. Lexis 3401 (April 30, 2012).

³¹ See, e.g., *Advocates for Highway and Auto Safety v. Fed. Highway Admin.*, 28 F.3d 1288, 1292 (D.C. Cir. 1994), and *Levesque v. Block*, 723 F.2d 175, 188 (1st Cir. 1983).

³² Asimow (1999) also suggests that a defect regarding interim rule is harmless error in considering the final rule.

Supply,³³ the Court held invalid a regulation applying the six-year or three-year statute of limitations to understatement of income as a result of overstatement of basis. It reasoned that, based on the Court's earlier interpretation in *Colony, Inc. v. Commissioner*³⁴ of the meaning of a phrase in the 1939 Code materially indistinguishable from the language at issue, the statutory language foreclosed the position taken in the regulation. Given the basis for its decision, the Supreme Court did not need to and did not discuss at all the procedural validity of the final regulation when it began as a temporary regulation without notice-and-comment, although briefs filed in the case discussed the procedural issue.

Nonetheless, unless an exception to notice-and-comment applies, there is a risk that courts could invalidate interim-final regulations, which are the kind most likely to be issued after tax reform.

D. Exceptions to the Notice-and-Comment Requirement

In a number of court cases, such as *Intermountain*, the IRS has argued that § 7805(e) per se authorizes departure from APA notice-and-comment requirements. Congress, of course, can authorize specific exceptions to APA notice-and-comment requirements. However, APA § 559 states that a “[s]ubsequent statute may not be held to supersede or modify” APA rulemaking requirements “except to the extent it does so expressly,” (APA § 559). Thus, this IRS argument seems weak. As Tax Court Judges Holmes and Halpern have written (*Intermountain*, pp. 245–246),

[N]othing in the text of the statute [of § 7805(e)] suggests that the notice-and-comment requirement has been waived, nor does the legislative history state that it has. The legislative history does note that the Secretary commonly issued temporary regulations with immediate effect, but this alone hardly suggests Congress meant to waive notice and comment for all temporary regulations. The legislative history does not even mention the APA, and both the Supreme Court and the APA itself provide that exceptions to the APA's terms cannot be inferred — much less inferred from an absence in the legislative history.

The APA recognizes exceptions to the notice-and-comment requirement. To reconcile the APA and § 7805(e), the provisions of § 7805(e) regarding duration of temporary regulations and simultaneous issuance of proposed regulations should be viewed as additional requirements that apply only if the APA itself permits issuance of temporary regulations without notice-and-comment (Asimow, 1991; Hickman, 2007).

Section 553(b)(B) of the APA permits agencies to forgo notice-and-comment “when the agency for good cause finds (and incorporates the finding and a brief statement

³³ See *United States v. Home Concrete and Supply*, 132 S.Ct. 1836 (2012).

³⁴ See *Colony, Inc. v. Commissioner*, 357 US 28 (1958).

of reasons therefore in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.” Courts generally require agencies asserting the good cause exception to do so expressly and contemporaneously, as discussed by Koch (2010).³⁵ Furthermore, as just quoted, APA § 553(b)(B) itself requires that an agency claim of the exception to include both its finding of good cause and its reasons for that finding “in the rules issued.” As Asimow (1991, pp. 348–49) explains,

Numerous judicial decisions, well supported by the legislative history, establish that the good cause provision is narrowly construed. Courts make an independent judgment about whether it applies and do so on a contextual, case-by-case basis. Only in compelling situations will a court subordinate the values embodied in public participation to claims of administrative necessity ... To establish that notice and comment procedure would be “impracticable” or “contrary to the public interest,” the agency must show exigent circumstances. For example, an imminent implementation deadline imposed by a statute or a judicial decision or an emergency such as a serious public health problem might qualify as good cause. Similarly, situations in which a statutory purpose would be thwarted by the absence of immediately-enforceable regulations might qualify. However, the good cause test is not met simply because an agency wishes to adopt immediately-effective rules to provide guidance or simplify enforcement.

As the Ninth Circuit observed not long ago in rejecting a claimed justification for bypassing notice-and-comment, “If ‘good cause’ could be satisfied by an Agency’s assertion that ‘normal procedures were not followed because of the need to provide immediate guidance and information[.] ... then an exception to the notice requirement would be created that would swallow the rule.”³⁶ In a recent case, the DC Circuit rejected reliance by the Environmental Protection Agency on the good cause exception for an interim-final rule. It wrote that “the limited nature of the rule cannot in itself justify a failure to follow notice and comment procedures” and that an agency must ask “whether

³⁵ See *Bushman v. Schweiker*, 676 F.2d 352, 356-57 (9th Cir. 1982), and *Bohner v. Daniels*, 243 F. Supp. 2d 1171, 1176 (D. Or. 2003).

