

# FLORIDA TAX REVIEW

Volume 15

2013

Number 1

## TAX ABUSE ACCORDING TO WHOM?

by

Shannon Weeks McCormack\*

### ABSTRACT

*Before 1996, the Internal Revenue Code presumed that tax regulations applied to transactions executed before their enactment, giving the Treasury Department broad authority to regulate retroactively. In 1996, however, Congress reversed this presumption, requiring regulations relating to Code sections enacted after 1996 to operate prospectively. Congress also provided an important exception in section 7805(b)(3), allowing tax regulations to apply retroactively “to prevent abuse.” Congress did not, however, explicitly define abuse; nor did it designate to any specific actor the power to do so. This Article provides a comprehensive look at the level of deference reviewing courts owe a Treasury Regulation’s interpretation of section 7805(b)(3)’s abuse exception. Generally, an agency’s statutory interpretation is entitled to receive either the strong standard of deference articulated in *Chevron v. Natural Resource Defense Council*, or the lesser degree of deference articulated in *Skidmore v. Swift & Co.* To date, the courts reviewing retroactive tax regulations enacted to prevent abuse have declined to apply *Chevron* deference, relying on administrative law principles recently rejected by the Supreme Court in *Mayo Foundation v. United States*. This Article, therefore, provides a needed guide to future courts by applying the post-*Mayo* deference framework to Treasury Regulations that interpret section 7805(b)(3). This*

---

\* Associate Professor of Law, University of Washington School of Law. I especially thank Professors Kathryn Watts and Kristin Hickman for their comments on this project. I also thank Professors Dorothy Brown, Ted Seto, and the participants of the 2012 Critical Tax Workshop held at the University of Washington School of Law, the Pittsburgh Tax Conference at the Pittsburgh School of Law in March 2013, and the Critical Tax Conference at the University of California Hastings College of the Law in April 2013 for their comments at various stages of this project.

Article concludes that, under this framework, a Treasury Regulation's interpretation of section 7805(b)(3)'s abuse exception should receive strong Chevron deference so long as it is promulgated under proper administrative procedures.

This analysis provides a significant contribution. Through the issuance of retroactive regulations, Treasury promotes the efficient enforcement of the tax laws and deters egregious abuse. But case law suggests that the courts and Treasury Department have very different interpretations of the Code's abuse exception. Therefore, the ability of Treasury to respond to and prevent aggressive tax behavior through retroactive tax regulation may turn largely on which actor possesses primary authority to define tax abuse.

<b>I.</b>	<b>INTRODUCTION</b> .....	3
<b>II.</b>	<b>PUTTING RETROACTIVE TREASURY REGULATIONS IN CONTEXT</b> .....	8
	A. <i>The Significance of Retroactive Tax Regulations</i> .....	8
	B. <i>Retroactive Tax Regulations: Pre-1996 Law</i> .....	10
	C. <i>Retroactive Tax Regulations: Post-1996 Law</i> .....	13
<b>III.</b>	<b>THE NEW RETROACTIVITY CASES</b> .....	14
	A. <i>Background Information: Retroactive Regulation         1.752-6</i> .....	15
	B. <i>Murfam Farms and Stobie Creek</i> .....	19
	C. <i>Sala v. United States</i> .....	23
	D. <i>Where's the Deference?</i> .....	25
<b>IV.</b>	<b>WHO SHOULD INTERPRET TAX ABUSE?</b> .....	27
	A. <i>The Relevant Deference Doctrines</i> .....	27
	1. <i>Skidmore v. Swift &amp; Co.: An Intermediate,            Sliding-Scale Standard of Review</i> .....	28
	2. <i>Chevron v. Natural Resources Defense Council:            A Strong Standard of Review</i> .....	29
	3. <i>Step Zero: United States v. Mead Corporation</i> .....	30
	B. <i>Are Treasury Interpretations of Section 7805(b)(3)         Chevron-Eligible?</i> .....	32
	1. <i>Mead Step 1: Did Congress Delegate to            Treasury the Power to Interpret Tax Abuse            with the Force of Law?</i> .....	32
	2. <i>Mead Step 2: How Does Treasury Exercise            its Authority to Interpret Section 7805(b)(3)</i> .....	33

<b>V.</b>	<b>APPLYING CHEVRON TO TREASURY’S INTERPRETATIONS OF TAX ABUSE</b> .....	34
A.	<i>Chevron 1: Did Congress Intend for Treasury to Interpret Tax Abuse?</i> .....	35
1.	<i>Section 7805(b)(3)’s Role in the Code</i> .....	35
2.	<i>Legislative History</i> .....	35
3.	<i>Agency Expertise</i> .....	44
4.	<i>Even if Congress Intended Treasury to Interpret Tax Abuse, Did Congress Unambiguously Foreclose and Particular Interpretation of that Term?</i> .....	46
a.	<i>How Does the Interpretation Fit Within the Statutory Scheme?</i> .....	47
b.	<i>The Importance of the Question Presented</i> .....	49
B.	<i>Applying Chevron Step 2 to Treasury’s Interpretation of Section 7805(b)(3)</i> .....	51
1.	<i>Is Treasury’s Interpretation of Tax Abuse Within the Range of Permissible Choices?</i> .....	51
2.	<i>Chevron Step 2 as “Hard Look” Review</i> .....	53
<b>VI.</b>	<b>CONCLUSION</b> .....	55

## I. INTRODUCTION

If one were to tell an average taxpayer that the Treasury Department possesses some power to issue tax laws that might affect the tax treatment of transactions completed before those rules existed, one might expect that taxpayer to act with a mixture of surprise and horror.<sup>1</sup> However, the Treasury Department has long used retroactive regulations to prevent and respond to

---

1. See, e.g., Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509 (1986) [hereinafter Kaplow, *Economic Analysis of Transitions*] (acknowledging that there is “hostility towards retroactivity”); Michael J. Graetz, *Legal Transitions: The Case for Retroactivity in Tax Revisions*, 126 U. PA. L. REV. 47, 49 (1977) [hereinafter Graetz, *Legal Transitions*] (explaining that “retroactivity in tax legislation has been widely criticized”). See also Saul Levmore, *The Case for Retroactive Taxation*, 22 J. LEGAL STUD. 265, 265 (1993) [hereinafter Levmore, *Retroactive Taxation*] (“Retroactive taxation is generally regarded as unwise, abhorrent or even illegal”); David W. Ball, *Retroactive Application of Treasury Rules and Regulations*, 17 N.M. L. REV. 139, 139 (1987) [hereinafter Ball, *Retroactive Application*] (describing retroactive lawmaking as “shocking” to “notions of due process and fundamental fairness”).

egregious tax behavior<sup>2</sup> and to foster the efficient<sup>3</sup> and uniform administration of the tax laws.<sup>4</sup>

Before 1996, the Internal Revenue Code presumed that tax regulations applied to transactions executed before their enactment, giving the Treasury Department broad authority to regulate retroactively.<sup>5</sup> In 1996, Congress reversed this presumption in Code section 7805(b), requiring regulations relating to Code sections enacted after 1996 to operate prospectively.<sup>6</sup> Congress also provided an exception to this general requirement in section 7805(b)(3), allowing regulations to apply retroactively “to prevent abuse.”<sup>7</sup> Congress did not, however, explicitly define abuse; nor did it designate to any specific actor the power to do so. It, therefore, left open essential questions upon which this Article focuses: When the Treasury Department issues a retroactive regulation under section 7805(b)(3), is that regulation’s interpretation of tax abuse entitled to deference? If so, what level of deference should these interpretations receive?

The importance of these questions should not be underestimated. Granting Treasury some power to issue retroactive regulations allows it to police and prevent the most aggressive tax transactions. But case law suggests that the courts and the Treasury Department have very different interpretations of the Code’s abuse exception. Therefore, the Treasury’s

---

2. As argued by then-IRS Commissioner Fred Goldberg in hearings discussed in Section III, *infra*: “If the IRS is precluded from asserting positions retroactively in cases where taxpayers have taken questionable positions, the tax system will lose an implicit restraint.” See *Taxpayer Bill of Rights 2: Hearings on S. 2239 Before the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Committee on Finance, 102nd Cong.* (1992) [hereinafter *1992 TBOR 2 Hearings*].

3. Scholars have eloquently argued that retroactive regulation may be more efficient (or at least as efficient) as prospective rulemaking. See Kaplow, *Economic Analysis of Transitions*, *supra* note 1, at 512 (“Generally, transitional relief is inefficient because it insulates investors from the real effects of their decisions, and thus distorts their behavior.”); Graetz, *Legal Transitions*, *supra* note 1, at 73 (finding that an analysis of “various efficiency criteria demonstrates that grandfathered rules are not necessarily to be preferred in tax reform legislation.”); Levmore, *Retroactive Taxation*, *supra* note 1; but see generally Kyle D. Logue, *Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment*, 94 MICH. L. REV. 1129 (1996) (suggesting limits to the Graetz-Kaplow theory by identifying a category of tax provisions that should not be modified retroactively).

4. As argued by IRS Commissioner Shirley Petersen in hearings discussed in section II *infra*, a ban on retroactive regulations would “absolutely abolish uniformity between the date of enactment of the statute and the date the regulations are issued.” *1992 TBOR 2 Hearings*, *supra* note 2.

5. I.R.C. § 7805(b).

6. I.R.C. § 7805(b).

7. I.R.C. § 7805(b)(3).

ability to respond to and deter egregious tax behavior through retroactive tax regulation may turn largely on which actor possesses primary authority to define tax abuse.

