

Rethinking Validity Challenges to Tax Regulations

by Stuart J. Bassin

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In this article, Bassin examines the recent decision in *Silver* and its implications for challenges to IRS and Treasury regulations under the Administrative Procedure Act and related statutes.

When we were apprentice tax lawyers, we all learned the rules for challenging the validity of tax regulations. We learned to begin our analysis by determining whether the regulation was legislative or interpretative. While all tax regulations were granted judicial deference, legislative regulations were granted greater deference. If our clients were unhappy with a rule included in a regulation, they could challenge the rule as part of a deficiency or refund action, but only after an audit had been completed. Equally important, we were grateful to discover that we did not need to learn the ins and outs of administrative law because tax regulations were “exceptional” and not subject to the same rules as other agencies’ regulations.

The world began to change with the Supreme Court decision in *Mayo Foundation*.¹ The Court emphasized its commitment to a “uniform approach to judicial review of administrative action” and rejected application of a different set of rules in cases involving the taxing power. The degree of deference accorded to tax regulations did not depend on the old distinction between legislative and interpretative regulations. Many commentators have described the decision as heralding the demise of “tax exceptionalism.”

¹ *Mayo Foundation for Medical Education and Research v. United States*, 562 U.S. 44 (2011).

Drawing upon this fundamental change in the rules regarding tax regulations, innovative litigators have begun to pursue challenges to tax regulations that highlight defects in the procedures used by the IRS and Treasury in promulgating regulations. The litigators contend that regulations and other pronouncements are invalid because they were issued without compliance with statutorily mandated administrative procedures. The government has vigorously defended by arguing that courts lack jurisdiction to address these contentions, often citing the Anti-Injunction Act’s denial of judicial authority over any “suit for the purpose of restraining the assessment and collection of any tax.”²

The recent decision in *Silver*³ illustrates the challenges and implications in this brave new world. The plaintiffs in *Silver*, an American citizen and the controlled foreign corporation through which he practiced law in Israel, presented a multifaceted challenge to the validity of a prominent set of recent regulations implementing the transition tax under section 965. The plaintiffs argued that those regulations were invalid because the procedures used by the IRS and Treasury in promulgating the regulations violated the Administrative Procedure Act (APA),⁴ the Regulatory Flexibility Act (RFA),⁵ and the Paperwork Reduction Act (PRA).⁶

The government asserted its usual jurisdictional defenses, which were rejected by the district court, and the case will now proceed to a decision upon the merits of the taxpayers’ validity

² Section 7421.

³ *Silver v. Commissioner*, No. 19-247 (D.D.C. Dec. 24, 2019).

⁴ 5 U.S.C. section 551.

⁵ 5 U.S.C. section 601.

⁶ 44 U.S.C. section 3501.

challenges to the regulations. Of more general interest, the validity arguments advanced by the *Silver* plaintiffs may be available to other taxpayers seeking to challenge the validity of a broad collection of tax regulations.

Treasury's Noncompliance With APA

A series of statutes and an executive order govern the required procedures for promulgating regulations. The APA, for example, requires publication of a notice of proposed rulemaking, an opportunity for public comment and hearings, publication of a final rule, and an accompanying explanation of the agency's reasons for its choices and rejection of comments offered by the public. The RFA and PRA require agencies to address the concerns of small businesses during the rulemaking process, focusing on a requirement that the agency develop a regulatory flexibility analysis evaluating the impact of regulations on small businesses and considering less burdensome alternatives.

An executive order directs agencies to obtain approval of the Office of Management and Budget before issuing a regulation. Members of the public may file suit for judicial review of the agency's actions.⁷ Courts are authorized to set aside and rule unlawful any regulation or other agency actions that they find to be arbitrary, capricious, undertaken without compliance with required procedures, or were not supported by substantial evidence in the administrative record of the agency's actions.

Historically, the record of IRS and Treasury compliance with these requirements has been spotty, at best. A 1983 memorandum of agreement between OMB and Treasury largely exempted tax regulations from the OMB review procedure required under the executive order, although that agreement has been substantially modified within the past two years. (Of course, any agreement between OMB and Treasury cannot override the statutory requirements of the APA, RFA, and PRA.) While the IRS and Treasury have generally followed a "sort of" publication and comment process in promulgating regulations, compliance with other requirements has been less thorough.

⁷ See, e.g., 5 U.S.C. sections 611 and 701.

In 2016 the Government Accountability Office reported that only two of the more than 200 regulations issued between 2013 and 2015 complied with the RFA.

