

## The Limits of *Mayo Foundation v. United States*: Retroactive Regs

By Stuart J. Bassin and Beatrice Larkin

Stuart J. Bassin is a partner at the Washington office of Baker & Hostetler LLP, where he serves as practice team leader for the firm's tax litigation practice. Beatrice Larkin is a member of the New York Bar and an LLM (taxation) candidate at Georgetown University Law Center. She is completing an externship at Baker & Hostetler.

Many practitioners have commented on the impact of the Supreme Court's *Mayo* decision on the susceptibility of IRS regulations to validity challenges. This article focuses on *Mayo's* effect on challenges to the retroactive application of IRS regulations — an area of frequent litigation. The authors show that while *Mayo* will eliminate several arguments previously advanced by taxpayers, it leaves retroactive regulations vulnerable to validity challenges in important ways.

The U.S. Supreme Court's recent opinion in *Mayo Foundation v. United States*<sup>1</sup> was a watershed moment for both administrative law and tax law. The decision, which addressed the validity of a Treasury regulation promulgated to resolve a frequently litigated issue involving the tax treatment of medical resident stipends, refined the analysis used to evaluate validity challenges to tax regulations. A unanimous Court upheld the validity of the challenged regulation, and, more importantly, it appears to have lowered the standards that the government must satisfy in defending Treasury regulations.

Practitioners must now grapple with the question of *Mayo's* implications for future challenges to regulations. The Supreme Court viewed the decision as reconciling two lines of authority that enunciated standards of agency deference to be used in evaluating the validity of tax regulations — *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*<sup>2</sup> and *National Muffler Dealers Assn. Inc. v. United States*.<sup>3</sup> Nonetheless, some have viewed the opinion

far more broadly, suggesting that it significantly raises the bar for taxpayers when challenging regulations. They claim that *Mayo* will render it far more difficult to sustain a successful validity challenge to a regulation.<sup>4</sup> Of course, the real impact of *Mayo* will be measured through future decisions addressing validity challenges to Treasury's exercise of its regulation-writing authority.

One area in which the effect of *Mayo* is likely to be litigated involves challenges to the validity of determinations to apply new Treasury regulations retroactively. Taxpayers raising those challenges will invoke section 7805(b) as amended by the 1996 Taxpayer Bill of Rights,<sup>5</sup> which creates a presumption that newly promulgated regulations will apply prospectively only but leaves Treasury and the IRS the authority to apply new regulations retroactively under limited circumstances. Determinations to apply regulations retroactively under the statute have been litigated frequently in recent years, with mixed results. With Treasury and the IRS likely emboldened by their reading of *Mayo* as providing for greater deference to their regulatory actions,<sup>6</sup> one can expect them to attempt to apply more new regulations retroactively. The question practitioners must now consider is whether *Mayo* makes it easier for the government to defend challenges to the retroactive application of Treasury regulations.

### The *Mayo* Decision

The applicability of the FICA tax regime to medical resident stipends has been the subject of much litigation in the past decade. In those cases, the IRS contended that the stipends were wages for work performed by the residents and were therefore subject to FICA taxes. Teaching hospitals maintained that the stipends were in the nature of a scholarship, and therefore not subject to FICA taxes,

<sup>4</sup>See Jeremiah Coder, "The State of Tax Guidance After *Mayo*," *Tax Notes*, Feb. 7, 2011, p. 615, *Doc 2011-2419*, or *2011 TNT 25-1*; "Supreme Court Holds That Interpretive IRS Regs Are Entitled to Heightened Deference," *57 Fed. Taxes Weekly Alert* no. 3 (Jan. 20, 2011); and Coder, "*Mayo's* Unanswered Questions," *Tax Notes*, Mar. 7, 2011, p. 1118, *Doc 2011-4586*, or *2011 TNT 43-2*.

<sup>5</sup>P.L. 104-168 (1996).

