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Challenging Internal Revenue Service Regulations: The U.S. Supreme Court Makes the Path More Difficult

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The Internal Revenue Service issues two types of regulations. The first are issued under Internal Revenue Code Section 7805(a), which authorizes the U.S. Department of the Treasury to "prescribe all needful rules and regulations [to enforce the Internal Revenue Code], including all rules and regulations as may be necessary by reason of any alternation of law in relation to internal revenue." These are known as "interpretive regulations." The second type, called "legislative regulations," are mandated by Congress under a specific section of the Internal Revenue Code. For example, Section

414(o) - relating to employee benefit plans - obliges "The Secretary [of the Treasury] prescribe such regulations...as may be necessary to prevent the avoidance of any employee benefit requirements listed [above]."

In *National Muffler Dealers Association Inc. v. U.S.*, 440 U.S. 472 (1979), the U.S. Supreme Court upheld an interpretive regulation because its construction of the statute, while "not the only possible one,...does bear a fair relationship to the...statute...reflects the views of those who sought its enactment,...matches the purpose they articulated [and] has stood for 50 years...." This has been viewed as giving courts the ability to review a broad range of factors in weighing a regulation's reasonableness, which has resulted in regulations receiving a lesser level of deference when faced with a taxpayer challenge.

Chevron v. Natural Resources Defense Council Inc., 467 U.S. 837 (1984), meanwhile involved an interpretive regulation promulgated by the Environmental Protection Agency. The Clean Air Act did not explicitly define a key term and the legislative history did not address the issue. In *Chevron*, the Supreme Court held that the EPA's "interpretation represents a reasonable accommodation of manifestly competing interests, and is entitled to deference...." The accompanying two-part test required a court reviewing an agency interpretation of a statute to determine first whether Congress has directly spoken to the issue. If Congress' intent is clear, the Court said, "that is the end of the matter." However, if a court determines that Congress has not directly addressed the issue, "the court does not simply impose its own construction on the statute.... Rather, if the statute is silent or ambiguous as to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." (*Chevron*, 467 U.S. at 843). *Chevron* was viewed as giving a higher standard of deference to legislative regulations.

Another case, *Mayo Foundation for Medical Education and Research et al. v. United States*, 178 L.Ed.2d 588 (Jan. 11, 2011) involved a dispute over the Federal Insurance Contributions Act (Social Security) tax. In 2004, the IRS issued an interpretive regulation providing that an employee is a student, exempt from FICA, if the educational aspect of the relationship is "predominant." At the same time, an employee whose normal work schedule is 40 hours or more per week is considered a full-time employee and, therefore, not a student. (Regulation Section 31.3121(b)

SPECIAL REPORT

Top Women Lawyers

Our annual list of the Top Women lawyers in the state.



Thursday, May 12, 2011

Discipline

Receiver Sues Sedgwick For Malpractice

Sedgwick LLP has been hit with a \$200 million malpractice suit over its work for accused fraudulent investment company Medical Capital Holdings Inc.

Health Care & Hospital Law

Former Biotech GC Acquitted

A U.S. judge acquitted former GlaxoSmithKline general counsel Lauren Stevens on Tuesday of all six charges against her in an investigation of the company's marketing practices for an anti-depressant.

Zoning, Planning and Use

The Curse of Chavez Ravine

Are the Dodgers' financial problems a case of delayed retribution for how Dodger Stadium came about? By **Gideon Kanner** of Loyola Law School

International

The Benefits of Bilateral Investment Treaties When Investing in China

Bilateral investment treaties operate as "free insurance" with its minimal costs and direct benefits. By **Allan Marson, Grant Hanessian,** and **Michiel Kloes** of Baker & McKenzie

Construction

What to Do With a Busted Project

Distressed real estate projects are getting a shot of much needed adrenaline from preferred equity. By **Anita F. Sabine** of O'Melveny & Myers LLP

Letter to the Editor

America Is a Fair Country

Leon Snaid responds to "Death of Osama bin Laden: Could There Have Been a Trial?"

Criminal

Panel Lawyers Could Be Curtailed

A committee of federal judges is considering whether to create a new "alternate" public defender's office in the Central District of California that would be independent of the existing institution.

Judge Bars Gang Injunction Enforcement

A federal judge has approved an unusual permanent injunction against the Orange County district attorney, barring him from enforcing a gang injunction won in state court against 48 people.

(10)-2(d)(3)(iii)). In 2007, a federal district court held that the full-time employee rule is inconsistent with Section 3121's unambiguous text, which the court understood to dictate that "an employee is a 'student' so long as the educational aspect of his service predominates over the service aspect of the relationship with his employer." The court also used the *National Muffler* test to invalidate the full-time employee exception. In 2009, the 8th Circuit reversed the lower court. Using the more deferential *Chevron* standard, it held that excluding full-time employees from the student exemption was a valid interpretation of the statute.

The Supreme Court unanimously affirmed the 8th Circuit's decision, agreeing that the full-time employee rule was a reasonable construction of the statute. Although it had previously used a less deferential standard for interpretive regulations, the Court indicated that the higher *Chevron* deference is appropriate "when it appears that Congress delegated the authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority." In other words, the regulation's acceptability does not depend on whether the delegation from Congress was general or specific or whether the IRS or some other administrative agency issued the regulation. Overall, *Chevron* provides greater deference than *National Muffler* because the latter invalidates a regulation due to factors such as agency inconsistency, lapse of time between statutory change and the regulation, and the way the regulation evolved.

Will this higher level of deference apply to other forms of guidance issued by the [Internal Revenue Service], such as revenue rulings, notices and announcements?

Like *Chevron*, *Mayo* will make it more difficult for taxpayers to successfully challenge IRS interpretive regulations. For the taxpayer to even have a chance of success, he or she must argue that the statute is not ambiguous. Under the *Chevron* standard, the IRS' interpretation still bears a heavy burden. However, there are still many unknowns. The regulation in *Mayo* was issued only after the Administrative Procedure Act's notice and hearing process was followed. That process does not apply to interpretive regulations. At the same time, it is uncertain whether the higher level of deference will apply to temporary regulations (which normally do not go through the notice and comment period). Will this higher level of deference apply to other forms of guidance issued by the IRS, such as revenue rulings, notices and announcements? Will it apply to final regulations that have not gone through a notice and comment period? Will the IRS stop giving less formal means of guidance? Will it issue regulations retroactively to support its litigation positions? If so, will the courts give the same type of respect to those self-serving regulations?

The Supreme Court's decision in *Mayo* can be read as applying the *Chevron* standard of deference to IRS regulations, rather than the arguably less demanding test enunciated in *National Muffler*. However, it can also be viewed as eliminating the interpretive versus legislative categorization in favor of an unambiguous versus ambiguous distinction. Then again, it can be seen as simplifying the number of factors courts must consider in reviewing an IRS regulation. This will make the task of challenging regulations more difficult for taxpayers. Of course, they will still have room to attack inappropriate IRS regulations and other forms of guidance.

Judicial Profile

Making Her Mark

A framed reproduction of Botticelli's *Calumny of Apelles* hangs in U.S. Magistrate Judge Jennifer L. Thurston's chambers. The colorful painting, rich in allegory, depicts Slander dragging Innocence - the victim of false accusations by Envy,

Intellectual Property

Nevada Newspaper Pursues Copyright Cases

Despite some recent unfavorable court rulings, a Nevada company appears to be doubling down on its bet that suing hundreds of defendants for infringing the copyright of a Las Vegas newspaper is a winning strategy.