

WHO NEEDS *CHEVRON*? PFIZER, THE ANTI-INVERSION REGULATIONS, AND THE ANTI-INJUNCTION ACT

Matthew A. Melone*

The remedy for wrongs is to forget them.
-Publius Syrus**

INTRODUCTION	927
I. ANTI-INJUNCTION ACT	929
A. Tax or Penalty.....	932
B. Purpose of Suit	936
II. ADMINISTRATIVE LAW AND TAX EXCEPTIONALISM.....	939
A. Deference: A Crack in the Armor of Tax Exceptionalism	944
B. The State Farm Doctrine.....	951
III. PFIZER-ALLERGAN MERGER AND THE ANTI- INVERSION REGULATIONS.....	963
A. Background.....	963
B. Application of the Anti-Injunction Act.....	968
CONCLUSION	977

INTRODUCTION

In 2015 Pfizer, Inc., agreed to merge with Allergan—an Irish corporation—in a transaction that would have resulted in a corporate group with an Irish parent. This type of transaction, a so-called inversion, has been the subject of much media attention. Depending on one’s political and economic preferences, these transactions are either evidence of tax dodging

* J.D., C.P.A., Professor of Law, Lehigh University, Bethlehem, PA.

** Andy Zubco, Treasury of Spiritual Wisdom: A Collection of 10,000 Inspirational Quotations, 170 (3d ed. 1998) (quoting Publius Syrus).

by unpatriotic corporations, or a rational response to an unduly burdensome U.S. corporate tax system. The Treasury Department issued regulations that eliminated the planned tax benefits of the Pfizer deal and similarly-situated inversions. The regulations are controversial and, allegedly exceed the Treasury's authority. We may never know whether these regulations are a proper exercise of agency authority. Pfizer did not challenge the regulations; instead, the transaction suffered an ignominious denouement—it was scuttled.

Pfizer had good reason to forgo a legal challenge. The Anti-Injunction Act, a century-and-a-half-year-old statute, precludes pre-enforcement challenges to tax rules. In virtually all cases, payment of the tax in dispute and a subsequent suit for refund is an adequate remedy for taxpayers. However, in unusual circumstances, a post-enforcement challenge is neither practical nor realistic. The anti-inversion regulations create unusual circumstances, leading Pfizer to walk away from its deal with Allergan without a fight.

Part I of this Article provides a detailed analysis of the Anti-Injunction Act and its scope, as refined by a number of court decisions. The statute emphasizes the importance of the government's revenue collection function and the result of its application can be quite harsh. Taxpayer attempts to skirt the statute, whether by assertions that the challenged exaction is not a tax or by assertions that the purpose of the suit has nothing to do with revenue collection, have been largely unsuccessful. The Supreme Court, in its landmark case upholding the constitutionality of the individual health insurance mandate imposed by the Patient Protection and Affordable Care Act, clarified the statute's application in certain respects.

Part II of this Article examines the special treatment often afforded the Treasury in its tax administration role. The Anti-Injunction Act is but one example of tax exceptionalism. The Treasury enjoys advantages granted by Congress, but it also has appropriated advantages for itself. Its casual relationship with the Administrative Procedure Act is well known. For decades, however, the notion that tax rules were somehow different from other rules resulted in less judicial deference to certain Treasury regulations. In what was, at the time, considered a major win for the Treasury, a 2011 Supreme Court decision rejected tax exceptionalism and held that Treasury regulations are entitled to the same deference enjoyed by other agencies. The cost of this victory has been the application of general administrative law principles to tax regulations, a previously foreign concept to the tax world. In certain cases, administrative failures can render tax regulations invalid on their face. An open question is whether such a failure opens the door for a pre-enforcement taxpayer challenge.

Part III of this Article discusses the Pfizer-Allergan transaction and

the anti-inversion regulations that sounded its death knell. This part also examines the judicially-created exceptions to the Anti-Injunction Act and asserts that the existing exceptions are of little utility because they are either inapplicable or are of little practical utility to a taxpayer contemplating a transaction of the magnitude of the Pfizer deal. This part concludes with the argument that the courts should apply the existing exceptions to the statute in a more nuanced and equitable manner. The effect of the anti-inversion regulations on taxpayers is unusual and the courts should react accordingly. There is something unseemly about a legal system which leaves a taxpayer with no practical alternative to capitulating to tax rules that it believes are unlawful. The importance of the revenue raising function is not in dispute, but that importance should not blind the courts to basic principles of equity. The ever-increasing use of the tax code as an instrument of social policy, as opposed to government funding, should give impetus to the courts to be less reflexive in their application of the statute.

I. ANTI-INJUNCTION ACT

I.R.C. section 7421, the Anti-Injunction Act, prohibits any “suit for the purpose of restraining the assessment or collection of any tax . . . in any court by any person, whether or not such person is the person against whom such tax was assessed.”¹ Similarly prohibited are suits for the purposes of restraining the assessment or collection of the liability of a transferee of property of a taxpayer with respect to any internal revenue tax or the amount of the liability of a fiduciary for unpaid taxes.² The statute’s requirement that taxpayers resolve their tax disputes in a suit for refund, a principle that has been in effect in some statutory form since 1867, is an unremarkable admonition to taxpayers that they must exhaust administrative remedies before proceeding to court.³ The Anti-Injunction Act provides legislative

1. I.R.C. § 7421(a) (2012).

2. I.R.C. § 7421(b).

3. Act of March 2, 1867, ch. 168, 169, § 10, 14 Stat. 475 (1867). The 1867 legislation amended an 1866 statute that precluded suits for the recovery of any tax alleged to have been erroneously or illegally assessed or collected before an appeal was duly made to the commissioner. *See Snyder v. Marks*, 109 U.S. 189, 191-92 (1883) (discussing the changes made by the 1867 amendment to the 1866 act). There is no recorded legislative history of the 1867 statute. *Bob Jones Univ. v. Simon*, 416 U.S. 725, 736 (1974); *see also* Erin Morrow Hawley, *The Equitable Anti-Injunction Act*, 90 NOTRE DAME L. REV. 81, 95-98 (2014) (noting that the legislative history of the Anti-Injunction Act is not recorded, but there are some indicators of congressional motive). In order to file a refund suit, a taxpayer must first file a claim for refund with the I.R.S. I.R.C. § 7422(a). Full payment of the assessed tax is required in order to bring a suit for refund. *See Flora v. United States*, 362 U.S. 145 (1960) (interpreting 28 U.S.C. § 1346(a) (2012) to mean the district courts and the U.S. Court of Federal Claims have concurrent jurisdiction in any civil action against the United States for the recovery of

notice of the “[g]overnment’s need to assess and collect taxes as expeditiously as possible with a minimum of pre-enforcement judicial interference.”⁴

Taxpayers do have a mechanism to challenge I.R.S. action prior to enforcement—the United States Tax Court—but that mechanism is rather limited and is, almost always, a pre-assessment mechanism.⁵ If the I.R.S.

any tax alleged to have been erroneously or illegally assessed or collected, and finding that the statutory language does not limit such suits to the person against whom the tax was assessed). The Court has also held that a non-assessed party that had paid a tax to remove a federal tax lien from her property had standing to bring a refund suit. *United States v. Williams*, 514 U.S. 527 (1995).

4. *Hibbs v. Winn*, 542 U.S. 88, 103 (2004) (quoting *Bob Jones*, 416 U.S. at 736). *Hibbs* involved another statute, the Tax Injunction Act, which precludes federal court interference with the assessment, levy or collection of any tax under state law where an efficient remedy is available through the state’s courts. 28 U.S.C. § 1341 (2012). The Court has interpreted this statute similarly to the Anti-Injunction Act. *See Direct Mktg. Ass’n v. Brohl*, 135 S. Ct. 1124, 1129 (2015) (suggesting the language of the Tax Injunction Act was modeled after the Anti-Injunction Act and assuming the language used in both Acts are used the same way). Whether an exaction is a tax for purposes of the Tax Injunction Act, an issue discussed in this Article in the context of the Anti-Injunction Act, is beyond the scope of this work. At least one court has defined the term “tax” very broadly for this purpose. *See Henderson v. Stalder*, 407 F.3d 351, 356 (5th Cir. 2005) (quoting *Tramel v. Schrader*, 505 F.2d 1310, 1315 (5th Cir. 1975) (defining a tax as an “extraction of property from a private person by a sovereign for its use”). In addition, the Declaratory Judgment Act precludes any declaratory judgments “with respect to Federal taxes.” 28 U.S.C. § 2201(a) (2012). Although the language of the Declaratory Judgment Act is broader than the language of the Anti-Injunction Act, the statutes have been interpreted to be coterminous. *See Bob Jones*, 416 U.S. at 733 n. 7 (acknowledging that a number of courts have held the two statutes as coterminous, but finding no occasion for the Court to resolve in case at bar) (internal citations omitted); *see also Cohen v. United States*, 650 F.3d 717, 727-28 (D.C. Cir. 2011) (highlighting precedent that interprets the Declaratory Judgment Act and the Anti-Injunction Act as coterminous). An exception is provided in the statute for declaratory judgments relating to the determinations of the tax-exempt status of certain organizations. I.R.C. § 7428 (2012). This exception was added by the Tax Reform Act of 1976 and has mitigated the hardship that the preclusion of a pre-enforcement remedy imposed upon tax exempt organizations. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1306, 90 Stat. 1520, 1717 (1976). A discussion of cases involving the tax-exempt status of organizations is available in footnotes 39-46 of this text.

5. The Tax Court has operated as a court of record under Article I of the Constitution since 1969. *See* I.R.C. § 7441 (2012) (establishing the United States Tax Court as a Constitutional court). Its predecessors, the Board of Tax Appeals and the Tax Court of the United States, were both executive branch agencies. The former was created in 1924 and operated until 1942 when it was re-designated as the Tax Court of the United States. *See* Revenue Act of 1924, Pub. L. No. 68-176, ch. 234, § 900, 43 Stat. 253, 336 (1924) (establishing the Board of Tax Appeals); *see also* Revenue Act of 1942, Pub. L. No. 77-753, ch. 619, § 504(a), 56 Stat. 798, 957 (1942) (establishing the Tax Court of the United States). Congress believed that its placement within the executive branch raised questions about its ability to act impartially as a judge of executive agency actions. Tax Reform Act of 1969, S. Rep. No. 91-552, 302 (1969). At present, the court is comprised of nineteen judges, appointed by the President and confirmed by the Senate to fifteen year terms, who can be removed from

determines that there is a deficiency in the tax shown on income, estate, or certain excise tax returns, or if no returns were filed, then it must send the taxpayers a statutory notice of deficiency.⁶ The taxpayer may then petition the Tax Court to review the deficiency claim within ninety days (150 days if the notice is addressed to a person outside the United States) after the statutory notice was mailed.⁷ The I.R.S. is precluded from assessing or collecting the tax in question during the ninety day period (or 150 day period, if applicable) and, if a petition to the Tax Court is filed, during the pendency of the Tax Court's proceedings.⁸

Section 7421 provides several exceptions to its general prohibition. Collection activity may be enjoined in certain circumstances involving a spouse seeking relief under the innocent spouse provisions of I.R.C. section 6015 and injunctions may be issued to prevent assessments and collections during the pendency of Tax Court proceedings.⁹ In addition, as a result of perceived abuses by the I.R.S. in its collection processes, Congress provided taxpayers with the right to an administrative hearing upon the filing of a notice of lien and prior to levy.¹⁰ Taxpayers may appeal the resultant determination to the Tax Court. Collection activity must cease during the pendency of the proceedings, and such activities may be enjoined by the Tax Court or any other proper court.¹¹

the bench only for cause. I.R.C. § 7443(b)-(f) (2012). Subject to certain exceptions, a decision of the court is reviewable by the United States Court of Appeals and the court considers itself bound by the rulings of the Court of Appeals to which the particular case before it is appealable. I.R.C. § 7482 (2012); *see also* Golsen v. Comm'r, 54 T.C. 742, 757 (1970) (determining that judicial administration of the United States Tax Court is better when decisions by the appropriate Court of Appeals are followed). The Supreme Court set forth the framework for determining whether the scope of authority conferred upon a non-Article III tribunal violates Article III, section 1 of the Constitution in *Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833 (1986), an analysis of which is beyond the scope of this work.

6. I.R.C. § 6212(a) (2012).

7. I.R.C. § 6213(a).

8. *Id.*

9. *See id.* (providing for injunction exceptions to the section 7421 prohibition).

10. I.R.C. §§ 6320(c), 6330(d)(1).

11. I.R.C. § 6330(e). Several other exceptions exist. The federal district court may, among other exceptions, issue an injunction to prevent irreparable harm to the property rights of others in the context of a levy or sale of property by the I.R.S. I.R.C. § 7426(b)(1). Moreover, third parties are expressly provided standing to vindicate an interest in property that has been wrongfully levied. I.R.C. § 7426(a). Exceptions to the statute are also provided for collection activities undertaken during the pendency of a Tax Court proceeding challenging federal liens and levies, with respect to certain partnership related matters, levy and distraint proceedings, jeopardy assessments and levies, controversies regarding employment status, and certain payroll tax matters. *See* I.R.C. § 7421(a).

A. Tax or Penalty

A threshold question is whether the exaction subject to challenge is, in fact, a tax subject to the statute. In *National Federation of Independent Business v. Sebelius*, the controversial case that upheld the individual health insurance mandate imposed by the Patient Protection and Affordable Care Act, the Court's opinion placed significant emphasis on the label that Congress chose to give to an exaction.¹² The Patient Protection and Affordable Care Act added section 5000A to the Internal Revenue Code, requiring that individuals maintain a certain level of health insurance coverage for themselves and dependents each month beginning after 2013.¹³ Failure to meet this requirement for one or more months results in the imposition of a shared responsibility payment—which the statute terms a penalty.¹⁴

Emphasizing that the Anti-Injunction Act applies to suits that seek to restrain the assessment or collection of any tax, the Court stated that “[t]here is no immediate reason to think that a statute applying to ‘any tax’ would apply to a ‘penalty.’”¹⁵ It considered the fact that section 5000A labels the exaction a penalty significant because many other exactions in the Patient Protection and Affordable Care Act are labeled taxes, and it is generally

12. Nat'l Fed'n of Indep. Bus. v. Sebelius, 567 U.S. 519, 543-544 (2012).

13. Patient Protection and Affordable Care Act, Pub. L. No. 111-148, §§ 1501(b), 10106(b)(1), 124 Stat. 119, 244-49, 909-10 (2010) (codified as I.R.C. § 5000A (2012)). The penalty amount imposed by the statute was amended shortly thereafter by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, §1002, 124 Stat. 1029, 1032-33 (2010) (codified at I.R.C. § 5000A (2012)). Certain exceptions are made for individuals who qualify for statutorily defined religious conscience or health ministry exemptions, individuals who are not citizens or nationals of the United States or legal aliens present in the United States, incarcerated persons, members of Indian tribes, and low-income individuals. I.R.C. §§ 5000A(d), 5000A(e)(1)-(3) (2012).

14. I.R.C. § 5000A(b)(1) (2012). No penalty is imposed for gaps in coverage of less than three months. I.R.C. § 5000A(e)(4). Payment of the penalty is made with a taxpayer's income tax return for the taxable year which includes the month that the failure to obtain minimum essential coverage occurred. I.R.C. § 5000A(b)(1)-(2). The amount of the penalty due for a taxable year is the lesser of the sum of the monthly penalty amounts or the amount of the national average insurance premiums for a particular level of coverage for the applicable family size involved offered through insurance exchanges. I.R.C. § 5000A(c)(1). The national average premium is determined for plans that provide a “bronze” level of coverage, a level of coverage that is designed to provide benefits that are actuarially equivalent to sixty percent of the full actuarial value of statutorily enumerated benefits. *Id.*; 42 U.S.C. §§ 18022(b), 18022(d) (2010). The monthly penalty amount is one-twelfth of the greater of a flat dollar amount or a percentage of income. I.R.C. § 5000A(c)(2). The flat dollar amount is \$95 per individual failure in 2014, \$325 per individual failure in 2015, and \$695 per individual failure thereafter. I.R.C. §§ 5000A(c)(3)(A)-(B). The latter figure is adjusted annually for cost of living increases beginning in 2017. I.R.C. § 5000A(c)(3)(D).

15. *Sebelius*, 567 U.S. at 543.

presumed that the use of one term in one part of a statute and a different term in another part of that statute is intentional.¹⁶ According to the Court, Congress may determine for itself whether a particular statutory enactment is subject to the Anti-Injunction Act and the best evidence of such a determination is the text of the statute in question.¹⁷ Therefore, the Anti-Injunction Act can apply to exactions that are not considered taxes for other purposes.¹⁸ Moreover, the Anti-Injunction Act can apply to penalties if Congress chooses to make it applicable to particular penalties.¹⁹

The Court noted that the Internal Revenue Code defines the term “taxes” to include penalties that are codified at subchapter 68B of the Code.²⁰ However, despite the fact that the statute states that the shared responsibility payment shall be assessed and collected in the same manner as an assessable penalty under subchapter 68B, the shared responsibility payment is not found in subchapter 68B.²¹ The Court dismissed the argument that the language of I.R.C. section 6201(a), which authorizes the Secretary of the Treasury to assess all taxes and parenthetically defines taxes to include assessable penalties, requires that the penalty be deemed a tax for purposes of the Anti-Injunction Act.²² The Court unanimously held that, for purposes of the Anti-Injunction Act, section 5000A imposes a penalty and not a tax.²³ Accordingly, the Anti-Injunction Act did not apply to bar adjudication of the issues on the merits.²⁴ More recently, the D.C. Circuit, citing extensively to *Sebelius*, held that the Anti-Injunction Act applied to bar a suit challenging a penalty imposed upon banks that failed to report interest paid to certain foreign account holders.²⁵ The penalty at issue in the case was located in

16. *Id.* (citing *Russello v. United States*, 464 U.S. 16, 23 (1983)); *see e.g.*, I.R.C. §§ 1411 (imposing a 3.8 percent Medicare tax on unearned income beginning in 2013), 4191 (imposing a 2.3 percent tax on the sale of medical devices beginning in 2013), 4980I (imposing a forty percent tax on employers providing high cost insurance coverage beginning in 2018), 5000B (imposing a ten percent tax on tanning salon services to be paid by the individual on whom the service is performed) (2012).

