

Mayo v. United States: Treasury Earns Chevron Deference

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Prior to 2011, the Supreme Court had not articulated a clear standard for the deference to be given to Treasury regulations by the judiciary. Because of this ambiguity, taxpayers have been permitted to challenge the validity of the regulations through tax returns, with a reporting structure implemented for the express purpose of disclosing positions taken that are contrary to regulatory authority. See Form 8275-R—Regulation Disclosure Statement, available on the Service’s website. However, in its recent holding in the case of *Mayo Foundation for Medical Ed. and Research v. United States*, 131 S. Ct. 704 (Jan. 11, 2011), the Supreme Court arguably eliminated a taxpayer’s ability to successfully challenge a Treasury regulation unless such regulation is “arbitrary or capricious in substance, or manifestly contrary to the statute.” *Mayo*, 131 S. Ct. at 711 (quoting *Household Credit Services, Inc. v. Pfennig*, 541 U.S. 232, 242 (2004)). The *Mayo* case has the practical effect of giving Treasury regulations nearly “the force of law.” *Mayo*, 131 S. Ct. at 713 (quoting *United States v. Mead Corp.*, 533 U.S. 218, 226–27 (2001)).

History Before the Mayo Decision

Prior to the *Mayo* decision, two Supreme Court cases served as the most commonly cited authority for the deference owed to Treasury regulations by the courts: *National Muffler Dealers Assn., Inc. v. United States*, 440 U.S. 472 (1979), and *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

National Muffler

In *National Muffler*, an association of Midas franchisees sought to qualify for tax exemption as a business league, but failed a requirement set out only in a regulation. The association challenged the validity of the regulation, with the case ultimately being heard by the Supreme Court. In considering how much deference to give the regulation at issue, the Court examined multiple factors, including: 1) whether the regulation harmonized with the statutory language, its origin, and its purpose; 2) whether the regulation was enacted substantially contemporaneously with the statute; 3) the length of time the regulation was in effect; 4) the reliance previously placed upon the regulation; 5) the consistency of the Commissioner’s various interpretations; and 6) the extent

of congressional consideration of the regulation while enacting later legislation. Based on its analysis, the Court concluded that the regulation was a valid exercise of the authority delegated by Congress, and rejected the taxpayer’s challenge.

Chevron

At issue in *Chevron* was a regulation promulgated by the Environmental Protection Agency under the Clean Air Act. In analyzing the regulation, the Supreme Court ignored the multi-factor analysis of *National Muffler*, instead stating that, where a “statute is silent or ambiguous with respect 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. Where Congress has explicitly granted to an agency the authority to fill statutory gaps, such regulations “are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.” *Chevron*, 467 U.S. at 844. Even where the congressional delegation of authority is only implicit, “a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.” *Chevron*, 467 U.S. at 844. The Court did not even mention the *National Muffler* factors. The Court, determining that the regulation in question was not arbitrary, capricious, or

manifestly contrary to the statute, upheld its validity. The strong deference given to the regulatory authority by the Court in this case has come to be known as “*Chevron* deference.”

The Mayo Decision

For over two decades following *Chevron*, the courts, including the Supreme Court, variously cited to both *Chevron* and *National Muffler*, with *Chevron* gradually emerging as the dominant analysis. Against this background of authority, the Supreme Court decided *Mayo* on January 11, 2011. The *Mayo* litigation addressed Code section 3121(b)(10), which provides an exemption from FICA tax for work that is “incident to” a student’s education. The Mayo Foundation sought to apply the exclusion to medical residents, doctors who remain nominally “students” but who effectively work full-time in the treatment of patients. Following losses in prior litigation on the student work exemption, the Treasury Department promulgated a regulation stating that work was inherently not incident to a student’s education if the student was normally scheduled to work more than 40 hours per week. See Treas. Reg. § 31.3121(b)(10)-2(d)(3)(iii). The Mayo Foundation, a significant employer of medical residents, filed a claim for refund challenging this regulation’s validity. This suit was ultimately appealed to the Supreme Court.