To date, cases that have reviewed the validity of retroactive tax regulations enacted to prevent abuse under section 7805(b)(3)'s abuse exception have resulted in government defeat.<sup>8</sup> The courts reviewing these regulations have declined to apply strong *Chevron* deference, relying on administrative law principles recently rejected by the Supreme Court in *Mayo Foundation v. United States*.<sup>9</sup> In doing so, each court rejected the government's arguments that "abuse" should be defined expansively for purposes of section 7805(b)(3) in favor of its own narrow construction of the term. This Article, therefore, provides a needed guide to future courts by applying the post-*Mayo* deference framework to Treasury Regulations that interpret section 7805(b)(3). Generally, an agency's statutory interpretation (such as Treasury's interpretation of the Internal Revenue Code), is entitled either to the strong standard of deference articulated in *Chevron v. Natural Resource Defense Council*<sup>10</sup> or the lesser degree of deference articulated in *Skidmore v. Swift & Co.*<sup>11</sup> After *Mayo*, Treasury's interpretations of the Internal Revenue Code are entitled to *Chevron* deference, if they meet the two-step test articulated in *United States v. Mead Corp.*<sup>12</sup> (and are otherwise entitled to deference under *Skidmore*). *Mead* instructs courts to first ask whether Congress "delegated authority to the agency . . . to make rules carrying the force of the law."<sup>13</sup> In its 2013 decision, *City of Arlington v. Federal Communications Commission*,<sup>14</sup> the Supreme Court held that when Congress delegates to an agency general authority to administer a particular statute, it, has vested that agency with authority to make legally binding rules.<sup>15</sup> Because section 7805(a) authorizes Treasury to provide "all needful rules and regulations"<sup>16</sup> necessary to enforce the Internal Revenue Code, interpretations found in Treasury Regulations, including interpretations of

---

8. *See infra* section III.

9. 131 S. Ct. 704 (2011).

10. 467 U.S. 837 (1984).

11. 323 U.S. 134 (1944).

12. 533 U.S. 218 (2001).

13. *Id.* at 226–27. The "agency interpretation claiming deference" must also be "promulgated in the exercise of that authority." *Id.* at 227.

14. 133 S. Ct. 1863 (2013).

15. *Id.* at 16 ("It suffices to decide this case that the preconditions to deference under *Chevron* are satisfied because Congress has unambiguously vests the FCC with general authority to administer the Communications Act through rulemaking and adjudication, and the agency interpretation at issue was promulgated in the exercise of that authority.").

16. I.R.C. § 7805(a).

section 7805(b)(3)'s abuse exception, would seem easily to pass *Mead's* first hurdle.<sup>17</sup>

A Treasury Regulation's interpretation of section 7805(b)(3) will therefore be eligible for strong *Chevron* deference so long as it is "promulgated in the exercise of th[e] authority" granted in section 7805(a),<sup>18</sup> *Mead's* second step. It is not entirely clear that Treasury's current method of interpreting section 7805(b)(3) satisfies this requirement. When Treasury interprets a provision of the Internal Revenue Code by issuing a regulation pursuant to notice and comment or other formal adjudication procedures, it is clear that Treasury has acted within the exercise of the general authority granted in section 7805(a), and *Chevron* deference is warranted.<sup>19</sup> However, to date, Treasury has explained its reasons for making a particular regulation retroactive under section 7805(b)(3)'s abuse exception in the preamble of that regulation. When Treasury interprets a Code section in a preamble, is that action exercising the general authority granted by Congress? While there is no direct authority on this point, it would seem logical that these interpretations would be *Chevron* eligible so long as they appear in the preamble for the entire notice and comment period. Nevertheless, Treasury might wish to avoid the ambiguity in the future by interpreting section 7805(b)(3) in separate regulations.

Having reached this conclusion, this Article illustrates how *Chevron* deference should be applied to a Treasury Regulation's interpretation of section 7805(b)(3). *Chevron* instructs courts to first ask whether "Congress had spoken to the precise question at issue"<sup>20</sup> or whether Congress left an ambiguity that it intended an agency to resolve (*Chevron* Step 1).<sup>21</sup> In the latter case, according to *Chevron*, a court should uphold that agency's interpretation so long as it is a "permissible construction"<sup>22</sup> that is not "arbitrary, capricious or manifestly contrary to the statute"<sup>23</sup> (*Chevron* Step 2).

Clearly, Treasury's power to issue retroactive regulations to "prevent abuse" is an ambiguous one and when terms in a statute are ambiguous,

---

17. United States v. Mead Corp., 533 U.S. 218, 226–27 (2001).

18. *Id.* at 227.

19. Mayo Found. v. United States, 131 S. Ct. 704, 704 (2011).

20. *Id.* at 842.

21. *Id.* See also United States v. Home Concrete & Supply, LLC, 132 S. Ct. 1836 (2012). The Supreme Court made clear that *Chevron's* first step seeks to solve the "underlying interpretive problem of deciding whether or when a particular statute in effect delegates to an agency the power to fill a gap, thereby implicitly taking from a court the power to void a reasonable gap-filling interpretation." When a statute is silent or ambiguous about the question addressed by the agency interpretation, it is likely that Congress intended the agency to fill the statutory gap.

22. *Id.* at 844.

23. *Id.*

courts generally conclude that Congress intended the relevant agency to provide clarification. However, the powers granted in section 7805(b) are purposefully limited and prohibit retroactive regulation unless certain exceptions apply. It is therefore not clear whether Congress intended Treasury to interpret the meaning of these exceptions, including section 7805(b)(3)'s abuse exception, or expected courts to play this role. To answer this question, this Article considers the way in which section 7805(b)(3) fits within the Internal Revenue Code, the legislative history of section 7805(b)(3), and the special expertise of the Treasury and Internal Revenue Service, and ultimately concludes that Congress intended Treasury to interpret section 7805(b)(3)'s abuse exception. As a result, a Treasury Regulation's interpretation of section 7805(b)(3) will generally satisfy *Chevron* Step 1.<sup>24</sup>

If it does, that interpretation will be upheld so long as it is not an "arbitrary or capricious" construction of section 7805(b)(3) (*Chevron* Step 2).<sup>25</sup> While this standard is high, it is not necessarily "insurmountable."<sup>26</sup> For instance, this Article argues that Courts should invalidate interpretations that enact too great an alteration to current tax laws.<sup>27</sup>

This Article proceeds in four parts. Section II explains the significant role retroactive regulations play in curbing tax abuse and describes past and current laws regarding retroactive tax regulations. Section III summarizes the cases that have applied section 7805(b)(3) to review retroactive Treasury Regulations. Section IV applies relevant deference doctrines to conclude that a Treasury Regulation's interpretation of section 7805(b)(3)'s abuse exception should be eligible to receive strong *Chevron* deference, so long as it is enacted under proper procedures. Section V shows the way in which *Chevron*'s two-step test should be applied to regulations made retroactive to "prevent abuse" under section 7805(b)(3).

---

24. As discussed in Section III, some courts might also look at whether Congress unambiguously foreclosed a particular interpretation of section 7805(b)(3) at *Chevron* Step 1. Other courts might reserve this inquiry for *Chevron* Step 2.

25. *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984).

26. Leandra Lederman, *The Fight Over "Fighting Regs" and Judicial Deference in Tax Litigation*, 92 B.U. L. REV. 643, 697 (2012) [hereinafter Lederman, *Fighting Regs*] (citing *Judulang v. Holder*, 132 S. Ct. 476, 479 (2011)).

27. As discussed, this inquiry may fall either at *Chevron* step 1 or 2, depending on the court. See *infra* Section III.

## II. PUTTING RETROACTIVE TREASURY REGULATIONS IN CONTEXT

### A. *The Significance of Retroactive Tax Regulations*

Although the scope of this authority has changed over time, the Treasury Department has long possessed some power to issue retroactive regulations.<sup>28</sup> Even before one becomes acquainted with the specific laws governing this power, one might wonder whether Treasury should possess any ability to issue regulations that apply to transactions completed prior to their enactment. Scholars and lawmakers have engaged in considerable debate about how to define the ideal boundaries of this power.<sup>29</sup> Far less controversial, however, is the need for Treasury to have some ability to use retroactive regulations to respond to and deter egregious tax behavior.

Sophisticated taxpayers and their advisors are constantly engaged in efforts to devise transactions that produce tax savings within the literal meaning of the Internal Revenue Code but that are clearly not intended by the tax laws.<sup>30</sup> These transactions are extremely sophisticated and varied, making it impossible to predict their occurrence *ex ante*.<sup>31</sup> It is, therefore, well understood that the tax laws cannot be adequately enforced through traditional, forward-looking legislation alone.<sup>32</sup> In response to this reality, courts have developed several anti-abuse doctrines. For instance, under the

---

28. See I.R.C. § 7805(b) (creating presumption that Treasury Regulations operate prospectively); compare I.R.C. § 7805(b) (creating opposite presumption).

29. See *supra* note 3.

30. See, e.g. Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775, 1777 (June 21, 1999) (“The tax shelter, while supported by a literal reading of the statute, regulation or case law produces a result that is inconsistent with the commonly understood tax principles and is not supported by clearly defined legislative intent”).

31. See e.g. Marvin A. Chirelstein & Lawrence A. Zelenak, Essay, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1951–52 (2005) (“Contemporary tax shelters are considerably more varied in design — and in the Code provision they exploit — than were their predecessors.”); Shannon Weeks McCormack, *Tax Shelters and Statutory Interpretation: A Much Needed Purposive Approach*, 2009 U. ILL. L. REV. 697, 705 (2009) [hereinafter Weeks McCormack, *Tax Shelters and Statutory Interpretation*] (“Lawmakers... cannot be expected to predict today’s abusive transactions before they occur because the complexity and diversity of today’s shelters prevents lawmakers from foreseeing the transactions”).

32. James S. Eustice, *Abusive Corporate Tax Shelters, Old “Brine” in New Bottles*, 55 TAX L. REV. 135, 141 (2002) [hereinafter Eustice, *Old “Brine” in New Bottles*] (“Even when Congress attempts to close down a perceived abuse, it frequently comes late to the rescue, reacts with excessive overkill, and then repents at leisure, if ever, only rarely returning to the scene of the accident.”); Weeks McCormack, *Tax Shelters and Statutory Interpretation*, *supra* note 31, at 704–8 (discussing how lawmakers cannot handle the tax shelter problem alone).



so-called economic substance doctrine, the tax savings associated with a transaction will be disallowed if that transaction is not motivated by a substantial non-tax purpose and did not meaningfully change the taxpayer's economic position aside from the tax benefits claimed.<sup>33</sup> These doctrines operate retroactively by stripping taxpayers of the tax savings associated with transactions completed prior to litigation.

But once a tax shelter scheme is devised, numerous taxpayers will rush to mimic it, driven by the promise of large tax savings. If forced to rely solely on the judicial anti-abuse doctrines, the Internal Revenue Service would be required to litigate each of these transactions on a case-by-case basis. In addition to being extremely costly and time-consuming, each court will have its own opinion about whether and to what extent the tax savings associated with a particular transaction should be disallowed.<sup>34</sup> Retroactive regulation, by contrast, can efficiently and uniformly respond to transactions the Treasury believes to subvert the purposes of the tax laws.