17. *Sebelius*, 567 U.S. at 544.

18. *Id.*

19. *Id.*

20. *Id.* I.R.C. section 6671(a) states that any reference in the Internal Revenue Code to taxes includes the penalties imposed by provisions codified in subchapter 68B. I.R.C. § 6671(a) (2012). Accordingly, because the Anti-Injunction Act is part of the Internal Revenue Code, it applies to assessable penalties included in subchapter 68B.

21. *Sebelius*, 567 U.S. at 545.

22. *See id.* (interpreting this language merely as a procedural directive to the Secretary of the Treasury to employ assessment and collection mechanisms with respect to the penalty similar to those mechanisms used to assess and collect taxes).

23. *Id.* at 546.

24. *Id.*

25. *Fla. Bankers Ass’n v. U.S. Dep’t of the Treasury*, 799 F.3d 1065 (D.C. Cir. 2015), *cert. denied*, 136 S. Ct. 2429 (June 6, 2016).

Subchapter 68B of the Internal Revenue Code.²⁶

The *Sebelius* decision was controversial because the Court held that the individual health insurance mandate exceeded Congress's power under the Commerce Clause but that it was a permissible exercise of Congress's taxing power.²⁷ Although Congress may designate an exaction a penalty for purposes of the Anti-Injunction Act, whether an exaction is a penalty or a tax for constitutional purposes depends on the nature of the exaction and not the label that Congress chooses to give it.²⁸ For constitutional purposes, several factors caused the shared responsibility payment to resemble a tax (including the fact that it is paid with tax returns): it is inapplicable to low-income households; its amount is based on factors such as income, the number of dependents, and income tax filing status; it is codified in the Internal Revenue Code; and it is enforced by the I.R.S.²⁹

The distinguishing feature of a penalty is its punishment of an unlawful act or omission; the Court determined that the statute's provision of an inducement to purchase insurance need not be interpreted to make the failure to do so unlawful.³⁰ The majority opinion discussed the three characteristics of penalties that were set forth in *Bailey v. Drexel Furniture*, the child labor

26. *Id.* at 1067.

27. *Sebelius*, 567 U.S. at 547-575.

28. *Id.* at 564.

29. *Id.* at 563-564. The dissenting Justices found these features unpersuasive for two reasons. *Id.* at 666-669 (Scalia, Kennedy, Thomas, Alito, JJ., dissenting). They disagreed that variations in the amount of an exaction are indicative of taxes and gave no credence to section 5000A's codification in the Internal Revenue Code. *Id.* They pointed out that the amounts of numerous penalties are influenced by the violators' ability to pay and, moreover, that the placement of the mandate in the operative provisions of the Patient Protection and Affordable Care Act, rather than in its revenue provisions, is evidence that the shared responsibility payment was enacted as a penalty. *Id.*

30. *Id.* at 567 (first citing *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213, 224 (1996); then citing *United States v. La Franca*, 282 U.S. 568, 572 (1931)). The fact that no consequences attach to the failure to purchase insurance, other than the requirement to pay the exaction at issue, and the fact that the Congressional Budget Office estimated that four million people would choose to pay the tax and remain uninsured belie that Congress intended that the failure to obtain insurance be considered unlawful. *Id.* at 568. In *Lipke v. Lederer*, 259 U.S. 557 (1922), the Court held that a provision of the National Prohibition Act that taxed profits from the illegal sale of alcohol at double the rate otherwise applicable to legal profits was a penalty and not a tax. *Id.* at 561-62. Because evidence of a crime was required for the tax to apply, the exaction in question was intended to punish violations of the National Prohibition Act and, hence, was a penalty. An alternative framework with which to decide whether an exaction is a penalty or a tax was proposed by Robert Cooter and Neil Siegel. See Robert D. Cooter & Neil S. Siegel, *Not the Power to Destroy: An Effects Theory of the Tax Power*, 98 U. VA. L. REV. 1195 (2012) (arguing that the classification of an exaction should be based on whether Congress rationally believed that the exaction would reduce or prevent the behavior on which the exaction is imposed).

tax case.³¹ First, a penalty imposes an exceedingly heavy burden regardless of the extent of the infraction.³² Second, penalties typically include scienter requirements.³³ Finally, penalties are enforced by agencies other than the I.R.S., an agency whose function is to collect revenue.³⁴ The shared responsibility payment does not impose an exceedingly heavy burden because, for most individuals, the amount due will be far less than the cost of insurance and can never exceed the cost of such insurance.³⁵ Moreover, further support for the categorization of the shared responsibility payment as a tax is the lack of any scienter requirement, its assessment and collection by the I.R.S. through normal means, and the statute's prohibition of the use of criminal sanctions, liens, and levies.³⁶

In light of the *Sebelius* decision, it appears that if Congress labels an exaction of a penalty that falls outside of the statutory definition of a tax, then the Anti-Injunction Act is inapplicable to that exaction regardless of the nature of the exaction. Moreover, it appears that the reverse is also true. If Congress labels an exaction a tax, it is subject to the Anti-Injunction Act regardless of its constitutional status as a penalty. In *Drexel Furniture*, the Court held that a statute enacted in 1919 that imposed a ten percent excise tax on the net profits of an enterprise that employed children was unconstitutional because, according to the Court, the tax was, in reality, a penalty.³⁷ *Drexel Furniture* and *Sebelius* are analogous in that the taxing

31. *Sebelius*, 567 U.S. at 565.

32. *Id.*

33. *Id.* at 565-566.

34. *Id.* at 566.

35. *Id.* A discussion of the statutory cap on the amount of the shared responsibility payment is available at footnote 14 of this text.

36. *Sebelius*, 567 U.S. at 566. Taxes as a means to regulate behavior were sanctioned by the Court long ago. *Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381, 393 (1940). For example, the Court upheld the validity of a significant increase in excise taxes applicable to certain coal producers who did not join the Bituminous Coal Code, a group subject to regulation and price setting by a government commission:

Clearly this tax is not designed merely for revenue purposes. In purpose and effect it is primarily a sanction to enforce the regulatory provisions of the Act. But that does not mean that the statute is invalid and the tax unenforceable. Congress may impose penalties in aid of the exercise of any its enumerated powers. The power of taxation, granted to Congress by the Constitution, may be utilized as a sanction for the exercise of another power which is granted it.

Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381, 393 (1940).

37. *Bailey v. Drexel Furniture Co.*, 259 U.S. 20 (1922). This case was decided approximately four years after *Hammer v. Dagenhart*, in which the Court held that it was not within Congress's power to regulate interstate commerce to enact a ban on the interstate transportation of goods manufactured with the use of child labor. 247 U.S. 251 (1918). *Hammer* was overruled by *United States v. Darby*, one of a series of cases that expanded the scope of the commerce power after the so-called "switch in time that saved nine" in the New

power was posited in both cases as justification for a legislative action that was not supportable by the commerce power. However, a companion case to *Drexel Furniture* was not decided on the merits. The Court held in that case that the Anti-Injunction Act prohibited the issuance of an injunction that prevented the assessment and collection of the tax.³⁸

B. *Purpose of Suit*

The Anti-Injunction Act applies to a “suit for the purpose of restraining the assessment or collection of any tax.”³⁹ A taxpayer’s purpose for seeking relief is, in the vast majority of cases, transparent—to reduce her tax liability. On occasion, however, taxpayers have asserted alternative purposes for their challenges. For example, in *Bob Jones*, the petitioner challenged the I.R.S.’s denial of tax exempt status.⁴⁰ Such denial was predicated on the petitioner’s racially discriminatory policies and threatened the petitioner’s fund raising objectives because its tax exempt status was necessary in order for donors to obtain a tax deduction for their donations to the petitioner.⁴¹ Moreover, denial of tax exempt status would subject the organization to federal income taxes and certain payroll tax obligations.⁴² The petitioner argued that its suit was not for the “purpose of restraining the assessment or collection of any tax” but to maintain its flow of donor contributions.⁴³ The Court held that the suit was precluded by the Anti-Injunction Act because the petitioner’s challenge implicated its liability for income taxes, payroll taxes, and also the tax liability of others—its donors.⁴⁴ Consequently, this action fell “within the literal scope and the purposes of the Act.”⁴⁵ The Court reached a similar conclusion in a decision that was rendered the same day in a companion case, *Alexander v. Americans United Inc.*⁴⁶ The Court made clear that the Anti-Injunction Act’s applicability is neither predicated on a taxpayer seeking to restrain the assessment or collection of its own taxes nor on whether the

Deal era. 312 U.S. 100 (1941).

38. *Bailey v. George*, 259 U.S. 16, 20 (1922).

39. I.R.C. § 7421(a) (2012).

40. *Bob Jones Univ. v. Simon*, 416 U.S. 725 (1974).

41. *Id.* at 727-36; *see also* I.R.C. §§ 170(a); 501(c)(3) (2012).

42. *Bob Jones*, 416 U.S. at 730-31. The deleterious effects of the denial or revocation of tax exempt status on an organization led Congress, in 1976, to amend the Declaratory Judgment Act to provide an exception for actions that challenge such denials or revocations. *See supra* note 4.

43. *Id.* at 738.

44. *Id.* at 738-39. The Court acknowledged that, due to various deductions, whether the petitioner would owe income taxes was open to debate. *Id.* at 738.

45. *Id.* at 739.

46. *Alexander v. “Americans United” Inc.*, 416 U.S. 752 (1974).

effect on the taxpayer is merely collateral.⁴⁷

In a relatively recent case, the D.C. Circuit held that a suit that challenged the legality of a refund process established by the I.R.S. related to telephone excise taxes paid but later found invalid was not barred by the Anti-Injunction Act.⁴⁸ The court held that because the tax in question had already been assessed and collected by the I.R.S. that the suit did not seek to restrain the assessment or collection of any tax. Instead, the suit challenged the procedures established the I.R.S. under which money would be refunded.⁴⁹ The court distinguished this case from both *Bob Jones* and *Alexander* on the grounds that, unlike those cases, this case did not impact the future tax liabilities of the taxpayer.⁵⁰ Moreover, the Court rejected a “single mechanism” theory of assessment and collection under which any suit that affects the money retained by the Treasury involves assessment and collection.⁵¹ Instead, the court held that the terms assessment and collection, for purposes of the Act, are to be defined as those terms are defined in the Internal Revenue Code.⁵² In this case, the taxes in question had long been assessed and collected. With respect to the scope of the Anti-Injunction Act the Court stated that “[t]he principle the case law elucidates is therefore quite simple: The AIA, as its plain text states, bars suits concerning the ‘assessment or collection of any tax.’ It is no obstacle to other claims seeking to enjoin the IRS, regardless of any attenuated connection to the broader regulatory scheme.”⁵³

The Court’s rejection of a “single mechanism” theory of assessment and collection in this case followed from its reasoning in *Foodservice & Lodging Institute v. Regan* several decades earlier.⁵⁴ At issue in that case were several regulatory provisions that implemented a restaurant tip reporting statute. One provision required restaurants to report total charge receipts and total charged tips.⁵⁵ The regulations, in contrast, required restaurants to report only charge receipts in which a tip was charged.⁵⁶ The regulation was challenged by the food service industry because the industry believed that the information that the regulation required to be provided tended to overstate tips.⁵⁷ The court held that the statutory provision in question was

47. *Id.* at 760-61.

48. *Cohen v. United States*, 650 F.3d 717 (D.C. Cir. 2011).

49. *Id.* at 725.

50. *Id.* at 726 n.7.

51. *Id.* at 726.

52. *Id.*

53. *Id.* at 727.

54. *Foodservice & Lodging Inst. v. Regan*, 809 F.2d 842 (D.C. Cir. 1987).

55. *Id.* at 845-46.

56. *Id.* at 846.

57. *Id.*

enacted to assist the I.R.S. is determining the extent of tip reporting compliance in the food service industry and, therefore, the challenge to the regulation did not implicate the assessment of collection of tax.⁵⁸ The extent of industry-wide compliance with a reporting requirement and the assessment and collection of tax is not too attenuated because evidence of significant noncompliance would most likely lead to regulatory measures to counter such noncompliance. However, the D.C. Circuit disagreed and applied the Anti-Injunction narrowly.⁵⁹

Most recently, the D.C. Circuit held that the Anti-Injunction Act did not bar a suit by an organization that alleged that the I.R.S. was unlawfully delaying a decision regarding its tax exempt status because the organization's political views were inconsistent with the Obama Administration's Middle East policies.⁶⁰ The court distinguished this case from *Cohen*, the telephone excise tax case discussed above, because this case did have potential tax implications for the taxpayer in the future.⁶¹ However, in contrast to *Bob Jones* and *Alexander*, the taxpayer in this case was not seeking tax exempt status but only a fair and lawful process in the determination of its status.⁶² The court's decision was based, in large part, on its belief that the organization would be left with no adequate remedy if its suit was barred—an exception to the application of the statute discussed later in this Article.⁶³ However, the court did indicate that the suit was not for the purpose of restraining the assessment or collection of any tax but merely to prevent the I.R.S. from processing its request in an unconstitutional manner.⁶⁴ It is not clear whether the court would have held similarly if it believed the taxpayer had an adequate remedy at its disposal. Quite possibly, the court would not have so held because if the action did not involve an attempt to restrain the assessment of collection of any tax then it would have found no need to dwell on the taxpayer's lack of an adequate remedy.

The importance of the revenue collection function for the operation of

58. *Id.*

59. *Id.*

60. *Z St. v. Koskinen*, 791 F.3d 24 (D.C. Cir. 2015). Similar issues were raised by a number of tax-exempt organizations and the allegations that the I.R.S. was discriminating against conservative organizations led to Congressional hearings and political headaches for the Obama Administration. See TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, Ref. No. 2013-10-053, INAPPROPRIATE CRITERIA WERE USED TO IDENTIFY TAX-EXEMPT APPLICATIONS FOR REVIEW (2013), available at <https://www.treasury.gov/tigta/auditreports/2013reports/201310053fr.pdf> [<https://perma.cc/FHQ9-ZZJV>] (discussing allegations of I.R.S. discrimination against conservative organizations).

61. *Z St.*, 791 F.3d at 31.

62. *Id.* at 30.

63. *Id.* at 31-32.

64. *Id.* at 32.

the government provides the justification for the statutory bar to pre-enforcement challenges to tax rules but this statutory bar is by no means the only evidence that the tax function is administered in a manner unlike the administration of other government functions. Statutorily, the Treasury, with few exceptions, has been placed in an enviable position in comparison to other agencies. Moreover, the Treasury has appropriated for itself various advantages that have been subject to much criticism and that, in light of recent developments, may be curtailed.

II. ADMINISTRATIVE LAW AND TAX EXCEPTIONALISM

The Anti-Injunction Act recognizes the importance of the federal government's revenue collection function and is a manifestation of tax exceptionalism, the belief that the administration of the tax laws is justifiably different than the administration of other laws. However, the Act is not the sole manifestation of this belief. Various statutes advantage the Treasury in its dealings with taxpayers.⁶⁵ Moreover, the Treasury has enjoyed remarkable latitude in its rulemaking with respect to the restrictions imposed on administrative agencies by the Administrative Procedure Act.

Alarm at the increasing power of executive branch agencies, particularly during World War II, the diminishing popularity of the Democratic Party, and the courts' reluctance to limit agency power led to the passage of the Administrative Procedure Act in 1946.⁶⁶ The objectives of

65. See e.g., I.R.C. §§ 7805(b)(1)(C), 7805(b)(2) (2012) (permitting tax regulations to have retroactive effect in certain circumstances). Regulations, including re-issued regulations, may take effect on the date that notice was issued to the public that substantially described the expected contents of any temporary, proposed, or final regulations. *Id.* Moreover, regulations that are filed or issued within eighteen months of the date that the statute to which the regulations relate was enacted may have retroactive effect. *Id.* (permitting tax regulations to have retroactive effect). General administrative law principles are less amenable to agency retroactive rulemaking. See e.g., *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204 (1988) (finding that the Secretary of Health and Human Services did not have authority to impose retroactive cost-limit rules). In addition, the I.R.S. has broad collection powers that private creditors can only envy. See generally Steve R. Johnson, *The IRS as Super Creditor*, 92 TAX NOTES 655 (2001) (contemplating the unique powers of the I.R.S. relative to private creditors). Not all idiosyncrasies of tax administration favor the government, however. In tax litigation, no deference is given to the I.R.S.'s factual determinations, which are subject to *de novo* review. See James M. Puckett, *Structural Tax Exceptionalism*, 49 GA. L. REV. 1067, 1103-09 (2015) (discussing the treatment of I.R.S. determinations in tax litigation). See also Diane L. Fahey, *Is the United States Tax Court Exempt from Administrative Law Jurisprudence When Acting as a Reviewing Court?*, 58 CLEV. ST. L. REV. 603, 637-43 (2010) (considering the deference given by the U.S. Tax Court to I.R.S. conclusions of fact).

66. 5 U.S.C. §§ 551-59, 701-06 (2012); Anthony W. Mongone, Note, *Business Roundtable: A New Level of Judicial Scrutiny and its Implications in a Post-Dodd-Frank*

the Act are to inform the public about agencies' procedures, rules, and organization; provide the public with the opportunity to participate in the rulemaking process; establish standards for the promulgation of rules and adjudicating disputes; and set forth the scope of judicial review of agencies' actions.⁶⁷ With certain exceptions, the Act requires that notice and comment procedures be adhered to in the promulgation of proposed regulations.⁶⁸ However, the notice and comment requirements do not apply to interpretive rules, general statements of policy, or rules of agency organization, procedure, or practice.⁶⁹ Moreover, notice and comment procedures may be dispensed with if the agency finds, with good cause, that such procedures are impractical, unnecessary, or contrary to the public interest.⁷⁰ As discussed

World, 2012 COLUM. BUS. L. REV. 746, 770-85 (2012). The federal government's role in the nation's economic affairs increased in response to the industrialization of the economy during the nineteenth century and to the post-Civil War need to protect the newly acquired rights of African-Americans. Lawrence M. Friedman, *Friedman, A History of American Law*, 439-466 (2d. ed. 1985). The creation of the Interstate Commerce Commission in 1887 marked the birth of what would become an immense federal bureaucracy and the Progressive period resulted in the increased regulation of railroads, the institution of occupational licensing, and the enactment of the Sherman Antitrust Act. *Id.* (considering how the *Lochner* era proved to be a temporary reprieve to the increasing role of the public sector in private enterprise); see *Lochner v. New York*, 198 U.S. 45 (1905) (holding that a New York statute regulating the hours of bakers was an unconstitutional infringement on the right and liberty to contract). The *Lochner* era, in my opinion, closed with the Court's decision in *West Coast Hotel Co. v. Parrish*. This decision upheld the constitutionality of Washington state's minimum wage law and overturned an earlier precedent to the contrary, *Adkins v. Children's Hospital*, 261 U.S. 525 (1923). *West Coast Hotel Co. v. Parrish*, 300 U.S. 379 (1937). The Supreme Court's initial resistance to expansive federal powers over economic matters came to an end with its decision in the seminal case of *N.L.R.B. v. Jones & Laughlin Steel Corp.* 301 U.S. 1 (1937) (upholding the constitutionality of the National Labor Relations Act of 1935). Several years later, the Court laid to rest any doubts as to the extent of the federal commerce power. See *Wickard v. Filburn*, 317 U.S. 111 (1942) (holding that Congress's power to regulate interstate commerce includes the power to regulate activity that has an indirect effect on such commerce).