<sup>6</sup>In a recent speech, IRS Chief Counsel William J. Wilkins said that he views the *Mayo* decision as reinforcing the Service's ability to issue regulations that are contrary to prior case law and that the IRS will raise the decision in cases on the validity of regulations, *Doc 2011-2194*, *2011 TNT 22-15*.

<sup>1</sup>131 S. Ct. 704 (Jan. 11, 2011), *Doc 2011-609*, *2011 TNT 8-10*.

<sup>2</sup>467 U.S. 837 (1984).

<sup>3</sup>440 U.S. 472 (1979).

because the residents' work was "incident to and for the purpose of pursuing a course of study." The courts were divided on the question.<sup>7</sup>

The IRS attempted to end the controversy by promulgating reg. section 31.3121(b)(10)-2 in December 2004.<sup>8</sup> The regulation, which applied prospectively only, essentially codified the government's litigating position that the services of medical residents were not incident to and for the purpose of pursuing a course of study and that the amounts received were wages subject to FICA taxes. The IRS later conceded all the pending cases involving tax periods before the effective date of the regulation.<sup>9</sup>

Even after the regulation became effective, some taxpayers continued to contend that medical resident stipends were not subject to FICA taxes. They asserted that the regulation was invalid because it was inconsistent with the underlying statutory provision, and they argued that the less deferential test established in *National Muffler* should govern analysis of the regulation's validity, not the more deferential *Chevron* test. In their view, the FICA regulation was an interpretative regulation promulgated under Treasury's general rulemaking authority under section 7805(a), not a legislative regulation promulgated under a specific congressional grant of authority, and therefore it was not entitled to the level of deference afforded by *Chevron*. Under the *National Muffler* test, the validity of the regulation depended on a number of factors, including its contemporaneity with the enactment of the relevant statutory provision, its consistency with prior agency and judicial interpretation of the statute, and whether it was promulgated to address pending litigation.

Those arguments were first tested in the district court in *Mayo*,<sup>10</sup> which found that the regulation was invalid. Pointing to *National Muffler*, the court noted that the amended regulation was issued 65 years after the student exemption was enacted, that it was issued in response to adverse court decisions,

and that it was inconsistent with the IRS's long-standing interpretation of the student exemption statute. The Eighth Circuit reversed and upheld the regulation.<sup>11</sup> Applying the *Chevron* test, the appellate court concluded that the regulation was valid because it represented a reasonable interpretation of an ambiguous statute. The Mayo Foundation filed a petition for certiorari, which the government opposed, and the Supreme Court granted the petition.

On January 11 the Supreme Court issued a unanimous decision affirming the Eighth Circuit's ruling and upholding the validity of the regulation. The Court analyzed the regulation's validity under the two-part *Chevron* test, rejecting essentially all the Mayo Foundation's arguments. The Court dispensed with the traditional distinction between interpretative and legislative regulations, concluding that a single standard of review applies to both categories. Also, the Court found the factors commonly cited by taxpayers invoking the *National Muffler* line of authority — agency inconsistency, lack of contemporaneity with the statute, and issuance in response to litigation — irrelevant to the analysis.

Instead, the Court held that the regulation was subject to review solely under a two-part test based on the *Chevron* line of cases. The first part of the test asks whether Congress has "directly addressed the precise question at issue," because regulations cannot override an unambiguous statute. Concluding that the statute was ambiguous on its application to medical residents, the Court determined that the regulation satisfied this first test. The Court proceeded to the second part of the prong, which asks whether the regulation is "arbitrary or capricious in substance." The Court had no difficulty concluding that the second part of the test was satisfied. It described the regulation as a "perfectly sensible" way to determine eligibility for the FICA student exemption, promoting administrative convenience, furthering the purpose of the Social Security Act, and adhering to precedent requiring the narrow interpretation of exemptions from taxation.

