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LEGAL ALERT

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Supreme Court Holds *Chevron* Deference Applicable to "Interpretive" Regulations

The U.S. Supreme Court's recent decision in *Mayo Found. for Medical Education and Research v. United States* (January 11, 2011), on the standard of deference for judicial review of "interpretive" tax regulations, will inform both the future regulation-writing process for and challenges to employee benefit and executive compensation tax regulations.

In *Mayo*, the Court unanimously upheld Treasury regulations interpreting the "service by a student" exclusion to the definition of "employment" for FICA purposes. In reaching its decision, the Court applied the two-step deference standard set forth in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), rather than the multi-factor analysis set forth in *National Muffler Dealers Assn., Inc. v. United States*, 440 U.S. 472 (1979).

Prior to *Mayo*, the lower courts had disagreed on as to which standard should be applied in testing the validity of "interpretive" Treasury regulations. Under *Chevron*'s two-step approach to testing the validity of a regulation, "step one" requires the court to determine whether "Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter." 467 U.S. at 842-43. If the court determines that the statute has not unambiguously addressed the precise question at issue, "step two" requires the court to determine "whether the regulation is based on a permissible construction of the statute." *Id.*

By contrast, under *National Muffler*, after determining that the statute was unclear, a court would look to "whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose." 440 U.S. at 477. In testing the validity of an interpretive regulation, *National Muffler* would take into consideration factors such as whether a regulation was issued contemporaneously with the statute, the length of time the regulation has been in effect, the reliance placed on it, the consistency of the IRS interpretation, and the degree of scrutiny devoted to the regulation by Congress. *Id.*

In many cases, the conclusion reached would be the same under both approaches, but in some cases it would diverge.

The *Mayo Foundation* Case

Mayo involved the issue of whether medical residents are "students" covered by an exemption from employment tax under Internal Revenue Code (IRC) § 3121(b)(10). In 2004, after notice and comment, Treasury issued new regulations providing additional clarification that a medical resident performing full-time services would not be treated as a "student" for purposes of § 3121(b)(10). Notwithstanding the regulation, the Mayo Foundation filed a refund suit for taxes it had withheld and paid on its medical residents' stipends. Relying on the factors enumerated in *National Muffler*, the district court held that the 2004 regulations were inconsistent with the unambiguous text of § 3121(b)(10). Relying on *Chevron*, the U.S. Court of Appeals for the Eighth Circuit reversed the district court.

In an 8-0 decision (in which Justice Kagan did not participate), the Supreme Court, in an opinion by Chief Justice Roberts, affirmed the Eighth Circuit. Initially, without even discussing the conflict between *Chevron* and *National Muffler*, the Court applied step one of *Chevron* to determine that the statute was

ambiguous as applied to medical residents. (*National Muffler* would have required the same initial statutory analysis.) The Court next stated that, in the "typical case," with the statute determined to be ambiguous, it would then move on to apply step two of *Chevron,* under which it would not disturb an agency rule unless it was "arbitrary or capricious in substance, or manifestly contrary to the statute." Slip Op. at 7, quoting *Household Credit Services. Inc. v. Pfennig*, 541 U.S. 232 (2004), which in turn quoted *United States v. Mead Corp.*, 533 U.S. 218 (2001).

Instead, however, the Court addressed the taxpayer's argument that *National Muffler* was the proper precedent for reviewing interpretive tax regulations. The Court did not see "any justification" for applying the different standards of *National Muffler* to Treasury regulations as distinguished from other types of regulations, since Treasury is required to make interpretive choices in filling gaps in the Internal Revenue Code that are "at least as complex as the ones other agencies must make in administering their statutes." Slip Op. at 9. The Court rejected the notion that it should accord less deference to Treasury regulations promulgated under the general authority to issue "interpretive" regulations under IRC § 7805(a) than to "legislative" regulations issued under a specific grant of authority, pointing out that interpretive regulations issued by other agencies are accorded *Chevron* deference. Slip Op. at 10-11.

In the Court's view, *Chevron* step two must be applied "[w]here an agency rule sets forth important individual rights and duties, where the agency focuses fully and directly upon the issue, where the agency uses full notice-and-comment procedures to promulgate a rule, [and] where the resulting rule falls within the statutory grant of authority." Slip Op. at 12, *quoting Long Island Care at Home, Ltd. v. Coke*, 551 U.S. 158, 173 (2007) (brackets original).

The Court then held that the regulations involved in *Mayo* "easily" satisfied *Chevron* step two because they were a "reasonable interpretation" of the statute, and thus were valid.

Implications of *Mayo*

Mayo answered one question with respect to the judicial deference afforded Treasury regulations, but also raises new questions.