67. DEP'T OF JUSTICE, ATTORNEY GENERAL'S MANUAL ON THE ADMINISTRATIVE PROCEDURE ACT 9 (Wm. W. Gaunt & Sons 1973). This source also provides a detailed description and analysis of the statute.

68. 5 U.S.C. §§ 553(a)-(b) (2010). In general, final regulations may not take effect within 30 days after notice is given. However, this requirement is inapplicable to regulations that relieve burdens on those persons subject to the regulations. 5 U.S.C. § 553(d)(1) (2010). Tax regulations that are favorable to taxpayers may be insulated from taxpayer challenges due to lack of standing. Not all taxpayer-friendly regulations will be so insulated, however. See *King v. Burwell*, 135 S. Ct. 2480, 2487 (2015) (holding that standing was no barrier to challenges to Treasury regulations that interpreted the availability of tax credits provided by the Patient Protection and Affordable Care Act in a manner favorable to taxpayers because the availability of tax credits could cause a taxpayer to be subject to the so-called individual mandate, the requirement to purchase health insurance).

69. 5 U.S.C. § 553(b) (2010).

70. *Id.* An agency that invokes the good cause exception must set forth its reasons for

later in this Article, agencies also must provide reasoned explanations for their actions, a requirement that offers some assurance that agency actions do not implicate separation of powers issues, provides a modicum of political accountability, and potentially improves the quality of agency decisions.⁷¹

The Treasury has been rather cavalier with the Administrative Procedure Act. The Treasury derives its regulatory authority from two sources. First, Congress may delegate it the authority to issue rules and regulations to carry out the provisions of a specific statute within the statute itself. That regulatory authority typically is phrased in broad terms, such as the authority to prescribe regulations as may be necessary and appropriate to carry out the statutory provisions in question, but it is not uncommon for Congress to reference specific provisions of the statute in its grant of authority indicating its expectation that regulations will be forthcoming with respect to those provisions.⁷² I.R.C. section 7805(a), which delegates general regulatory authority to the Treasury for the enforcement of the tax laws, is a second source of regulatory authority.⁷³

The Treasury took the frequently criticized position that regulations issued under section 7805 were interpretative and, therefore, not subject to the notice and comment provisions of the Administrative Procedure Act.⁷⁴

doing so. 5 U.S.C. § 553(b)(B) (2010). The Attorney General's Manual and the courts have interpreted the good cause exception to apply in cases when timely guidance is critical and the notice and comment requirement would impose an impediment to such timely guidance, minor rules with little public interest, and the somewhat unusual case in which notice and comment would be counterproductive. Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with the Administrative Procedure Act Rulemaking Requirements*, 82 NOTRE DAME L. REV. 1727, 1781-82 (2007).

71. See Steve R. Johnson, *Reasoned Explanation and IRS Adjudication*, 63 DUKE L. J. 1771, 1788 (2014) (reflecting on the reasoned explanation requirement). See also *infra* notes 98-113 and accompanying text.

72. See *e.g.*, I.R.C. §§ 263A(i), 409A(e), 469(l) (2012).

73. I.R.C. § 7805(a) (2012). With certain exceptions, proposed, temporary, or final regulations cannot have retroactive effect. I.R.C. § 7805(b). Temporary regulations must also be issued in the form of proposed regulations and expire within three years of their issuance. I.R.C. § 7805(e). All published proposed and temporary regulations must be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact that such regulations will have on small business. I.R.C. § 7805(f). The Treasury must consider comments from the Chief Counsel for Advocacy of the Small Business Administration and discuss any response to such comments in the preamble to final regulations. *Id.*

74. See Kristin E. Hickman, *A Problem of Remedy: Responding to Treasury's (Lack of) Compliance with the Administrative Procedure Act Rulemaking Requirements*, 76 GEO. WASH. L. REV. 1153, 1158 n.16. (citing a study that found, in 232 regulatory projects studied, that the notice and comment requirement was explicitly disclaimed in almost 92 percent of such projects). See also *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 55-58 (2011) (applying the same standard of deference to regulations issued under a general grant of authority that is applied to other regulations); *Chevron U.S.A., Inc. v. Natural*

Moreover, the increasing complexity of tax law, particularly after the enactment of the Tax Reform Act of 1986, prompted the Treasury to issue rules in the form of temporary regulations which are binding upon taxpayers without any opportunity for pre-promulgation comments by interested parties.⁷⁵ Congress responded in 1988 by enacting I.R.C. section 7805I, which mandated the issuance of temporary regulations contemporaneously with a Notice of Proposed Rulemaking and required that such temporary regulations expire within three years.⁷⁶

The I.R.S. regularly engages in informal rulemaking through the issuance of Revenue Rulings and Notices, neither of which are subject to the Administrative Procedure Act.⁷⁷ Rulings are designed to apply the law to a

Res. Def. Council, 467 U.S. 837, 844 (1984) (stating that oftentimes legislative delegations are implicit); *Swallows Holding, Ltd. v. Comm'r*, 515 F.3d 162, 168-69 (3d Cir. 2008) (holding that regulations promulgated pursuant to I.R.C. section 7805 have the force of law); Hickman, *supra* note 74, at 1760-73. See also *ABA Section of Taxation Report of the Task Force on Judicial Deference*, 57 TAX LAW 717 (2004) [hereinafter *ABA Task Force Report*] (discussing the Treasury's use of Temporary Regulations). Congress exhibited a modicum of concern with this practice and expressly required the Treasury to comply with the provisions of the Regulatory Flexibility Act regardless of whether the regulations were legislative or interpretative. 5 U.S.C. § 603(a) (2010).

75. Hickman, *supra* note 74, at 1160. See Michael Asimov, *Public Participation in the Adoption of Temporary Tax Regulations*, 44 TAX LAW 343, 343 (1991) (questioning whether the Treasury's use of temporary regulations complied with the Administrative Procedure Act). In a study conducted by Professor Hickman, the Treasury frequently asserted that the provisions of the Administrative Procedure Act did not apply to regulations, whether temporary or final, due to the good cause exception. See Hickman, *supra* note 74, at 1749-51.

76. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6232(a), 102 Stat. 3342, 3734-35 (1988) (codified at I.R.C. § 7805(e) & (f)). Recently, the Treasury issued temporary and proposed regulations to hinder inversion and post-inversion transactions pursuant to which a domestic corporation relocates its domicile in a low tax jurisdiction but maintains significant operations in the country of its former domicile. See generally Temp. Treas. Reg. §§ 1.304-7T; 1.367(a)-3T; 1.367(b)-4T; 1.956-2T; 1.7701(l)-4T; 1.7874-1T-4T; 1.7874-6T-12T (2016). The issuance of these regulations reportedly scuttled the pending Pfizer-Allergan merger, as well as other pending transactions. Katie Thomas & Chad Bray, *Pfizer Weighs Split as Allergan Deal Collapses*, N.Y. TIMES, Apr. 7, 2016, at B1; Domenic Chopping & Ben Tita, *Tax Inversion Rules Complicate Crane Deal*, WALL ST. J., April 28, 2016, at B3 (reporting that the new rules could derail a merger between Terex Corp. and Konecranes Oyj); see *infra* notes 196-202 and accompanying text.

77. Revenue Rulings are official, published interpretations of the tax law applicable to a particular set of facts and are designed to both promote the uniform application of the tax laws and to assist in taxpayers' compliance with such laws. See Rev. Proc. 2003-1, C.B. 1 (Jan. 2003) (stating that the revenue procedure explains to taxpayers the kind of guidance the Service provides, how to request it, and how it is provided); Rev. Proc. 89-14, 1989-1 C.B. 814, 814-15 (Jan. 1989) (setting forth the standards for publication of rulings and procedures). Rulings do not have the force and effect of regulations, although they may be used as precedent by taxpayers. 26 C.F.R. § 601.601 (d)(2)(v)(d). The deference that a court will afford Notices, in comparison to Revenue Rulings, is unclear. Compare

specific set of facts and, to that extent, can be fairly described as interpretative. Notices, however, are often used to provide guidance pending the issuance of a ruling or proposed regulations and frequently contain substantive interpretations of the tax law. Although Notices provide taxpayers with welcome guidance pending the conclusion of formal rulemaking, they also have been used to advance controversial positions without any opportunity for public comment.⁷⁸

The Anti-Injunction Act imposes a significant procedural obstacle to taxpayers who wish to challenge the legality of burdensome formal or informal Treasury rules. With respect to allegedly unlawful rules that confer a benefit on all or a portion of the taxpayer population, the Treasury is immune to legal challenges and its actions are subject only to political repercussions—a result of the Supreme Court’s standing jurisprudence.⁷⁹

Constantino v. TRW, Inc., 13 F.3d 969, 980-81 (6th Cir. 1994) (stating that Revenue Rulings are entitled to greater deference) with *Phillips Petroleum Co. v. Comm’r*, 101 T.C. 78, 99 (1993) (stating that Revenue Rulings and Notices are entitled to equal deference).

78. Perhaps the best example of the use of Notices in this manner was Notice 2008-83. This Notice, issued during the height of the financial crisis in 2008, was criticized by tax experts and members of Congress as a bailout to the banking industry. See Matthew A. Melone, *A Leg to Stand On: Is There a Legal and Prudential Solution to the Problem of Taxpayer Standing in the Federal Tax Context?*, 9 PITT. TAX REV. 111-14 (2012).

79. Federal taxpayer standing jurisprudence had its genesis in the 1923 case *Frothingham v. Mellon*. In that case, a taxpayer alleged that federal expenditures under a statute increased her tax bill in violation of due process. *Frothingham v. Mellon*, 262 U.S. 447 (1923). The Court denied the taxpayer standing because the effect of the expenditures on her federal tax liability was “so remote, fluctuating, and uncertain” and that “his interest in moneys of the Treasury . . . is shared with millions of others.” *Id.* at 487. Per the Court, federal judicial power can be invoked by a party upon a showing “not only that the statute is invalid, but that he has sustained . . . some direct injury as a result of its enforcement, and not merely that he suffers in some indefinite way in common with people generally.” *Id.* at 488. The Court has been similarly unreceptive to suits brought by members of Congress that allege an institutional injury but have allowed allegations of personal injury to proceed. See *Raines v. Byrd*, 521 U.S. 811 (1997) (finding that Congress members did not have standing based solely on loss of political power); *Powell v. McCormack*, 395 U.S. 486 (1969) (allowing suit where member of House of Representatives was excluded despite meeting the Article I Section 2 standing requirements of the Constitution); see also *Shays v. FEC*, 414 F. 3d 76 (D.C. Cir. 2005) (affirming that congressmen had standing to bring suit where the FEC exposed them to competition intensified by BCRA-banned practices and deprivation of fair reelection contests). Legislators may have standing to challenge executive action in the absence of a particularized individual harm if they have undertaken the challenge in a representational capacity. For example, a committee of the House of Representatives had standing to enforce a subpoena issued by the committee to a member of the executive branch. *Comm. On Judiciary, U.S. House of Representatives v. Miers*, 558 F. Supp. 2d 53, 55, 68 (D.D.C. 2008). See also *INS v. Chadha*, 462 U.S. 919, 939 (1983) (stating, in dicta, that “Congress is the proper party to defend the validity of a statute when a Government agency, as a defendant charged with enforcing the statute, agrees with plaintiffs that the statute is unconstitutional”). In *United States v. Windsor*, the case that struck down the Defense of Marriage Act, the Bipartisan Litigation Advisory Group (BLAG) of the House of Representatives petitioned to

The objectives of the Administrative Procedure Act are laudable, but the Act has its critics. The procedural requirements imposed on agencies can result in delays in the issuance of needed guidance or the reluctance to issue guidance due to the fear of legal challenges.⁸⁰ Moreover, compliance with the Act is costly and such compliance often does little to prevent well-heeled or influential parties from controlling the information upon which an agency formulates its guidance.⁸¹ The negative consequences of compliance with the Act are not unique to tax rulemaking but, given the reach of the tax laws and general antipathy toward tax compliance, such consequences are particularly deleterious in the tax area.⁸² As previously noted, the law has recognized, in various ways, the exceptional nature of the government's revenue collection function.⁸³ The Anti-Injunction Act is perhaps the most prominent example of tax exceptionalism.

In recent years, the extent to which tax rules are permitted to exist apart from the general population of administrative rules has been called into question. In 2011, the Supreme Court seemingly handed the Treasury a major victory with respect to the deference that its tax regulations enjoy.⁸⁴ However, that victory may have come at a steep price because the Court pointedly rejected the notion of tax exceptionalism.⁸⁵ As a result, Treasury actions have been subject to challenge under administrative law doctrines that were rarely, if ever, applied to tax rules.

A. *Deference: A Crack in the Armor of Tax Exceptionalism*

The seminal case of *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.* held that a very deferential standard of review was applicable

intervene to defend the statute as an interested party after being notified by the Attorney General that the Department of Justice would not defend the statute's constitutionality. 133 S. Ct. 2675 (2013). While the Court found it unnecessary to determine whether BLAG had standing on its own right, Justices Alito and Thomas believed that BLAG did have standing, and would maintain the standing of a member of Congress to defend the constitutionality of any statute provided that the member has the institutional imprimatur to do so. *Id.* at 2686-2688.

80. See Stephanie Hunter McMahon, *The Perfect Process is the Enemy of the Good Tax: Tax's Exceptional Regulatory Process*, 35 VA. TAX REV. 553, 579-580 (2016) (explaining that pre-notice rulemaking requires a serious commitment of agency resources when it comes to issuing guidance).

81. *Id.* at 583-85.

82. *Id.* at 589-602, 611-12.

83. See *supra* note 65 and accompanying text.

84. See *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44 (2011) (holding that the *Chevron* standard applied to all Treasury regulations issued after notice and comment).

85. *Id.* at 55-56.

to agency action that had been subject to notice and comment.⁸⁶ This standard employs a two-step inquiry. Step one inquires whether the subject of the agency action directly addresses the precise question at issue and, if not, step two inquires whether the agency action is arbitrary, capricious in substance, or manifestly contrary to the statute.⁸⁷ So long as the statute is sufficiently ambiguous, agency action will not be disturbed unless it is arbitrary, capricious in substance, or manifestly contrary to the statute.⁸⁸

86. *Chevron, U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837 (1984). Deference to agency actions existed long before the *Chevron* decision. In *Skidmore v. Swift & Co.*, the Court held the level of deference that an agency's action warrants depends upon the thoroughness of the agency's deliberations, the validity of its reasoning, its consistency with earlier and later pronouncements, and other factors which provide the agency with the power to persuade. 323 U.S. 134, 140 (1944). This rather vague standard was thought not to offer meaningful guidance by Justice Scalia. See *United States v. Mead*, 533 U.S. 218, 250 (2001) (Scalia, J., dissenting) (opining that this standard's resort to the totality of the circumstances is not practical in the modern administrative state). In 1979, the Court applied a multi-factor test—the so-called *National Muffler* test—to determine whether Treasury regulations issued under the general authority of I.R.C. section 7805(a) were a permissible interpretation of a statute. *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 477 (1979). The Court examined whether the regulations in question were a contemporaneous construction of the statute promulgated with the awareness of congressional intent, the length of time that the regulations were in effect, the degree of reliance placed on the regulations by affected parties, the consistency of the agency's position, and the degree of scrutiny given the regulations by Congress during subsequent re-enactments of the statute. *Id.* The Court later applied this test in two cases decided not long after its *National Muffler* decision and, in both cases, noted that less deference is owed to Treasury interpretations issued pursuant to I.R.C. section 7805. *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982); *Rowan Cos. v. United States*, 452 U.S. 247, 253 (1981).

87. *Chevron*, 467 U.S. at 842-844. The *Chevron* two-step test is more deferential than the *National Muffler* test in several respects. For example, under *Chevron*, whether the agency's action is consistent with its previous position on the matter at hand and whether the regulation had been issued contemporaneously with the statute are not relevant to the level of deference due the agency. See *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 1001 n.4 (2005) (stating that the lack of consistency does not undermine the case for deference); *Cent. Laborers' Pension Fund v. Heinz*, 541 U.S. 739, 748 (2004) (deferring to a regulation that upset a longstanding agency position to the contrary); *Smiley v. Citibank*, 517 U.S. 735, 740-41 (1996) (applying *Chevron* deference to regulations issued approximately a century after the enactment of the statute). Moreover, the Court has held that *Chevron* deference is owed to regulations that are contrary to previous judicial holdings regarding the meaning of statutory terms. See *Brand X*, 545 U.S. at 981-982 (deferring to an agency interpretation that was a reversal of actual agency policy).

88. *Mead*, 533 U.S. at 227. *Chevron* deference is not always applicable to regulations that clarify statutory ambiguities. In *King v. Burwell*, the Court upheld Treasury regulations that made available tax credits to purchasers of health insurance on federal exchanges. 135 S. Ct. 2480 (2015). However, the Court did not apply *Chevron*. *Id.* According to the Court, deference under *Chevron* is premised on the notion that statutory ambiguities “constitutes an implicit delegation from Congress to the agency to fill in the statutory gaps.” *Id.* at 2488 (quoting *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 159 (2000)). This premise may not be warranted in extraordinary cases and this was such a case.