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In upholding the regulation, the Supreme Court extended so-called *Chevron* deference to all Treasury regulations, rendering regulations binding on the courts so long as they are not “arbitrary or capricious in substance, or manifestly contrary to the statute.” *Mayo*, 131 S. Ct. at 711 (quoting *Household Credit*, 541 U.S. at 242). Based on this standard, the Court concluded that the regulation, representing a “reasonable construction of what Congress has said” in response to a question “to which Congress has not directly spoken,” was entitled to deference from the courts. *Mayo*, 131 S. Ct. at 716. While *Chevron*, by omitting any discussion of the *National Muffler* factors, implied that those factors were not relevant to the analysis, the holding in *Mayo* makes such irrelevance explicit. The Court stated that, under *Chevron*, “deference to an agency’s interpretation of an ambiguous statute does not turn on [the] considerations” set out in *National Muffler*. *Mayo*, 131 S. Ct. at 712. Agency inconsistency, proximity in time to the enactment of a statute, or promulgation of a regulation in response to litigation are now irrelevant to the analysis of the validity of such regulation. *Mayo*, 131 S. Ct. at 712–13. The Court concluded that “[t]he principles underlying our decision in *Chevron* apply with full force in the tax context.” *Mayo*, 131 S. Ct. at 713.

Additional Implications of *Mayo*

Of further note, the Court in *Mayo* also held that the distinction between general and specific grants of authority is no longer relevant. In prior cases, the Court had stated that a regulation enacted pursuant to a general delegation of rule-making power was entitled to less deference than a regulation promulgated under a specific grant of authority. See, e.g., *Rowan Cos. v. United States*, 452 U.S. 247 (1981); *United States v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982). In contrast, in *Mayo*, the Court specifically

stated that the deference due a regulation “does not turn on whether Congress’s delegation of authority was general or specific.” *Mayo*, 131 S. Ct. at 714. The Court concluded that the sole analysis is whether the regulation promulgated falls within the “gap-filling authority” granted to the regulatory agency. *Mayo*, 131 S. Ct. at 714 (quoting *Long Island Care at Home, Ltd. v. Coke*, 551 U.S. 158 (2007)). Given the language in section 7805(a), delegating to the Treasury the authority to “prescribe all needful rules and regulations for the enforcement of the Internal Revenue Code,” as referenced by the Court in its discussion, it appears the Treasury Department’s “gap-filling authority” is very broad indeed.

As an additional point of deference to the rulemaking power of executive agencies, the Supreme Court in *Mayo* also explicitly conferred the same controlling weight to regulations promulgated in direct response to an unfavorable result in litigation. The Court stated that it is “immaterial to our analysis that a regulation was prompted by litigation.” *Mayo*, 131 S. Ct. at 712 (quoting *Smiley v. Citibank (South Dakota), N. A.*, 517 U.S. 735, 741 (1996)). This, coupled with prior case law in which the Supreme Court invited the Treasury to overrule its holding through regulations, clearly confers judicial blessing on regulations promulgated to reverse losses in prior litigation. See, e.g., *United Dominion Industries, Inc. v. United States*, 532 U.S. 822 (2001) (“[T]o the extent the Government disagrees [with the result], it may amend its regulations to provide for a different one.”).

In summary, the Supreme Court held in *Mayo* that Treasury regulations are binding on the courts unless they are “arbitrary or capricious in substance, or manifestly contrary to the statute,” even if enacted in response to a loss in litigation or pursuant only to the general authority granted by Congress. It appears that regulations may now be

seen as effectively immune from challenge unless they are incompatible with the unambiguous language of the Code. It remains an open question whether or not a tax position taken contrary to a regulation may have a “reasonable basis,” thereby permitting a taxpayer to avoid the risk of a substantial underpayment penalty through disclosure of the position with the return. See I.R.C. § 6662(b)(2)(ii)(II). ■

