

Altera Corp. & Subs. v. Comm’r: The Tax Court Delivers An APA-Based Smackdown

Since the Supreme Court decided the *Mayo Foundation* case in 2011, the government has done everything it can to limit the scope of the Supreme Court’s 2011 *Mayo Foundation* decision. Even though the *Mayo Foundation* Court declined “to carve out an approach to administrative review good for tax law only” and otherwise signaled fealty to general administrative law norms in the tax context, the IRS and the Department of Justice have repeatedly pursued a narrow construction of *Mayo Foundation*, and the Tax Court has often been happy to play along. Not today.

In [*Altera Corp. & Subs. v. Comm’r*, 145 T.C. No. 3](#), the Tax Court unanimously invalidated regulations under Section 482 requiring participants in qualified cost-sharing arrangements to include stock-based compensation costs in the cost pool in order to comply with the arm’s length standard, on grounds that the regulations were not the product of reasoned decisionmaking as required by Administrative Procedure Act (APA) § 706(2)(A) and [*Motor Vehicle Manufacturers Association of the United States v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 \(1983\)](#), known in administrative law circles as *State Farm*. From top to bottom, the *Altera* opinion reads like a treatise on general administrative law requirements and norms. Without delving into the policy details of the regulation at issue, the following paragraphs summarize the Tax Court’s opinion and its potential implications.

First, notwithstanding the Supreme Court’s conclusion in *Mayo Foundation* that general authority Treasury regulations issued under Section 7805(a) carry the force of law, in the Internal Revenue Manual and elsewhere, the IRS has continued to assert that most of its regulations are interpretative rules exempt from APA notice-and-comment procedural requirements. Applying the Ninth Circuit’s version of the *American Mining Congress* standard for distinguishing between legislative regulations that require notice-and-comment rulemaking and interpretative regulations that do not, the Tax Court held that the Treasury regulation at issue in *Altera* was a legislative rule because the regulation was necessary to sustain an adjustment to the taxpayer’s income and because Treasury expressly invoked general rulemaking authority under Section 7805(a) in promulgating the regulation. In reaching that decision, moreover, the Tax Court also concluded more broadly that regulations promulgated pursuant to Section 7805(a) “carry the force of law” and that “the Code imposes penalties for failing to follow them,” such that “ ‘Congress has delegated legislative power to’ Treasury” through that grant of general rulemaking authority—*i.e.*, making regulations promulgated under that authority legislative rules subject to notice-and-comment rulemaking requirements. Elsewhere in the opinion, the Tax Court acknowledged that its past practice of referring “to regulations issued pursuant to specific grants of rulemaking authority as legislative regulations and regulations issued pursuant to Treasury’s general rulemaking authority, under sec. 7805(a), as interpretive regulations” was inconsistent with general administrative law use of the legislative and interpretive labels.

Second, notwithstanding the Supreme Court’s refusal in *Mayo Foundation* to approach judicial review in general (rather than merely *Chevron* review) differently in tax cases, the IRS in *Altera* resisted the taxpayer’s argument that the regulation in question had to satisfy the reasoned decisionmaking requirements of APA § 706(2)(A) and *State Farm*. The IRS claimed that *Chevron*, rather than *State Farm*, provided the appropriate evaluative standard. The precise relationship between *Chevron* and *State Farm* standards is unclear, with some courts and scholars contending that they overlap considerably, and others maintaining they are conceptually distinct. Regardless, courts and scholars generally would agree that agency regulations must satisfy both *Chevron*’s demand that they be substantively reasonable and *State Farm*’s requirement that they be the product of reasoned decisionmaking. Consistent with some appellate court decisions and a bit of dicta from the Supreme Court in [*Judulang v. Holder*, 132 S. Ct. 476, 483 n.7 \(2011\)](#), the Tax Court collapsed the two standards, reasoning that “the final rule must satisfy *State Farm*’s reasoned decisionmaking standard” because, even if *Chevron* provided the appropriate evaluative

standard, *State Farm*'s analysis is part of *Chevron* step two. *State Farm* analysis is very case by case, requiring both specific allegations as to where the agency's contemporaneous justification of its decisions is lacking and careful examination of the administrative record to support those allegations. Consequently, *State Farm* analysis is at least somewhat dependent upon interested parties raising issues and endeavoring to engage the agency in the rulemaking process itself. Commentators did so here. And examining the rulemaking record meticulously and at some length, the *Altera* court concluded that Treasury and the IRS simply failed to satisfy *State Farm*'s reasoned decisionmaking requirements. In particular, the court noted that Treasury's assumptions in adopting the rule were unsupported by evidence regarding real-world practices; that commentators introduced "significant evidence" in the rulemaking process that contradicted Treasury's assumptions; and that Treasury failed to respond to much of that evidence.

Finally, the Tax Court rejected the government's claim that deficiencies in Treasury's reasoning represented harmless error for purposes of APA § 706. According to the court, it was not clear from the administrative record that Treasury would have adopted the same regulation had Treasury determined the inclusion of stock-based compensation costs in the cost pool to be inconsistent with the arm's length standard.

Altera represents a natural extension of the Supreme Court's reasoning in the *Mayo Foundation* case, reflecting the spirit of that decision's rejection of tax exceptionalism from general administrative law requirements, doctrines, and norms. Given the *Altera* court's reasoning, it is difficult to imagine the IRS being able to argue successfully ever again that any Treasury regulation—whether promulgated under specific or general authority—is exempt from APA notice-and-comment rulemaking requirements as an interpretative rule. The *Altera* court's analysis therefore removes a layer of uncertainty risk for attorneys seeking to challenge Treasury regulations on APA grounds. Separately, [as Pat Smith has documented](#), many IRS regulations lack the sort of extensive contemporaneous justification of IRS policy choices that *State Farm* requires, and thus are susceptible to taxpayer claims that they fail to satisfy *State Farm*'s reasoned decisionmaking standard. Taken comprehensively, the *Altera* litigation is an exemplar for attorneys seeking to challenge other Treasury regulations under APA § 706(2)(A) and *State Farm*.

Whether and to what extent the Tax Court will extend general administrative law doctrines beyond Treasury regulations to other IRS actions remains to be seen. For example, some Tax Court judges have been reluctant to extend *State Farm* analysis to deficiency notices and other IRS determinations respecting individual taxpayers, accepting IRS claims that *Mayo Foundation* applies only to Treasury and IRS rulemaking and not to IRS adjudications (even though *Judulang v. Holder* involved an agency adjudication).

Regardless, the fact that the Tax Court unanimously backed such a thorough and unequivocal application of general administrative law principles in reviewing a Treasury regulation is truly remarkable. The Tax Court's decision in *Altera* should send a very powerful message to Treasury and the IRS that they need to be more attentive to administrative law requirements in promulgating tax regulations.