As noted above, the question clearly answered is whether *Chevron* deference applies to interpretive Treasury regulations issued under the general grant of authority in § 7805(a). Before *Mayo*, some courts applied *National Muffler* in determining the validity of interpretive Treasury regulations. *See e.g.*, *Swallows Holding, Inc. v. Commissioner*, 126 T.C. 96 (2006) (applying *National Muffler*), *vacated and remanded*, 515 F.3d 162 (3rd Cir. 2008) (applying *Chevron*). Not all judges of the Tax Court, and not all Circuit Courts, agreed that *National Muffler* was the proper standard to apply. *See e.g.*, *Swallows Holding, supra* (Holmes, J., dissenting, and cases there collected). Under *Mayo*, it is now clear that "interpretive" tax regulations issued under § 7805(a) must be analyzed under *Chevron* if the regulation "sets forth important individual rights and duties" and the IRS "focuses fully and directly upon the issue" using "full notice-and-comment procedures." Slip Op. at 12, *quoting Long Island Care at Home, Ltd. v. Coke*, 551 U.S. 158, 173 (2007).

Sutherland Observation: The *Mayo* decision will undoubtedly bolster the Treasury's confidence in its litigating posture with respect to the validity of its regulations. In fact, the day after the Supreme Court decided *Mayo*, the Department of Justice cited the case at oral argument in the Court of Appeals for the Federal Circuit in support of interpretive regulations. *See* Jeremiah Coder, News Analysis: *Federal Circuit Grapples with Aftermath of Mayo*, 2011 TNT 9-2 (Jan. 13, 2011) (quoting Gilbert Rothenberg, acting deputy assistant attorney general in the Department's Tax Division, "*Mayo* foreshadows how this appeal should be decided").

Questions Not Answered By *Mayo*

The Court did not address the role of legislative history in applying *Chevron* step one. In *Chevron* itself, the Supreme Court noted that courts should use "traditional tools of statutory construction" in applying *Chevron* step one. 467 U.S. at 843, n. 9. Presumably legislative history is one of these "traditional tools," but courts have been less than clear on this issue. *See Intermountain Ins. Serv. of Vail, LLC v. Commissioner,* 134 T.C. 211, 233-38 (2010) (Halpern and Holmes JJ. concurring, and the cases cited and discussed therein). In *Mayo*, the Court did not appear to have occasion to discuss the use of legislative history in step one of the *Chevron* analysis.

Mayo also may have created some confusion regarding the proper standard to be applied to interpretive tax regulations under *Chevron* step two. As noted, the Court articulated the *Chevron* standard in two ways. In first describing the step two analysis, the Court stated that the regulation would be upheld unless it was "arbitrary and capricious" or "manifestly contrary" to the statute. Slip Op. at 7, quoting *Household Credit Services*, which in turn quoted *Mead*. (*Mead* had held that tariff classification rulings were not the type of agency pronouncements entitled to *Chevron* deference, though they might be entitled to the benefit of the much lower level of deference accorded under *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944), under which an agency pronouncement is given deference according to its power to persuade.) When it came to actually applying *Chevron* step two to the Treasury regulations at issue in *Mayo*, however, the Court stated that the regulations would be upheld because they were a "reasonable interpretation" of the statute. Slip Op. at 12, quoting *Chevron*.

Is the proper *Chevron* step two standard "arbitrary and capricious," or "reasonable interpretation"? Or does the "arbitrary and capricious" standard apply only where the delegation of regulatory authority is explicit ("legislative" regulations), with the "reasonable interpretation" standard applying where the regulatory authority is general ("interpretive" regulations)? While the Court's reference to both standards in *Mayo* might be seen as creating a new uncertainty that may require further judicial interpretation, we read *Chevron* to indicate that the "reasonable interpretation" standard is intended to apply to an "interpretive" regulation promulgated under a general delegation of regulatory authority, with "arbitrary and capricious" being the standard to be applied to "legislative" regulations promulgated under an explicit delegation of regulatory authority.

Another question not answered by *Mayo* is what deference is appropriate for temporary Treasury regulations issued without notice and comment under IRC § 7805(e). Section 7805(e) provides that temporary regulations (which are immediately effective without prior notice and comment) must also be issued as proposed regulations. This procedure allows for notice and comment only after the temporary regulation has become effective. Many courts have held that post-promulgation notice and comment does not satisfy the requirements of the Administrative Procedure Act (APA). *See e.g., Paulsen v. Daniels, 413 F.3d 999, 1004-05 (9th Cir. 2005)* ("It is antithetical to the structure and purpose of the APA for an agency to implement a rule first, and then seek comment later.")*; United States. Steel Corp. v. Environmental Protection Agency,* 595 F.2d 207, 214-15 (5th Cir. 1979); s*ee also, Chrysler Corp. v. Brown*, 441 U.S. 281, 313-15 (1979). The IRS's position, which it has most recently asserted in the briefs filed in the appeal of the Tax Court's *Intermountain* decision to the D.C. Circuit, is that its authority to issue temporary regulations under § 7805(e) trumps the APA. In *Mayo*, the Court found it important in applying *Chevron* deference that the regulations in question had been issued after notice and comment. Slip Op. at 12. Temporary regulations subject only to post-promulgation notice and comment for regulations may therefore not pass muster under *Mayo*, leaving open the question whether they can still be tested under *National Muffler*.

Sutherland Observation: *Mayo* did not address the deference, if any, to be afforded to less-formal guidance issued by the IRS, such as Revenue Rulings, Revenue Procedures, Chief Counsel Advice, Announcements, etc.

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