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The IRS' APA Rulemaking Journey: There And Back Again

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After receiving a sizable budget increase from Congress, the IRS made headlines last year when it announced plans to hire thousands of new agents.[1] The IRS has made clear that enforcement will be a top priority going forward.

Many tax practitioners are already well aware of the IRS' increased emphasis on enforcement, as the IRS has been hitting taxpayers with new reporting obligations, increased penalties and new interpretations of decades old revenue laws.

Increased enforcement has prompted taxpayers and tax practitioners to ask: Are the rules the IRS uses as a springboard for enforcement clear and well reasoned enough for the IRS to consistently and fairly enforce them? And more importantly, are these rules clear enough to ensure public compliance?

For clarification, taxpayers, scholars and the courts began taking a closer look at the IRS rulemaking processes. As J.R.R Tolkien wrote in "The Hobbit":

> There is nothing like looking, if you want to find something. You certainly usually find something if you look.[2]

This observation has been particularly apt because opening the door into the IRS' rulemaking process revealed a substantive and procedural void.

This article explores why we are seeing so many Administrative Procedure Act challenges in the tax sphere now, and in particular, looks at recent at taxpayer victories in Hewitt v. Commissioner,[3] Mann Construction v. U.S.,[4] Liberty Global v. U.S.[5] and Green Valley Investors LLC v. Commissioner.[6]

First, we examine the two major hurdles taxpayers have faced when venturing into the administrative law realm: tax exceptionalism and the Anti-Injunction Act — two different creatures on their face that worked jointly to ensure very few had the chance to go behind IRS rules and guidance.

We then venture into the regulatory deference that the IRS requested and received from the U.S. Supreme Court. Along the way, we explain why this increased deference — and the APA rulemaking

obligations that come with it — prompted taxpayers to challenge the IRS' methods of issuing regulations, temporary regulations, and listing notices.

With this background in mind, we delve into why taxpayers and the IRS have different views on whether the APA applies to IRS rulemaking, and discuss how the courts are ruling on these new challenges. To conclude, we circle back again, asking more questions about where the administrative law journey will lead and what its ultimate consequences may be.

With that synopsis, let the journey begin.

The Anti-Injunction Act was passed by Congress to preclude taxpayers from seeking to enjoin the IRS' tax collection efforts even when a taxpayer was claiming the tax was illegal.[7]

As the court stated in CIC Services LLC v. IRS, "Because of the Act, a person can typically challenge a federal tax only after he pays it, by suing for a refund."[8] Therefore, unlike most agency rules, challenges to IRS rules had to be tied to a challenge to a tax or penalty arising from the IRS' determination that the taxpayer did not comply with the rule.

But what happens when a taxpayer wants to challenge an IRS rule without having to break it?

CIC Services brought that question to a head when it filed an APA suit challenging an IRS listing notice that obligated CIC Services to file hundreds of forms with the IRS or face large penalties for noncompliance.

When CIC Services challenged the listing notice in the U.S. District Court for the Eastern District of Tennessee, the IRS quickly moved to dismiss, arguing that a suit to set aside a listing notice, which would serve as the basis to collect penalties in the event of noncompliance, was tantamount to a suit to enjoin taxes.

CIC persisted through the U.S. Court of Appeals for the Sixth Circuit and up to the Supreme Court, arguing it was unreasonable to read the Anti-Injunction Act as requiring noncompliance with an IRS rule — to the point of facing potential criminal liability — before the process through which the IRS promulgated the rule could be challenged.

In its 2021 decision, the Supreme Court agreed with CIC Services and held that the Anti-Injunction Act was no bar to challenging a listing notice, even though it had a penalty attached to it.

The relief sought by CIC Services through its APA action, the Supreme Court held, was not to bar collection of a penalty — taxes — but to challenge agency action. Thus, CIC Services opened a door through which the public could bring APA challenges to IRS rules on reporting and filing obligations before breaking them.

But CIC Services' challenge to the IRS listing notice would not have been possible without a 2011 decision by the Supreme Court in Mayo Foundation for Medical Education and Research v. U.S.[9]

In Mayo, the IRS sought Chevron deference for its legislative rules to preclude the courts from considering a variety of factors when evaluating the reasonableness of IRS rules — and the IRS won.