### Retroactive Regulations Under Section 7805(b)

When Treasury issues a new regulation, the question arises whether it applies retroactively to transactions and periods preceding promulgation of the regulation. In theory, retroactive application is appropriate when the regulation merely clarifies existing law, and it is inappropriate when the regulation changes existing law and requirements. Retroactive application of regulations is governed

<sup>7</sup>Compare *United States v. Mem'l Sloan-Kettering Cancer Ctr.*, 563 F.3d 19, 27 (2d Cir. 2009), *Doc 2009-6657*, 2009 TNT 56-7; *United States v. Detroit Med. Ctr.*, 557 F.3d 412, 417-418 (6th Cir. 2009), *Doc 2009-4255*, 2009 TNT 37-16; *Univ. of Chi. Hosps. v. United States*, 545 F.3d 564, 567 (7th Cir. 2008), *Doc 2008-20287*, 2008 TNT 186-17; *United States v. Mount Sinai Med. Ctr. of Fla. Inc.*, 486 F.3d 1248, 1251-1256 (11th Cir. 2007), *Doc 2007-12257*, 2007 TNT 98-14 (medical residents can qualify for FICA student exemption); with *Albany Med. Ctr. v. United States* (N.D.N.Y. 2007); *United States v. Detroit Medical Center* (E.D. Mich. 2006) (medical residents ineligible for FICA student exemption).

<sup>8</sup>T.D. 9167, *Doc 2004-24024*, 2004 TNT 245-7.

<sup>9</sup>IR-2010-25, *Doc 2010-4482*, 2010 TNT 41-9.

<sup>10</sup>503 F. Supp.2d 1164 (D. Minn. 2007), *Doc 2007-18316*, 2007 TNT 153-7.

<sup>11</sup>568 F.3d 675 (8th Cir. 2009), *Doc 2009-13439*, 2009 TNT 112-75.

by section 7805(b), which created a presumption that regulations apply retroactively. The 1996 Taxpayer Bill of Rights legislation reversed that presumption and now creates a presumption that regulations do not apply retroactively.

Even under the old section 7805(b), the government's decision to apply a Treasury regulation retroactively was reviewable for abuse of discretion, and taxpayers occasionally succeeded in challenging retroactive applications. The leading case was *Anderson, Clayton & Co. v. United States*,<sup>12</sup> which identified four principal considerations in evaluating challenges to the IRS's retroactivity determinations: (1) the extent to which the taxpayer relied on prior law or policy and the extent to which the regulation alters that law or policy; (2) the extent to which the prior law or policy has been implicitly approved by Congress; (3) whether retroactivity would advance or frustrate the interest in equality of treatment among similarly situated taxpayers; and (4) whether retroactivity would produce an inordinately harsh result. In many respects, this standard is similar to the analysis under *National Muffler*, and taxpayers had some success in challenging Treasury regulations under that standard.<sup>13</sup>

The amendment of section 7805(b) as part of the 1996 Taxpayer Bill of Rights was designed to restrict the retroactive application of new Treasury regulations. In general, it provides that the application of any temporary, proposed, or final regulation shall be prospective only, unless one of six enumerated conditions is met: (1) the regulation was issued within 18 months of the enactment date of the related statutory provision; (2) the regulation was issued to prevent abuse; (3) the regulation was issued to correct a procedural defect in the issuance of a prior regulation; (4) the regulation relates to internal Treasury policies and procedures; (5) Congress has made a specific legislative grant authorizing the Treasury secretary to prescribe a retroactive effective date for a specific regulation; or (6) the taxpayer is allowed to elect to apply the regulation retroactively.<sup>14</sup> Under the revised statute, the IRS may still apply new regulations retroactively, but its discretion is narrowly circumscribed.

Since the amendment of section 7805(b), taxpayer challenges to the retroactive application of Treasury regulations have centered on reg. section 1.752-6. That regulation was issued in response to the proliferation of the son-of-BOSS tax strategy, which

involved the purchase and sale of offsetting currency options and their subsequent contribution to a newly formed partnership. Taxpayers asserted that under section 752, a partner's basis in his partnership interest (outside basis) was increased by the value of the purchased option but not reduced by the value of the sold option, because the sold option was a contingent liability. Thus, they contended that a partner who contributed offsetting options to the partnership had a high outside basis in the partnership and that when the partner later sold his partnership interest at its much lower fair market value, the partner could recognize a large loss.