In addition to policing tax abuse, providing Treasury the ability to regulate retroactively can deter taxpayers from engaging in abusive transactions in the first place by creating uncertainty and lowering the expected profitability of these structures.<sup>35</sup> Thus, retroactive regulation can play an important role in the administration of the tax laws. With this in mind, this Article now turns to the past and present laws governing the ability of the Treasury Department to enact retroactive tax regulations.

---

33. The economic substance doctrine has recently been codified but is still entrusted to the courts to administer. I.R.C. § 7701(o)(1): "In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if — (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."

34. For instance, numerous courts have considered similar versions of the so-called "Son-of-Boss" transactions discussed in Section III, *infra*. See, e.g., *Stobie Creek Inv., LLC v. United States*, 82 Fed. Cl. 636 (2008) (analyzing "Son-of-Boss-Transaction"); See also *Murfam Farms, LLC v. United States*, 88 Fed. Cl. 516 (2009); *Sala v. United States*, 552 F. Supp. 2d 1167 (D. Colo. 2008); *Klamath Strategic Inv. Fund, LLC v. United States*, 440 F. Supp. 2d 608 (E.D. Tex. 2006), *aff'd* 568 F.3d 537 (5th Cir. 2009); *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008); *Maguire Partners — Master Invs., LLC v. United States*, 2009 WL 4907033 (C.D. Cal. 2009).

35. David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 249 (2002) (discussing the role uncertainty may play in deterring tax shelters); Eustice, *Old "Brine" in New Bottles*, *supra* note 32, at 147 ("... there highly abusive transactions somehow have to be stopped, or at least seriously impeded and if menacing ambiguity is the only way to do it, then do it we must.").

B. *Retroactive Tax Regulations: Pre-1996 Law*

Before 1996, section 7805(b) created a presumption that Treasury Regulations would operate retroactively,<sup>36</sup> allowing the Secretary of the Treasury to use her discretion to determine whether a regulation should apply prospectively, or also apply to previously executed transactions.<sup>37</sup> While this accorded the Treasury Department, of which the Internal Revenue Service (the IRS) is part, rather wide latitude to choose the effective date of issued regulations, there were some limits on the way in which this discretion could be exercised. By 1996, the predominant standard<sup>38</sup> used to review the Treasury's "failure to limit a regulation to prospective application. . ."<sup>39</sup> was an "abuse of discretion" standard.<sup>40</sup>

---

36. See I.R.C. § 7805(b). "The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect."

37. *Id.*

38. See Toni Robinson, *Retroactivity: The Case for Better Regulations of Federal Tax Regulations*, 48 OHIO ST. L. J. 773, 784–93 (1987) (reviewing "older" theories used to analyze whether regulations could properly be applied retroactively). Professor Robinson writes: "Burdened by section 7805's approval of retroactivity, the courts fashioned several other avenues for non-retroactivity, including the doctrines of discrimination, legislative reenactment, and reliance." *Id.* at 784–85. She, however, later writes that the Fifth Circuit's multi-factored test for "abuse of discretion," discussed at note 46 *infra*, shows that "each of these other standards . . . is really part of abuse of discretion." *Id.* at 791. See also Ball, *Retroactive Application*, *supra* note 1, at 147–48 discussing alternative "equitable estoppel" arguments used to analyze retroactive regulations. This Article focuses on the "abuse of discretion" standard because it is the standard most often used by courts considering post-1996 cases under the pre-1996 version of § 7805(b). See, e.g., *Amergen Energy Co., LLC ex rel. Exelon Generation Co., LLC v. United States*, 94 Fed. Cl. 413 (2010) (using abuse of discretion standard); see also *Ford Motor Co. v. United States*, 94 Fed. Cl. 211 (2010); *Meserve Drilling Partners v. Commissioner*, 1996-72, 71 T.C.M. (CCH) 2146 (1996), *aff'd per curiam*, 98-2 U.S.T.C. ¶ 50,663 (9th Cir 1998); *Democratic Leadership Council, Inc. v. United States*, 542 F. Supp. 2d 63 (D.D.C. 2008); *Grapevine Imports, Ltd. v. United States*, 636 F.3d 1368 (Fed. Cir. 2012); *CSX Corp. Inc. v. United States*, 58 Fed. Cl. 341 (2003); *Rice v. Commissioner*, 77 T.C.M. (CCH) 1488 (1999); *Variety Club Tent No. 6 Charities, Inc. v. Commissioner*, 74 T.C.M. (CCH) 1485 (1997); *Salmon Ranch, Ltd. v. Commissioner*, 647 F.3d 929 (10th Cir. 2011); *Tate & Lyle, Inc. v. Commissioner*, 87 F.3d 99 (3d Cir. 1996). *But see* *Atchinson, Topeka & Santa Fe Ry., Co. v. United States*, 61 Fed. Cl. 501 (2004) (analyzing whether the retroactive application of the regulation violated due process); *Howard E. Clendenen, Inc. v. Commissioner*, 207 F.3d 1071 (8th Cir. 2000).

39. *Snap-Drape, Inc. v. Commissioner*, 98 F.3d 194, 202 (5th Cir. 1996) ("Although we have noted that regulations generally will have retroactive effect, the

To apply this standard, a variety of factors were considered. For instance, courts asked whether the retroactive application of the rule or regulation would produce “inordinately harsh result[s]”<sup>41</sup> and/or raise concerns of horizontal equity.<sup>42</sup> Courts also inquired whether the taxpayer was entitled to rely upon settled law reversed by the retroactive regulation,<sup>43</sup> whether Congress implicitly acquiesced to that settled law through reenactment<sup>44</sup> and/or whether the process of deciding to make the regulation

---

failure to limit a regulation to prospective application only is nevertheless reviewable for abuse of discretion.”).

40. *See, e.g., id.*; *Anderson, Clayton & Co. v. United States*, 562 F.2d 972 (5th Cir. 1977); *Wendland v. Commissioner*, 739 F.2d 580, 581 (11th Cir. 1984) (“The decision to make a ruling or regulation retroactive will stand unless it constitutes an abuse of discretion.”); *Auto. Club of Mich. v. Commissioner*, 353 U.S. 180, 185 (1957) (using “abuse of discretion” standard); *see also LeCroy Research Systems Corp. v. Commissioner*, 751 F.2d 1465 (11th Cir. 1984); *Baker v. United States*, 748 F.2d 1465 (11th Cir. 1984); *Elkins v. Commissioner*, 81 T.C. 669 (1983). *See also Benjamin J. Cohen & Catherine A. Harrington, Is the Internal Revenue Service Bound by Its Own Regulations and Rulings?*, 51 TAX LAW. 675 (1998) (discussing abuse of discretion standard).

41. *Snap-Drape*, 98 F.3d at 202; *Anderson, Clayton & Co.*, 562 F.2d at 981; *LeSavoy Found. v. Commissioner*, 238 F.2d 589 (3d Cir. 1956); *CWT Farms v. Commissioner*, 755 F.2d 790, 802 (7th Cir. 1986) (asking whether “change causes the taxpayer to suffer inordinate harm.”).

42. *Snap-Drape*, 98 F.3d at 202; *Anderson, Clayton & Co.*, 562 F.2d at 981; *Elkins v. Commissioner*, 81 T.C. 669 (1983) (rejecting taxpayer’s assertion that the retroactive amendments would “spawn unequal treatments among taxpayers.”); *IBM Corp. v. United States*, 170 Ct. Cl. 357 (1965); *Baker v. Commissioner*, No. 91-2822, 1992 WL 104812 (7th Cir. 1992).

43. *Chock Full O’ Nuts Corp. v. Commissioner*, 453 F.2d 300, 303 (2d Cir. 1971) (“A taxpayer, when acting in an area of unsettled law, has ‘no vested interest in a hypothetical decision in his favor prior to the advent of the regulations.’”) (citing *Helvering v. Reynolds*, 313 U.S. 428 (1971)); *Redhouse v. Commissioner*, 728 F.2d 1249 (9th Cir. 1984) (inquiring whether “taxpayer was. . .relying to his detriment on settled law); *Wedland v. Commissioner*, 739 F. 2d 580 (11th Cir.1984) (finding that there was no abuse of discretion because “taxpayers had notice of the impending amendment [to the law]” and that amendment “did not change settled law.”); *Anderson, Clayton & Co.*, 562 F.2d at 981 (asking “whether or to what extent the taxpayer justifiably relied on settled prior law or policy and whether or to what extent the putatively retroactive regulation alters the law.”). *See also Snap-Drape*, 98 F.3d at 381; *CWT Farms*, 755 F.2d at 802 (“[a]n abuse of discretion maybe found where retroactive regulation alters settled prior law or policy upon which the taxpayer justifiably relied and if the change causes the taxpayer to suffer inordinate harm”).

44. *Anderson, Clayton & Co.*, 562 F.2d at 981. The *Anderson, Clayton* court also asked “the extent, if any, to which the prior law or policy has been implicitly approved by Congress, as by legislative reenactment of the pertinent Code

operate retroactively was flawed.<sup>45</sup> In 1977, the Fifth Circuit adopted a five-factored test that essentially incorporated all of these elements.<sup>46</sup> The test has since been applied by other courts, though it is by no means universally accepted.<sup>47</sup>

Regardless of how a particular court formulates the “abuse of discretion” standard, it has generally been applied in a way that is deferential to agency determinations,<sup>48</sup> making it “... a difficult threshold for taxpayers to surmount.”<sup>49</sup> In 1996, however, the Treasury’s ability to regulate retroactively was dramatically altered.

---

provisions.” *Id.* See also *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939), which pre-dated the abuse of discretion test, and held that retroactive repeal of law that Congress had implicitly authorized through reenactment was improper.

45. See, e.g., *Chock Full O’ Nuts Corp.*, 453 F.2d at 302 (stating that “The Internal Revenue Service does not have carte blanche [to issue retroactive regulations]. Its choice must be a rational one supported by relevant considerations.”) (citing *IBM Corp.*, 170 Ct. Cl. 357). *Pac. First Fed. Sav. Bank v. Commissioner*, 101 T.C. 117, 128 (1993) (considering factors considered in establishing retroactive effective date).