The court ended tax exceptionalism by holding that Treasury regulations were afforded Chevron

deference. The court did not opine on whether the other 25 types of IRS guidance received Chevron deference.[10]

In arguing for Chevron deference, the IRS failed to consider the cost of such deference: substantive and procedural compliance with the APA. After Mayo, IRS rules received greater deference but also became vulnerable to APA challenges if they were not sufficiently explained or if comments were not properly addressed.

And with potentially 41% of all Treasury regulations most likely missing a component of APA compliance[11] — since the IRS was not in the habit of complying with the APA when promulgating its rules — the regulations subject to challenge are plentiful.

The decisions in CIC Services and Mayo, when combined with the IRS' historical practice of loose rulemaking and aggressive enforcement tactics, which rely on new interpretations of old IRS rules, created an environment ripe for APA challenges.

This environment resulted in taxpayer victories at the appellate level in Hewitt,[12] and Mann Construction,[13] at district court in Liberty Global[14] and at the U.S. Tax Court in Green Valley Investors.[15]

The U.S. Court of Appeals for the Eleventh Circuit's 2021 decision in Hewitt exemplifies how the IRS has positioned itself for major APA losses. As the Supreme Court observed in its 1984 Heckler v. Community Health Services of Crawford County Inc. decision:

> [It] is no less good morals and good law that the Government should turn square corners in dealing with the people than that the people should turn square corners in dealing with the Government.[16]

And no taxpayer turns more square corners in the current IRS enforcement environment than a taxpayer who donates a conservation easement.

Hewitt donated a conservation easement to protect his family's farm. In challenging the deduction claimed by Hewitt, the IRS took the aggressive position that the deduction should be disallowed in full, arguing that the long-accepted language drafted by the land trust, which allocated proceeds from post-donation improvements to the landowner if the easement is ever extinguished, failed to comply with Section 1.170A-14(g)(6)(ii) of the Treasury regulations.

But how could an entire industry of land trusts charged by Congress with overseeing donations of conserved property develop standard language — to the trusts' detriment — that went unchallenged for decades if the regulation clearly precluded such allocation?

To answer that question, Hewitt went digging into the regulation's promulgation to try and see if the regulation's background provided any clarity on what the regulation required.

Hewitt found that the U.S. Department of the Treasury provided no explanation or reason for the allocation in the regulation being advocated by the IRS, even though the Treasury had received over a dozen relevant comments from land trusts and other members of the public concerning that regulation.

By failing to turn square corners with the taxpayers who were subject to the regulation, the Treasury left hundreds, if not thousands, guessing whether and why the IRS and Congress would require a taxpayer to

turn over some portion of the value of a home he built on his property to a land trust simply because the taxpayer — or a prior landowner — had donated a conservation easement on that same property years, perhaps decades, before.

Hewitt brought an APA challenge, arguing the Treasury could not impose this requirement without some explanation, particularly when the public had expressed concerns that the regulation would discourage conservation — the very purpose of the statute pursuant to which the regulation was issued.

The Eleventh Circuit agreed that the Treasury should have said something, especially when the public had lodged at least one significant comment to the regulation. Accordingly, the Eleventh Circuit held that the regulation was invalid under the APA.

The new environment created by Mayo and CIC Services has also prompted taxpayers to consider whether other IRS rules issued without notice, comment or explanation can be subject to APA challenge. While Mayo concerns Treasury regulations, it is silent on other IRS rules.

Some IRS rules, including listing notices and temporary Treasury regulations, have the same binding effect as final regulations. And as with final regulations, failure to comply with these rules could lead to criminal and even civil penalties.

While CIC Services provided a path to challenge an IRS listing notice before a taxpayer — or material adviser — was penalized for failure to comply, taxpayers and advisers still had to overcome the IRS' position that the APA's notice and comment requirements did not apply to listing notices.

This final hurdle was quickly surpassed by the taxpayer in Mann Construction. Specifically, the plaintiff challenged the validity of Notice 2007-83, arguing that it was improperly issued without notice and comment required by the APA.

After deciding that the listing notice was a legislative rule subject to the APA, the court considered whether Congress exempted the IRS from having to follow notice and comment when promulgating listing notices.

The court then held Congress did not exempt the IRS from following the APA because abrogating the APA's requirements requires an explicit and clear directive from Congress, language absent from Internal Revenue Code Sections 6011 and 6707A. Because it was undisputed that no notice and comment procedures occurred before promulgation of Notice 2007-83, the court set it aside under the APA.

Undeterred by its loss in the Sixth Circuit, the IRS proceeded to argue in both the Tax Court and in district courts outside the Sixth Circuit that the APA was not applicable to listing notices.