Reg. section 1.752-6 grew out of Notice 2000-44,<sup>15</sup> which the IRS released in August 2000 to advise taxpayers that it would be promulgating regulations designed to bar the section 752 arguments and that the regulations would be effective retroactively. True to its word, the IRS issued the final version of reg. section 1.752-6 in May 2005.<sup>16</sup> The regulation expands the definition of liability for purposes of section 752 to include contingent liabilities, thus invalidating the legal theory underlying the son-of-BOSS tax strategy. The preamble explains that the regulation applies retroactively to transactions after October 18, 1999, and it cites the grant of authority in section 309 of the Community Renewal Tax Relief Act of 2000 (the 2000 Act) as authority for retroactive application.<sup>17</sup>

The courts have been divided on whether the retroactive application of reg. section 1.752-6 is valid. Relying on the 2000 Act, the government has argued in these cases that retroactive application is permitted by both the antiabuse exception and the legislative grant of authority exception of section 7805(b). Taxpayers have maintained that retroactive application of the regulation is not authorized by that statute.

The courts in *Murfam Farms LLC v. United States*,<sup>18</sup> *Stobie Creek Investments LLC v. United States*,<sup>19</sup> and *Klamath Strategic Investment Fund LLC v. United States*<sup>20</sup> invalidated retroactive application of the regulation. They construed section 309 of the 2000

<sup>12</sup>562 F.2d 972 (5th Cir. 1977).

<sup>13</sup>See *Gehl Co. v. Commissioner*, 795 F.2d 1324 (7th Cir. 1986); *LeCroy Research Sys. Corp. v. Commissioner*, 751 F.2d 123 (2d Cir. 1984); and *CWT Farms Inc. v. Commissioner*, 755 F.2d 790 (11th Cir. 1985).

<sup>14</sup>Section 7805(b)(2)-(7).

<sup>15</sup>2000-2 C.B. 255, *Doc 2000-21236*, 2000 TNT 157-7.

<sup>16</sup>T.D. 9207, *Doc 2005-11348*, 2005 TNT 99-14.

<sup>17</sup>Section 309 of the 2000 Act authorized Treasury to issue regulations providing for "appropriate adjustments . . . to prevent the acceleration or duplication of losses through the assumption of (or the transfer of assets subject to) liabilities described in section 358(h)(3) . . . in transactions involving partnerships." The definition of liability in section 358(h)(3) covers both fixed and contingent liabilities. P.L. 106-554 (2000).

<sup>18</sup>88 Fed.Cl. 516 (2009), *Doc 2009-17336*, 2009 TNT 146-84.

<sup>19</sup>82 Fed.Cl. 636 (2008), *Doc 2008-16870*, 2008 TNT 149-5.

<sup>20</sup>440 F. Supp.2d 608 (E.D. Tex. 2006), *Doc 2006-13753*, 2006 TNT 140-14.

Act narrowly, as authorizing a retroactive regulation only in situations involving acceleration and duplication of losses. The challenged regulation did not involve a loss duplication situation and, according to those courts, was not authorized by the congressional mandate of the 2000 Act. Interestingly, the *Klamath* court went on to apply the *Anderson*, *Clayton* factors, concluding that the challenged regulation was invalid primarily because it changed a well-established IRS legal position.<sup>21</sup>

Conversely, in *Cemco Investors LLC v. United States*,<sup>22</sup> the court affirmed the retroactive application of reg. section 1.752-6. Unlike the other courts, the Seventh Circuit determined that section 309 of the 2000 Act authorized retroactive application of the regulation. The *Cemco* court read the statute more generously, relying on evidence of the broader context in which the regulation was drafted to establish the regulation's connection to the authorizing statute. Interestingly, on finding the legislative grant of authority for a retroactive regulation, the court made no further inquiry into the reasonableness of the IRS's decision to apply the regulation retroactively.

