federal level. In this situation, the tax practitioner is generally left with two less than perfect options. The discussion below focuses on Maryland law; the practitioner is likely to find that rules in other jurisdictions are similar.

The first option is to appeal the state income tax assessment. The taxpayer is unlikely to find success at the state level until the appeal is resolved at the federal level because many states limit the allowable items on a taxpayer's state income tax returns to the allowed federal amounts. For example, under Maryland law, an individual's Maryland adjusted gross income and itemized deductions are limited to the individual's federal adjusted gross income and federal itemized deductions for the tax year. Md. Code Ann., Tax-Gen. §§ 10-203, 10-218(b). A corporation's Maryland modified income is the corporation's federal taxable income for the taxable year. Md. Code Ann., Tax-Gen. § 10-304(1). As a result, the representative's efforts may be hamstrung until resolution of the federal tax issues. If the practitioner elects to resolve the case through the state's appeal process, the best plan is to request a delay of the state's first hearing in order for the federal appeal to be resolved.

The second option is to pay the assessment of tax, interest, and penalty to prevent the accrual of interest while the federal tax dispute is pending. The taxpayer should then file a refund claim for the amount paid. There are, of course, concerns with taking this approach. The taxpayer may be apprehensive about paying the state tax liability up front, operating under the mistaken belief that once the state has his or her money, the state will never agree to refund it. Although the issue involved is slightly different because only local taxes were involved, the recent decision in *Armour v. City of Indianapolis*, 132 S. Ct. 2073 (2012), did nothing to assuage taxpayers' concerns about prepayment of taxes. A more difficult problem with this option is often the lack of available funds.

If the taxpayer is able to pay the amount due and the taxpayer is later victorious at the federal level, the representative must be very careful to monitor the period of limitations on refund claims. Under Maryland law, taxpayers may claim a refund of taxes no later than one year from the date of: (1) a final adjustment report of the Service; or (2) a final decision of the highest U.S. court to which an appeal of a final decision of the Service is taken. Md. Code Ann., Tax-Gen. § 13-1104(c)(2). After the federal tax issues have been resolved, the representative should file the taxpayer's amended state income tax return as soon as possible, lest disaster ensue. *See King v. Comptroller of the Treasury*, 425 Md. 171, 38 A.3d 433 (2012) (statute of limitations for filing refund suit began running when the Service identified adjustments to personal liability attributable to a partnership audit). Depending on the state, the statute may even provide for payment of interest on prepayment by the taxpayer. ■

Validity of Guidance Questioned by the Courts

By Adam C. Silva*

Two recent court decisions call into question the validity of administrative guidance issued by Treasury and the Service. In one case, the District Court for the District of Columbia held that an IRS Notice violated the Administrative Procedure Act (APA) because it failed to comply with the APA's notice-and-comment requirements. The Court of Appeals for the D.C. Circuit dealt a second blow when it invalidated a regulation, ruling that Treasury acted contrary to section 706(2) of the APA because it did not provide a reasoned explanation when it issued the regulation as required by Supreme Court precedent.

Generally, the APA requires that notice of proposed rulemaking be published in the *Federal Register* and that interested parties be given at least thirty days to comment on the proposed rules. *See* APA § 553. After consideration of the relevant matters presented, the agency must incorporate in the rules adopted a concise general statement of the rules' basis and purpose. *Id.* Additionally, the Supreme Court has held that "the agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choices made.'" *Motor Vehicles Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

Notices are typically issued by the Service without APA notice-and-comment. *In re Long-Distance Tel. Serv. Fed. Excise Tax Refund Litig.*, 2012 WL 1179063 (Miscellaneous Action No. 07-014 (RMU)) (D.D.C. April 10, 2012), involved the Service's telephone excise tax refund procedures. The D.C. Circuit had remanded the case to the district court after finding that Notice 2006-50 bound the Service, tax collectors, and taxpayers and that the district court had jurisdiction to hear the case. *Cohen v. United States*, 578 F.3d 1, 8 (D.C. Cir. 2009), *vacated in part*, 599 F.3d 652

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(D.C. Cir. 2010), and 650 F.3d 717 (D.C. Cir. 2011) (*en banc*). Upon remand, the district court found that the Service was required to abide by the APA's notice-and-comment requirements and that it had failed to meet these requirements. The district court vacated Notice 2006-50 prospectively. *In re Long-Distance Tel. Serv. Fed. Excise Tax Refund Litig.*

