POINTS TO REMEMBER

Do Treasury and the Service Have to Explain Their Choices?

By Steve R. Johnson*

The validity of tax regulations has been challenged by taxpayers almost as long as there have been tax regulations. Now, however, we are in a period of unusually high activity on this front. The Supreme Court recently upheld the validity of a regulation under section 3121 in *Mayo Foundation for Medical Ed. and Research v. United States*, 131 S. Ct. 704 (2011); many cases are testing the validity of regulations extending the six-year statute of limitations under section 6501(e) to basis overstatements (or, as the Service would put it, clarifying the law in this regard); and many cases are testing the validity of regulations imposing a two-year limitations period on claims for equitable spousal relief under section 6015(f).

(One of the section 6501(e) cases is discussed in my article, Intermountain *and the Importance of Administrative Law in Tax Law*, Tax Notes, Aug. 23, 2010, at 837. *Mayo* and other cases are discussed in my article, Mayo *and the Future of Tax Regulations*, published in the March 28 issue of *Tax Notes*.)

This article addresses an interesting and potentially significant aspect of one of the cases involving the section 6015(f) regulations. The Tax Court has repeatedly held the regulation in question, section 1.6015-5(b)(1), to be invalid, and the action has shifted to the circuit courts. The Sixth Circuit has yet to weigh in. *Hall v. Commissioner*, 135 T.C. No. 19 (2010), *on appeal* No. 10-2628 (6th Cir.). Two other circuits have. Three-judge panels have reversed the Tax Court and upheld the validity of the regulation in *Lantz v. Commissioner*, 607 F.3d 479 (7th Cir. 2010), *rev'g* 132 T.C. 131 (2009), and *Mannella v. Commissioner*, 2011 WL 149379 (3d Cir. Jan. 19, 2011), *rev'g* 132 T.C. 196 (2009).

Five of the six judges on the *Lantz* and *Mannella* appellate panels saw the regulation as valid. The sole exception was Judge Ambro in *Mannella*. Like the other five appellate judges, Judge Ambro rejected the Tax Court's view that the regulation is invalid at *Chevron* Step One. *See Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842 (1984).

Instead, Judge Ambro thought the regulation invalid on a different theory: that the regulation fails at *Chevron* Step Two because "the IRS has not advanced any reasoning for its decision to impose a two-year limitations period on taxpayers seeking relief under [6015(f)], leaving us no basis to conduct the analysis mandated by *Chevron* step two." 2011 WL 149379 at *11. A month after *Mannella*, the Court of Federal Claims rejected a "failure to explain" challenge to a regulation under section 263A. *Dominion Resources, Inc. v. United States*, 2011 WL 722970, at *21-22 (Ct. Fed. Cl. Feb 25, 2011).

This Article addresses the "failure to explain" argument. Part I describes the administrative law obligation on agencies to explain the bases of their regulatory choices. Part II evaluates that obligation in the *Mannella–Lantz–Hall* context. Part III addresses the potential of the "failure to explain" argument when taxpayers challenge tax regulations in other contexts.

I. Agencies' Obligation to Explain

Numerous cases have held that administrative agencies are required to explain why they made the regulatory choices they did and that the agency's position can be reversed or, more frequently, remanded to the agency for better explanation before the position or rule can become effective. Judges and commentators have looked to various sources as the basis of the obligation to explain, including the Administrative Procedure Act ("APA") (5 U.S.C. §§ 553(c), 557(c), or 706(2)), administrative common law, *Chevron* Step Two, or the U.S. Constitution, including the delegation doctrine, other aspects of the separation of powers principle, and the Due Process and Equal Protection components of the Fifth Amendment.

Wherever the obligation may be located, numerous cases have invoked it. Some of the cases predated the proliferation of agencies in the New Deal Era. *E.g., American Express Co. v. South Dakota ex rel. Caldwell*, 244 U.S. 617 (1917).

Another plank in the doctrine was added by the *Chenery* cases decided near the time of the enactment of the APA. It is settled that a statute can be upheld—even if Congress articulated no reason (or a constitutionally defective reason) for it—as long as the court can devine or devise an acceptable reason. Similarly, an appellate court can affirm a lower court's decision—even if the decision rests on an erroneous foundation—if the appellate court can identify a sufficient alternative rationale. *Chenery* teaches that this is not the case with

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respect to acts by agencies: "an administrative order [or, as subsequent cases have established, an administrative regulation] cannot be upheld unless the grounds upon which the agency acted in exercising its powers were those upon which its action can be sustained." *SEC v. Chenery Corp.*, 318 U.S. 80, 95 (1943), *additional opinion*, 332 U.S. 194 (1947).