46. The Fifth Circuit proposed a multi-factored test to determine whether retroactive application constitutes an abuse of discretion, first articulated in *Anderson, Clayton & Co.* 562 F.2d at 981, and later used by other Fifth Circuit courts, including *Snap-Drape, Inc. v. Commissioner*, 98 F.3d 194, 202 (5th Cir. 1996) and *Klamath Strategic Inv. Fund, LLC v. United States*, 568 F.3d 537 (5th C. 2009).

47. See *supra* note 39 and accompanying text.

48. See, e.g., Ball, *Retroactive Application*, *supra* note 1, at 142 (noting generally “...courts have historically accorded extraordinary deference to the discretion of the Commissioner under [the post-1996 version of] Section 7805(b)”).

49. Kristin E. Hickman, *A Problem of Remedy: Responding to Treasury’s (Lack of) Compliance With Administrative Procedure Act Rulemaking Requirements*, 76 GEO. WASH. L. REV. 1153, 1193 (2008). For instance, in the often-cited case *Snap-Drape v. Commissioner*, the court explicitly found that the “retroactive application of [the] regulation [at issue]...produced inordinately harsh results” but held that the Secretary had not abused his discretion because these results were not “totally unforeseeab[le].” 98 F.3d at 203. This is not, of course, to imply that taxpayers cannot be successful on their claims of abuse of discretion. See, e.g., *Gehl Co. v. Commissioner*, 795 F.2d 1324 (7th Cir. 1986) (holding that it was an abuse of discretion to apply a regulation retroactively when Treasury Handbook had “promised” to not change the law without further notice); see also *IBM Corp. v. United States*, 170 Ct. Cl. 357 (1965) (holding that there was an abuse of discretion when commissioner failed to retroactively apply favorable treatment provided in competitor’s Private Letter Ruling).

C. *Retroactive Tax Regulations: Post-1996 Law*

As part of the Taxpayer Bill of Rights 2, section 7805(b) was changed to reverse the presumption that regulations would operate retroactively.<sup>50</sup> Specifically, the post-1996 version of section 7805(b) provides that regulations relating to sections of the Internal Revenue Code enacted after 1996<sup>51</sup> may not apply earlier than:

(A) the date on which [the] regulation was filed with the Federal Register; (B) In the case of a final regulation, the date on which any proposed or temporary regulation to which such final regulation related was filed with the Federal Register; or (C) The date on which any notice substantially describing the expected contents of any temporary, proposed or final regulation is issued to the public.<sup>52</sup>

“New section 7805(b)” carves out several exceptions to this general prohibition against retroactivity. Most of these exceptions are concretely defined. For instance, the prohibition will not apply to “promptly issued regulations,”<sup>53</sup> defined as those “regulations filed or issued within 18 months of the date...the statutory provision to which the regulation relates”<sup>54</sup> was enacted; or “when Congress has specifically authorized the Secretary to prescribe the effective date ... [of a regulation];”<sup>55</sup> nor will the prohibition apply to “internal regulations”<sup>56</sup> or regulations enacted to “prevent a procedural defect.”<sup>57</sup>

New section 7805(b)(3) includes a less defined exception, allowing regulations to apply retroactively “to prevent abuse.”<sup>58</sup> Section 7805(b)(3)

---

50. See Pub. L. 104-168, § 1101, 110 Stat. 1452, 1468 (codified in I.R.C. § 7805(b)).

51. See *id.* (stating “The amendment[s]... shall apply with respect to regulations which relate to statutory provisions enacted on or after the date of the enactment of this Act.”).

52. I.R.C. § 7805(b)(1) (2006). This section does not apply to rulings under I.R.C. § 7805(b)(8) (2006), stating “The Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulation) relating to the internal revenue laws shall be applied without retroactive effect.”

53. I.R.C. § 7805(b)(2).

54. *Id.*

55. I.R.C. § 7805(b)(6).

56. I.R.C. § 7805(b)(5).

57. I.R.C. § 7805(b)(4).

58. I.R.C. § 7805(b)(3).

does not provide a definition of abuse and its legislative history does not elaborate further.<sup>59</sup> The Joint Committee Report adds little, stating only that the “abuse” to which section 7805(b)(3) refers is “abuse of the statute.”<sup>60</sup>

By failing to expressly define abuse or designate to a specific actor the power to do so, Congress left open essential questions regarding the administration of new section 7805(b). As discussed below, the cases which have reviewed the validity of retroactive tax regulations enacted to prevent abuse under section 7805(b)(3)’s abuse exception have resulted in government defeat.

### III. THE NEW RETROACTIVITY CASES

Since July 30, 1996, there are six cases which resolve the issue of whether a regulation can be applied retroactively under new section 7805(b)<sup>61</sup> and only three of these cases engage in any substantial discussion

---

59. *See, e.g.*, *Murfam Farms, LLC v. United States*, 88 Fed. Cl. 516, 526 (2009) (“Unfortunately, ‘abuse’ is not defined by the statute.”). *See* United States Supplemental Memorandum of Law in Opposition to Plaintiff’s Motion for Partial Summary Judgment as to the Validity of Treasury Regulation 1.752-6 referring to “Court Order dated September 25, 2008, *Murfam Farms*, 2010 WL 3260167 (Fed.Cl. Aug 16, 2010), No. 1:06-cv-00245-EJD” at 14 [hereinafter United States Supplemental Memorandum Responding to Court Order] (“Neither Section 7805(b)(3) or its legislative history define the word abuse.”). *See* *Sala v. United States*, 552 F. Supp. 2d 1167, 1201 (D. Colo. 2008) (“The question of what constitutes ‘abuse’ is not clarified by the statute.”) (*citing* Edward A. Morse, *Reflections on the Rule of Law and “Clear Reflection of Income:” What Constrains Discretion?*, 8 CORNELL J.L. & PUB. POL’Y 445, 488 (1999) (“The scope of this exception is unclear and it remains to be seen whether it will be exercised independently of Congress’ power to authorize retroactive regulations.”)).

60. STAFF OF JOINT COMM. ON TAXATION, 104TH CONG., BACKGROUND AND INFORMATION RELATING TO THE TAXPAYER BILL OF RIGHTS 22 (Comm. Print 1995).

61. In order to reach this conclusion, six searches were run, using Westlaw databases: SCT, CTA, DCT, ALLFEDS. The searches were as follows: Search 1: “26 U.S.C. s 7805” & Dates between 1995- 2013; Search 2: “26 U.S.C.A. s 7805” & Dates between 1995-2013; Search 3: “26 U.S.C. s 7805(b)” & Dates between 1995-2013; Search 4: “26 U.S.C.A. s 7805(b)” & Dates between 1995-2013; Search 5: “Internal Revenue Code” & “7805(b)” & Dates between 1995-2013; Search 6: “Tax!” & “7805(b)” & Dates between 1995-2013. Out of 193 cases produced in this search, 30 cases were coded as resolving the issue of whether a regulation could operate retroactively. Retroactivity was considered a resolved issue only if both a) the court found that the challenged regulation or ruling operated retroactively to affect the taxpayer and b) the court made a specific holding as to whether such retroactive application was valid. Twenty-three of these cases resolved the issue

of section 7805(b)(3)'s abuse exception.<sup>62</sup> These cases deal with the more specific issue of whether Treasury Regulation section 1.752-6 ("Regulation section 1.752-6") can be applied retroactively to disallow the tax savings claimed by taxpayers engaged in various versions of the notorious Son-of-Boss tax shelter transactions.<sup>63</sup>

The fact that so few cases discuss section 7805(b)(3) underscores rather than minimizes that section's importance. As discussed in Section I.A., granting Treasury the ability to regulate retroactively can serve to police and prevent the most aggressive tax planning. The relative scarcity of cases suggests that the Treasury Department uses this power sparingly. But as the facts of these cases also suggest, when that power is exercised, it is used to respond to extremely egregious transactions that seek to subvert the purposes of the tax laws. In the absence of retroactive regulation, each of these transactions must be litigated on a case-by-case basis, resulting in (sometimes extreme) judicial inefficiency.

#### A. *Background Information: Retroactive Regulation 1.752-6*

In order to understand Regulation 1.752-6, it is helpful to first understand the transaction that led to its enactment. The transaction at issue in *Coltec Industries, Inc. v. United States*<sup>64</sup> provides a useful example. In that case, Coltec, through its subsidiaries, created a new corporation ("Newco") to which it transferred non-business assets worth \$379.2 million.<sup>65</sup> Coltec did not transfer any business assets to Newco. Newco, however, did assume \$375 million worth of contingent asbestos liabilities (*i.e.* liabilities whose amount had not yet been determined) associated with products that Coltec had previously manufactured.<sup>66</sup> In other words, Coltec transferred "naked

---

using the pre-1996 version of Section 7805(b) and six resolved the issue using the post-1996 version. (Search last run 7/18/13).

62. *See infra* note 88.

63. These cases are: *Stobie Creek Inv., LLC v. United States*, 82 Fed. Cl. 636 (2008); *Murfam Farms, LLC*, 88 Fed. Cl. 516; *Sala*, 552 F. Supp. 2d 1167; *Klamath Strategic Inv. Fund, LLC v. United States*, 440 F. Supp. 2d 608 (E.D. Tex. 2006); 568 F.3d 537 (5th Cir. 2009); *Cemco Investors, LLC v. United States*, 515 F. 3d 749 (7th Cir. 2008); *Maguire Partners — Master Inv., LLC v. United States*, 2009 WL 4907033 (C.D. Cal. 2009).

64. 454 F.3d 1340 (Fed. Cir. 2006). For a similar transaction, *see Black & Decker v. Commissioner*, 436 F.3d 431 (4th Cir. 2006).

65. Specifically, the assets consisted of \$375M notes and \$4.2M nonbusiness property. *Coltec*, 436 F.3d at 1342.

66. *Id.* at 1343. *Coltec* also transferred employees to Newco to "manage" these liabilities.

liabilities”<sup>67</sup> to Newco — business liabilities severed from the business assets with which they were associated.<sup>68</sup> In exchange for these transfers, Coltec received Newco stock. This transaction had no tax consequence because it qualified under section 351 of the Code.<sup>69</sup>

Soon afterwards and as always planned, Coltec sold the stock for \$500,000.<sup>70</sup> Under general tax principles, Coltec would have reduced its basis in the Newco stock by the amount of liabilities assumed by Newco, claiming a basis of \$4 million.<sup>71</sup> However, under then-existing law, a taxpayer was not required to reduce its basis in the transferee-corporate stock (here, Newco) if the assumed liability would have been deductible by the transferor (here, Coltec).<sup>72</sup> Coltec qualified for this exception and thus claimed a basis equal to \$379.2 million, allowing it to claim large losses upon the sale of the Newco stock for \$500,000 (the stock’s value).