Chevron was premised on prudential grounds and acknowledged that the modern administrative state demands that agencies possess specialized knowledge beyond the “ordinary knowledge” possessed by the courts.⁸⁹ The expert agency is surely better equipped to do the job than district judges issuing ad hoc, case-by-case injunctions. Federal judges lack the scientific, economic, and technological resources an agency can utilize in coping with issues of this order.”⁹⁰ Ostensibly, *Chevron* pays fealty to congressional intent and separation of powers, but its constitutional underpinning should not be exaggerated.⁹¹

The tax credits are among the Act’s key reforms, involving billions of dollars in spending each year and affecting the price of health insurance for millions of people. Whether those credits are available on Federal Exchanges is thus a question of deep “economic and political significance” that is central to this statutory scheme; had Congress wished to assign that question to an agency, it surely would have done so expressly. It is especially unlikely that Congress would have delegated this decision to the IRS, which has no expertise in crafting health insurance policy of this sort. This is not a case for the IRS.

Id. at 2489 (internal citations omitted).

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

90. *Am. Elec. Power Co., Inc. v. Conn.*, 564 U.S. 410, 428 (2011). *Chevron* also rested on the notion of congressional intent and the concomitant political accountability that follows. *Chevron*, 467 U.S. at 843. Judicial deference to agency action is warranted because “[t]he power of an administrative agency to administer a congressionally created . . . program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress.” *Id.* at 843. Critics often question the political legitimacy of agency actions because of the inordinate influence that the regulated constituency often exerts over the regulator, influence that is based, in part, on resource and information disparities, political influence, and the revolving door between agencies and their regulated constituents. David J. Arkush, *Direct Republicanism in the Administrative Process*, 81 GEO. WASH. L. REV. 1458, 1473-75 (2013). The House of Representatives passed the Separation of Powers Restoration Act of 2016, H.R. 4768, 114th Cong. (2016), which would require *de novo* judicial review of all relevant questions of law and agency rules.

91. The link between the Constitution and *Chevron* is tenuous. Deference is invited by sweeping delegations of authority from Congress to agencies. Such delegations may either violate separation of powers principles or come close to doing so. As the Court made clear in *Field v. Clark*, Congress cannot delegate its Article I legislative powers. 143 U.S. 649, 692 (1892). Additionally, broad delegations of regulatory authority to agencies may constitute an impermissible delegation by Congress of its legislative authority. The Court has applied an “intelligible principle” test, described in *Mistretta v. United States*, to determine whether a congressional delegation is too broad:

Applying this “intelligible principle” test to congressional delegations, our jurisprudence has been driven by a practical understanding that in our increasingly complex society, replete with ever changing and more technical problems, Congress simply cannot do its job absent an ability to delegate power under broad general directives. Accordingly, this Court has deemed it “constitutionally sufficient if Congress clearly delineates the general policy, the public agency which is to apply it, and the boundaries of this delegated authority.”

488 U.S. 361, 372-73 (1989) (internal citations omitted).

Scholars have debated whether the two steps of the *Chevron* test are redundant. Stephenson and Vermeule assert that “[t]he single question is whether the agency’s construction is permissible as a matter of statutory interpretation; the two *Chevron* steps both ask the question, just in different ways. As a result, the two steps are mutually convertible.”⁹² Richard Re, in a compelling counterargument, asserted that *Chevron* step one provides the answer to the question of whether Congress left only one permissible interpretation of a statute.⁹³ If, under *Chevron* step one, a genuine statutory ambiguity exists, then *Chevron* step two defers to any number of interpretations, so long as they are reasonable.⁹⁴

The standard by which courts were to determine whether and to what extent to defer to Treasury regulations issued under I.R.C. section 7805(a) was set forth in *National Muffler* not long before the *Chevron* decision.⁹⁵ After *Chevron*, the continuing vitality of the *National Muffler* standard was unclear due to a distinction between explicit and implicit delegations seemingly made by *Chevron* itself.⁹⁶ Some commentators, including the

The Administrative Procedure Act precludes judicial review of actions committed to agency discretion by law. 5 U.S.C. § 701(2) (2012). The Court has held that this exception is to be construed narrowly, applicable in the rare instances where the statutory terms are so broad that there is no law to apply. *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 410-11 (1971). The non-delegation doctrine set forth in *Mistretta* appears to be in tension with the “no law to apply” standard set forth in *Overton Park*. See Viktoria Lovei, *Revealing the True Definition of APA § 701(a)(2) by Reconciling “No Law to Apply” with the Nondelegation Doctrine*, 73 U. CHI. L. REV. 1047 (2006) (explaining that when Congress passes a statute that confers a large degree of authority upon the executive, there is a conflict between the non-delegation doctrine and the agency discretion exception of the Administrative Procedure Act). Moreover, a constitutional underpinning to *Chevron* putatively renders any statutory rejection or limitation on judicial deference unconstitutional. For example, the Freedom of Information Act mandates *de novo* review of government actions to withhold records from the public. Margaret B. Kwoka, *Deference, Chenery, and FOIA*, 73 MD. L. REV. 1060 (2014).

92. Matthew C. Stephenson & Adrian Vermeule, *Chevron Has Only One Step*, 95 VA. L. REV. 597, 599 (2009).

93. Richard M. Re, *Should Chevron Have Two Steps?*, 89 IND. L. J. 605, 610-16 (2014).

94. *Id.*

95. *National Muffler Dealers Ass’n v. United States*, 440 U.S. 472 (1979).

96. The Court stated:

If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. Sometimes the legislative delegation to an agency on a particular question is implicit rather than explicit. In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.

Chevron, U.S.A. Inc. v. NRDC, Inc., 467 U.S. 837, 843-44 (1984).

American Bar Association, believed that *Chevron* set forth two separate step-twos: an arbitrary, capricious, or manifestly contrary to the statute test for regulations promulgated under explicit congressional delegations of authority, and a less deferential reasonable interpretation standard for regulations promulgated under implicit congressional delegations of authority.⁹⁷ Consequently, the deference afforded to regulations issued pursuant to I.R.C. section 7805(a) by *National Muffler* is appropriate after *Chevron*.⁹⁸

After *Chevron*, the Court continued to apply the *National Muffler* test, somewhat inconsistently and often confusingly, to Treasury regulations issued under I.R.C. section 7805.⁹⁹ As a result, confusion and contradiction emanated from the lower courts and the Tax Court as to whether *Chevron* replaced *National Muffler*, whether they are in fact similar, and when to apply one standard versus the other.¹⁰⁰ Critics of the application of *Chevron*

97. See Mark E. Berg, *Judicial Deference to Tax Regulations: A Reconsideration in Light of National Cable, Swallows Holding, and Other Developments*, 61 TAX LAWYER 481, 495 (2008) (explaining that the *Chevron* Court set forth two standards: an “arbitrary-and-capricious standard” and “a permissible-construction standard”); *ABA Task Force Report*, *supra* note 74, at 739 (asserting that specific authority regulations are subject to an “arbitrary and capricious” standard while general authority regulations are subject to a “reasonableness” standard).

98. *Id.* at 737-38. The Court made clear that the *Skidmore* standard survived *Chevron* at least with respect to informal rulemaking. See *United States v. Mead Corp.*, 533 U.S. 218, 234-36 (2001) (explaining that *Chevron* did not overrule *Skidmore* and stating that this case may lend itself to a *Skidmore* claim); see also *Christensen v. Harris County*, 529 U.S. 576, 587 (2000) (stating that *Skidmore* deference is applicable to informal agency actions such as opinion letters, manuals, guidelines, and policy statements); *Nelson v. Comm’r*, 568 F.3d 662, 665 (8th Cir. 2009) (applying *Skidmore* deference to revenue rulings); *Kornman & Assoc., v. U.S.*, 527 F.3d 443, 452-57 (5th Cir. 2008) (concluding that revenue rulings are entitled to *Skidmore* deference). Not everyone has concluded revenue rulings are entitled to *Skidmore* deference. See *Tualatin Valley Builders Supply, Inc. v. U.S.*, 522 F.3d 937, 948 (9th Cir. 2008) (O’Scannlain, J., concurring) (concluding that *Chevron* deference was appropriate for a Revenue Procedure). The Department of Justice has indicated that it will not argue for the application of *Chevron* deference to revenue rulings and revenue procedures. See Marie Sapirie, *DOJ Won’t Argue for Chevron Deference for Revenue Rulings and Procedures*, *Official Says*, 131 TAX NOTES 674 (2011) (reporting on the Justice Department’s decision not to argue for *Chevron* deference and citing Gilbert Rothenberg, the acting deputy assistant attorney general in the DOJ’s Tax Division).

99. See Berg, *supra* note 97, at 502 (noting that since *Chevron*, “the Tax Court as well as the courts of appeals have been wrestling with the question of *Chevron*’s effect (if any) on the *National Muffler* standard”); Kristin E. Hickman, *The Need for Mead: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537, 1579-86 (2006) (describing the inconsistency in the courts’ application of deference standards to tax cases).

100. Berg, *supra* note 97, at 500-16 (discussing a number of Circuit Court cases and Tax Court cases in which different standards were applied). In one case, the Tax Court stated that the *National Muffler* standard “has not been changed by *Chevron*, but has merely been restated in a practical two-part test with possibly subtle distinctions as to the role of legislative history and the degree of deference to be accorded to a regulation.” *Cent. Pa. Sav. Ass’n v. Comm’r*,

to tax regulations asserted a sort of tax exceptionalism pursuant to which a lesser standard of deference was justified for tax regulations.¹⁰¹

In 2011, the Court's decision in *Mayo Foundation for Medical Education & Research v. United States* dismissed notions of tax exceptionalism and held that the *Chevron* standard applied to all Treasury regulations issued after notice and comment.¹⁰² *Mayo* upheld a tax regulation promulgated pursuant to the general grant of authority under I.R.C. section 7805 that denied medical residents an exemption from payroll taxes.¹⁰³ The Court forcefully rejected the notion that tax regulations are somehow entitled to less deference than the regulatory action of other agencies.

Mayo has not advanced any justification for applying a less deferential standard of review to Treasury Department regulations than we apply to the rules of any other agency. In the absence of such justification, we are not inclined to carve out an approach to administrative review good for tax law only. To the contrary, we have expressly “[r]ecogniz[ed] the importance of maintaining a uniform approach to judicial review of administrative action.” . . . Filling gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation at least as complex as the ones other agencies must make in administering their statutes. . . . We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to *Chevron* to the same extent as our review of other regulations.¹⁰⁴

104 T.C. 384, 392 (1995).

101. According to some, the inherent advantages enjoyed by the I.R.S. over taxpayers, the severity of tax penalties, the sweep of the revenue collection function, and the complexity of the tax code justify special treatment for tax administration. See *ABA Task Force Report*, *supra* note 74, at 723-25 (highlighting the advantages enjoyed by the I.R.S.). The idea of tax exceptionalism is not universally held. See Hickman, *supra* note 99, at 1592-98 (disagreeing with the arguments of tax exceptionalists, who believe that a more “diluted” version of *Chevron* should be applied to general authority Treasury regulations).

102. *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 55-57 (2011).

103. *Id.*

104. *Id.* at 55-56. The Court also made clear the distinction between the *Chevron* and *National Muffler* standards and why the former is significantly more deferential than the latter. *Id.* at 54-55. *Chevron* left a number of issues—tax and otherwise—unresolved and *Mayo* did not resolve all deference questions with respect to Treasury actions. Two scholars posed fourteen questions that they believe *Chevron* left unanswered in addition to the basic question of whether there are certain subject matters for which deference is not appropriate. See Thomas W. Merrill & Kristin E. Hickman, *Chevron's Domain*, 89 GEO. L. J. 833, 849-52 (2001) (identifying the unresolved questions that have come up in lower courts and that have led to circuit splits). For example, whether *Chevron* deference is predicated on the issuance of regulations after notice and comment is not clear. *Mayo* hinted that notice and comment is a prerequisite for *Chevron* deference but did not say so categorically. “The Department issued the full-time employee rule only after notice-and-comment procedures, again a consideration

After *Mayo*, the deference to which Treasury regulations issued after notice and comment are entitled no longer depends upon their source of authority. *Mayo*, therefore, was a win for the Treasury, and it may embolden the Treasury to exercise its interpretative authority more aggressively, or, alternatively, it will provide an impetus for the Treasury to submit to notice and comment procedures more frequently.¹⁰⁵ It may do both. *Mayo*, however, ultimately may prove to be a hollow victory. The Court's unequivocal rejection of tax exceptionalism in that case has opened the door to the application of general administrative law principles that have largely gone unnoticed in the tax area.

identified in our precedents as a 'significant' sign that a rule merits *Chevron* deference." *Mayo*, 562 U.S. at 57-58 (first quoting *United States v. Mead Corp.*, 533 U.S. 218, 230-31 (2001), and then quoting *Long Island Care at Home, Ltd. v. Coke*, 551 U.S. 158, 173-74 (2007)). Thus, whether temporary Treasury regulations are entitled to *Chevron* deference is unlikely, and, if not, whether *National Muffler* or *Skidmore* deference should apply is unclear. The Seventh Circuit, however, indicated that it would apply *Chevron* deference to temporary regulations, at least those that have been replaced by nearly identical final regulations issued after notice and comment:

This temporary regulation, which was issued without notice and comment at the same time as an identical proposed regulation, purports to offer taxpayers guidance by resolving an open question and stating definitively that in the case of a disposition of property, an overstatement of basis can lead to an omission from gross income. This temporary regulation has since been replaced by a nearly identical final regulation, issued after a notice and comment period. Because we find that *Colony* is not controlling, we need not reach this issue. However, we would have been inclined to grant the temporary regulation *Chevron* deference, just as we would be inclined to grant such deference to T.D. 9511. We have previously given deference to interpretive Treasury regulations issued with notice-and-comment procedures, and the Supreme Court has stated that the absence of notice-and-comment procedures is not dispositive to the finding of *Chevron* deference.

Beard v. Comm'r, 633 F.3d 616, 623 (7th Cir. 2011), cert. granted, vacated, 132 S. Ct. 2099, 182 L. Ed. 2d 865 (2012).

It is not clear whether proposed regulations are entitled to any deference whatsoever although the Court has indicated that such regulations are not so entitled. *Boeing Co. v. U.S.*, 537 U.S. 437, 453 n.13 (2003) (rejecting the taxpayer's reliance on proposed regulations and stating, "we find these proposed regulations to be of little consequence given that they were nothing more than mere proposals").

105. See Steve R. Johnson, *Preserving Fairness in Tax Administration in the Mayo Era*, 32 VA. TAX REV. 269, 275-78, 289-98 (2012) (setting forth the benefits of the *Mayo* decision but cautioning that *Mayo* could lead to Treasury overreach). A recent study of the Circuit Courts' application of *Chevron* found that it is invoked less frequently in tax cases but, when invoked, the Treasury's win rate is relatively high. Kent Barnett & Christopher J. Walker, Article, *Chevron in the Circuit Courts*, 115 MICH. L. REV. (forthcoming 2017) (Table 2, manuscript at 49).

B. *The State Farm Doctrine*

Under the Administrative Procedure Act, a court may invalidate agency actions that are arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.¹⁰⁶ One year before *Chevron*, the Court decided the seminal case concerning the Act's arbitrary and capricious standard, *Motor Vehicle Manufacturers Association of the U.S. v. State Farm Mutual Automobile Insurance Co.*¹⁰⁷ The National Traffic and Motor Vehicle Safety Act of 1966 directed the Secretary of Transportation to issue practical and objective motor vehicle safety standards and, in so doing, to consider all relevant safety data, the reasonableness and practicality of proposed safety standards, and whether such standards will contribute to carrying out the purpose of the statute.¹⁰⁸ The Department of Transportation issued several standards between 1967 and 1978, first requiring automobile manufacturers to install seatbelts and later requiring full passive front seat occupant restraint systems, airbags or automatic seatbelts, in model year 1984 vehicles.¹⁰⁹ In 1981, the Department ordered a one-year delay in the new standard, later proposed a rescission of the standard, and eventually rescinded the standard.¹¹⁰

106. 5 U.S.C. § 706(2)(A) (2010). Courts may also set aside agency action that is contrary to constitutional right, power, privilege, or immunity; in excess of statutory jurisdiction, authority, or limitations, or short of statutory right; taken without observance of required procedure; a decision in certain hearings that are unsupported by substantial evidence; or unwarranted by the facts to the extent that the facts are subject to a trial de novo. 5 U.S.C. §§ 706(2)(B)-(F) (2010). Unless a statute provides otherwise, only final agency actions are reviewable by a court. 5 U.S.C. § 704 (2010). In general, a person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review. 5 U.S.C. § 702 (2010). However, agency actions are not subject to judicial review if a statute precludes such review or the action is committed to agency discretion by law. 5 U.S.C. §§ 701(a)(1)-(2) (2010). For a discussion of actions committed to agency discretion and the non-delegation doctrine, *see supra* note 91 and accompanying text.

107. *Motor Vehicle Mfrs., Ass'n of the U.S. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983).

108. *Id.* at 33-34.

109. *Id.* at 34-37. Originally, passive restraints were required in all vehicles manufactured after August 15, 1975. *Id.* at 25. In the two years preceding the effective date of the passive restraint requirement, vehicles could be manufactured with passive restraint or shoulder belts coupled with an ignition lock. *Id.* The shoulder belt/ignition lock option was selected by most manufacturers but the unpopularity of this feature led Congress to amend the statute in 1974 to foreclose this option. *Id.* The effective date was later postponed for approximately one year and then suspended pending the outcome of a demonstration project. *Id.* Finally, a new Secretary of Transportation had the Department of Transportation issue the new standard in 1978. *Id.* at 37. The standard was to be phased in first with large cars in model year 1982 and then to all cars by model year 1984. *Id.*

110. *Id.* at 38.