In November 2022, the IRS was dealt what appears to be a final blow in its effort to immunize listing notices from the APA. The Tax Court in Green Valley Investors issued a fully reviewed opinion authored by U.S. Tax Court Judge Christian Weiler, and joined by 10 other judges, concluding that the listing notices, including Notice 2017-10, were subject to the APA's notice and comment requirements.

The Tax Court went through the same two-step process as the Sixth Circuit did in Mann Construction, concluding first that Notice 2017-10 is a legislative rule subject to APA requirements.

The court found it significant that Notice 2017-10 did more than subject taxpayers to reporting obligations; advisers also had hefty reporting obligations even though they claimed no tax benefit, making "material advisors ... records repositories for the IRS" under threat of penalty, a "prototype of a legislative rule."[17]

As for step two, the Tax Court had to decide whether "Congress has established procedures so different from those required by the APA that it intended to displace" APA compliance.[18]

Like the Sixth Circuit in Mann Construction, the Tax Court noted that Congress provided no express intention to exclude Section 6011 or Section 6707A from the APA, and the IRS' attempts to provide an express intent with its own regulations was unavailing.

The Tax Court held that "Congress operated under the expectation that administrative agencies respect their APA obligations except when Congress expressly chooses different procedures."[19]

Importantly, the Tax Court also held that Congress' amendment of Section 6707A after the IRS had promulgated listing notices thereunder did not ratify the IRS' actions, holding along with Mann Construction that inaction "may, but does not always, mean ratification and rarely suffices to show express modification of the APA's bedrock procedural guarantees given the raft of potential explanations for inaction on Capitol Hill."[20]

Last, the Tax Court held that Congress' concerns with tax transactions covered under a listing notice, even if they amount to Senate Finance Committee reports and hearings, are still "insufficient to supplant the APA."[21]

And while the IRS is clearly not happy with these decisions, it has taken steps to reissue Notice 2017-10 using the notice-and-comment procedures required by the APA.

The proposed regulation was released on Dec. 8, 2022. The IRS will be receiving comments until Feb. 6, and hold a public hearing on March 1.

The IRS' decision to use notice-and-comment in reissuing Notice 2017-10, rather than exempting itself from notice-and-comment for "good cause," seems to be a clear indication that the IRS wants to avoid APA challenges in the future.

In its November 2022 decision in Liberty Global Inc. v. U.S., the U.S. District Court for the District of Colorado observed that the IRS failed to invoke the good cause exception to justify its decision to skip notice-and-comment when issuing temporary treasury regulations and further indicated that such justification might not withstand scrutiny.[22]

District courts in other recent APA cases have likewise been skeptical of an agency's decision to invoke the good cause exception to skip notice and comment.[23]

The struggles to comply with the APA do not begin or end with the IRS. From 1995 to 2012, agencies overall avoided the notice and comment process on 52% of final rules,[24] a troubling statistic.

As the administrative state grows, agencies look for ways to circumvent the APA's procedures by identifying an APA exception or asserting that the guidance is not subject to the APA's requirements.

In response, the public with whom agencies are not interacting can be expected to find new ways of curbing agency overreach through several different methods, including constitutional challenges.[25]

As agencies continue to try and work around the APA's procedural obligations,[26] and the public continues to push back on invalid agency guidance, courts are caught in the melee of deciding whether remedies for invalid agency action will be "American Revolution" or "French Revolution."[27]

As the Tax Court held in Green Valley Investors, invalidity of IRS guidance for one means invalidity of IRS guidance for all that are similarity situated.

But in GBX Associates LLC v. U.S., in the U.S. District Court for the Northern District of Ohio, the court was reluctant to hold a listing notice invalid for anyone other than the taxpayer at issue.[28]

We appreciate any concern for invalidating large swathes of IRS guidance at once, leaving gaps in the tax law.[29] But it is delaying the inevitable — and extremely costly — to require each taxpayer affected by an invalid agency action to bring suit to receive justice.[30]

The delay and individualized approach in GBX negatively affects the government and taxpayers. So while the guillotine approach may shock the conscience, it shortens the overall length and cost of war.

Bringing the question of how we got here full circle — or there and back again — the question becomes, where are we going?

With the APA and even some constitutional concerns in play, lots of questions apply:

1. Is every regulation under the tax-exceptionalism regime at risk for invalidation under the APA?

2. What other IRS guidance, beside regulations and listing notices, might also fall under the APA's shadow?

3. Is the IRS still different from other federal agencies, such as the U.S. Environmental Protection Agency, where the public can sue for invalidation of a regulation as soon as it is finalized — before enforcement is even thought about?