There are several reasons why this result was deemed troubling. Some argued that Coltec’s liability deduction was artificially accelerated,<sup>73</sup> violating the general rule that liabilities may not be deducted until the liability amount can be determined with reasonable certainty.<sup>74</sup> Under this general rule, Coltec would not have been able to deduct the contingent asbestos liabilities. However, by transferring the naked liabilities to Newco and not reducing its basis in the Newco stock by the liability amount, Coltec deducted that liability amount when calculating the losses associated with the Newco stock sale.

---

67. See Weeks McCormack, *Tax Shelters and Statutory Interpretation*, *supra* note 31, at 745–46 (“The taxpayers . . . transferred over liabilities severed from their businesses (naked liabilities) to generate capital losses from the sale of the Newco stocks.”).

68. *Id.*

69. I.R.C. § 351.

70. *Coltec*, 454 F.3d at 1344.

71. See I.R.C. § 358(d)(1) (providing that the assumption of a liability is treated as money received, so that the transferor (here *Coltec*) would have to reduce its basis by the amount of that liability). See also I.R.C. § 358(a)(1) (providing general basis calculation for section 351 transfers).

72. I.R.C. § 358(d)(1).

73. See, e.g., Lee A. Sheppard, *A More Intelligent Economic Substance Doctrine*, 112 TAX NOTES 325, 330 (2006) (“The tax law is dead set against premature recognition of expense and loss, as indicated by section 461(h) and the all-events requirement.”). See also 70 Fed. Reg. 37414, 17415 (explaining that in transactions such as that involved in *Coltec* “taxpayers attempted to duplicate a loss in corporate stock and to accelerate deduction that typically are allowed only on the economic performance of these obligations.”).

74. I.R.C. § 461(h). This requirement is known as the all events requirement.



Others argued that the Coltec transaction violated the general principle that a deduction may only be claimed once.<sup>75</sup> Coltec deducted the liability amount in calculating its loss on the sale of the Newco stock. The liability deduction, some argued, might then be duplicated if Newco were later entitled to deduct the liability amount because it became fixed.<sup>76</sup>

In 2000, after these transactions were identified, Congress enacted section 358(h), which applied to future section 351 transactions. Section 358(h) generally requires the transferor of property to reduce its basis in the corporate stock acquired by the amount of contingent liabilities assumed by the transferee corporation.<sup>77</sup> Thus, had section 358 been in effect at the time of Coltec's transaction, Coltec would have been required to reduce its basis by the contingent asbestos liabilities assumed by Newco and would not have been able to claim large losses upon the sale of the Newco stock.<sup>78</sup>

Congress, however, realized that section 358 only applied to corporate transfers and that similar abuse could still occur at the partnership level.<sup>79</sup> Thus, in section 309(c) of the 2000 Tax Act, Congress authorized the Secretary of the Treasury to prescribe rules that were "comparable" to those in section 358 and to "provide appropriate adjustments to [the partnership tax laws] to prevent the acceleration or duplication of losses through the assumption of . . . liabilities described in section 358(h)(3) of the Code."<sup>80</sup> Section 358(h)(3) makes clear that liabilities include both fixed and contingent obligations.<sup>81</sup> Section 309(c) of the 2000 Act also provided that

---

75. See Weeks McCormack, *Tax Shelters and Statutory Interpretation*, *supra* note 31, at 751 (summarizing these arguments).

76. *Id.*

77. I.R.C. § 358(h). Section 358(h)(1) provides that when the basis of the partnership interest exceeds its fair market value, the basis will be reduced the basis in that interest will be reduced (but not below its fair market value) by liabilities assumed by the partnership. Section 358(h) makes clear that contingent liability should be treated as other liabilities. Certain exceptions are found in section 358(h)(2). A basis reduction is not required if the assumed liability is part of "the amount (determined as of the date of the exchange) of any liability "the trade or business with which the liability is associated is transferred to the person assuming the liability as part of the exchange, or substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange." Coltec would not have qualified for these exceptions.

78. The difference between the \$4.2 million basis and \$500,000 sales price might have been considered genuine loss.

79. 68 Fed. Reg. 36414, 37415 ("Congress recognizes that taxpayers were attempting to use partnerships to carry out the same types of abuses that Section 358(h) was designed to deter.").

80. Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554 (app. G), § 309, 114 Stat. 2763A-587, 2763A-638 (codified at 26 U.S.C. § 358 note) [hereinafter Section 309, 2000 Tax Act].

81. I.R.C. § 358(h)(3).

regulations issued under its grant of authority could be made retroactive to October 18, 1999.<sup>82</sup>

Treasury then promulgated Regulation section 1.752-6, issued in temporary version on June 24, 2003 and finalized on May 26, 2005.<sup>83</sup> Under Regulation section 1.752-6, when a taxpayer contributes property to a partnership and that partnership also assumes contingent liabilities that qualify under section 358(h), the partner must generally reduce its basis in the partnership interest by the amount of the liability.<sup>84</sup> The regulation was intended to “adopt the approach of section 358(h), with some modifications...made to...conform the application of section 358(h) to partnerships.”<sup>85</sup>

Treasury Regulation section 1.752-6 applies retroactively to transactions occurring after October 18, 1999 and before June 24, 2003.<sup>86</sup> The Treasury claimed that the regulation could operate retroactively because it was expressly authorized by Congress in section 309(c) of the 2000 Tax Act<sup>87</sup> and prevented abuse under section 7805(b)(3).<sup>88</sup> Treasury explained that “[t]hese ... regulations are necessary to prevent abusive transactions of the type described in Notice 2000-44.”<sup>89</sup> That earlier Notice identified certain partnership transactions that generated non-economic losses and alerted taxpayers engaged in these transactions that these losses would be disallowed. One of these transactions was virtually identical to the transactions involved in the cases discussed below.<sup>90</sup> In its explanation of Notice 2000-44 in the Federal Register, Treasury explained:

[I]n a transaction addressed in Notice 2000-44, a taxpayer purchases and writes economically offsetting options and then purports to create substantial positive basis by transferring those option positions to a partnership. On the disposition of the partnership interest, the liquidation of the partner’s interest in the partnership or the taxpayer’s sale or depreciation

---

82. Section 309, 2000 Tax Act, *supra* note 80.

83. 70 Fed. Reg. 37414, 37414.

84. Reg. § 1.752-6.

85. T.D. 9207, Assumption of Partner Liabilities, 70 Fed. Reg. 30334, 30335 (May 26, 2005). One of these modifications was that exception found in L.R.C. § 358(h)(2) would not apply to transactions described in Notice 2000-44, 2000-2 C.B. 255, and at issue in the cases described, *infra*. Thus, Regulation section 1.752-6 created an exception to section 358(h)(2)’s exception.

86. Reg. § 1.752-6(d); T.D. 9207, Assumption of Partner Liabilities, 70 Fed. Reg. 30334, 30335 (May, 26 2005).

87. *See* 70 Fed. Reg. 30334, 30335.

88. *Id.*

89. *Id.*

90. *See infra* Sections III.B. and IV.C.

of distributed partnership assets, the taxpayer claims a tax loss, even though the taxpayer has incurred no corresponding economic loss.<sup>91</sup>

Three cases clearly discuss whether Regulation 1.752-6 could operate retroactively under section 7805(b)(3)'s abuse exception.<sup>92</sup> *Murfam Farms, LLC v. United States*<sup>93</sup> and *Stobie Creek Investments, LLC v. United States*,<sup>94</sup> decided by the Court of Federal Claims and *Sala v. United States*,<sup>95</sup> decided by the United States District Court for the District of Colorado.

#### B. *Murfam Farms and Stobie Creek*

The transactions in *Murfam Farms*,<sup>96</sup> *Stobie Creek*<sup>97</sup> and *Sala*<sup>98</sup> (discussed below) are extremely similar to the transaction in *Coltec*, except that the former transactions involved partnerships rather than corporations. In *Murfam Farms*, for instance, the taxpayers employed a version of the Son-of-Boss shelter known as COBRA (Currency Options Bring Rewards).<sup>99</sup> The individual taxpayers — members of the Murphy Family — purchased and sold long and short “put” currency options, and then contributed these offsetting options to a partnership in exchange for partnership interests.<sup>100</sup> The taxpayers claimed a high basis in these partnership interests equal to the value of the long options but unreduced by the value of the short options.<sup>101</sup>

---

91. 70 Fed. Reg. 30334, 30335. *See also* Notice 2000-44, *supra* note 85.

92. In *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008), Judge Easterbrook quickly found that the regulation fell within the express grant of section 309(c). He did not appear to reach the issue of whether the regulation was necessary to prevent tax abuse and deference was not discussed. In *Maguire Partners—Master Invs., LLC v. United States*, 2009 WL 4907033 (C.D. Cal. 2009), the court found that the regulation could be applied retroactively but did not directly address new section 7805(b). It instead appears to have found that the regulation was valid because it did not depart from prior law. In *Klamath Strategic Inv. Fund, LLC v. United States*, 440 F. Supp. 2d 608 (E.D. Tex. 2006), the court failed to recognize a distinction between old and new section 7805(b), applying the old abuse of discretion framework discussed in Section I to analyze the retroactivity issue. This is odd and incorrect unless one is to assume that there is no difference between the way one analyzes retroactive effect under the post- and pre-1996 versions of section 7805(b).

93. 88 Fed. Cl. 516 (2009).

94. 82 Fed. Cl. 636 (2008).

95. 552 F. Supp. 2d 1167 (D. Colo. 2008), *rev'd* 613 F.3d 1249 (10th Cir. 2010).

96. *Murfam Farms*, 88 Fed. Cl. at 516.

97. *Stobie Creek*, 82 Fed. Cl. at 636.

98. *Sala*, 552 F. Supp. 2d 1167.

99. *Murfam Farms, LLC v. United States*, 88 Fed. Cl. 516, 519 (2009).

100. *Id.* at 520.