The agency assumed that airbags would be installed in sixty percent of new cars but the vehicle manufacturers planned to meet the standard in approximately ninety-nine percent of new cars through the installation of automatic seat belts.¹¹¹ Because most automatic seat belts could be disengaged with relative ease, the agency believed that the costs to comply with the standard would be unreasonable in light of the minimal safety benefits to be derived from its imposition.¹¹² Moreover, the agency believed that the public's attitude toward vehicle safety would be soured by the imposition of an expensive, yet ineffective, standard.¹¹³

State Farm and an automobile insurance trade group challenged the rescission of the safety standard and the D.C. Circuit invalidated the agency's rescission because it believed that there was insufficient evidence to support the agency's conclusion regarding seat belt use, and because the agency failed to give proper consideration to either a requirement to install non-detachable seat belts or a requirement to install airbags.¹¹⁴ The Court agreed with the D.C. Circuit that rescission of a regulation is reviewable under the arbitrary and capricious standard but it held so in more sweeping terms.¹¹⁵ The Court stated that "the revocation of an extant regulation is substantially different than a failure to act" and obligates an agency "to supply a reasoned analysis for the change beyond that which may be required when an agency does not act in the first instance."¹¹⁶

According to the Court, the arbitrary and capricious standard is narrow and does not sanction the substitution of a court's judgment for that of the agency.¹¹⁷ An agency must articulate a satisfactory explanation for its action and there must be a rational nexus between the facts found and the agency's action.¹¹⁸ An agency rule is arbitrary and capricious if the agency: (1) relied

111. *Id.*

112. *Id.* at 39.

113. *Id.*

114. *Id.* at 39-40. The court held that the rescission was reviewable under the arbitrary and capricious standard and that such rescission was not analogous to a failure to issue regulations. *Id.* The Administrative Procedure Act authorizes a court to compel agency action unlawfully withheld or unreasonably delayed. 5 U.S.C. § 706(1) (2010). However, the courts are much more reluctant to compel agency action than they are to invalidate actions once such actions are taken, and will do so only if they find that the agency has a clear, nondiscretionary duty to act. See Eric Biber, *Two Sides of the Same Coin: Judicial Review of Administrative Agency Action and Inaction*, 26 VA. ENVTL. L. J. 461, 465-66 (2008) (describing the difference between judicial review of agency inaction and agency action, and explaining the difficulty of obtaining judicial review of agency inaction). Agency inaction is often considered committed to agency discretion by law or not considered final agency action, and therefore, unreviewable. *Id.*

115. *State Farm*, 463 U.S. at 41-42.

116. *Id.*

117. *Id.* at 43.

118. *Id.* (citing *Burlington Truck Lines v. U.S.*, 371 U.S. 156, 168 (1962)).

on factors that Congress did not intend it to consider; (2) entirely failed to consider an important aspect of the issue in question; (3) offered an explanation that is counterfactual; or (4) offered an explanation that is so implausible that it belies a difference of opinion or agency expertise.¹¹⁹ An agency's reasoning, if opaque, may be discerned by a court,¹²⁰ but, pursuant to *SEC v. Chenery Corp.*, the judiciary cannot provide a reasoned basis for an agency's action that the agency itself has not advanced.¹²¹ The Court held that the rescission of the passive restraint requirement was arbitrary and capricious because the ineffectiveness of detachable seat belts does not provide a rational basis for rescinding the airbag requirement and, with respect to automatic seatbelts, the agency failed to consider evidence regarding the effect that detachable seat belts would have on vehicle safety.¹²²

1. Is *State Farm* Distinct from *Chevron*?

Several scholars and the American Bar Association have asserted that *Chevron* and *State Farm* implicate similar inquiries and that the discernment of a conceptual distinction between the two standards is difficult.¹²³ *Chevron* step two is unlikely to be met either by actions supported by counterfactual or implausible justifications or by actions that fail to consider an important aspect of the issue in question. However, despite their oft-stated similarity, *State Farm* and *Chevron* are not the same. *Chevron* examines whether an agency has reasonably interpreted the law,¹²⁴ whereas *State Farm* seeks an

119. *Id.*

120. *Id.*

121. *Id.* (citing *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947)).

122. *Id.* at 48-49. The Court found that the Department of Transportation gave no consideration to amending the standard to mandate airbags in light of its position that detachable seat belts are not effective. *Id.* at 50. The agency's assertions that airbags create difficulties in the production of small cars and that public reaction to mandatory airbags would be negative were, according to the Court, *post hoc* rationalizations. *Id.* *Chenery* mandates that agency action, if it is to be sustained, be based on the reasons articulated by the agency when it took action. *Id.* (first citing *Burlington Truck Lines*, 371 U.S. at 168; then citing *SEC v. Chenery Corp.*, 332 U.S. at 196; and then citing *Am. Textile Mfrs. Inst., Inc. v. Donovan*, 452 U.S. 490, 539 (1981)). The Court acknowledged that agencies often operate in the face of uncertainty and that judgments may be drawn from facts and probabilities. However, an agency must do more than merely recite "substantial uncertainty" as its rationale for an action. *Id.* at 51-52. Instead, it must rationally connect the facts found with the choice made and justify why it is rescinding a rule before searching for further evidence. *Id.* The Court found the Department of Transportation's reliance on various data and its consideration of a "continuous passive" seat belt option inadequate. *Id.* at 52-56.

123. See David Zaring, *Reasonable Agencies*, 96 VA. L. REV. 135, 162-64 (2010) (arguing there is "little meaningful difference" between *Chevron* and *State Farm*).

124. *United States v. Mead*, 533 U.S. 218, 229 (2001).

articulated, reasonable factual and/or policy basis for an agency's action.¹²⁵ Although both *State Farm* and *Chevron* will yield the same result in many, if not most, cases, the tests are not identical. *Chevron* rests on notions of agency expertise and congressional intent, but *State Farm* has other justifications, including the imposition of discipline on agency decisions, the legitimization of agency action, and the enablement of judicial review.¹²⁶

Chevron step two permits any number of agency choices provided that those choices are reasonable.¹²⁷ In contrast, *State Farm* asks why the agency made a particular choice. An agency's choice may be permissible in the abstract yet be inadequately justified. In *State Farm*, the Department of Transportation had significant latitude to take action under the statute¹²⁸ and a variety of possible approaches—for example, passive seat belts only, air bags only, seat belts for certain cars and air bags for others, or manual seat belts with an interlock or buzzer feature—would probably have passed muster under *Chevron* step two.¹²⁹ *State Farm* however, required the agency to articulate the reasoning to support the choice it made. In *Mayo*, medical residents were subjected to payroll taxes by regulation because the Treasury chose to address the status of medical residents on the basis of hours worked and not on the primary purpose of the work performed.¹³⁰ This choice is neither arbitrary nor capricious in substance nor contrary to the statute, and the Treasury articulated satisfactory reasons for its choice.¹³¹ Had the Treasury failed to provide adequate reasons for its decision the regulation in question would have been invalidated under *State Farm* but not under *Chevron*. *Chevron* step two is, or should be, applied in the abstract. If statutory language permits an action, then *State Farm* requires that a hard look be taken at the reasons behind the action. This failure of *Chevron* step two inevitably will result in a concomitant failure of the *State Farm* test. Meanwhile, the opposite is not necessarily true.¹³²

125. *State Farm*, 463 U.S. at 41-42. Justice Breyer has noted that the law versus facts distinction between the two tests is counterintuitive because of its implication that the courts are more likely to defer to an agency's interpretation of law than to an agency's factual and policy conclusions. Thomas J. Miles & Cass R. Sunstein, *The Real World of Arbitrariness Review*, 75 U. CHI. L. REV. 761, 765 (citing Stephen Breyer, *Judicial Review of Questions of Law and Policy*, 38 ADMIN. L. REV. 363, 394 (1986)).

126. See Jodi L. Short, *The Political Turn in American Administrative Law: Power, Rationality, and Reasons*, 61 DUKE L. J. 1811, 1820-23 (2012) (laying out theories of reason giving in the administrative context).

127. *Chevron, U.S.A. Inc. v. NRDC, Inc.*, 467 U.S. 837, 842-43 (1984).

128. *State Farm*, 463 U.S. at 33-34.

129. *Id.*

130. *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44 49-50 (2011).

131. *Id.* at 59-60 (explaining that the Treasury Department justified its actions on the basis of administrative efficiency and the policy underlying the Social Security Act).

132. *Chevron* and *State Farm* are most similar in circumstances that do not involve

2. *State Farm* and Tax Regulations

The Supreme Court has never examined tax regulations under the *State Farm* standard.¹³³ Recently, *State Farm* has surfaced in two tax cases.¹³⁴ In one case, a court applied both *Chevron* and *State Farm* to invalidate a Treasury regulation.¹³⁵ In the other, a case with significant financial ramifications for multinational enterprises, a court invalidated a Treasury regulation under *State Farm*.¹³⁶

a. *Dominion Resources*

I.R.C. section 263A sets forth rules for the capitalization of costs attributable to real or personal property produced by a taxpayer and to real or personal property acquired by a taxpayer for resale.¹³⁷ Under the statute, interest costs incurred during the production period and allocable to real property and certain personal property with a long useful life are subject to

statutory interpretation. In such circumstances, the determination of whether an agency action is permissible in the abstract cannot be ascertained without examining the factual basis for the action. However, a statutory interpretation that requires no empirical data for support, as was the case in *Mayo*, or a statutory interpretation for which no reasoned explanation is put forth, as was the case in *State Farm*, may be permissible in the abstract. For example, assume that a statute requires that compensation must be reasonable to be deductible and that reasonableness is to be determined based on compensation paid for comparable work in comparable circumstances. If the Treasury issued a regulation that determined reasonableness based on some metric such as profit, revenue, or some other such variable, then whether this regulation is a permissible interpretation of the statute depends on whether the factual data supports that such a rule approximates comparable pay standards. If not, it is not a permissible interpretation but this cannot be determined until a hard look review of the Treasury's reasoning takes place. In a deportation case, Justice Kagan stated the Court would have reached the same conclusion whether it reviewed a Board of Immigration Appeals' action under *Chevron* step two or *State Farm*. *Judulang v. Holder*, 565 U.S. 42, 52 n.7 (2011). See Aaron Saiger, *Agencies' Obligation to Interpret the Statute*, 69 U. VA. L. REV. 1231, 1234-46 (2016) (arguing that an agency has an ethical obligation to put forth the best interpretation of statute and not any interpretation that will pass muster under a statute).

133. Two scholars recently examined all Supreme Court decisions between 1983 and 2014 that involved an arbitrary and capricious holding. See Jacob Gersen & Adrian Vermeule, *Thin Rationality Review*, 114 MICH. L. REV. 1355, 1407-12 (2016) (listing all arbitrary and capricious holdings). Their compilation included one tax case, *Mayo*. However, the Court did not review the Treasury regulation at issue in that case under *State Farm*. See *Mayo*, 562 U.S. at 52 (applying only *Chevron*).

134. *Dominion Res., Inc. v. United States*, 681 F.3d 1313 (Fed. Cir. 2012); *Altera Corp. v. Comm'r*, 145 T.C. 91 (2015).

135. *Dominion Res., Inc. v. United States*, 681 F.3d 1313 (Fed. Cir. 2012);

136. *Altera Corp. v. Comm'r*, 145 T.C. 91 (2015).

137. I.R.C. § 263A(a-b) (2012).

capitalization.¹³⁸ In addition to interest on any debt that is directly attributable to production expenditures with respect to a property, interest on any other debt is assigned to property under production to the extent that such debt could have been reduced if the production expenditures had not been incurred.¹³⁹ Consequently, if production is financed by equity, internal cash flow, or other non-debt sources of funds, then interest expense on any debt can be capitalized under the theory that debt unrelated to production could have been reduced but for the production expenditures. The Treasury issued regulations that defined production expenditures, in the case of the purchase of property for further production, to include the adjusted basis of other property that is temporarily idled by the production, thus adding to the total production expenditures and increasing the amount of interest that must be capitalized.¹⁴⁰ *Dominion Resources* challenged the validity of the regulation, and the Court of Federal Claims, applying *Chevron*, granted the government's motion for summary judgment.¹⁴¹ This decision was reversed by the Federal Circuit Court because, according to the court, the regulation in question failed both *Chevron* step two and the *State Farm* test.¹⁴²

The court believed that the statute's definition of production expenditures did not speak directly to the issue at hand and, therefore, *Chevron* step one was satisfied.¹⁴³ However, the court held, for three reasons, that the requirement to include the basis of idled property in the production costs for which interest must be capitalized was not a reasonable interpretation of the statute.¹⁴⁴ The court further held that the regulation was

138. I.R.C. §§ 263A(f)(1), 263A(f)(4)(A) (2012). The interest capitalization rules also apply to property whose estimated production period exceeds two years or whose estimated production period exceeds one year and whose cost exceeds one million dollars. I.R.C. §§ 263A(f)(1)(B)(ii-iii).

139. I.R.C. § 263A(f)(2)(A)(1-2).

140. See Treas. Reg. § 1.263A-11(e)(1)(ii)(B) (1994) (defining accumulated production expenses for improvements to real property).

141. *Dominion Res., Inc. v. U.S.*, 97 Fed. Cl. 239 (2011), *rev'd*, 681 F.3d 1313 (Fed. Cir. 2012). The court upheld the regulation despite its finding of several internal inconsistencies within the regulations and its belief that the regulation's interpretation of the statute stretched the bounds of reasonableness. See *id.* at 257.

142. *Dominion Res., Inc. v. United States*, 681 F.3d 1313, 1314 (Fed. Cir. 2012), *rev'g*, 97 Fed. Cl. 239 (2011).

143. *Id.* at 1317.

144. *Id.* at 1318. First, the court noted that no debt could have been reduced had production expenditures not been incurred. The cost of the idled property cannot be an avoided cost because such cost had already been incurred prior to production. *Id.* The Treasury's position makes sense only under the assumption that the idled facility could have been sold and the sale proceeds used to pay down debt—an assumption that belies reality because such a sale obviates the very reason for any improvement to the property. *Id.* at 1318-19. Second, the court held that the plain meaning of production expenditures is an amount actually expended or spent. *Id.* at 1318. Moreover, the statute determined the amount of

arbitrary and capricious under *State Farm*—the first appellate court to invalidate a tax regulation—because the Treasury offered no rationale either when it issued the Notice that provided guidance on the forthcoming regulation or when it issued the regulation in proposed or final form.¹⁴⁵

In concurrence, Judge Clevenger explicitly distinguished *Chevron* step two from *State Farm*.¹⁴⁶ He agreed that the regulation should be invalidated under *State Farm*.¹⁴⁷ However, he did not believe that the regulation should have been invalidated under *Chevron* step two because the Treasury's position could be supported for several reasons.¹⁴⁸ Judge Clevenger then succinctly captured the distinction between *Chevron* and *State Farm*. The application of *Chevron* “creates a binding rule (at least in this circuit) that the government can never re-promulgate its associated-property rule for property temporarily withdrawn from service, no matter how well-formed its reasoning.”¹⁴⁹ An agency can, in fact, advance a position that, in the abstract, is a reasonable interpretation of a statute but that is insufficiently justified.

interest to be capitalized based on the amount of debt that could have been reduced had no production expenditures been incurred. *Id.* at 1317. The basis of existing property is not an amount that is incurred by a taxpayer. *Id.* This rationale is somewhat puzzling. If the statute plainly foreclosed such a regulation, then *Chevron* step one was not met. If the meaning of the terms “expended,” “spent,” and “incurred” are plain, then the statute does speak to the precise issue at hand. Finally, the court concluded that the Treasury regulation could lead to absurd results because the adjusted basis of idled property bears little relation to the cost of improvements. *Id.* at 1318. Consequently, the same improvement could result in significantly different amounts of interest capitalized. *Id.* Dominion's two improvements were comparable in cost yet the regulations required vastly different amounts of interest to be capitalized solely because the adjusted basis of the two idled properties that were improved differed by over \$100 million. *Id.*

145. *Id.* at 1319. In *Mannella v. Commissionerr*, the court upheld the validity of a Treasury regulation under *Chevron*. 631 F.3d 115 (3d Cir. 2011). The dissent quoted from *State Farm*, but the quote was used to support the argument that *Chenery* precluded the court from considering the Treasury's assertions in this case. *Id.* at 127 (Ambro, J., dissenting). *State Farm* surfaced in a number of Tax Court cases over twenty years ago. See Patrick J. Smith, *Mannella, State Farm, and the Arbitrary and Capricious Standard*, 131 TAX NOTES 387, 393 n.44 (2011) (listing citations of *State Farm* in the Tax Court).

146. Dominion Res., Inc., 681 F.3d at 1320 (Clevenger, J., concurring).

147. *Id.*

148. *Id.* at 1321. See, e.g., *id.* at 1321-22 (explaining that the idling of a facility does result in the incurrence of costs—lost revenue). Moreover, the regulation minimizes the opportunity for tax evasion because the regulation prevents a taxpayer from temporarily placing such a property in service to avoid interest capitalization. *Id.* at 1322.

149. *Id.* at 1322-23. See Christopher J. Walker, *The Ordinary Remand Rule and the Judicial Toolbox for Agency Dialogue*, 82 GEO. WASH. L. REV. 1553 (discussing the circumstances in which a court will or will not remand a matter to an agency for further consideration); see also *Allied-Signal, Inc. v. U.S. Nuclear Reg. Comm'n*, 988 F.2d 146, 150-51 (D.C. Cir. 1993) (holding that in certain circumstances, remand without vacatur is appropriate).

b. *Altera*

The prevention of tax base erosion through the improper shifting of income to foreign subsidiaries by U.S. corporations has been a long-standing tax policy.¹⁵⁰ I.R.C. section 482 attempts to determine the “true taxable income” of a controlled taxpayer by putting such taxpayer in “tax parity with an uncontrolled taxpayer.”¹⁵¹ This statute grants the I.R.S. broad authority to distribute, apportion, or allocate gross income, deductions, credits, and allowances among controlled taxpayers as is necessary in order to prevent tax evasion or to clearly reflect the income of such entities.¹⁵² Treasury regulations have promulgated the “arm’s length” standard, under which the terms of a transaction among controlled taxpayers must be similar to the terms of comparable transactions among uncontrolled taxpayers.¹⁵³ The difficulty in determining comparable terms for transfers of intangible assets led Congress to amend the statute in 1986 to require that the income with respect to a transfer or license of intangible assets be commensurate with the income attributable to the intangibles.¹⁵⁴ This standard requires the retention by the transferor of a “super royalty” that is subject to *ex post* adjustments based on the income generated from the intangible in question.¹⁵⁵ According to the Treasury, the commensurate with income standard did not supplant, but is consistent with, the arm’s length standard.¹⁵⁶

The enactment of the commensurate with income standard was not intended to prohibit the use of bona fide research and development cost-

150. See Charles Duhigg & David Kosieniewski, *Inquiry Into Tech Giants’ Tax Strategies Nears End*, N.Y. TIMES, Jan.4, 2013, at B1; Charles Duhigg & David Kosieniewski, *How Apple Sidesteps Billions in Taxes*, N.Y. TIMES, April 29, 2012, at A1 (discussing companies’ attempts to income shift).