³⁶ See *United States v. Valverde*, 628 F.3d 1159, 1166 (9th Cir. 2010), and quoting *Zhang v. Slattery*, 55 F.3d 732, 746 (2d Cir. 1995). The regulation at issue involved retroactive application of a registration requirement under the Sex Offender Registration and Notification Act. In contrast to the Ninth Circuit, the Fourth, Seventh, and Eleventh Circuits have held that the Attorney General satisfied the good cause exception in promulgating the rule. 628 F.3d at 1164. The First, Second, Third, Eighth, and Tenth Circuits have held that the registration requirements apply to pre-Act offenders from the date of the Act’s enactment, prior to any specification by the Attorney General. See *Reynolds v. U.S.*, 132 S.Ct. 975, 980 (2012). The Supreme Court has held that the Act does not apply until the Attorney General issued a specification, but remanded the case on the issue of whether the interim rule sets forth a valid specification. See 132 S.Ct. at 984.

providing notice and comment would be contrary to the public interest,” not “whether *dispensing* with notice and comment” would do so.³⁷

Asimow (1991, p. 350) acknowledges that some tax regulations meet the good cause test. He lists temporary regulations that are needed “to prevent serious economic dislocations, forestall massive tax avoidance, or to carry out Congressional intent for immediate implementation.” For many years, however, the IRS Manual instructed employees to include only the following language in preambles to regulations claiming the good cause exception: “These regulations are necessary to provide taxpayers with immediate guidance,” as discussed by Hickman (2007, p. 1781). As of September 30, 2011, the IRS updated the IRS Manual. It retains this language, but identified additional considerations to support a good cause claim. These include: (1) the need to avoid confusion; (2) the complexity of the regulatory framework addressed by the regulation; (3) congressional authorization for the issuance of the rule; (4) the temporary or interim effect of the rule during which the agency devises a final rule incorporating notice and comment; and (5) agency diligence in seeking notice and comment and promulgating a final rule incorporating those comments in accordance with the APA.³⁸ These factors, however, bear little resemblance to judicial requirements for reliance on the good cause exception. Only one factor, the need to avoid confusion, has even a possible relationship to the exigent circumstances required for the exception. The other factors do little more than restate the general requirements of administrative law and the particular requirements of § 7805(e).

Moreover, to rely on the good cause exception, the agency must explain the basis for the agency’s conclusion. Currently, regulations asserting the good cause exception do no more than offer two or three generic sentences about the need for immediate guidance, as discussed by Hickman (2007), and Lavilla (1989). If, after tax reform, the IRS and Treasury wish to rely on the good cause exception in promulgating temporary regulations, the agencies should go beyond the factors currently listed in the Internal Revenue Manual and delineate with considerable care their reasons for such reliance. Otherwise, they risk judicial invalidation of any temporary regulations, including interim-final regulations.

V. WHAT CONGRESS CAN DO

In enacting tax reform, Congress has options that could avoid possible invalidation of Treasury and IRS guidance, particularly guidance in the form of temporary regulations, on grounds of the regulations’ failing to comply with the required APA procedures of notice-and-comment or to offer an explanation of why the good cause exception to notice-and-comment applies.

In theory, Congress could try to bypass the need for regulations by writing extremely detailed, largely self-enforcing statutes. Of course, Congressional adoption of such an approach is neither practical nor realistic. Even if it were, drafting such detailed stat-

³⁷ See *Mack Trucks, Inc. v. EPA*, No. 12-1077 (June 12, 2012), slip opinion at 12 (*quoting Mid-Tex Electric Coop. v. FERC*, 822 F.2d 1123, 1132 (D.C. Cir. 1987), 13.

³⁸ See Internal Revenue Manual, § 32.1.4.7.5.1(7), (8).

utes is not a good use of Congressional resources, and, given the inherent ambiguity of language and inevitable issues of administrability, it is hard to imagine avoiding the need for interpretation of statutory provisions by IRS and Treasury.