Increased judicial suspicion of agencies in the 1960s and 1970s gave rise to more rigorous review known as "hard look" review. Integral to such review was scrutiny of the agency's asserted reasons for its choice and correlation of those reasons with the purposes of the statute—rationality review. In the "hard look" tradition, the Supreme Court decided the *State Farm* case, repeating the *Chenery* injunction and holding that "an agency must cogently explain why it has exercised its discretion in a given manner." *Motor Vehicle Mfrs. Assn. of United States, Inc. v. State Farm Mut. Automobile Ins. Co.*, 463 U.S. 29, 48 (1983).

II. Obligation to Explain in *Mannella*

Judge Ambro considered, and found deficient, four rationales asserted by the Government in support of the challenged regulation: (1) the absence of a two-year deadline for section 6015(f) claims would render superfluous the statutory two-year deadline for section 6015(b) claims, (2) the Service can exercise its discretion under section 6015(f) to exclude a class of claimants (those who delay filing their claims), (3) the regulation is an exercise of the delegation to create procedures governing relief, and (4) the regulations reduce to manageable proportions the volume of claims for relief.

More important than his particular responses to the above rationales was the general response Judge Ambro essayed. In their various public pronouncements on the regulation, Treasury and the Service stated no reasons for imposing the two-year limitations period as to section 6015(f) equitable claims. Reasons were advanced in briefs in *Mannella*, but under *Chenery* and *State Farm* (both cited by Judge Ambro) *post facto* justifications by lawyers for the agency cannot take the place of contemporaneous explanation by the agency itself. *E.g.*, *State Farm*, 463 U.S. at 50 ("It is well established that an agency's action must be upheld, if at all, on the basis articulated by the agency itself.").

Neither of the judges in the *Mannella* majority responded to Judge Ambro's "failure to explain" argument. The Government did not have the opportunity to do so because, contrary to the usual rules of appeals, Judge Ambro's dissent raised the argument *sua sponte*. It had not appeared in the briefs or oral argument in the case.

However, the Government's opening brief in *Hall* pending before the Sixth Circuit did address the argument. There have been many explanation cases since *State Farm* was decided in 1983. The Government argued in its Sixth Circuit brief that, in light of *Verizon* (one of those subsequent cases), "Judge Ambro's criticism is . . . completely misconceived." Specifically, the Government maintained that *State Farm* applies only when an agency changes course, not when it is "taking a position in the first instance," which it was in the section 6015(f) regulation. Brief of Appellant, *Hall v. Commissioner*, No. 10-2628, at 58 (Jan. 26, 2011) (citing *Verizon Communications Inc. v. FCC,* 535 U.S. 467, 502 n.20 (2002)).

I do not find the Government's response convincing. *State Farm* did involve an agency changing its position, but numerous other "hard look" and explanation cases dealt with initial positions, not changed positions. The Government may be confusing what is accidental in one case with what is essential in a line of cases.

The Government's argument is hard to square with *Fox*, a 2009 Supreme Court decision refining *State Farm*. The *Fox* Court said: "We find no basis in the [APA] or in our opinions for a requirement that all agency change be subjected to more searching review. . . . [T]he agency need not always provide a more detailed justification [for a change of policy] than what would suffice for a new policy created on a blank slate." *FCC v. Fox Television Stations, Inc.*, 129 S. Ct. 1800, 1810–11 (2009). The explanation obligation applies to initial positions as well as to changed positions.

If the response it essayed in *Hall* is weak, does the Government have available a better response to the "failure to explain" argument? Perhaps so in the *Mannella* context. The case law recognizes various exceptions to the explanation obligation. One exception is situations in which it is obvious why the choice was made. *E.g., American Standard, Inc. v. United States*, 602 F.2d 256, 269 (Ct. Cl. 1979). This accords with the venerable maxim that the law does not command the commission of meaningless acts.

Arguably, this exception applies as to the regulation imposing the two-year limitations period with respect to section 6015(f) claims. Why are statutes of limitation ever created? The two standard reasons are finality and avoiding decisions based on stale evidence. Perhaps these purposes are so routine that they are obvious reasons for the two-year limit in the regulation.