Dominion Res., Inc. v. United States, 681 F.3d 1313 (D.C. Cir. May 31, 2012), involved a dispute between a taxpayer and the Service over the proper timing of an interest expense. The Service applied regulation section 1.263A-11(e)(1)(ii)(B) to capitalize a $3.3 million deduction taken by the taxpayer. In ruling for the taxpayer, the D.C. Circuit invalidated the regulation. The court held that the regulation was not a reasonable interpretation of section 263A. *Id.* at 1317–19. It further held that the Department of Treasury acted contrary to section 706 of the APA in failing to provide a reasoned explanation when it promulgated the regulation. The court explained that it is not enough for Treasury to merely alert interested potential commentators of the issues at the heart of the regulations but, rather, under *State Farm*, Treasury regulations must articulate a satisfactory or cogent explanation for their promulgation. *Id.* at 1319.

It is difficult to draw a principled distinction between Notice 2006-50, rejected by the D.C. District Court for failing to follow notice-and-comment requirements of the APA, and scores of other binding Service guidance items promulgated with similar deficiencies. It is too early to tell what effect *In re Long-Distance Telephone Service Federal Excise Tax Refund Litigation* will mean for the future of guidance promulgated without adhering to the requirements of the APA and whether any other court will adopt its rationale. Subjecting Service guidance for non-regulation matters to APA notice-and-comment requirements would add another burden to guidance that is already too little and too slow and may not be in the best interests of taxpayers.

Guidance such as notices, revenue rulings, and revenue procedures appear to be the most vulnerable in the instances where they bind the Service, tax collectors, and taxpayers. Furthermore, the district court's analysis of the good cause and harmless error exceptions to the APA's notice-and-comment requirements can be applied to any number of guidance items: "… the defendant's 'utter failure to comply with notice and comment' cannot be considered harmless error since there is 'uncertainty … as to the effect of that failure.'" *In re Long-Distance Tel. Serv. Fed. Excise Tax Refund Litig.*, *supra*, at *4 (quoting *AFL-CIO v. Chao*, 496 F. Supp. 2d 76, 89 (D.D.C. 2007)).

Treasury regulations may be less vulnerable to a notice-and-comment challenge than notices, revenue rulings, and revenue procedures. Treasury regulations almost always involve a form of notice-and-comment. Typically, Treasury issues a notice of proposed rulemaking at the same time it issues temporary regulations, reviews the resulting comments, and then finalizes the regulations with or without changes. *See generally* Kristin E. Hickman, *A Problem of Remedy: Responding to Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 76 Geo. Wash. L. Rev. 1153, 1160 (2008). The finalized regulations have therefore undergone notice-and-comment, albeit in an altered form. For example, the regulation invalidated in *Dominion Resources* was promulgated following notice-and-comment procedures.

With respect to temporary regulations, it may be difficult to apply APA notice-and-comment requirements. Section 7805(e) specifically allows Treasury to issue temporary regulations, which can be retroactive under certain situations set out in section 7805(b), provided that the government also issues proposed regulations at the same time. Further, any temporary regulation issued after November 20, 1988, expires within 3 years after the date of its issuance. Thus, it appears that section 7805(e) contemplates that Treasury may issue a temporary regulation before proposed regulations have undergone notice-and-comment. However, courts have not yet addressed whether section 7805(e) trumps APA notice-and-comment requirements. The two rules seemingly are in conflict with one another.

Notice-and-comment compliance aside, Treasury regulations with deficiencies similar to the regulation invalidated in *Dominion Resources* may be vulnerable. While the court found that regulation section 1.263A-11(e)(1)(ii)(B) was invalid as an unreasonable interpretation of section 263A regardless of whether it contained a reasoned explanation, undoubtedly this regulation is not the lone Treasury regulation promulgated without the requisite reasoned explanation. After *Dominion Resources*, these regulations appear to be susceptible to challenges based on their failure to comply with the APA's requirement to have a reasoned explanation. Even if the APA notice-and-comment requirement is not applicable to a temporary Treasury regulation, there is no reason why the rationale in *Dominion Resources* and *State Farm*—that the agency needs to supply a reasoned explanation for its rule adopted in a temporary regulation—does not apply.

While not specifically addressing whether Treasury regulations are subject to the APA, the Supreme Court noted in *Mayo Found. for Med. Educ. v. United States*, 131 S. Ct. 704 (2011), that the regulation in question in *Mayo* was issued after notice-and-comment. *Id.* at 714. The Court indicated that this was a good indicator of *Chevron* deference. This reference to notice-and-comment likely indicates that the Supreme Court believes that Treasury regulations are

subject to the APA as are other federal agency regulations.