Another option rests at the other end of the spectrum — for Congress to paint tax reform with the broadest possible strokes, that is, to specify only in the briefest outline the content of new tax provisions and give Treasury the authority to fill the statutory gap. For example, under current law, § 1502 of the Internal Revenue Code is considered to give Treasury enormous authority to issue regulations. It grants the Secretary of the Treasury the authority to “prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group ... may be returned, determined, computed, assessed, collected and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.”³⁹ The consolidated return statutory provisions are not self-executing. They depend on promulgation of regulations for taxpayers to know how to comply.

Whatever the wisdom of such broad delegations as a matter of policy, regulations issued pursuant to similar grants of authority seem likely, or at least more likely, to meet the good cause test for temporary regulations, on the grounds that the statutory purpose would otherwise be thwarted. If Congress were to pass such broad delegations and the tax agencies to rely on them, however, it would be important, as noted earlier, for Treasury and the IRS to specify its basis for relying on the good cause exception.

Congress could also adopt specific procedural rules in connection with tax reform. It could, for example, explicitly give Treasury and the IRS an across-the-board exception from APA notice-and-comment rulemaking for guidance issued in connection with tax reform, as the APA requires in order to supersede or modify its procedural requirements. A broad exception, however, seems unlikely. If it did so, Congress would be rejecting both the principled and the pragmatic reasons for notice-and-comment, procedures that have been the mainstay of the administrative state since the New Deal.

Asimow (1999, p. 741) has endorsed a variation of this possibility, one that would not undermine the APA so broadly because it would be limited to interim-final regulations. He recommends “a statute providing that a final rule supplanting an interim-final rule may not be invalidated simply because the agency lacked good cause to adopt the interim-final rule.” He makes this suggestion for all administrative agencies, across-the-board, but Congress could adopt a statute applicable only to interim-final rules adopted in connection with tax reform. That is, Congress might follow the model of § 9833 of the Internal Revenue Code, which explicitly gives the Secretary authority to “promulgate any interim final rules as the Secretary determines are appropriate to carry out” the Health Care Portability and Accountability Act of 1996, a provision that has been understood as explicitly overriding the need for a good cause exception under the APA in relying on interim-final regulations, as discussed by Hickman (2007).

³⁹ See I.R.C., Title 26, Chapter 6, “Consolidated Returns,” § 1502, p. 2287.

Another possibility would be for Congress to take a narrower approach and adopt by statute the “open mind” standard for regulations related to tax reform. This standard accepts interim-final regulations if a court makes a finding that the agency demonstrated an “open mind” regarding comments made in the course of adopting final regulations. Such a statute would put pressure on the tax agencies to demonstrate its careful consideration of comments received in the course of adopting final regulations. Moreover, “open mind” would establish a very vague statutory test that would be subject to litigation.

Furthermore, satisfying this standard would be particularly difficult, for example, if the existence of temporary regulations discourages public comment. Treasury and the IRS, for example, received only a single comment on the regulations at issue in the recent *Home Concrete* case, a case that went all the way to the Supreme Court. Nonetheless, enacting an open mind standard as a statutory matter could reduce the possibility of judicial invalidation of important post-tax reform regulations.

Far more possible, I think, would be for Congress to take a narrower approach and revise § 7805(b)(2) and § 7805(e) of the Internal Revenue Code as applied to statutory provisions enacted as part of tax reform. Such a revision could take many forms: making the exception for retroactive regulations greater than the current 18 months from the date of enactment of the statutory provision to which the regulation related; allowing temporary regulations to last more than three years; or allowing Treasury to issue proposed regulations in connection with temporary regulations after some specified period of time, rather than requiring it to do so immediately.

Of course, Congress could simply rely on the courts, concluding that regulations, including interim-final regulations, promulgated shortly after major tax reform are not invalid under the APA. Courts may decide that such regulations qualify for the APA good cause exception because of exigent circumstances, because of the need not to thwart the legislative purpose, and because of the need not to imperil the fisc. That is, Congress might assume that courts will uphold interim-final regulations after tax reform even in the absence of a detailed statement by the agency as to why the good cause exception applies. Courts might also conclude that giving taxpayers the opportunity for notice-and-comment before the regulations become final is sufficient. Failure by Congress to take some action, however, is risky, especially in the case of regulations related to tax reform that, because of workload, are not promulgated soon after the reform statute’s enactment. It is important for Congress to consider approaches such as those outlined here in order to avoid the risk of regulations crucial to tax reform being invalidated by courts on the grounds that Treasury and the IRS failed to comply with the procedural requirements of the APA.

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