This approach may gain additional traction as a result of *Mayo*. Some courts have used explanation failures as independent, sufficient-unto-themselves bases for invalidating regulations. Judge Ambro did not; he deployed the failure as part of his *Chevron* Step Two analysis. In *Mayo*, the Supreme Court held that Treasury may enlist enhanced administrability to establish the reasonableness of a regulation at Step Two. *Mayo*, *supra*, 131 S. Ct. at 715. The perhaps obvious finality and staleness reasons are part of administrability.

III. Obligation to Explain in Future Tax Cases

Whatever the ultimate fate of Judge Ambro's contention in the section 6015(f) cases, does "failure to explain" have a future in other cases? I think the answer is "yes"—*if* taxpayers' counsel are willing to immerse themselves in general administrative law enough to argue the issue skillfully.

It is clear that general administrative law does apply to tax rules and regulations. With exceptions not here relevant, the APA applies to all federal agencies, including Treasury and the Service. 5 U.S.C. § 551(1). Despite the desire of some to deny it, it has long been clear that tax is not exempt from general administrative law. The Supreme Court's unanimous *Mayo* decision ends any question in this regard. *See Mayo*, 131 S. Ct. at 712–13.

Moreover, Judge Ambro's opinion is not the first time the explanation obligation has appeared in a tax case. Some (though not many) previous cases have addressed it. *E.g.*, *American Standard, supra; Georgia Fed. Bank, F.S.B. v. Commissioner*, 98 T.C. 105, 110 (1992). More cases entailing challenges to tax regulations would have dealt with this issue had it been raised more often by taxpayers' counsel.

Mayo makes it more likely that counsel will wade into these waters in the future. In *Mayo* and in some other cases, taxpayers challenging Treasury regulations argued in part as follows: (1) *National Muffler*, not *Chevron*, provides the governing standard when tax regulations (especially general authority regulations promulgated under section 7805(a)) are challenged; (2) *National Muffler* is more rigorous than *Chevron*; and (3) the challenged regulation fails to pass muster under *National Muffler. National Muffler Dealers Assn., Inc. v. United States*, 440 U.S. 472 (1979).

As I argue in my March *Tax Notes* article, this argument was wrong and contorted the real meaning of *National Muffler*. In any event, the argument was decisively rejected in *Mayo*. *See* 131 S. Ct. at 711–14. It no longer is available to taxpayers, creating the need for aggrieved taxpayers to find other doctrinal bottles into which to pour the vinegar of their discontent.

That being so, one may expect taxpayers—in addition to pressing standard substantive contentions, such as that the regulation is inconsistent with the governing statute—to seek procedural grounds on which to attack inconvenient regulations. One of those grounds may be a *Mannella*-style argument that Treasury failed to adequately explain and justify the choices it made in the regulation. It will be interesting in the years to come to see what develops along this front. ■

The Service Traces Clearer Definitions in the Proposed Regulations on "Publicly Traded" Debt Instruments

By AJ Picchione*

My law school Contracts professor took some pleasure in pointing out various lexical oddities in our material. I vividly recall his introduction of the "parol evidence rule" as the triple misnomer. "Rule" is a misnomer because it is a principle, not a rule. "Evidence" is a misnomer because it is a principle of contract law, not of evidence. "Parol" is a misnomer because it applies to written as well as oral (*i.e.*, parol) statements. Tax law is similarly rife with inaccurately named concepts and defined terms that seem to defy common sense. One such crime against language perpetrated by the Service is the definition of "traded on an established securities market" under Regulations section 1.1273-2 or, as it is more commonly referred to, the "publicly traded" debt rule. Recently, the Service issued proposed regulations that, by most accounts, should substantially clarify many of the uncertainties under the current regulations.

Code section 1273 provides rules for determining the amount of original issue discount, or OID, attributable to certain debt instruments. Very generally, under section 1273, if the "issue price" of a debt instrument is less than the amount to be returned to the investor upon maturity of the instrument (excluding any normal interest payment that is paid at maturity), then that debt instrument is said to have been issued with OID. The consequence of holding a note with OID is that the holder must take portions of that "discount" into income over the term of the note, even though the cash is not received until maturity. This is the so called "phantom income" that haunts the debt markets. As a result of this phantom income, debt instruments issued with OID have a more limited pool of investors than do issuances of so called plain vanilla debt instruments. Specifically, taxable U.S. investors are generally less likely to purchase OID instruments. In the case of new issuances, OID instruments are often purchased by tax-exempt and non-U.S. investors. However, problems can arise

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