Whether this means that more regulations will be invalidated or whether Treasury will revisit deficient regulations and provide a reasoned explanation remains to be seen. While it may be tempting to argue that a broad spectrum of guidance is invalid, it is difficult to believe that these cases alone provide a basis to negate decades of such guidance. A more thoughtful approach is likely required to select which regulations may be susceptible to a successful challenge. ■

Entergy v. Commissioner: The "Untenable" Circuit Split

By Matthew R. Sontag*

In a prime example of the incongruous outcomes that can flow from the U.S. circuit court system, on June 5, 2012, the Fifth Circuit split from recent Third Circuit precedent and allowed a U.S. foreign tax credit for the U.K. Windfall Profits Tax (Windfall Tax). As a result, two taxpayers with "materially identical facts" have sustained incremental U.S. federal income tax liabilities on dividend income from a foreign affiliate that differ by tens of millions of dollars based solely on the parent's appellate venue.

The importance, and potentially lasting influence, of this circuit split flows directly from the courts' divergent analysis of the specific implementation of the foreign tax at issue. Any discussion must therefore begin with the precise and calculated manner in which the Windfall Tax was forged.

The U.K. Windfall Profits Tax

From the late eighties to the mid-nineties, the British government sold 32 then-public utilities into private hands. Freed of state control, the performance of these businesses rapidly surpassed even the most optimistic projections. As a result, corporate insiders and the privatizing investors realized enormous—and politically untenable—profits.

In an attempt to minimize the fallout, the U.K. government formulated the Windfall Tax, a charge to be levied only once, and only upon the 32 specific privatized taxpayers. Imposed at a nominal rate of 23%, the Windfall Tax applied to the difference between each of the formerly-public companies' "flotation price" and its "profit-making value."

As a mechanism to simplify valuation, the enacting statute defined profit-making value as nine times the annual earnings of the company averaged, in almost every case, over the four years following privatization. (The actual formula was 23% x [{(365 x (Profits / 1,461)) x 9} – Flotation Value]. *PPL Corp. v. Commissioner*, 135 T.C. 304, 328 (2010).) This calculation could be mathematically reformulated as an incremental 52% surtax on after-tax annual profits in excess of that which produced a flotation-price-to-earnings ratio of 9, being "the lowest average price/earnings ratio of the taxpaying companies during the relevant periods, grouped by sector." *Id.* at 314–15, quoting the U.K. Inland Revenue announcement dated July 2, 1997.

It is important to remember that, despite the complex calculation required, at its core the Windfall Tax was explicitly designed to impose a specific charge at a specific rate on a specific set of entities, based entirely on events which had already transpired at the time of enactment. The Windfall Tax ultimately achieved precisely that goal—31 of the 32 privatized companies paid the Windfall Tax, 29 of them at or near the 52% reformulated rate. *Id.* at 329. Ultimately the forecasted revenues from the Windfall Tax matched the actual money raised with "extreme accuracy." *Entergy Corp. v. Commissioner*, 683 F.3d 233, 238 (5th Cir. 2012) (*Entergy II*). Finally, consistent with its purpose, the Windfall Tax was a one-time charge—having provided for a single levy against profit-making value for a specified known group of companies, the Windfall Tax never again applied under any circumstances to any taxpayer.

The Credit and the Tax Court Opinion

At the time the Windfall Tax was assessed, U.S. companies had come to own significant stakes in several of the privatized enterprises. Typically, these U.S. investors responded to the Windfall Tax by claiming a deemed-paid credit under section 902 against the U.S. tax imposed on dividends received from the U.K. companies. The Service challenged these credits, and litigation ultimately ensued. The two cases giving rise to the circuit split, *PPL* and *Entergy*, were decided by the Tax Court in favor of the respective taxpayers on September 9, 2010, under the same written opinion. The opinion issued in *Entergy* states simply that that case, having "materially identical facts," was decided—without further discussion—in reliance upon the decision and opinion rendered in *PPL*. *Entergy v. Commissioner*, T.C. Memo 2010-197, 100 T.C.M. (CCH) 202 (2010).

In the *PPL* opinion, the Tax Court sought to determine whether the Windfall Tax was an "income, war profits, or excess profits tax" as those

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