151. Treas. Reg. § 1.482-1(a)(1) (2012); *Comm’r v. First Sec. Bank*, 405 U.S. 394, 400 (1972). A controlled taxpayer is a taxpayer directly or indirectly owned or controlled by the same interests. Treas. Reg. § 1.482-1(i)(5) (2012). A controlled taxpayer also includes a taxpayer that owns or controls other taxpayers. *Id.* For this purpose, control is broadly defined. See Treas. Reg. § 1.482-1(i)(4) (2012) (defining controlled for the purposes of this section).

152. I.R.C. § 482 (2012).

153. Treas. Reg. § 1.482-1(b)(1) (2012).

154. I.R.C. § 482.

155. Reuven S. Avi-Yonah, *Xilinx Revisited*, 126 TAX NOTES 1621 (March 29, 2010); H.R. Rep. No. 99-426, at 423-26 (1985); Treas. Reg. § 1.482-4(f)(2) (2011) (describing adjustments for transfers of intangible property). It is not clear whether the commensurate with income standard is consistent with, or supersedes, the arm’s length standard. See Deborah Brubaker Burns, *Golden Apple of Discord: International Cost-Sharing Arrangements*, 15 HOUS. BUS. & TAX L.J. 55, 68 n.57-58 (2015) (discussing the IRS’s comparison of the commensurate with income standard and the arm’s length standard).

156. Notice 88-123, 1988-2 C.B. 7, 21 (1988).

sharing arrangements.¹⁵⁷ Compliance with the regulations allows taxpayers to avoid messy factual disputes and the concomitant uncertainty of whether these arrangements meet the arm's length standard.¹⁵⁸ The regulations require that development costs be shared by the parties to a cost-sharing arrangement in proportion to their share of reasonably anticipated benefits.¹⁵⁹ To that end, they require that stock-based compensation costs directly identified with, or reasonably allocable to, the development of intangible property be included in the cost pool subject to the cost-sharing arrangement.¹⁶⁰

Altera Corporation, a Delaware corporation, challenged the requirement to include equity-based compensation in the cost pool subject to the cost sharing arrangement.¹⁶¹ Altera and its Cayman Island subsidiary entered into a research and development cost-sharing agreement.¹⁶² Altera compensated certain employees who performed research and development

157. H.R. Conf. Rep. No. 99-481 (Vol. II), at II-637-38 (1986).

158. Treas. Reg. § 1.482-1(b) (2013) (defining the arm's length standard).

159. Treas. Reg. § 1.482-7 (2013) (explaining methods to determine taxable income when a cost-sharing agreement is in place).

160. Treas. Reg. § 1.482-7(d)(3)(i-ii). The amount and timing of such costs are determined under the rules that govern the deductibility of such costs. Treas. Reg. § 1.482-7(d)(3)(iii)(A). However, a taxpayer may elect to determine the amount and timing of the costs of stock options on publicly traded stock under generally accepted accounting principles as reflected in the taxpayer's audited financial statements. Treas. Reg. § 1.482-7(d)(3)(iii)(B). Stock grants are taxable to the recipient and deductible by the employer at the time the stock is transferable by the recipient or not subject to a substantial risk of forfeiture, whichever occurs earlier. I.R.C. § 83(a) (2012). The amount of income recognized by the transferee from such a transaction is the excess of the fair market value of the property received over the amount paid by the recipient for such property. I.R.C. § 83(a)(1-2). Correspondingly, the transferor of the property is entitled to a compensation deduction, at the time the recipient of the property recognizes income, equal to the amount includible in the income of the recipient. I.R.C. § 83(h). If, however, the stock is subject to a substantial risk of forfeiture, then the income recognition and the corresponding deduction is postponed until such time that the risk of forfeiture lapses. *See* Treas. Reg. § 1.83-3(c)(1) (1985) (describing procedures in case of the property being at a substantial risk of forfeiture). However, the recipient of restricted property may elect to accelerate the incidence of taxation to the time that the property is transferred and this election also accelerates the employer's compensation deduction. I.R.C. §§ 83(b); 83(h). With respect to compensatory stock options, income recognition and the compensation deduction are postponed until the date of exercise or disposition provided that, at the time the option is granted, it has no readily ascertainable fair market value. Treas. Reg. § 1.83-7(a) (1978). Under generally accepted accounting principles, a grant of restricted shares is valued at the date of grant and such amount is charged to expense over the vesting period. *See generally* SHARE-BASED PAYMENT, Statement of Fin. Acct. Standards No. 123, §§ 16, 39 (Fin. Acct. Standards Bd. revised 2004). This standard conformed U.S. accounting standards with international accounting standards. *See generally* SHARE-BASED PAYMENT, Int'l Accounting Standards No. 2 (Int'l Acct. Standards Bd. 2004). Stock options are valued at the date of grant pursuant to one or more option pricing models. *Id.*, Appendix A at §§ A13-A37.

161. *Altera Corp. v. Comm'r*, 145 T.C. 91 (2015).

162. *Id.* at 93.

activities in part with stock options and other forms of equity-based compensation and the costs associated with this compensation were not included in the cost pool.¹⁶³ The I.R.S. allocated approximately \$80 million in income to Altera Corporation from its Cayman Island subsidiary as a result of its addition of the equity-based compensation paid to research and development personnel to the cost pool subject to the cost-sharing arrangement between the companies.¹⁶⁴

Accordingly to the court, the Treasury was required to provide an empirical basis for its position and, therefore, *State Farm* supplied the appropriate standard of review.¹⁶⁵ The regulations failed to pass muster under *State Farm* for four reasons.¹⁶⁶ First, because the Treasury was unable to produce any evidence that unrelated parties share equity compensation costs, the regulations lacked any basis in fact.¹⁶⁷ Second, the regulations' application to all cost-sharing arrangements belied a rational connection with the regulations and the facts found by the Treasury.¹⁶⁸ The Treasury's assertion that no unrelated party transactions exist for cost-sharing arrangements for the development of high-profit intangibles, if true, indicate that the regulations should have distinguished between cost-sharing arrangements for the development of such intangibles and those arrangements for the development of other intangibles.¹⁶⁹ Instead, all cost-sharing arrangements are subject to the same rules.¹⁷⁰ Third, the court believed that the Treasury's response to the comments it received concerning the regulations was inadequate.¹⁷¹ Finally, the court held that the regulations

163. *Id.*

164. *Id.* at 94.

165. *Id.* at 119.

166. *Id.* at 119-131. The Treasury argued that *Chevron* supplied the appropriate standard of review in this case because the interpretation of I.R.C. section 482 requires no empirical evidence. *Id.* at 123. The court, however, concluded that whether the regulation complied with the arm's length standard, which always require an analysis of comparable unrelated party transactions, is an empirical question and is in no way dependent on statutory interpretation. Accordingly, *State Farm* provides "the more apt analytic framework." *Id.* at 119 (citing *Judulang v. Holder*, 565 U.S. 42, 52 n.7 (2011)).

167. *Id.* at 121-22.

168. *Id.* at 113.

169. *Id.* at 125-26.

170. *Id.* Support for a uniform rule on the ground of administrative convenience was not sufficient because the Treasury did not articulate this reason for the rule. *Id.* Moreover, even if this rationale was articulated, the Treasury provided no facts to determine whether the rule is justified by its purported administrative benefits. *Id.*

171. *Id.* at 126-30. Written comments were submitted to the Treasury and testimony given at a public hearing by several prominent law and accounting firms, trade associations, and academics regarding the regulation at issue. *Id.* at 104. The comments and testimony asserted that no contracts between unrelated parties included equity-based compensation in the cost pool subject to cost-sharing. *Id.* at 104-05. A survey of members of the American Electronics

were contrary to the evidence because no evidence was presented to contradict the evidence presented against the regulation, evidence whose credibility was not challenged.¹⁷² The court dismissed the Treasury's admonition that the harmless error rule should be applied to save the regulations.¹⁷³

The Tax Court's decision is puzzling for two reasons. First, the court reviewed the Treasury regulation at issue against the arm's length standard as if that standard is set forth in a statute, but the standard is a creature of Treasury regulations.¹⁷⁴ The cost-sharing regulations interpret the commensurate with income standard and its relationship to the arm's length standard.¹⁷⁵ The Treasury was interpreting both the statute and its own regulations. Consequently, whether the regulations permissibly construed the commensurate with income standard should have been determined under *Chevron* step two and whether the regulations were permissible in light of the long-standing regulatory-based arm's length standard should have been determined under the standards of *Auer v. Robbins*.¹⁷⁶ Because

Association and model contract provisions used in the petroleum industry provided further support that such costs are not subject to cost-sharing between unrelated parties primarily because such costs are speculative, uncertain, and outside the control of the compensating party. *Id.* Also noted by commentators was the fact the federal procurement regulations prohibit the inclusion of equity compensation in the cost pool subject to federal government reimbursement. *See id.* at 106 (citing 48 C.F.R. § 31.205-6(i) (2013)). Two economists also argued that compensatory stock options do not result in any cost to the grantor of the options. *Id.*

172. *Id.* at 131.

173. *Id.* The harmless error rule is based on section 706 of the Administrative Procedure Act and allows a court to uphold an agency action if the agency's mistake was not outcome determinative. *Id.* at 131-32. The court was not persuaded by the Treasury's assertions that it had sufficient alternative reasons for its position and that subsequent developments in financial reporting evidenced that its position is settled policy. *Id.* at 132-33. The Treasury never indicated that it was prepared to rely on any reasons other than the arm's length standard as a basis for its adoption of the regulation and, due to treaty obligations, it was not clear that the agency would have underpinned the rule on something other than the arm's length standard. *Id.* at 132. With respect to subsequent financial reporting development, the court held that such developments were not relevant because the Treasury itself disavowed financial reporting standards in promulgating the rule and, in any event, *Chenery* precludes reliance on *ex post* developments. *Id.* at 133.

174. Treas. Reg. § 1.482-1(b)(1).

175. See Notice 88-123, *supra* note 156 (stating that the "commensurate with income" standard is consistent with the "arm's length" standard); H.R. Conf. Rep. No. 99-481 (Vol. II), at II-637-38 (1986) (indicating that bona-fide research arrangements are permissible under the "commensurate with income" standard). *See also supra* notes 152-58 and accompanying text.

176. *Auer v. Robbins*, 519 U.S. 452 (1991). Under *Auer*, an agency's interpretation of an ambiguous regulation is given controlling weight unless such interpretation is inconsistent with the regulation or statute or is plainly erroneous. *Id.* at 461. *Auer* deference is not due to an agency if its interpretation is not the result of "fair and considered judgment," conflicts

the legislative history of the commensurate with income standard stated that cost-sharing arrangements were permissible if such arrangements provided for a sharing of all costs, the inclusion of equity compensation costs in the cost pool is, in my opinion, a reasonable interpretation of that standard.¹⁷⁷ Moreover, the inclusion of equity-based compensation in the cost pool does not appear to be plainly inconsistent with the arm's length standard and, therefore, the regulation should pass muster under *Auer*. At this point, under *State Farm*, the rule chosen by the Treasury must be adequately justified.¹⁷⁸

Second, and more problematically, the Tax Court failed to understand the purpose of the cost-sharing regulations and, as a result, it required the Treasury to produce evidence that is nonexistent. The cost-sharing regulations, designed in response to the administrative burdens and regulatory uncertainty imposed by I.R.C. section 482, are a safe harbor.¹⁷⁹ Taxpayers have every right to ignore the cost-sharing regulations if they are willing to risk noncompliance with the other rules set forth in the regulations. In many respects, the arm's length standard is a fiction because it assumes that transactions between unrelated parties and transactions among controlled group members share similar economic attributes—a dubious assumption in a post-industrial economy in which the creation and use of intangible assets is central to wealth creation. Because intangible assets often are efficiently deployed only in the context of a controlled group and require exclusivity to protect market share, comparable transactions do not exist.¹⁸⁰

with a prior interpretation, or represents a “convenient litigating position” or a “post-hoc rationalization.” *Christopher v. SmithKline Beecham Corp.*, 567 U.S. 142, 170 (2012) (first quoting *Auer*, 519 U.S. at 562; then quoting *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 213 (1988); then quoting *Auer*, 519 U.S. at 462)). In a recent case, the Fourth Circuit held that the Department of Education's interpretation of its regulations under Title IX of the Civil Rights Act of 1964 that required schools to treat transgender students consistent with their gender identity was entitled to deference under *Auer*. See *G.G. ex. rel. Grimm v. Gloucester Cty. Sch. Bd.*, 822 F.3d 709 (4th Cir. 2016), *vacated sub nom.*, *Gloucester Cnty. Sch. Bd. v. G.G.*, 137 S. Ct. 1239, (2017). *But see Texas v. U.S.*, 201 F.Supp.3d 810, 832-34, 836 (N.D. Tex. 2016) (granting preliminary injunction) (holding that *Auer* deference was inapplicable to the Department's interpretation).

177. H.R. Conf. Rep. No. 99-481 (Vol. II), at II-637-38 (1986).

178. See *Motor Vehicle Mfg. Ass'n of the U.S. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 34 (1983) (holding that the agency must present an “adequate basis and explanation” for a rule).

179. Treas. Reg. § 1.482-1(b).

180. Controlled groups have collective assets—management, information systems, sources of financing, institutional memory, brand equity, and culture, for example—that lead such groups to enter into transactions that would not be offered to anyone outside the group. Ilan Benshalom, *Sourcing the “Unsourceable”: The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions*, 26 VA. TAX REV. 631, 642-47 (2007).

State Farm requires that the Treasury provide a reasoned explanation for the adoption of the rule in question.¹⁸¹ The preamble to the regulations parroted the legislative history of the commensurate with income standard when it explained that the cost-sharing rules attempt to clearly reflect income among related parties when comparable unrelated party transactions do not exist.¹⁸² The Treasury's long battle against tax base erosion provided it with the intuition that research and development arrangements among controlled entities have no counterparts among unrelated parties. Agency intuition, as noted by the Supreme Court, is entitled to deference in certain cases because "there are some propositions for which scant empirical evidence can be marshaled."¹⁸³

Whether one agrees with the application of *State Farm* in either case is not relevant here. The salient point is that *State Farm* has surfaced, with some ferocity, in tax cases. An open question is whether a *State Farm* challenge can survive the Anti-Injunction Act.

III. PFIZER-ALLERGAN MERGER AND THE ANTI-INVERSION REGULATIONS

A. *Background*

The United States, unlike many countries, taxes its citizens and residents on their worldwide income.¹⁸⁴ Tax jurisdiction over foreign taxpayers, however, is exercised under a source-based scheme.¹⁸⁵ Foreign nonresident alien individuals and corporations are subject to U.S. income tax on their income from sources within the United States, and the tax scheme varies considerably depending on whether the U.S. source income is

Moreover, the transactional approach of the arm's length standard often fails to properly source the parties' allocable share of non-routine, or residual, profits. See Bret Well & Cym Lowell, *Tax Base Erosion: Reformation of Section 482's Arm's Length Standard*, 15 FLA. TAX REV. 737, 745-65 (2014) (discussing one-side and two-sided pricing methodologies and the deficiencies in the former methodology).

181. *State Farm*, 371 U.S. at 168.

182. *Altera Corp. v. Comm'r*, 145 T.C. 91, 107-09 (2015).

183. *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 519 (2009).

184. Mechanisms to avoid double taxation include tax treaties and the foreign tax credit. This credit allows U.S. citizens or residents to credit, within statutorily defined limits, foreign taxes paid against their U.S. income tax liability. I.R.C. §§ 901-08 (2012).

185. For example, corporate inversion transactions have as their objective the replacement of the U.S.-based parent of a corporate group with a foreign corporation based in a low tax jurisdiction. These and other "earnings stripping" transactions have resulted in recent legislative changes. U.S. DEPT. OF THE TREASURY, 108TH CONG., REP. ON EARNING STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES (Comm. Print 2007) [hereinafter TREASURY REP. ON EARNINGS STRIPPING].

effectively connected with the conduct of a trade or business in the United States. The net income connected with such trade or business is taxed at graduated tax rates.¹⁸⁶ Otherwise, absent a statutory exemption or contrary treaty provision, a flat thirty percent tax is levied upon the gross income generated from certain specified classes of U.S. source income.¹⁸⁷

Consequently, a foreign corporation is not subject to U.S. tax if it conducts no business in the United States and has no income that is sourced in the United States. Subject to certain exceptions, a U.S. shareholder in a foreign corporation is taxable on dividends that it received from the foreign corporation.¹⁸⁸ If the earnings of the foreign corporation are not repatriated then no tax is due to the United States. The disparity in the tax schemes applicable to U.S. and foreign corporations has led to various attempts by U.S. taxpayers to engage in transactions to avoid U.S. taxation of worldwide income including the use of intercompany debt and aggressive transfer pricing for intercompany transactions to strip earnings from U.S. corporations and shift such earnings to an affiliated foreign corporation.¹⁸⁹

186. I.R.C. § 882(a) (2012). The performance of personal services within the United States, subject to a minor exception, constitutes the conduct of a trade or business within the United States. I.R.C. § 864(b) (2012). Trading in stock, securities, or commodities for the taxpayer's own account will not, unless the taxpayer is a dealer in such stock, securities, or commodities, constitute a trade or business. I.R.C. §§ 864(b)(2)(A)(ii), 864(b)(2)(B)(ii) (2012); Treas. Reg. § 1.864-2(c)(2) (1975). Direct ownership of property, with its concomitant right to management and exposure to liability, is required for trade or business status. *Higgins v. Comm'r*, 312 U.S. 212, 218 (1941). Manufacturing activities, on the other hand, invariably are trades or businesses. Treas. Reg. § 1.864-4(b), Ex. 1 (2005). Similarly, the purchase and sale of goods will constitute a trade or business. Treas. Reg. § 1.864-4(b), Ex. 2 (2005). The U.S. Department of the Treasury has issued the United States Model Income Tax Convention of November 15, 2006 (U.S. Model Treaty), whose provisions are a starting point for negotiations with foreign nations. With respect to the taxation of business profits, the U.S. Model Treaty provides that the profits earned by a foreign enterprise are not taxable by the source country unless the enterprise carries on business through a permanent establishment, defined as a fixed place of business through which the business of an enterprise is wholly or partly carried on, situated in the source country. U.S. Model Treaty, art. 7(1) (2006). Gain from the disposition of a U.S. real property interest is treated as income that is effectively connected with the conduct of a U.S. trade or business. I.R.C. § 897(a) (2012). United States' real property interests are broadly defined to include fee ownership interests, co-ownership interests, leaseholds, options, and interests in certain corporations, partnerships, trusts, and estates. I.R.C. §§ 897(c)(6)(A), 897(g) (2012).