101. *Id.*

Generally, in an exchange like that described, taxpayers must reduce their basis in acquired partnership interests by the amount of liabilities assumed by that partnership. However, under the then-existing *Helmer* doctrine, partners did not have to reduce their bases by assumed contingent liability amounts, including short options.<sup>102</sup>

The offsetting options expired according to their terms, at which time the partnership acquired municipal bonds.<sup>103</sup> As was always planned, the partnership interests were then transferred to an S corporation and the partnership was liquidated.<sup>104</sup> As was also planned, the S corporation then sold the municipal bonds.<sup>105</sup> Because the corporation claimed that the high basis in the partnership interests attached to the bonds, the sale generated a large tax loss that was then allocated to the partners — the members of the Murphy family.<sup>106</sup> The government argued, *inter alia*, that Regulation 1.752-6 applied retroactively to the taxpayer's transactions which would require the taxpayers to reduce their bases in the bonds by the short option amount, resulting in a disallowance of the large losses claimed.<sup>107</sup>

The Court of Federal Claims in *Murfam Farms* first found that section 309(c) of the 2000 Act did not expressly authorize the retroactive application of Regulation section 1.752-6 because the regulation did not “prevent the acceleration or duplication of losses” as required.<sup>108</sup> In arguing to the contrary, the government explained the similarity of the COBRA transaction to the *Coltec* transaction, to which Congress had already responded in Code section 358, and argued that, like that transaction, the *Murfam Farms* transaction resulted in duplicative losses.<sup>109</sup> The first loss, the government argued, was claimed by the partnership when the options expired worthless.<sup>110</sup> Because most or all of the options expired “out of the money” the partnership claimed losses that were then allocated to the individual

---

102. *Id.* at 521.

103. *Id.* at 520.

104. *Murfam Farms, LLC v. United States*, 88 Fed. Cl. 516, 520 (2009).

105. *Id.*

106. *Id.*

107. *Id.* at 521–2.

108. *Id.* at 523–26.

109. *See* United States Supplemental Memorandum Responding to Court Order, *supra* note 59. It did not argue that the loss was accelerated, *See* United States; Supplemental Memorandum of Law in Opposition to Plaintiff's Motion for Partial Summary Judgment as to the Validity of Treasury Regulation 1.752-6, *Murfam Farms*, 2010 WL 3260167 (Fed.Cl. Aug 16, 2010), No. 1:06-cv-00245-EJD at 2-10 [hereinafter United States Supplemental Memorandum Regarding Validity of Treasury Regulation 1.752-6].

110. United States Supplemental Memorandum Regarding Validity of Treasury Regulation 1.752-6, *supra* note 109, at 4–10.

members of the Murphy family, as partners.<sup>111</sup> A second duplicative loss, the government argued, was claimed when the municipal bonds were sold by the S corporation, because the S corporation “claimed that the artificially inflated bases in their partnership interests then carried over and attached to the [bonds].”<sup>112</sup> By doing so, the S corporation claimed a large non-economic loss of \$61,543,012 from this sale, and the individual members of the Murphy family then reported their alleged pro-rata share of losses.<sup>113</sup> The court, however, rejected this argument. It agreed that the taxpayers had artificially inflated their basis, which may have resulted in their claiming non-economic losses. The court found, however, that because S corporations are pass-through entities — *i.e.* entities that do not themselves pay taxes and instead pass their taxable income to their owners — that the losses were not duplicative as required by section 309(c).<sup>114</sup>

The court also found that Regulation section 1.752-6 did not prevent abuse within the meaning of section 7805(b)(3). The government argued that prevention of abuse should be defined expansively.<sup>115</sup> While abuse is not defined in section 7805(b)(3), the government explained, it is defined elsewhere in the Internal Revenue Code.<sup>116</sup> For instance, it explained that section 357(b)(1) provides an anti-abuse rule preventing taxpayers from claiming that an exchange is tax free when the transferee assumes liabilities “principally for tax avoidance purposes [that] lack a bona fide business purpose.”<sup>117</sup> The government also cited the broad anti-abuse rules of Treasury Regulation 1.701-2, which require that partnerships “be bona fide and [that] each partnership transaction or series of transactions...be entered into for a substantial business purpose.”<sup>118</sup> The government argued that abuse

---

111. *Id.* at 4–10.

112. *Id.* at 4.

113. *Id.*

114. *Id.* The court found that the government’s argument amounted to “a cosmetic reframing of [the government’s previously asserted] argument that [the taxpayer’s] transaction created ‘artificially inflated basis in the S corporation.’” However, the court held, “[t]he mandate of Congress to the Treasury in Section 309(c)(1) ... was not to combat inflation of basis – artificial or otherwise – rather, to preclude the acceleration and/or duplication of losses.” *Murfam Farms, LLC v. United States*, 88 Fed. Cl. 516, 525–26 (2009).

115. To help it determine whether the retroactive application of Regulation 1.752-6 would “prevent abuse” within the meaning of section 7805(b)(3), the court ordered the government to explain “how... ‘prevention of abuse’ under 26 U.S.C. 7805(b) [should] be defined?” See United States Supplemental Memorandum Responding to Court Order, *supra* note 59, at 14.

116. *Id.*

117. *Id.*

118. See United States Supplemental Memorandum Responding to Court Order, *supra* note 59, at 14.

should be defined in a similarly broad manner for purposes of section 7805(b)(3) and that Regulation section 1.752-6 would prevent abuses that also fell within these other anti-abuse provisions.<sup>119</sup>

The court, however, rejected these arguments, essentially finding that a transaction was abusive within the meaning of section 7805(b)(3) only if it lacked economic substance. In general, the economic substance doctrine is used by courts to disallow the tax savings associated with transactions that are not motivated by any substantial non-tax purpose or that fail to meaningfully change the taxpayer's economic position aside from the tax benefits claimed.<sup>120</sup> The government argued that abuse should be defined to include transactions lacking economic substance but should not be confined only to those transactions.<sup>121</sup> "Various statutes can be manipulated to produce an array of different types of abuse ... [so that] ... the U.S. Treasury is engaged in a perpetual game of catch up with the innovative geniuses who seek to subvert the tax system and Congressional intent."<sup>122</sup> In light of this known environment, the government argued, Congress intended abuse to be defined expansively when enacting section 7805(b)(3).<sup>123</sup>

However, the United States Court of Federal Claims granted the taxpayer's motion for summary judgment, invalidating retroactive Regulation section 1.752-6, stating:

the question of whether the transaction at the heart of this case lacked economic substance has yet to be determined...[I]t is possible, at least in theory that the transactions in which a partnership assumes the liabilities of a partner without a corresponding reduction in the partnership's outside basis could likewise have economic substance.<sup>124</sup>

---

119. *Id.*

120. I.R.C. § 7701(o)(1): "In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."

121. United States Supplemental Memorandum Responding to Court Order, *supra* note 59, at 17.

122. *Id.* at 15 (citing *IRS v. CM Holdings, Inc.*, 254 B.R. 578, 624 (D. Del. 2000), *aff'd*, 301 F.3d 96 (3d Cir. 2002)).

123. *Id.*

124. *Murfam Farms, LLC v. United States*, 88 Fed. Cl. 516, 526 (2009).

The court, therefore, decided that “abuse” was synonymous with transactions lacking economic substance, rejecting the government’s contrary arguments.

The Court of Federal Claims also invalidated Regulation section 1.752-6 in *Stobie Creek*,<sup>125</sup> employing extremely similar reasoning.<sup>126</sup>

C. *Sala v. United States*

In *Sala*,<sup>127</sup> the taxpayer, Carlos Sala participated in a COBRA transaction similar to the transactions conducted by the Murfam Family, described above. Mr. Sala purchased long and short options which “essentially offset one another,”<sup>128</sup> and contributed them along with \$8 million in cash to a partnership.<sup>129</sup> Rather than claiming a basis of \$8 million in the partnership interests, Mr. Sala included only the value of the long options and claimed a basis of \$69 million.<sup>130</sup> Like the taxpayers in *Murfam Farms*, Mr. Sala did not reduce his basis by the short option amount, claiming that it was a contingent liability falling under the previously discussed *Helmer* doctrine.<sup>131</sup>

One month later, as was always planned, the partnership sold the options “resulting in a profit of between \$90,000 and \$110,000”<sup>132</sup> and

---

125. *Stobie Creek Inv., LLC v. United States*, 82 Fed. Cl. 636, 636–38 (2008).

126. *Id.* at 667–71.

127. *Sala v. United States*, 552 F. Supp. 2d 1167 (D. Colo. 2008), *rev’d* 613 F.3d 1249 (10th Cir. 2010).

128. *Id.* at 1251. On October 23, 2000, Sala deposited an initial sum of \$500,000 into a personal account with Refco Capital Markets, which was managed by Krieger through Deerhurst Management. Opting to participate beyond the “test period,” Sala contributed another \$8,425,000 to his Refco account on November 21, 2000. Krieger used the funds in this account to acquire a combination of twenty-four long and short foreign currency options on Sala’s behalf, resulting in a net cost to Sala of \$728,297.85. The options had a total sales price of \$60,259,568.94 for the short options, if exercised, and a total purchase price of \$60,987,866.79 for the long options, if exercised. In other words, the long and short options essentially offset one another. *Id.*

129. *Id.*

130. *Id.* Applying the rule in *Helmer*, Solid calculated its adjusted basis in Deerhurst GP by disregarding the short options. Thus, only the value of the long options, approximately \$61 million, plus \$8 million in cash Solid contributed to the partnership were used to calculate Solid’s basis in its partnership interest. *See* 26 U.S.C. §§ 705, 722 (2006).

131. *See supra* text at note 102.

132. *Sala*, 552 F. Supp. 2d at 1186.

liquidated.<sup>133</sup> Mr. Sala received \$8 million in cash and two foreign currency contracts. Mr. Sala claimed a \$61 million basis in these contracts, a value far in excess of their \$1 million fair market value.<sup>134</sup> Mr. Sala sold the options for this value and claimed a large loss.

Like the Court of Federal Claims in *Murfam Farms* and *Stobie Creek*, the United States District Court for the District of Colorado held that retroactive Regulation 1.752-6 was neither authorized by section 309(c) nor properly enacted to prevent abuse under section 7805(b)(3).

