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District Court Holds Anti-Inversion Regulation Unlawfully Issued

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"[W]e are not inclined to carve out an approach to administrative review good for tax law only." *Mayo Found. for Medical Educ. & Research v. United States*, 562 US 44, 55 (2011).

With this language, the US Supreme Court put taxpayers and the Internal Revenue Service (IRS) and US Department of the Treasury (Treasury) on notice that administrative law applies equally to tax law. Since this announcement, administrative law issues have figured prominently in several tax cases with the result that certain practices of the IRS and Treasury in issuing regulations have been called into question. (Please see our most recent post on the Administrative Procedures Act [APA] as applied to notices of deficiency issued by the IRS.) One such practice is the issuance of temporary regulations—without prior opportunity for comment by the public—that the IRS and Treasury treat as binding rules of law. One such example is the temporary anti-inversion regulations issued in April 2016 that address transactions that the IRS and Treasury believe are structured to avoid the purposes of Internal Revenue Code (Code) Section 7874 and 367.

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As is common practice by the IRS and Treasury, the regulations were simultaneously issued in both proposed and temporary form. The regulations include the rules described in prior Notices, as well as new rules designed to address issues not covered by the Notices. The regulations totaled more than 200 pages, addressing many issues in the area.

Naturally, taxpayers and practitioners were quick to respond to the proposed and temporary regulations. Some questioned whether the IRS and Treasury had exceeded the scope of authority granted by Congress. Ultimately, the Chamber of Commerce of the United States of America and the Texas Association of Business filed a lawsuit alleging violations of the APA with respect to Treas. Reg. § 1.7874-8T, which identifies stock of a foreign acquiring corporation that is to be disregarded in determination of an ownership fraction relevant to categorization for federal tax purposes because the stock is attributable to prior domestic-entity acquisitions. *See Chamber of Commerce of the United States of America, et al. v. Internal Revenue Service*, Dkt. No. 1:16-CV-944-LY (W.D. Tex.).

As noted above, *Mayo* ushered in a string of arguments relating to whether the APA applies, and has been followed, in various tax matters. In the anti-inversion litigation, several procedural issues were raised relating to whether the plaintiffs had standing, the applicability of the Anti-Injunction Act (AIA), whether the IRS and Treasury had the authority issue the anti-inversion regulations, whether the regulations were arbitrary and capricious, and whether the notice-and-comment requirement applied to the regulations. Each issue is addressed below.

First, the district court concluded that the plaintiffs had standing to challenge the anti-inversion regulations because they demonstrated an actual, concrete injury, which was fairly traceable to implantation of the anti-avoidance regulations.

Second, the court held that the plaintiffs' claims were not barred by the AIA because the regulations did not involve assessment or collection of tax. To recap, the AIA provides that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed." Code Section 7421(a). Normally, taxpayers challenge the

validity of a regulation after taking a position on a tax return that is questioned by the IRS, which does not implicate the AIA. However, the court reasoned that because the plaintiffs were challenging the anti-inversion regulations so that a reasoned decision could be made regarding whether to engage in a potential future transaction that would subject them to taxation, no restraint on assessment or collection of tax was being sought. The court's holding breaks new ground, and arguably conflicts with *Florida Bankers Association v. Treasury*, 799 F.3d 1065 (DC Cir. 2015), in which the DC Circuit held that the AIA barred two banking associations from seeking pre-enforcement review of regulations that impose a penalty for failure to report interest paid to foreign account holders.

Third, the court found that Congress delegated broad authority to the IRS and Treasury to promulgate regulations and therefore the statutory jurisdiction of the agencies was not exceeded.

Fourth, the court found that the IRS and Treasury provided a thorough explanation and basis for the regulations in the preamble. Thus, the agencies did not engage in arbitrary and capricious rulemaking.

Finally, and perhaps most importantly, the court found that the IRS and Treasury violated the APA because they failed to provide affected parties with notice and an opportunity to comment with respect to the temporary regulations. The court rejected the defendants' argument that Congress intended to permit the IRS and Treasury to issue temporary regulations carrying the force of law without first going through the general notice-and-comment requirements of the APA. The court found no exception for temporary rules in the Code and rejected the defendants' argument that the legislative history could override the explicit directives of the APA. The court further found that the temporary regulations were not "interpretative" rules issued merely to advise the public of an agency's construction of the statutes and rules it administers. Instead, the regulations were intended to have the force and effect of law, as reflected by the promulgation of the regulations pursuant to Congress's express grant of authority to issue the regulations.

Interestingly, the district court did not cite to *Burks v. United States*, 633 F.3d 347 (5th Cir. 2011), *cert. denied* 132 S.Ct. 2099 (2012), to further support its position on the APA notice-and-comment issue. (Four current McDermott tax controversy lawyers were involved in the *Burks* litigation and advanced several APA-related arguments). In that case, which the Fifth Circuit stated in a footnote:

Moreover, *Mayo* emphasized that the regulations at issue had been promulgated following notice and comment procedures, "a consideration identified ... as a significant sign that a rule merits *Chevron* deference." 131 S.Ct. at 714. Legislative regulations are generally subject to notice and comment procedure pursuant to the Administrative Procedure Act. *See* 5 U.S.C. § 553(b)(A). Here, the government issued the Temporary Regulations without subjecting them to notice and comment procedures. This is a practice that the Treasury apparently employs regularly. *See* 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, 1158-60 (2008) (noting that the treasury frequently issues purportedly binding temporary regulations open to notice and comment only after promulgation and often denies the applicability of the notice and comment procedure when issuing its regulations because that requirement does not apply to regulations that are not a significant regulatory action, while continuing to assert that the regulations are entitled to legislative regulation level deference before the courts). That the government allowed for notice and comment after the final Regulations were enacted is not an acceptable substitute for pre-promulgation notice and comment. *See U.S. Steel Corp. v. U.S. EPA*, 595 F.2d 207, 214-15 (5th Cir. 1979).

Although the district court's order was only directed at Treas. Reg. § 1.7874-8T, its rationale could extend to any temporary regulation issued without the opportunity for public comment. This calls into question many temporary regulations that were issued prior to November 20, 1988, the date prior to which temporary regulations did not have to be finalized within three years.

Practice Point: The district court's ruling is a substantial setback for the government. It remains to be seen whether the government will appeal the order and what action the Fifth Circuit might take on the subject. If the government were to appeal and the Fifth Circuit were to affirm on the AIA and APA issues, this would arguably create a split in the circuits due to *Florida Bankers*. We will continue to follow this development closely and provides updates on any future developments.