4. What other IRS decisions are vulnerable to APA challenges as final agency actions?

5. What relief is given — and to whom — when an IRS rule or regulation is held invalid?

And while the answers to these questions are not known, one thing is certain: Taxpayers and the IRS will continue to work together and apart when it comes to IRS rules.

The Supreme Court's deference to IRS rules recognizes the expertise agencies have in their fields and relieves the judicial system of having to use its own judgment when evaluating the reasonableness of an IRS rule.

Likewise, the APA's requirement that the IRS receive input from members of the public who are affected by those rules provides an important safeguard for rules that are made outside the legislative process.

And while historically the IRS has not given public comments their due, taking steps moving forward to

solicit and consider the public's response will serve both the IRS and the public by providing the IRS with the tools necessary to craft better rules.

So while the IRS' historic practice of exempting itself from APA procedures provides current taxpayers with much fodder to challenge these rules, the IRS' increased diligence in its rule-making process going forward may leave future taxpayers with few options to exempt themselves from IRS rules.

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[1] https://news.bloombergtax.com/tax-insights-and-commentary/irs-is-hiring-new-employees-not-raising-an-army.

[2] J.R.R. Tolkien, The Hobbit or There and Back Again (1937).

[3] 21 F.4th 1336 (11th Cir. 2021).

[4] 27 F.4th 1138 (6th Cir. 2022).

[5] No. 1:20-cv-03501-RBJ, 2022 WL 1001568 (D. Colo. Apr. 4, 2022).

[6] 159 T.C. No. 5 (2022).

[7] CIC Servs. LLC v. IRS., 141 S. Ct. 1582 (2021).

[8] Id. at 1586.

[9] 562 U.S. 44 (2011).

[10] Matthew H. Friedman, Reviving National Muffler: Analyzing the Effect of Mayo Foundation on Judicial Deference as Applied to General Authority Tax Guidance, 107 NW. U. L. Rev. Colloquy 115, 122 (Aug. 31, 2012).

[11] David Berke, Reworking the Revolution: Treasury Rulemaking & Administrative Law, 7 Mich. J. Envtl. & Admin. L 353, 364 (Spring 2018).

[12] 21 F.4th 1336 (11th Cir. 2021).

[13] 27 F.4th 1138 (6th Cir. 2022).

[14] No. 1:20-cv-03501-RBJ, 2022 WL 1001568 (D. Colo. Apr. 4, 2022).

[15] 159 T.C. No. 5 (2022).

[16] Heckler v. Cmty. Health Servs. of Crawford County Inc., 467 U.S. 51, 61 n.13 (1984).

[17] Green Valley Investors, 2022 WL 16834499, at *8-9.

[18] Id.

[19] Id. at *12.

[20] Id. at *13 (quoting Mann Construction, 27 F.4th at 1147).

[21] Id. at *14.

[22] No. 1:20-cv-03501-RBJ, 2022 WL 1001568, at *5-6 (D. Colo. Apr. 4, 2022).

[23] Health Freedom Def. Fund, Inc. v. Biden, No. 8:21-cv-1693-KKM-AEP, 2022 WL 1134138 (M.D. Fla. Apr. 18, 2022).

[24] 7 Mich. J. Envtl. & Admin. L. at 388.

[25] These procedures protect the public from agencies wielded by whatever executive is in office. Without requiring well-reasoned and thought-out rules, a president can pressure an executive branch agency to pass rules fitting current political agendas, with deference potentially attached to those hasty decisions. See generally Bethany A. Davis Noll, "Tired of Winning": Judicial Review of Regulatory Policy in the Trump Era, 73 Admin. L. Rev. 353 (Spring 2021).

[26] See Cochran v. U.S. S.E.C., 20 F.4th 194 (5th Cir. 2021); Jarkesy v. S.E.C., 34 F.4th 446 (5th Cir. 2022).

[27] 7 Mich. J. Envtl. & Admin. L at 354.

[28] GBX Assoc. LLC v. U.S., No. 1:22cv401, 2022 WL 16923886 (N.D. Ohio 2022).

[29] See 7 Mich. J. Envtl. & Admin. L at 364 for more information on this concern.

[30] For example, five additional cases have been filed in district courts with the same issue and a similarity situated taxpayer.