As in *Murfam Farms*, the government explained how the COBRA transaction in *Sala* was similar to the *Coltec* transaction.<sup>135</sup> It also argued that “[t]he promulgation of Treas. Reg. § 1.752-6 was necessary to prevent certain taxpayers who – prevented from abusing the corporate form by the new I.R.C. § 358 – would undoubtedly ‘go down the street’ to the partnership form in order to avoid paying their fair share of taxes,”<sup>136</sup> rendering Code section 358(h) “impotent.”<sup>137</sup>

The District Court, however, rejected these arguments, explaining:

...the facts show Sala’s participation in the Deerhurst program was a genuine investment transaction that possessed economic substance and was entered into for the purposes of realizing profits above and beyond the tax losses. Because Sala’s investment in the Deerhurst program was not abusive, it is immaterial whether other transactions of the general type he entered into were abusive.<sup>138</sup>

Thus, like the Court of Federal Claims, the District Court decided that the term abuse was synonymous with transactions that lack economic substance and independently defined section 7805(b)(3)’s abuse exception narrowly.

---

133. *Sala v. United States*, 552 F. Supp. 2d 1167 (D. Colo. 2008), *rev’d* 613 F.3d 1249 (10th Cir. 2010).

134. *Id.* at 1200.

135. The government again did so in claiming that Reg. 1.752-6 was authorized under section 309. “Treas. Reg. 1.752-6 goes to the very heart of the harm referred to by Congress in Section 309 of the 2000 act – abusive transactions designed to inflate basis artificially in a way that creates an artificial tax loss.” United States’ Supplemental Brief at 9, *Sala v. United States*, 552 F. Supp. 2d 1167 (D. Colo. 2008) (No. 1:05-cv-00636-LTB-KTM) [hereinafter United States’ Sala Supplemental Brief]. The Colorado District Court in *Sala* held that Regulation 1.752-6 exceeded the statutory authority. *Sala*, 552 F. Supp. 2d at 1200.

136. United States’ Sala Supplemental Brief, *supra* note 135, at 9.

137. *Id.*

138. *Sala*, 552 F. Supp. 2d at 1202.



D. *Where's the Deference?*

Generally, an agency's interpretation of a statute it is entrusted to administer is entitled to some level of deference. In order to determine the level of deference owed to Treasury Regulation section 1.752-6, the courts in each of the described cases used administrative law principles now rejected by the Supreme Court in *Mayo Foundation v. United States*.<sup>139</sup>

As discussed in greater detail below, generally courts apply the two-part test set forth in *United States v. Mead Corp.*<sup>140</sup> to determine whether an agency's statutory interpretation is owed the strong deference articulated in *Chevron v. Natural Resource Defense Council*<sup>141</sup> or the lesser standard of deference articulated in *Skidmore v. Swift & Co.*<sup>142</sup> Before *Mayo*,<sup>143</sup> however, it was not clear whether the *Mead* test applied to tax regulations or whether the standards articulated in *Rowan Cos. v. United States*<sup>144</sup> and *United States v. Vogel Fertilizer Co.*<sup>145</sup> controlled.<sup>146</sup> While *Rowan* and *Vogel* pre-dated *Chevron* and *Mead*, the latter two cases were not tax-specific. Thus, some argued that *Rowan* and *Vogel*, which involved tax regulations, still applied to Treasury interpretations.<sup>147</sup> Under these two cases, tax regulations issued under specific Congressional grants of authority were entitled to strong *Chevron* deference. However, some believed that Treasury Regulations issued under general grants of authority — such as that provided in section 7805(a), authorizing Treasury to provide “all needful rules and regulations”<sup>148</sup> — should be scrutinized under the multi-factored approach articulated in *National Muffler Dealers Ass'n, Inc. v. United States*,<sup>149</sup> which

---

139. 131 S. Ct. 704, 704 (2011).

140. 533 U.S. 218, 218 (2001).

141. 467 U.S. 837, 837 (1984).

142. 323 U.S. 134, 134 (1944).

143. *Mayo*, 131 S. Ct. at 704.

144. 452 U.S. 247 (1981).

145. 455 U.S. 16 (1982).

146. Kristin Hickman, *The Need for Mead: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537, 1549 (2006) [hereinafter Hickman, *The Need for Mead*] (explaining the post-*Mayo* framework).

147. *Id.*

148. I.R.C. § 7805(a) (2006).

149. 440 U.S. 472, 477 (1979). (“In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonizes with the plain language of the statute, its origin and its purpose. A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a later period the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance place on it, the consistency of the

involved the interpretation of a Treasury Regulation.<sup>150</sup> The *Mayo* Court rejected the distinction between general and specific authority regulations and held that the *Mead* test should be applied to determine the deference owed to tax regulations.<sup>151</sup> *Mayo* also made clear that all tax regulations that cleared *Mead*'s two-part test were *Chevron* eligible, regardless of whether they were issued under a specific or general grant of authority.<sup>152</sup>

The cases analyzing Regulation section 1.752-6 predated *Mayo*. As a result, those cases utilized the now-rejected distinction between regulations promulgated under general versus specific grants of authority. Specifically, in each of the cases discussed above, the courts believed strong deference should apply only if Regulation section 1.752-6 was promulgated pursuant to section 309(c)'s express authorization. After finding that the regulation was not expressly authorized, each of these cases suggested that while a lesser standard of deference might apply, Regulation 1.752-6 must be invalidated.<sup>153</sup>

---

commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute.”).

150. In *National Muffler*, a trade organization representing muffler dealers sued for an income tax refund, claiming that they were entitled to the so-called “business league” exception and that the treasury regulation defining “business league” (a definition which would exclude muffler dealers) was not a valid interpretation of the statute granting the exemption. See Hickman, *The Need For Mead*, *supra* note 146. See also Ellen Aprill, Irvin Salem & Linda Galler, *ABA Section of Taxation Report of the Task Force on Judicial Deference*, 57 TAX LAWYER 717, 740 (2004) (“This Report reviews post-*Chevron* tax cases through the end of 2003, and concludes that although *Chevron*'s two-step process has been affirmed for tax cases, the Supreme Court nonetheless has consistently applied the *National Muffler* test to determine if a general authority regulation is reasonable.”); Thomas W. Merrill & Kathryn Tongue Watts, *Agency Rules with the Force of Law: The Original Convention*, 116 HARV. L. REV. 467, 570–75 (2002) (discussing tax exceptionalism in administrative law); Paul Caron, *Tax Myopia, or Mamas Don't Let Your Babies Grow up to be Tax Lawyers*, 13 VA. TAX. REV. 517 (1994).

151. *Mayo Found. v. United States*, 131 S. Ct. 704, 713–14 (2011) (“We have held that *Chevron* deference is appropriate ‘when it appears that Congress has delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority...Our inquiry in that regard does not turn on whether congress’ delegation was general or specific.’”).

152. *Id.* at 714 (“We believe *Chevron* and *Mead*, rather than *National Muffler* and *Rowan*, provide the appropriate framework for evaluating [the tax regulation at issue.]”)

153. The Courts also appeared to believe that once the regulation fell outside the Congressional grant of section 309(c), Treasury could not invoke section 7805(b)(3) at all. For instance, in *Stobie Creek* the Court of Federal Claims stated:

*Mayo*, however, clearly rejected the “tax exceptionalist”<sup>154</sup> methodology used by these courts, holding that the level of deference courts owe Treasury Regulations depends on the same general framework applied to all other agency regulations. Thus, neither courts nor scholars have had the opportunity to speak to the questions upon which the remainder of this Article focuses:<sup>155</sup> When the Treasury Department issues a retroactive regulation pursuant to section 7805(b)(3), is that regulation’s interpretation of tax abuse entitled to deference? If so, what level of deference should these interpretations receive?

To address these questions, this Article now turns to the general administrative law framework that is, after *Mayo*, clearly applicable to Treasury Regulations.

#### IV. WHO SHOULD INTERPRET TAX ABUSE?

##### A. *The Relevant Deference Doctrines*

When determining whether an agency regulation is a valid interpretation of the statute to which it relates, there are two predominant

---

[The government] alternatively argues that the retroactive application of Treasury Regulation § 1.752-6 is appropriate pursuant to I.R.C. § 7805(b)(3) in order ‘to prevent abuse.’ ... it would be an incongruous result to defer to Treasury’s determination that a particular regulation must apply retroactively in order to prevent abuse, when Congress saw fit to decree the end of one named abuse on a retroactive basis (acceleration and duplication of losses), but not all potential abuses related to transfers of partnership assets. Because Treasury Regulation § 1.752-6 exceeds the congressional mandate to address transactions that accelerate and duplicate losses, this broad ‘abuse prevention’ authority cannot serve as an alternate ground for validating retroactive application.

*Stobie Creek Inv., LLC v. United States*, 82 Fed. Cl. 636, 671 (2008).

154. *See supra* note 139 and accompanying text.

155. The Circuit Courts to which these cases were appealable did not address issues regarding section 7805(b). In 2009, the taxpayers and the Internal Revenue Service reached a settlement in *Murfam Farms*, so that the issue will not be considered by the Federal Circuit, to which it was appealable. *Murfam Farms, LLC ex rel. Murphy v. United States*, 2010 WL 3260167 (Fed. Cl. Aug 16, 2010) (referring to settlement agreement). On appeal in *Sala*, the Tenth Circuit did not address the issue of retroactivity, finding it unnecessary because the taxpayer was not entitled to the claimed losses on other grounds. *Sala v. United States*, 613 F.3d 1249 (10th Cir. 2010). In *Stobie Creek*, the government did not appeal the issue of retroactivity. *Stobie Creek Inv. LLC v. United States*, 608 F.3d 1366, 1374 (n.4) (Fed. Cir. 2010).

standards of deference that a court might apply. A regulation might receive the strong level of deference articulated in *Chevron v. Natural Resource Defense Council*.<sup>156</sup> If a regulation is not *Chevron*-eligible, courts will generally apply the multi-factored “sliding-scale” approach articulated in *Skidmore v. Swift & Co.*<sup>157</sup>

I. *Skidmore v. Swift & Co.: An Intermediate, Sliding-Scale Standard of Review*

In the 1944 Supreme Court case *Skidmore v. Swift & Co.*,<sup>158</sup> the Supreme Court held that the weight to be accorded to an agency’s judgment should “depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements and all those factors which give it power to persuade, if lacking power to control.”<sup>159</sup> The approach advocated in *Skidmore* is often referred to as “sliding-scale deference” since a court may, after considering the various factors discussed above, view the agency interpretation with “great respect,” “near indifference,” or something anywhere between the two.<sup>160</sup>

For about four decades after *Skidmore* was decided, this standard “enjoyed prominence as perhaps the Supreme Court’s best expression of its policy of judicial deference toward many if not most agency interpretations of law.”<sup>161</sup> In 1984, however, *Chevron v. Natural Resources Defense Council*<sup>162</sup> dramatically shifted the administrative law landscape.