187. I.R.C. § 881(a) (2012). The tax is generally withheld at the source. See I.R.C. §§ 1441-42 (2012). Treaty provisions often provide for reduced rates of tax on such income. *Id.*

188. See I.R.C. §§ 951-965, 1293-1295 (2012) (stating that in certain circumstances shareholders of a controlled foreign corporation must include certain amounts of taxable income generated by the controlled foreign corporations prior to the repatriation of such earnings).

189. See generally TREASURY REP. ON EARNINGS STRIPPING, *supra* note 185, at 11-23, 55-61 (discussing, at length, the extent of tax base erosion through the use of intercompany debt and aggressive transfer pricing).

Corporate inversion transactions, which have occurred for some time, result in the restructuring of a U.S. based multi-national group of corporations so that the ultimate parent of the group is a foreign corporation.¹⁹⁰ As a result, the future profits of foreign subsidiaries are not subject to U.S. tax because the shareholder of such subsidiaries is not subject to U.S. tax. Moreover, inversions often are accompanied by other maneuvers, such as the use of intercompany debt and the transfer of intangibles to foreign members of the group, to reduce reportable profits from U.S. operations.¹⁹¹

The American Jobs Creation Act of 2004 added section 7874 to the Internal Revenue Code to mitigate the erosion of the U.S. tax base caused by inversion transactions.¹⁹² This provision did not preclude the existing tax treatment of such transactions. Instead, unless the foreign corporation has substantial business activities in its country of incorporation relative to its worldwide operations, the tax treatment of an inversion is based on the stake that the shareholders of the domestic corporation retain in the post-inversion foreign corporation. A detailed analysis of section 7874 is beyond the scope of this work. In brief, if the shareholders of the domestic corporation own, after the acquisition, at least eighty percent of the stock of the foreign corporation by reason of their former ownership of the domestic corporation then the foreign corporation will be treated as a domestic corporation for tax purposes.¹⁹³ If shareholders of the domestic corporation own, after the acquisition, at least sixty, but less than eighty, percent of the stock of the foreign corporation by reason of their former ownership of the domestic corporation then the foreign corporation is considered a surrogate foreign corporation and the income and gain that arises from transfers of assets by the domestic entity and its U.S. affiliates for a ten year period are subject to

190. OFFICE OF TAX POL'Y, DEPT. OF THE TREASURY 107TH CONG., CORPORATE INVERSION TRANSACTIONS: TAX POLICY IMPLICATIONS 3-4 (May 2002), *available at* https://web.law.columbia.edu/sites/default/files/microsites/millstein-center/panel_1_001_office_to_tax_policy.pdf [<https://perma.cc/FE9D-UQRT>]. The methods by which such a result is effectuated vary. *Id.* at 4-6.

191. *Id.* at 6-7. There are other tax consequences that result from inversion transactions, including the potential for immediate gain recognition as a result of transfers to foreign entities. *See generally* I.R.C. § 367(a) (2012) (denying tax favored treatment for certain transfers of property by a U.S. corporation by treating such corporation, for this purpose, as a non-corporate taxpayer). A discussion of the immediate tax implications of these transactions is beyond the scope of this work. Also, regulations were issued in October 2016 that restrict the ability of U.S. corporations to strip earnings through the use of intercompany loans. Treas. Reg. §§1.385-1-4 (2016).

192. American Job Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

193. I.R.C. § 7874(b) (2012). Stock of the foreign corporation sold in a public offering related to the acquisition of the domestic corporation is disregarded. I.R.C. § 7874(c)(2)(B) (2012).

U.S. tax.¹⁹⁴ If shareholders of the domestic corporation own, after the acquisition, less than sixty percent of the stock of the foreign corporation by reason of their former ownership of the domestic corporation then section 7874 is not applicable.¹⁹⁵ Transfers of properties and liabilities are disregarded if such transfers are part of a plan a principal purpose of which is to avoid the purposes of the statute.¹⁹⁶

The statute grants the Treasury the authority to issue regulations to determine whether a corporation is a surrogate foreign corporation, including rules related to the treatment of warrants, options, convertible securities, and other equity-flavored instruments as stock and to treat stock as not stock.¹⁹⁷ In addition, the Treasury is granted broad authority to issue regulations to prevent avoidance of the statute.¹⁹⁸ In 2009, the Treasury exercised its authority when it issued a regulation that required that the ownership stake of multiple domestic corporation shareholders be combined for the determination of whether the statutory ownership thresholds are met if the acquisition of such multiple domestic corporations were part of the same plan.¹⁹⁹ That same year, the I.R.S. announced, in Notice 2009-78, that stock issued by the foreign corporation in an offering, whether a public offering or otherwise, related to the acquisition of a domestic entity in exchange for cash or liquid assets would be disregarded for purposes of determining whether the statute's ownership thresholds are met.²⁰⁰ Temporary regulations were issued in 2014 that incorporated the guidance set forth in the Notice.²⁰¹ In 2015 and 2017, further guidance was provided by the I.R.S. and the Treasury that clarified certain rules, tightened others, and provided de minimis exceptions to the application of previously issued rules.²⁰²

In April 2016, the Treasury issued temporary regulations that contained rules discussed in the previously issued Notices.²⁰³ However, the new regulations also contained a new multiple acquisition rule pursuant to which any stock issued by a foreign corporation in prior acquisitions of domestic corporations that occurred during the three year period before the execution

194. I.R.C. § 7874(a) (2012).

195. *Id.*

196. I.R.C. § 7874(c)(4).

197. I.R.C. § 7874(c)(6).

198. I.R.C. § 7874(g).

199. Treas. Reg. § 1.7874-2(e) (2009).

200. I.R.S. Notice 2009-78, 2009-2 C.B. 452.

201. Temp. Treas. Reg. § 1.7874-4T(i)(7) (2014). I.R.S. Notice 2014-52, 2014-2 C.B. 712, also indicated that such a rule was forthcoming.

202. I.R.S. Notice 2015-79, 2015-49 I.R.B. 775; Guidance for Determining Stock Ownership; Rules Regarding Inversions and Related Transactions, 82 Fed. Reg. 5388 (January 18, 2017).

203. Inversions and Related Transactions, 81 Fed. Reg. 20588 (April 8, 2016) (codified in various sections of 26 C.F.R.).

of the agreement of the acquisition in question, whether or not such previous acquisitions were part of a plan to avoid the statute, is disregarded.²⁰⁴ Despite the fact that affected parties had no opportunity to comment and the Treasury failed to explicitly indicate a good cause for the need for immediacy, this rule was effective immediately.²⁰⁵

In November of 2015, Pfizer Inc., the U.S. pharmaceutical corporation, and Allergan plc, an Irish corporation, announced an inversion transaction, a plan to merge into a new corporation that would be incorporated in Ireland.²⁰⁶ Allergan plc itself was the product of several transactions including a stock transaction with Actavis plc earlier in 2015.²⁰⁷ Actavis plc was the product of a 2013 inversion transaction between Actavis, Inc., a U.S. corporation, and Warner Chilcott, PLC, an Irish corporation, and a later acquisition of Forest Laboratories, Inc., another U.S. corporation.²⁰⁸ Because of the multi-step acquisition rule described above, the stock issued in the Warner Chilcott and Forest Laboratories acquisitions would be disregarded. Consequently, the Pfizer shareholders' percentage ownership of the post-merger entity would exceed the eighty percent statutory threshold thereby causing the post-merger entity to be taxed as a U.S. corporation. Pfizer and Allergan subsequently scuttled the deal pursuant to an "adverse tax law change" clause in their agreement.²⁰⁹ The Chamber of Commerce of the United States and the Texas Association of Business have filed suit alleging that the multi-step acquisition rule is arbitrary and capricious under the Administrative Procedure Act.²¹⁰

204. Temp. Treas. Reg. § 1.7874-8T (2016).

205. Inversions and Related Transactions, 81 Fed. Reg. 20588, 20904 (April 8, 2016).

206. Press Release, Allergan, Pfizer and Allergan to Combine (Nov. 23, 2015), *available at* <http://www.allergan.com/news/news/thomson-reuters/pfizer-and-allergan-to-combine> [<https://perma.cc/ZY4Q-HQPX>].

207. Press Release, Allergan, Actavis Completes Allergan Acquisition (March 17, 2015), *available at* <http://www.allergan.com/news/news/thomson-reuters/actavis-completes-allergan-acquisition> [<https://perma.cc/H87V-B9VE>].

208. Press Release, Allergan, Actavis Completes Warner Chilcott Acquisition (Oct. 1, 2013), *available at* <http://www.allergan.com/investors/news/thomson-reuters/actavis-completes-warner-chilcott-acquisition> [<https://perma.cc/VT9P-V6YK>]; Press Release, Allergan, Actavis Completes Forest Laboratories Acquisition (July 1, 2014), *available at* <http://www.allergan.com/investors/news/thomson-reuters/actavis-completes-forest-laboratories-acquisition> [<https://perma.cc/X4GU-4PNB>].

209. Press Release, Pfizer, Pfizer Announces Termination of Proposed Combination with Allergan (April 6, 2016), *available at* http://www.pfizer.com/news/press-release/press-release-detail/pfizer_announces_termination_of_proposed_combination_with_allergan [<https://perma.cc/YUP4-B5XT>].

210. Complaint at 6, Chamber of Commerce of the United States v. I.R.S., No. 1:16-cv-944 (W.D. Tex. Aug. 4, 2016).

B. *Application of the Anti-Injunction Act*

By one estimate, Pfizer stood to avoid approximately \$35 billion in U.S. taxes because of the inversion transaction with Allergan.²¹¹ Therefore, given the stakes, it would have been quite bold for the Pfizer's board of directors to authorize the consummation of the transaction and then challenge the inevitable denial of the tax benefits by the I.R.S. in court. Unfortunately for Pfizer, the Anti-Injunction Act requires such boldness. Although a few judicially created exceptions to the application of the Act exist, these exceptions are narrowly tailored and do not appear applicable to Pfizer. Moreover, it is unlikely that the creation of a new exception for rulemaking that is arbitrary and capricious under *State Farm* will have much practical significance. The effect of the anti-inversion regulations on affected taxpayers is unusual—perhaps not *sui generis*, but close to it. These regulations have enormously deleterious tax consequences on transactions that, once consummated, are virtually impossible to undo. Consequently, the pay now, sue later paradigm imposed by the Anti-Injunction Act is, for all practical purposes, a bar to taxpayer challenges. The courts should examine whether the existing exceptions they created should be tweaked to consider practical realities. Further impetus for such an examination should come from Congress's recent proclivity to use the tax code for purposes other than revenue, a purpose the Anti-Injunction Act singularly protects.

The Court has carved out several exceptions to the application of the Anti-Injunction Act. It has held that proceedings whose success would have the effect of increasing tax revenue are not barred by the Anti-Injunction Act.²¹² The Court has also acknowledged two narrow common law

211. See Lynnley Browning, *Pfizer Seen Avoiding \$35 Billion in Tax Via Allergan Merger*, BLOOMBERG POLITICS, <http://www.bloomberg.com/politics/articles/2016-02-25/pfizer-seen-as-avoiding-35-billion-in-tax-via-allergan-merger> [https://perma.cc/7JT7-KBG5] (Feb. 25, 2016) (explaining that the inversion regulations were not the only tax blow to the proposed merger). Proposed regulations were issued in April 2016 that were finalized in October 2016 that would hinder Pfizer's ability to strip U.S. earnings through the use of intercompany debt). See Treas. Reg. §§ 1.385-1-4 (2016).

212. *Hibbs v. Winn*, 542 U.S. 88, 10302-03 (2015) (citing to two lower court decisions). This case involved another statute, the Tax Injunction Act, which has been interpreted similarly to the Anti-Injunction Act; see also *E. Ky. Welfare Rights Org. v. Simon*, 506 F.2d 1278, 1283-85 (D.C. Cir. 1974) (holding that the statute does not apply when a suit seeks to increase taxes), *rev'd*, *Simon v. E. Ky. Welfare Rights Org.*, 426 U.S. 26 (1976) (holding that the suit should have been dismissed for lack of standing under the Anti-Injunction Act). This case involved a claim by several organizations promoting access to health care by the poor alleging that an I.R.S. ruling that two hospitals were tax exempt violated I.R.C. section 501(c)(3). The plaintiffs asserted that the ruling violated the statute because it did not condition the tax exemption closely enough to the hospitals' charitable care for the indigent,

exceptions to the Anti-Injunction Act. First, a pre-enforcement challenge will be countenanced if the government could not prevail under any circumstances and the taxpayer would suffer irreparable harm from enforcement action. Mere allegations of unconstitutionality are insufficient to trigger the application of this exception, as the Court noted in *Bailey v. George*, the child labor tax case.²¹³ Approximately a decade later, in *Miller v. Standard Nut Margarine Co. of Florida*, the petitioner challenged an excise tax that the government asserted was applicable to the sale of its products.²¹⁴ The Court found that the government's assertion was erroneous and, in light of previous court decisions, arbitrary and capricious.²¹⁵ According to the Court:

[I]n cases where complainant shows that in addition to the illegality of an exaction in the guise of a tax there exists some special and extraordinary circumstances sufficient to bring the case within some acknowledged head of equity jurisprudence, a suit may be maintained to enjoin the collector. . . . It has never held the rule to be absolute, but has repeatedly indicated that extraordinary and exceptional circumstances render its provisions inapplicable.²¹⁶

The Court enjoined the enforcement of the excise tax because there existed no legal possibility that the tax could have been validly assessed and the payment of the tax would have had severe negative repercussions for the taxpayer's business.²¹⁷

Thirty years later, the Court significantly narrowed the application of this exception in *Enochs v. Williams Packing & Navigation Co.*, a case involving the application of payroll taxes.²¹⁸ The Court held that whether a challenged exaction would cause the ruination of the taxpayer's business is not, by itself, grounds for equitable relief from the application of the Anti-Injunction Act.²¹⁹ The Court acknowledged the exception set forth in *Standard Nut* but stated that whether the government has any chance of

that its members were denied medical care, and that the I.R.S.'s action encouraged such denial by the hospitals. *Id.* at 30-33. According to the Court, whether any encouragement caused by the tax exemption resulted in the alleged denial of medical service was purely speculative and it was plausible that the hospitals in question would forego the tax exemption and operate unfettered by the restrictions imposed by such exemption. *Id.* at 42-44.

213. *Bailey v. George*, 259 U.S. 16, 19-20 (1922). *See also* *Dodge v. Osborne*, 240 U.S. 118, 121-122 (1915) (“[A] suit may not be brought to enjoin the assessment or collection of a tax because of the alleged unconstitutionality of the statute imposing it.”)

214. *Miller v. Standard Nut Margarine Co. of Florida*, 284 U.S. 498 (1932).

215. *Id.* at 509-510.

216. *Id.* (citations omitted).

217. *Id.* at 510-11.

218. *Enochs v. Williams Packing & Navigation Co.*, 370 U.S. 1 (1962).

219. *Id.* at 6-7.

prevailing on the merits is to be determined on the basis of information available to the government at the time of suit and under the most liberal view of the law and the facts.²²⁰ In a later case, the Court characterized *Williams Packing* as the case that “switched the focus of the extraordinary and exceptional circumstances test from a showing of the degree of harm to the plaintiff absent an injunction to the requirement that it be established that the Service’s action is plainly without a legal basis.”²²¹ The Court has made clear on several occasions that it is very difficult for taxpayers to show that the government has no chance of prevailing on the merits.²²² Most recently, the Court held that a suit alleging that a tax on coal exports violated the Export Clause of the Constitution was barred because, at the time the tax was assessed, the scope of the Export Clause was unsettled.²²³

Under the second common law exception, a pre-enforcement action is permitted if, under the circumstances, no other legal remedy is available.²²⁴ In *Allen v. Regents of the University System of Georgia*, the Court permitted the University of Georgia and the Georgia School of Technology to challenge the constitutionality of a federal admissions tax imposed upon patrons of the schools’ football games for which the two schools were responsible to collect and remit to the federal government.²²⁵ The schools asserted that the admissions tax imposed an unconstitutional burden on an essential state function.²²⁶ Because the tax was imposed on patrons, the schools were unable to bring a suit for refund. The Court stated that the statutory bar to tax challenges did not apply: “[I]n exceptional cases where there is no plain, adequate, and complete remedy at law. This is such a case, for here the assessment is not of a tax payable by respondent but of a penalty for failure to collect it from another.”²²⁷

220. *Id.* at 7-8.

221. *Bob Jones Univ. v. Simon*, 416 U.S. 725, 745 (1974).

222. *See, e.g., id.* at 737, 748-49 (stating that a determination of whether the government could prevail must be decided under the most liberal view of law and facts in favor of the government, and holding that the petitioner’s claims were sufficiently debatable to foreclose the possibility that the government could not prevail); *Alexander v. Ams. United Inc.*, 416 U.S. 752, 761-762 (1974).

223. *United States v. Clintwood Elkhorn Mining Co.*, 553 U.S. 1, 14 (2008). This case involved the application of I.R.C. section 7422, a statute that precludes suits for refund if a claim for refund was not filed. *Id.* The statute of limitations for filing refund claims had expired and the taxpayer sought a refund under a non-tax statute whose statute of limitations was considerably longer. *Id.* at 4-6. The Court believed that I.R.C. section 7422 was more restrictive than the Anti-Injunction Act, but went on to examine the taxpayer’s argument that *Williams Packing* did not bar its suit. *Id.* at 13-14.

224. *Univ. Sys. of Ga.*, 304 U.S. 439 (1938).

225. *Id.*

226. *Id.* at 448.