### Challenges to Retroactivity After *Mayo*

The *Mayo* decision, endorsing the *Chevron* test as the review standard for all Treasury regulations, established a two-step analysis for evaluating the validity of a regulation. In the context of a retroactive regulation, the first step would be to ask whether Congress has directly spoken to the precise question of retroactivity. The second step would involve an inquiry into whether retroactive application of the regulation is arbitrary and capricious.

Several of the arguments made by taxpayers in prior challenges to the validity of retroactive Treasury regulations appear to have lost much of their force in light of *Mayo*. Labeling the challenged regulation as interpretive would seem to provide little benefit for taxpayers, and the *Anderson*, *Clayton* factors appear to play a very limited role in the analysis, perhaps helping taxpayers establish that retroactive application of a regulation is arbitrary or capricious in substance — the relevant inquiry under *Chevron*. Evidence of a change in the IRS's position on a legal issue or evidence that a regula-

tion was promulgated to dispose of pending litigation might have more influence after *Mayo*.

But *Mayo* does not give Treasury and the IRS carte blanche to promulgate retroactive regulations. *Chevron* still requires an evaluation of whether a statute unambiguously addresses the issue. Inconsistency with an unambiguous statutory provision will result in a regulation's automatic invalidation, and no level of deference — *Chevron* or otherwise — is afforded to the regulation.

In analyzing a retroactive regulation, two statutory provisions must be considered: section 7805(b), which sets the limitations for retroactive application, and the specific provision that the regulation purports to construe. Under section 7805(b), the burden is on the government to show that a specific statutory provision authorizes retroactive application of a regulation. When a court finds the regulation to have exceeded the congressional grant of authority, as in *Klamath* and *Murfam Farms*, retroactivity is not allowed. Section 7805(b) thus acts as an express statutory limitation on Treasury's retroactive rulemaking authority.

This reversal of burdens makes it much easier for a taxpayer to challenge a retroactive regulation. In a challenge to a prospective regulation, the challenger must demonstrate the regulation's inconsistency with a statutory provision. In contrast, the IRS bears the burden of proving statutory authority for the validity of retroactive application. When the statutes are somewhat ambiguous, the ambiguity may weigh in favor of the IRS in a challenge to a prospective regulation, but it weighs against the Service in a challenge to a retroactive regulation.

The importance of statutory authorization as a limitation on Treasury and the IRS's rulemaking authority even after *Mayo* (particularly authorization for retroactive regulations) is demonstrated by the recent decisions in *Home Concrete & Supply LLC v. United States*<sup>23</sup> and *Burks v. United States*.<sup>24</sup> Both cases involved section 6501(e)(1), which establishes a six-year statute of limitations for assessment and collection when the "taxpayer omits from gross income an amount properly includible therein." Prior judicial decisions, primarily the Supreme Court's decision in *Colony Inc. v. Commissioner*,<sup>25</sup> had construed section 6501 not to authorize an extended statute of limitations in cases involving an overstatement of basis, because a basis overstatement was not an omission from gross income. In

<sup>21</sup>Both *Stobie Creek* and *Klamath* were appealed, but neither appellate decision addressed the validity of the retroactive application of reg. section 1.752-6. *Stobie Creek Investments LLC v. United States*, 608 F.3d 1366 (Fed. Cir. 2010), *Doc 2010-12971*, 2010 TNT 113-15; and *Klamath Strategic Investment Fund ex rel. St. Croix Ventures v. United States*, 568 F.3d 537 (5th Cir. 2009), *Doc 2009-11265*, 2009 TNT 94-15.

<sup>22</sup>515 F.3d 749 (7th Cir. 2008), *Doc 2008-2695*, 2008 TNT 27-8.

