January 14, 2011

Judicial Deference to the IRS

Supreme Court Holds that *Chevron* Deference Applies to “Interpretive” Treasury Regulations

SUMMARY

On January 11, 2011, the U.S. Supreme Court held, in *Mayo Foundation for Medical Education and Research v. United States* (the “Case”), that a Treasury regulation issued under a general grant of regulatory authority (rather than a specific delegation of authority) was entitled to deference under the standard set forth in *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.* Under the *Chevron* standard, an interpretive rule will be upheld if: (i) Congress has not “directly addressed the precise question at issue” and (ii) the rule is not “arbitrary, capricious or manifestly contrary to the statute.”

The question presented by the Case involved a Treasury regulation governing a social security tax exemption. However, the Case is likely to have an impact on any judicial challenge made in the future to the validity of any “interpretive” Treasury regulation (i.e., a regulation promulgated under a general grant of rulemaking power under the Internal Revenue Code of 1986, as amended (the “Code”), rather than pursuant to a specific delegation of authority in a particular Code section) issued under normal IRS procedures. Prior to the Supreme Court’s decision, uncertainty had existed regarding whether interpretive tax regulations should be subject to a standard permitting more in-depth court review than the rule provided in *Chevron*. By applying the principles of *Chevron* to an interpretive Treasury regulation, the Supreme Court resolved much of this ambiguity. However, the *Chevron* standard is highly deferential to an administrative agency. A taxpayer seeking to challenge an interpretive Treasury regulation should, accordingly, carefully consider whether its position is likely to be sustained under a *Chevron* analysis, particularly if that regulation was issued under the IRS’s standard “notice and comment” procedures. The impact of the Supreme Court’s decision on temporary regulations and other Treasury regulations issued outside the IRS’s “notice and comment” procedures is less certain.
BACKGROUND

Broadly speaking, the Treasury Department issues two types of regulations: (i) “legislative” regulations issued under grant of authority in a specific Code provision and (ii) “interpretive” regulations promulgated under a provision (Section 7805(a) of the Code) that generally authorizes the Secretary of the Treasury to issue “all needful rules and regulations for the enforcement of” the Code. Certain Treasury regulations, such as the consolidated return rules, are legislative in nature. However, most Treasury regulations are interpretive.

Legislative regulations are subject to the “notice and comment” procedures of the Administrative Procedure Act, and have the full force and effect of law. *Chevron* deference has long applied to legislative regulations issued by the Treasury Department and other agencies: so long as Congress has not “directly addressed the precise question at issue,” these rules typically cannot be set aside through judicial review unless they are procedurally defective, or “arbitrary, capricious or manifestly contrary to the statute.”

Although the IRS believes that interpretive regulations generally are not subject to the “notice and comment” procedures of the Administrative Procedure Act, it typically follows those procedures in developing final regulations. The standard to be applied when the validity of an “interpretive” regulation is litigated was, until the Supreme Court’s decision in the Case, less certain. In particular, the Supreme Court and lower courts had relied on both the *Chevron* rule and the standard set forth in *National Muffler Dealers Association v. United States* to evaluate interpretive Treasury regulations. The *National Muffler* case called for a more flexible, multifactor analysis to determine whether an interpretive regulation “harmonizes with the plain language of the statute, its origin and its purpose.” In conducting such an inquiry, a court applying the *National Muffler* standard examined the age of the regulation, whether the regulation was issued substantially contemporaneously with the underlying statute, the reliance placed on the regulation, whether the IRS has consistently interpreted the regulation and the degree of scrutiny that the regulation was given by Congress.

The Case itself involved the validity of a regulation interpreting Section 3121 of the Code, which defines “wages” that are subject to social security tax as any remuneration for “employment,” but exempts “services provided in the employ of a school, college or university” from the definition of “employment” if those services are rendered by a “student who is enrolled and regularly attending classes at such school, college or university.” Interpretive Treasury regulations have long limited the scope of this exemption to work performed “as an incident to and for the purpose of pursuing a course of study,” and in 2004, the relevant regulations were amended to provide that the services of any employee whose normal, scheduled workweek equals or exceeds forty hours are not “incident to and for the purpose of pursuing a course of study.” Shortly after this amendment, Mayo sued for a refund of the social security taxes it withheld and paid on its medical residents’ stipends during the second quarter of 2005, claiming that the...
amended regulation was invalid. Mayo was successful in the District Court, but its victory was overturned by the Eighth Circuit on appeal, which ruled in favor of the Treasury Department.

DISCUSSION
In its opinion, the Supreme Court concluded that: (i) *Chevron* deference, rather than the *National Muffler* standard, should apply to the regulation discussed above and (ii) under a *Chevron* analysis, the regulation is valid because Congress did not precisely define whether medical residents should be subject to social security tax and the regulation’s interpretation of the statute is reasonable.

Although the regulation examined in the Case involves a payroll tax exemption, it was promulgated under the same Code provision that is used to issue other interpretive Treasury regulations, and using the same procedures. In reaching its decision, the Supreme Court—while acknowledging that earlier case law had suggested that a less deferential standard could apply to Treasury regulations—observed that “we are not inclined to carve out an approach to administrative review good for tax law only,” and further that “[t]he principles underlying our decision in *Chevron* apply with full force in the tax context.”

In light of the Supreme Court’s decision, little (if any) difference is likely to exist in the level of deference granted by courts to legislative Treasury regulations and interpretive Treasury regulations issued under the current, general IRS procedures for promulgating final regulations. Accordingly, in considering whether to seek judicial review of a final interpretive Treasury regulation that was issued through ordinary IRS procedures, a taxpayer should examine whether its challenge is likely to succeed under a highly deferential *Chevron* analysis. Because the Supreme Court specifically cited the Treasury Department’s use of “notice and comment” procedures as a consideration in its analysis, it is possible that regulations issued using other procedures (for example, temporary regulations, including temporary regulations issued on or before November 20, 1988 that are not subject to the three-year sunset rule of Section 7805(e) of the Code) may be reviewed under a different framework.

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ENDNOTES

1. 467 U.S. 837.

2. *Chevron*, 467 U.S. at 844.


4. See Internal Revenue Manual § 32.1.2.3.3 (“Interpretative regulations are generally not subject to the APA provisions on rulemaking, including its notice and comment requirements. However, although most IRS/Treasury regulations are interpretative, the IRS usually publishes its [notices of proposed rulemaking] in the Federal Register and solicits public comments.”).


7. *Id.* at 477.

8. See *id*.


12. See *Mayo Foundation for Medical Education and Research et al v. United States*, 568 F.3d 675 (8th Cir. 2009).
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