227. *Id.* at 449. A refund claim was sought by the respondents and denied because the schools were mere collecting agents and had no interest in the funds collected if such funds

In 1984, the Court granted South Carolina leave to file a complaint against the Secretary of Treasury.²²⁸ The state sought to enjoin the Treasury from enforcing a recently enacted provision in the Internal Revenue Code that would deny a tax exemption to interest earned on the obligations of any state unless the obligations were issued in registered form.²²⁹ South Carolina asserted that the conditions imposed by the Internal Revenue Code provision at issue destroyed the state's freedom to issue debt obligations in a form of her choosing and, thus, violated the Tenth Amendment.²³⁰ Moreover, the state asserted that the federal government may not tax interest earned on state obligations regardless of the form of such obligation.²³¹ The state would be required to pay higher interest rates on taxable obligations than it would on tax exempt obligations. However, the state would be unable to challenge the statute's legality in a suit for refund because any taxes at issue would have been imposed on the holders of the obligations.²³²

The Court believed there was no need for it to determine whether the exception it set forth in *Williams Packing* was applicable because it held the Anti-Injunction Act "was not intended to bar an action where, as here, Congress has not provided the plaintiff with an alternative legal way to challenge the validity of a tax."²³³ Despite the dearth of legislative history regarding the statute, the Court believed that the circumstances of its enactment suggested that Congress did not intend for it to apply unless an alternative legal avenue to contest the legality of a tax was available to an aggrieved party.²³⁴ The Court proceeded to dismiss the government's argument that holders of the debt could challenge the legality of the provision in question because of the uncertainty of whether such a challenge would, or could, be mounted.²³⁵

The D.C. Circuit, in the *Z Street* case previously discussed, held that the

were, in fact, unlawfully collected. *Id.* at 446. The Court ruled in favor of the government on the merits. *See id.* at 452-53 (reversing the Fifth Circuit's decree in favor of plaintiff).

228. *South Carolina v. Regan*, 465 U.S. 367, 370 (1984).

229. *Id.* at 370-71.

230. *Id.* at 371-72.

231. *Id.* at 372.

232. *Id.* at 378-80.

233. *Id.* at 373.

234. *Id.* at 373-76. In the Court's opinion, the amendment to the statute to include third parties within its strictures was not relevant in this case. *Id.* at 376-77; I.R.C. § 7421(a) (2012).

235. *South Carolina v. Regan*, 465 U.S. at 380-81. I.R.C. section 7478 permits a state to seek a declaratory judgment from the Tax Court as to whether obligations a state desires to issue meet the requirements for tax exemption. However, this provision does not permit an action challenging the constitutionality of a provision or provisions that set forth the standards for obligations to obtain tax exempt status. *See id.* at 378 n.17 (noting that IRC section 7478 does not provide a cause of action for contesting constitutionality as to section 103(j)(1)).

Anti-Injunction Act did not apply to a non-profit organization's claim that the I.R.S. was delaying the processing of the organization's application for tax exempt status because of the organization's political positions.²³⁶ The court held that the action did not fall within the confines of the statute because the suit was not brought for the purpose of restraining the assessment or collection of any tax.²³⁷ However, the court also held that the Anti-Injunction Act did not apply because its application would leave the organization with no remedy.²³⁸ Section 7428 of the Internal Revenue Code does permit an organization to seek a declaratory judgment with respect to its qualification as a tax exempt organization if the I.R.S. has not acted on its application by a certain time.²³⁹ However, in this case, the organization was not seeking to establish its qualification as a tax exempt organization but rather to prevent the I.R.S. from unlawfully delaying its application. According to the court, to require an organization to wait the requisite time and then seek a declaratory action would free the I.R.S. to engage in viewpoint discrimination in its processing of applications for tax exempt status.²⁴⁰ If the organization's action was barred, then it would have no legal means to challenge the I.R.S.'s procedures for processing its application.²⁴¹

Sebelius could have created another exception to the applicability of the Ant-Injunction Act. The individual mandate at issue in that case did not become effective until 2014, more than a year after the Court rendered its decision.²⁴² The I.R.S. was not yet enforcing the provision and, therefore, challenges to the validity of the provision at the time the issue was litigated did not impede the federal government's assessment and collection of revenue. Because the Court held that the mandate was not a tax for purposes of the Anti-Injunction Act, it had no need to consider whether challenges to a tax prior to its effective date are barred by the statute.²⁴³

The exceptions to the Anti-Injunction Act set forth in *Williams Packing* and *Regan* do not appear to apply to a pre-enforcement challenge to the

236. *Z St. v. Koskinen*, 791 F.3d 24 (D.C. Cir. 2015)

237. *Id.* at 32.

238. *Id.* at 31-32.

239. I.R.C. § 7428 (2012).

240. *Z St.*, 791 F.3d at 31-32. The organization could, in the event its application is denied, challenge any tax deficiency asserted against it or sue for refund of any disputed taxes it paid. *Id.* Similarly, the court held that these remedies offer no redress for unlawful processing of applications. *See id.* at 31 (noting that remedies provided for in other provisions would do nothing to offer relief as to the alleged delay in processing the *Z Street*'s application).

241. *Id.*

242. *See Patient Protection and Affordable Care Act*, Pub. L. No. 111-148, §§ 1501(b); 10106(b)(1), 124 Stat. 119, 244-49, 909-10 (2010) (codified as I.R.C. § 5000A (2012) (mandating individuals to maintain certain amounts of health insurance coverage beginning after 2013).

243. *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 567 U.S. 519, 546 (2012).

regulations that derailed the Pfizer-Allergan combination. As the Court made clear in a later case, *Williams Packing* requires the taxpayer to show that, with the facts and the law interpreted liberally in favor of the government, the government could not prevail on the merits under any circumstances.²⁴⁴ The anti-inversion regulations were issued pursuant to a broad statutory grant of authority. Whether the regulations have gone too far in light of the statute is not obvious and the Treasury's position is, at the very least, colorable. The regulations may very well be a permissible interpretation of the statute under a deferential *Chevron* review. The statute does not appear to preclude the Treasury from enacting a bright-line rule that takes account of multiple acquisitions that occur within a certain time frame for purposes of applying the statutory percentage thresholds. Such a rule may very well be a reasonable use of the Treasury's broad authority to issue regulations to prevent avoidance of the statute.²⁴⁵ As previously noted, the Court refused to grant a taxpayer relief to challenge an export tax that it knew was unconstitutional because, at the time the tax was assessed, the constitutional status of the tax was unsettled.²⁴⁶ *Williams Packing* is, indeed, a high hurdle to overcome and the exception's utility appears limited to egregious regulatory overreach.

As previously discussed, the *State Farm* doctrine is separate and distinct from *Chevron* and often its application does not go to the merits of an agency's action but to the agency's adherence to procedural requirements. For example, a regulation that may very well pass muster under *Chevron* may not be supported by a reasoned explanation by the agency. Alternatively, the agency may have failed to address comments in opposition of the regulation. Arguably, an obvious failure to meet the strictures of *State Farm* would render the regulation invalid under any circumstances, whether those circumstances are viewed in a light most favorable to the agency. However, even if one were to concede that procedural defects render the agency's action invalid on its face, it is unlikely that a pre-enforcement would be countenanced and, if it were, such a challenge would offer little practical utility.

If we assume that anti-inversion regulations were arbitrary and capricious under the *State Farm* standard and that the agency could not prevail, the exception set forth in *Standard Nut* still requires the taxpayer to show an extraordinary degree of harm that results from the agency action.²⁴⁷ The Court in *Williams Packing* placed its focus on the merits of the government's position but it did not eliminate the second prong of *Standard*

244. *Bob Jones Univ. v. Simon*, 416 U.S. 725, 737 (1974).

245. I.R.C. § 7874(g).

246. *United States v. Clintwood Elkhorn Mining Co.*, 553 U.S. 1, 14 (2008).

247. *Miller v. Standard Nut Margarine Co.*, 284 U.S. 498, 509 (1932).

Nut, a showing of extraordinary harm.²⁴⁸ It is not clear whether the harm must rise to the ruinous level that existed in *Williams Packing*, but it probably has to be close to such level. It is unlikely that Pfizer could show such a degree of harm to its business. Without question, the anti-inversion regulations negatively altered the economics of the contemplated transaction. However, had Pfizer consummated the transaction, it is not at all clear that subsequent steps could not be taken to leave Pfizer in a tax position not all that far from where it would have been had it acquired Allergan in a more conventional acquisitive transaction. Moreover, it is inconceivable that an enterprise of the size of Pfizer can encounter an extraordinarily devastating blow from a tax regulation that diminishes the profitability of its operations by subjecting it to taxes that it had been subject to prior to the transaction in question.

In addition, a *State Farm* challenge that does not get to the merits of the government's position is, for practical purposes, of little utility. As the concurrence noted in *Dominion Resources*, regulations that fail on procedural grounds may very well have merit on substantive grounds.²⁴⁹ Procedural defects can be remedied by an agency and the rule in question reissued. As previously noted, Treasury regulations may be issued with retroactive effect in certain circumstances.²⁵⁰ Among those circumstances are regulations issued to correct procedural defects in previously issued regulations.²⁵¹ A company in Pfizer's position needs an answer on the merits and, as noted above, whether the Treasury's position has legal merit is not obvious.

The exception to the application of the Anti-Injunction Act that the Court applied in *Allen* and *Regan* is also unlikely to apply to a pre-enforcement challenge to the anti-inversion regulations. Both cases involved a challenge to a tax that was imposed on third parties but whose effect impacted the operations of the challengers.²⁵² The two universities and the State of South Carolina objecting to the tax provisions in question were not the taxpayers and, therefore, could not pay now and sue later. As

248. *Enochs v. Williams Packing & Navigation Co., Inc.*, 370 U.S. 1, 7-8 (1962).

249. *Dominion Res., Inc. v. United States*, 681 F.3d 1313, 1320 (Fed. Cir. 2012) (Clevenger, J., concurring).

250. *E.g.*, I.R.C. §§ 7805(b)(1)(C), 7805(b)(2) (enabling tax regulations to have retroactive effect in certain circumstances).

251. I.R.C. § 7805(b)(4) (“[T]he Secretary may provide that any regulation may apply retroactively to correct a procedural defect in the issuance of any prior regulation.”) Moreover, Treasury regulations can be effective on the date on which any notice substantially describing the expected contents of any temporary, proposed, or final regulation is issued to the public. I.R.C. § 7805(b)(1)(C) (2012).

252. *Allen v. Regents of the Univ. Sys. of Ga.*, 304 U.S. 439 (1938); *South Carolina v. Regan*, 465 U.S. 367 (1984).

consequence, the Court held the Anti-Injunction Act inapplicable in situations in which Congress provided no alternative means for a challenge.²⁵³ Pfizer and other companies in a similar position do have an alternative remedy available. Pfizer could have completed its transaction with Allergan and then challenged the inevitable denial of tax benefits in a suit for refund.

The anti-inversion regulations should cause the courts to consider whether the exceptions to the Anti-Injunction Act should be expanded. Specifically, the exception set forth in *Allen* and *Regan* should be applicable if there is no *practical* alternative legal remedy to a pre-enforcement challenge available to taxpayers. The circumstances in which such an expanded exception would apply would be rare but it would apply in Pfizer's case. Although Pfizer could have consummated its transaction with Allergan and then litigated the validity of the regulations, as a practical matter, Pfizer was left with no remedy. It is inconceivable that Pfizer's board of directors would approve the transaction in question on the belief that the company would prevail in litigation against the Treasury. The regulations in question are atypical from most tax regulations and, as such, warrant a practical, nuanced, and more equitable view of the scope of the Anti-Injunction Act.

The effects of the anti-inversion regulations are unique due to a combination of attributes. First, the anti-inversion regulations apply to transactions whose effects are, for all intents and purposes, long-lived. Once done, extrication from their effects is difficult for the parties involved. Second, such transactions are, by their nature, transformative in nature with significant financial effects on the parties. As a result, a taxpayer is unable to float a trial balloon as a test case to litigate the merits of the regulations. Third, these transactions are voluntary. No one is compelled, legally or practically, to undertake an inversion transaction. Many tax rules share some, but not all, of these properties.

For example, a tax regulation often has significant financial consequences on an ongoing operation. To that extent, the transactions it impacts are not voluntary in the sense that the affected transactions will take place with or without the rule in question. A post-assessment challenge is an adequate response to government overreach in such situations. Many tax regulations will pose barriers to one-off transactions that are rendered uneconomical by the rules imposed by the regulations in question. Tax rules may be issued that hinder transactions that are contemplated as part of a family's wealth management strategy, force the restructuring of an asset acquisition, or alter the terms of a large lawsuit

253. *Regents of the Univ. of Ga.*, 304 U.S. at 449; *Regan*, 465 U.S. at 373.

settlement, for example. However, in such cases, taxpayers who do not want to abandon their plans can usually challenge the rules by consummating a transaction on a small scale as a test case. Moreover, in such cases, the tax effects are isolated to a particular transaction and the decision to proceed notwithstanding the tax uncertainty may very well be a reasonable decision.

In some measure, the inability to challenge the anti-inversion rules is analogous to the cases in which not-for-profit entities, such as Bob Jones University, were unable to challenge their denial of tax exempt status prior to the assessment of tax. As a technical matter, such organizations had a remedy—a post-assessment suit for refund. Practically, this remedy offered little relief from the effects that the denial of tax exempt status had on the ability of such organization to raise funds from donors who, understandably, wanted assurance that their donations were tax deductible.²⁵⁴ Congress acted to remedy this problem by allowing pre-assessment reviews with respect to an organization's tax-exempt status.²⁵⁵ It is unlikely that Congress would enact legislation designed to encourage inversions.

Ironically, the Court did not adhere to a rigid application of rules but showed a willingness to examine the particular facts and circumstances in the very case that it refused to apply the Anti-Injunction Act: *Sebelius*.²⁵⁶ The Court ruled against the government on two issues in that case.²⁵⁷ First, it held that the individual health insurance mandate was beyond Congress's power to regulate interstate commerce.²⁵⁸ Second, it held that the expansion of Medicaid under the statute impermissibly compelled the states to enact or administer a federal program.²⁵⁹ The Court had long recognized that the federal government may induce states, through the spending power, to enact or administer programs.²⁶⁰ However, permissible financial inducements become impermissible coercion when a state is left with no practical choice but to comply—when “pressure turns into compulsion.”²⁶¹ In this case, a state that refused to expand its Medicaid program faced a loss of all federal

254. *Bob Jones Univ. v. Simon*, 416 U.S. 725, 738 (1974).

255. I.R.C. § 7428 (2012). This exception was added by the Tax Reform Act of 1976 and has mitigated the hardship that the preclusion of a pre-enforcement remedy imposed upon tax exempt organizations. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1306, 90 Stat. 1520, 1717 (1976).

256. *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 567 U.S. 519 (2012).

257. *Id.*

258. *Id.* at 587. The Court upheld the mandate under Congress's taxing power. *Id.* at 570.

259. *Sebelius*, 567 U.S. at 585.

260. *Id.* at 576.

261. *Id.* at 577 (citing *Steward Mach. Co. v. Davis*, 201 U.S. 548, 590 (1937)) (internal quotation marks omitted).

Medicaid funding.²⁶² In theory, a state had the option to refuse and lose a great deal of federal funding. Practically, given the amount of money at stake, a state had no choice.

Taxpayer standing rules prevent taxpayers from challenging unwarranted government largesse doled out as favors to specific industries or as a means to achieve non-tax policy goals.²⁶³ The fact that the political process can rectify agency overreach in such cases is of little comfort to taxpayers who value fiscal responsibility or the rule of law.²⁶⁴ However, the standing rules preclude a legal remedy for harms that are diffuse and common to all taxpayers. At a visceral level, there is something more sinister in the inability to challenge a rule that directly harms a particular taxpayer. Agency action that forces a taxpayer to abandon a transaction without the ability to challenge the merits of the agency's action is an invitation to agency overreach and usurps the separation of powers.

CONCLUSION

Over eighty years ago the Court opined that “taxes are the lifeblood of government, and their prompt and certain availability an imperious need.”²⁶⁵ To that end, the courts have been reluctant to expand taxpayers' ability to impede I.R.S. assessment and collection efforts. In light of the increasing use of the tax code to accomplish objectives unrelated to government funding, perhaps the courts should be less reticent to examine the equities of a particular case when encountered by the Anti-Injunction Act. The tax system has never served solely as a socially neutral revenue machine, but Professor Kristin Hickman, in a recent study, has shown that the tax system has been enlisted to serve policy goals unrelated to revenue to an increasing degree in recent decades.²⁶⁶ Professor Hickman's study cast some doubt on the notion of tax exceptionalism as a reason for the

262. *Id.* at 581.

263. A taxpayer must show the sustainment of some direct injury and not merely some indefinite injury she shares with people generally. *Frothingham v. Mellon*, 262 U.S. 447, 488 (1923). The assertion of harm based on the effect of a tax policy on federal revenues or expenditures is “too remote, fluctuating, and uncertain” and a taxpayer's “interest in moneys of the Treasury” is “shared with millions of others.” *Id.* at 487.

264. See Melone, *supra* note 78 (discussing Notice 2008-83 which provided favorable treatment to banks to assist healthy banks acquire struggling banks during the 2008 financial crisis and the resultant congressional response).

265. *Bull v. U.S.*, 295 U.S. 247, 259-60 (1935).

266. Kristin E. Hickman, *Administering the Tax System We Have*, 63 *Duke L. J.* 1717 (2014). See also Linda Sugin, *The Great and Mighty Tax Law: How the Roberts Court has Reduced Constitutional Scrutiny of Taxes and Tax Expenditures*, 78 *BROOKLYN L. REV.* 777 (2013) (discussing how recent Court decisions have removed barriers to the use of the tax code to achieve policy goals).

Treasury excusing itself from the general strictures of administrative law. The use of the tax code to serve social policy goals does not diminish the government's "imperious need" to raise revenue promptly. However, such use of the tax system should cause the courts to question the inviolability of the Anti-Injunction Act despite the equities of a particular case.

Admittedly, a multi-national corporation, particularly one seeking to move its domicile out of the United States for tax purposes, does not make for the most sympathetic party to argue the inequity of a statute. Nonetheless, such a party is more sympathetic than a federal government agency whose rulemaking is, for all practical purposes, beyond review.