<sup>23</sup>No. 09-2354 (4th Cir. Feb. 7, 2011), *Doc 2011-2674*, 2011 TNT 26-7. Earlier this month, the Fourth Circuit rejected the government's request for rehearing. *See Doc 2011-7254*, 2011 TNT 66-14.

<sup>24</sup>Nos. 09-11061, 09-60827 (5th Cir. Feb. 9, 2011), *Doc 2011-2857*, 2011 TNT 28-12.

<sup>25</sup>357 U.S. 28 (1958).

September 2009, after losing a Federal Circuit case in which it had argued that a six-year statute applied to an overstatement of basis, the IRS issued reg. section 301.6501(e)-1(a)(1)(iii),<sup>26</sup> which provided that a basis overstatement could constitute an omission from gross income, thus authorizing the IRS to apply a six-year statute of limitations. In both *Home Concrete* and *Burks*, the courts noted in dicta<sup>27</sup> that the regulation would not be entitled to *Chevron* deference, because section 6501(e)(1)(A) is unambiguous. In other words, the regulation would have failed the first part of the *Chevron* test — a lack of statutory authority for a regulation remains fatal to any regulation, even after *Mayo*.<sup>28</sup>

### Conclusion

The *Mayo* decision provides little help to the government in defending challenges to the validity of retroactive Treasury regulations. Section 7805(b) establishes the limits of the IRS's authority to apply regulations retroactively, and it requires that the Service establish unambiguous statutory authority

for retroactive application of a regulation. A retroactive regulation lacking a specific statutory hook will fail, as will efforts to justify retroactivity based on any of the other exceptions to the presumption against retroactivity codified in section 7805(b). Thus, while the *Mayo* decision may benefit the IRS in future litigation involving other types of challenges to regulations, it will provide it with little (if any) help in defending retroactive regulations.

<sup>26</sup>T.D. 9511, *Doc 2010-26662*, 2010 TNT 240-11.

<sup>27</sup>In both cases, the courts held the challenged regulation inapplicable for other reasons, notably the effective date provision of the regulation, thus making their discussion of *Mayo* and the standard of deference particularly noteworthy.

<sup>28</sup>Even more recently, the Federal Circuit reached the opposite conclusion, upholding the validity of the regulation in *Grapevine Imports Ltd. v. United States*, No. 2008-5090 (Fed. Cir. 2011), *Doc 2011-5233*, 2011 TNT 49-14. This decision is noteworthy because the Federal Circuit had decided in favor of a taxpayer on the same legal question (*Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009), *Doc 2009-17311*, 2009 TNT 145-13). The *Salman Ranch* court had held that section 6501(e)(1) was properly construed as not treating an overstatement of basis as an omission from gross income. The *Grapevine* court attempted to reconcile its conclusion that the six-year statute of limitations under section 6501(e)(1) should be construed as treating an overstatement of basis as an omission from income with the directly contrary construction of the same statute by the Federal Circuit two years earlier in *Salman Ranch*. In the *Grapevine* court's view, both courts had concluded that the statutory language of section 6501(e)(1) was ambiguous and that the deference due the intervening regulation altered the proper construction of the statute. One wonders whether the original Federal Circuit panel in *Salman Ranch* would agree, and whether an *en banc* rehearing will be sought or granted.

The *Grapevine* decision is also noteworthy because it briefly addresses the retroactive application of the challenged regulation to all years open as of the date of the regulation's enactment. The Federal Circuit's opinion upheld retroactive application based largely on cases under the prior version of section 7805(b), which viewed retroactive application of regulations as the norm. The opinion does not address the applicable form of section 7805(b), which created a presumption against retroactive application of regulations. It does not recognize the requirement of specific congressional authorization for retroactive application of a regulation, and it does not even attempt to establish express statutory authorization for retroactive application of the specific challenged regulation — omissions that may be the subject of further criticism of the *Grapevine* decision.