Government Responses to Challenges

Taxpayers have had mixed results in their challenges to IRS and Treasury pronouncements in cases focusing upon APA violations. In *Chamber of Commerce*,⁸ the taxpayer obtained an injunction against enforcement of a temporary regulation barring corporate inversions based on violations of the APA. In two other cases, *Florida Bankers Association* and *CIC Services*,⁹ divided courts of appeal panels rejected taxpayer efforts to enjoin enforcement of a regulation and a notice on jurisdictional grounds without reaching the merits of the asserted procedural violations. Questions involving the application of the APA to transfer pricing regulations also were addressed in *Altera*.¹⁰

The government's first line of defense to these suits continues to be that the courts lack jurisdiction to hear these cases. Almost all the decisions have rejected the government's basic argument that taxpayers cannot challenge the validity of an IRS or Treasury pronouncement through any vehicle other than a deficiency proceeding in Tax Court or a refund suit in district court or the Court of Federal Claims. The results have been mixed when the government's contention has been that the suit was barred by the Anti-Injunction Act.

Just before Christmas, the District Court for the District of Columbia rejected all the government's jurisdictional arguments in *Silver*. Characterizing the taxpayers' challenge as a claim under the APA, RFA, and PRA (not as a tax case), the court found that the taxpayers had standing to sue under the "procedural injury" line of precedent because of the compliance costs the taxpayers would incur. The court also rejected the

⁸ *Chamber of Commerce of the United States v. IRS*, No. 1:16-cv-00944 (W.D. Tex. 2017).

⁹ *Florida Bankers Association v. U.S. Department of the Treasury*, 799 F.3d 1065 (D.C. Cir. 2015); and *CIC Services LLC v. IRS*, 936 F.3d 501 (6th Cir. 2019); petition for cert. filed (U.S. Jan. 17, 2020).

¹⁰ *Altera Corp. v. Commissioner*, 145 T.C. 91 (2015), rev'd, 926 F.3d 1061 (9th Cir. 2019).

government's Anti-Injunction Act argument, stating that the taxpayers:

do not seek a refund or [to] impede revenue collection. Instead, they challenge the IRS's adopting of regulations without conducting statutorily mandated reviews designed to lessen the regulatory burden on small businesses. . . . Tax revenues and their collection are unaffected by such relief.

Thus, the court denied the government's motion to dismiss and will allow the case to proceed to a ruling on the merits — a ruling that could expose a fatal defect in the transition tax and many other regulations.

The Potential Implications of *Silver*

The *Silver* court has ordered the parties to propose a schedule for submitting briefs on the merits. At that time, the taxpayers will present their arguments regarding the statutory requirements for promulgation of regulations and the deficiencies in the procedures used by the IRS and Treasury in promulgating the transition tax regulations. It will be up to the government to demonstrate that it complied with the requirements of the APA, RFA, and PRA. A decision on the merits is likely later this year.

Should the court hold in the taxpayers' favor, questions will arise regarding the reach of the decision. Technically, *Silver* and his law firm are challenging only the regulations (not the underlying statute); they are addressing only the transition tax; they are the only plaintiffs in the suit; and many of their arguments are based on the statutory protections for small businesses. One can assume that the government would seek to narrowly construe the reach of an adverse decision. As a result, other taxpayers and their advisers would need to consider the extent to which they could rely upon a decision against the government.

On the other hand, if the GAO report has properly described the IRS's and Treasury's record of procedural noncompliance, a host of current regulations could be vulnerable to comparable challenges. The procedural statutes cited by the *Silver* plaintiffs date back decades and, given the relatively recent renunciation of the widespread

belief in tax exceptionalism by the *Mayo Foundation* court, it is unlikely that any defects in IRS and Treasury practices in promulgating regulations are a recent phenomenon. Taxpayers will have to individually consider the facts concerning promulgation of any specific regulation they might challenge, but one can imagine that taxpayers dissatisfied with the recent regulations issued to implement the Tax Cuts and Jobs Act will soon be consulting with their tax advisers.

Taxpayers interested in presenting similar challenges to regulations will also need to consider the available procedural options for presenting their claims. A pre-audit action under the RFA must be filed within one year of the promulgation of a challenged regulation. (This means that an RFA challenge to the global intangible low-taxed income regulations promulgated in June 2019 must be filed soon.) Similarly, taxpayers seeking to challenge regulations based on other APA violations before they are audited would likely want to file suit sooner rather than later; such a suit would focus on governmental misconduct (not the taxpayer's return) and could be brought in a refund forum without prepayment of a disputed tax. Other taxpayers may wait until late in the audit process before considering a challenge to a regulation based on APA violations.

To borrow from a Chinese proverb, these will be interesting times. ■