**Tax Enforcement**

**IRS May Face Legal Challenges On Tax Law Regulations**

The IRS may face legal challenges as it issues regulations to implement the new tax law, according to tax practitioners and law professors.

Budgetary constraints and staff shortages may increase chances of the agency running afoul of the Administrative Procedure Act (APA), they said. The APA defines the rulemaking process for administrative agencies and police agencies for improper behavior. Usually, an agency must give notice and have a comment period as part of the process. Noncompliance with the rulemaking process can trigger lawsuits.

"Taxpayers will scrutinize Treasury's adherence to the APA and be ready to pounce on any missteps. This includes whether the Treasury engages in reasoned decisionmaking in making the policy choices embodied in the regs," said Robert J. Kovacev, a partner at Steptoe & Johnson LLP in Washington, who previously was a senior litigation counsel in the Department of Justice Tax Division.

Practitioners told Bloomberg Tax that the Internal Revenue Service’s current funding and staffing issues make it susceptible to errors, and that taxpayers will be eager to challenge regulations stemming from the 2017 tax law (Pub. L. No. 115-97) as a result.

"The IRS and Treasury will need to issue a lot of guidance under the legislation and their resources are already stretched very thin," said Patrick Smith, a partner at Ivins, Phillips & Barker Chartered in Washington. "That combination of circumstances provides fertile ground for the agencies not being able to devote the necessary resources to every issue, and that in turn increases the risk of noncompliance with APA requirements."

**Matter of Timing** "Certainly it could be the case that states or individuals, when they see regulations issued by the IRS under the new tax bill, may bring a regulatory challenge," said Andy Grewal, a professor at the University of Iowa College of Law. "But the question then becomes, can you fight the IRS in court outside of a deficiency suit?"

Kristin Hickman, distinguished McKnight University professor and Harlan Albert Rogers professor of law at the University of Minnesota Law School in Minneapolis, said that taxpayers ordinarily challenge Treasury Department regulations or IRS guidance when the agency denies a refund or issues a deficiency notice based on interpretations in the regulations or guidance documents.

The U.S. Chamber of Commerce didn’t wait for a deficiency notice to take its dispute involving the agency’s anti-inversion regulations to court. The Chamber challenged Treasury Regulations Section 1.7874-8T (T.D. 9761, REG-135734-14, issued in April 2016), which was implemented to inhibit corporate inversions, including the Allergan-Pfizer merger. When the IRS didn’t allow for a notice-and-comment period as required by the APA, the Chamber challenged the regulations on their face.

The Chamber won its suit against the IRS. The U.S. District Court for the Western District of Texas ruled that the IRS unlawfully issued the regulations, and determined the Tax Anti-Injunction Act (TAIA) didn’t preclude pre-enforcement judicial review of IRS regulations.

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The agency on Nov. 27, 2017, filed a notice stating its intent to appeal the decision to the U.S. Court of Appeals for the Fifth Circuit.

"I think there’s a strong likelihood that a taxpayer who feels aggrieved by a regulation issued by Treasury will mount a legal challenge upfront rather than wait for the deficiency process to go all the way," Kovacev said. "For every other agency, that’s how it works. Plaintiffs don’t have to wait five years for the administrative process, they can just go to court."

**Why Is Tax Different?** Johnson said "if you’re challenging IRS actions based on the APA you still have to deal with justiciability issues such as finality, ripeness, and exhaustion of remedies, plus you have to deal with Section 7421, the TAIA."

The TAIA says “no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such
person is the person against whom such tax was assessed.”

The IRS tends to favor a broad interpretation of “restraining,” while taxpayers seeking to challenge an IRS action argue for a narrow interpretation.

Johnson said that pre-enforcement challenges, as opposed to the traditional method of waiting for deficiency notice, “will be a very important theme or dimension of tax litigation going forward.”

Some pre-enforcement challenges, such as the one brought by the Chamber of Commerce, have been successful, while others haven’t, Johnson said. In Fla. Bankers Assoc. v. United States, the majority of a U.S. Court of Appeals for the District of Columbia Circuit panel found banks couldn’t challenge, prior to enforcement, a regulation requiring them to report to the IRS deposit interest paid to nonresident aliens.

The pre-enforcement challenge under the APA provides a significant advantage for taxpayers because a resolution can be reached faster, Smith said at a Jan. 10 D.C. Bar panel on APA regulatory challenges.

Hickman said that parties challenging the new law may have difficulty establishing standing because no taxpayer injury has materialized yet.

To avoid APA challenges to regulations implementing the new law, the IRS can issue guidance in the form of notices “that provide their interpretation of the statute and they don’t need to go through the same process for those,” Kovacev said. Further, “interpretive regulations aren’t legally binding for taxpayers,” he said.

**Treading Lightly** In the aftermath of the U.S. Chamber case, Smith said the IRS will need to “explain why they are doing what they are doing and responding to comments” when it issues tax regulations.

The agency also needs to be sure that its regulations are in line with the tax law changes. “If an agency promulgates regulations that are consistent with a statute, you can’t use the APA,” said Steve R. Johnson, a tax law professor at Florida State University College of Law.

Johnson said that a suit also could be brought under Section 706 of the APA, which sets the standard for courts evaluating challenges to agency actions. Taxpayers might file a challenge saying the IRS’s guidance on the tax law provisions are “arbitrary and capricious,” he said, meaning that the agency made a decision that was inconsistent with the evidence before it. “Take the courts at their word that that is an uphill fight.”

The IRS could argue that disputed regulations are merely interpretive rules, but that position wouldn’t be legally sound, Hickman said.

With or without the immediate threat of an APA lawsuit, the IRS is likely aware that issuing regulations that aren’t APA-compliant can put those rules in legal jeopardy.

“The huge job they have ahead of them to interpret this legislation is going to be even more burdensome because of the consciousness that they have to be more careful and more diligent in explaining their decisions,” Smith said.

The IRS didn’t respond to a request for comment.

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