---

156. 467 U.S. 837, 837 (1984).

157. 323 U.S. 134, 134 (1944).

158. *Id.*

159. *Id.* at 140.

160. *See. e.g.* Kristin E. Hickman & Matthew D. Krueger, *In Search of a Modern Skidmore Standard*, 107 COLUM. L. REV. 1235, 1242 (2007) [hereinafter Hickman & Krueger, *Modern Skidmore Standard*] (positing that *Skidmore*’s sliding scale encompasses three zones or “moods” reflecting strong, intermediate, and weak or no deference). *See also* Amy J. Wildermuth, *Solving the Puzzle of Mead and Christensen: What Would Justice Stevens Do?* 74 FORDHAM L. REV. 1877 at 1887 (2006) (discussing *Skidmore* deference).

161. *See. e.g.*, Hickman & Krueger, *Modern Skidmore Standard*, *supra* note 160, at 1242.

162. 467 U.S. 837 (1984).

2. *Chevron v. Natural Resources Defense Council: A Strong Standard of Review*

In *Chevron v. Natural Resources Defense Council*<sup>163</sup> the Supreme Court articulated a two-part deference standard for reviewing an agency's interpretation of the statute it is entrusted to administer. Under *Chevron*, a court must first ask whether "Congress had spoken to the precise question at issue"<sup>164</sup> (*Chevron* Step 1). If Congress has done so, courts must "give effect to the unambiguous expressed intent of Congress."<sup>165</sup> If, however, Congress has left a gap or ambiguity that it intended an agency to fill or clarify,<sup>166</sup> a court should uphold the agency interpretation so long as it is a "permissible construction of the statute"<sup>167</sup> that is not "arbitrary, capricious or manifestly contrary" to the law (*Chevron* Step 2).<sup>168</sup>

Immediately after *Chevron*, it appeared that all statutory ambiguities might be viewed as implicit delegations, making agency interpretations of those ambiguities eligible for *Chevron* deference.<sup>169</sup> With this sweeping scope, it was unclear whether the *Skidmore* approach was rendered "an anachronism"<sup>170</sup> or whether there remained situations to which *Skidmore* could apply. In 2001, the Supreme Court spoke to these issues in *United*

---

163. *Id.* at 838.

164. *Id.* at 842.

165. *Id.* at 843.

166. *Chevron* is premised on the notion that courts should defer to agency interpretations when and only when Congress intended that agency to interpret its laws. *Christensen v. Harris County*, 529 U.S. 576 (2000); *United States v. Mead Corp.*, 533 U.S. 218 (2001). In its recent decision, *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012), the Supreme Court emphasized that *Chevron*'s first step seeks to solve the "underlying interpretive problem ... of deciding whether, or when a particular statute in effect delegates to an agency the power to fill a gap, thereby implicitly taking from a court the power to void a reasonable gap-filling interpretation." *Id.* at 1843.

167. *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984).

168. *Id.*

169. Adrian Vermeule, *Introduction: Mead in the Trenches*, 71 GEO. WASH. L. REV. 347, 348 (2003) [hereinafter Vermeule, *Mead in the Trenches*] ("[T]he key innovation of *Chevron* is to create a global interpretive presumption: ambiguities are, without more, taken to signify implicit delegations of interpretive authority to the administering agency.").

170. Hickman & Krueger, *Modern Skidmore Standard*, *supra* note 160, at 1242–43 ("*Chevron* did not make clear when exactly courts should presume that Congress delegated interpretive authority to the agency, or concomitantly, when *Chevron*'s framework of controlling deference was appropriate.").

*States v. Mead Corporation*,<sup>171</sup> narrowing the set of situations to which *Chevron* deference applies<sup>172</sup> and making clear that *Skidmore* retained a place in the administrative law landscape.<sup>173</sup>

Because *Mead* sets forth a two-part test to determine whether an agency's statutory interpretation is eligible for *Chevron* deference, *Mead* is often referred to as creating a "Step Zero" test.<sup>174</sup>

### 3. Step Zero: *United States v. Mead Corporation*<sup>175</sup>

In *United States v. Mead Corporation*,<sup>176</sup> the Supreme Court found that an agency's statutory interpretation is entitled to *Chevron* deference if two criteria are satisfied: First, "Congress [must have] delegated authority to

---

171. 533 U.S. 218 (2001). *Mead* built upon *Christensen v. Harris County*, 529 U.S. 576 (2000). See e.g. Hickman, *The Need for Mead*, *supra* note 146, at 1550–51 ("Mead and its foreshadowing predecessor, *Christensen v. Harris County*, clearly establish that the choice for the courts is not between *Chevron* or no deference at all by revitalizing the classic, pre-*Chevron* deference case of *Skidmore v. Swift & Co.* as an intermediate deferential alternative."). *Id.* The Supreme Court also spoke to Step Zero issues in *Barnhart v. Walton*, 535 U.S. 212 (2002). However, *Mead* represents the predominant method for determining whether an agency interpretation is *Chevron* eligible. For discussion of the confusion initially created by *Barnhart*, see generally Lisa Schultz Bressman, *How Mead Has Muddled Judicial Review of Agency Action*, 58 VAND. L. REV. 1443 (2005) [hereinafter Bressman, *Mead Has Muddled Judicial Review*].

172. Vermeule, *Mead in the Trenches*, *supra* note 169, at 348 ("*Mead* reverses this global presumption. Rather than taking ambiguity to signify delegation, *Mead* establishes that the default rule runs against delegation.>").

173. Hickman, *The Need for Mead*, *supra* note 146, at 1550–51 ("*Mead* and its foreshadowing predecessor, *Christensen v. Harris County*, clearly establish that the choice for the courts is not between *Chevron* or no deference at all by revitalizing the classic, pre-*Chevron* deference case of *Skidmore v. Swift & Co.* as an intermediate deferential alternative.>").

174. See, e.g., Cass Sunstein, *Chevron Step Zero*, 92 VA. L. REV. 187, 211 (2006) [hereinafter Sunstein, *Chevron Step Zero*] (referring to *Mead*, *Christensen*, and *Barnhart* as a "step Zero trilogy" in which "the Court ha[d] attempted to sort out the applicability of the *Chevron* framework.>"). See also Hickman & Krueger, *Modern Skidmore Standard*, *supra* note 160, at 1247 ("Some have described *Mead*'s inquiry as a 'step zero' in the overall analytical framework, coming before the application of either *Chevron*'s two steps or *Skidmore*'s multiple factors. Others view *Mead* as 'sort of a *Chevron* step one-and-one-half,' relevant only if the reviewing court first concludes that the statute's meaning is ambiguous.>") *Id.* This Article will refer to the questions dictating whether *Chevron* applies to a particular regulation as "step zero" questions with recognition that "both conceptualizations are technically correct."

175. 533 U.S. 218 (2001).

176. *Id.*

the agency generally to make rules carrying the force of the law.”<sup>177</sup> (*Mead* Step 1). Second, “the agency interpretation claiming deference [must have been] promulgated in the exercise of that authority.”<sup>178</sup> (*Mead* Step 2).

In *Mead*, the Court found that agency interpretations issued pursuant to Congress’ express authorization “to engage in the process of rulemaking or adjudication that produce[d] regulations or rulings,”<sup>179</sup> were likely to satisfy *Mead*’s first step.<sup>180</sup> Thus, the requisite “force of law” delegation required by *Mead* Step 1 is almost certain to exist where Congress has authorized the agency to issue rules through notice-and-comment rulemaking or formal adjudication, creating what some have called a procedural safe harbor.<sup>181</sup>

The *Mead* Court, however, was clear that an agency interpretation would not be rendered ineligible for *Chevron* deference solely for “want of procedure.”<sup>182</sup> Thus, the Customs Ruling in *Mead* was not barred from receiving *Chevron* deference solely because it was not subject to notice-and-comment rulemaking, but also because the Court could find nothing “suggesting that Congress ever thought of classification rulings as deserving” that deference.<sup>183</sup> However, the Court did not make clear what criteria an agency interpretation “wanting procedure” could possess to make it eligible for *Chevron* deference.

Having articulated this important two-part test for determining the scope of *Chevron* deference, the *Mead* Court also reaffirmed *Skidmore*’s continuing vitality. According to the Court, if an interpretation fails either of *Mead*’s two steps (as did the Ruling at issue), a reviewing court should apply *Skidmore*’s sliding scale approach to determine whether, and to what extent, courts should defer to the agency’s interpretation.<sup>184</sup>

---

177. *Id.* at 226–27.

178. *Id.* at 239.

179. *Id.* at 240 (referring to this express authorization as a “good indicator” that the requisite delegation had been made). *Id.* at 219.

180. *United States v. Mead Corp.*, 533 U.S. 218 (2001). “It is fair to assume generally that Congress contemplates administrative action with the effect of law when it provides for a relatively formal administrative procedure tending to foster the fairness and deliberation that should underlie a pronouncement of such force.” *Id.* at 230.

181. *Id.* at 246.

182. *Id.* at 251.

183. *Id.* at 231.

184. *Id.* at 234. “*Chevron* did nothing to eliminate *Skidmore*’s holding that an agency’s interpretation may merit some deference whatever its form, given the ‘specialized experience and broader investigations and information’ available to the agency, and given the value of uniformity in its administrative and judicial understandings of what a national law requires.” *Id.* at 235. The Court continued, “There is room at least to raise a *Skidmore* claim here, where the regulatory scheme

As discussed, the cases which have assessed the validity of retroactive regulations under new section 7805(b)(3)'s abuse exception used the now-rejected distinction between general authority and specific authority regulations to analyze the level of deference owed to Treasury's interpretation of section 7805(b)(3). This Article will now focus on the level of deference a reviewing court owes a Treasury Regulation's interpretation of section 7805(b)(3) under the now-applicable framework sanctioned in *Mayo*.

*B. Are Treasury's Interpretations of Section 7805(b)(3) Chevron-Eligible?*

As discussed above, an agency's statutory interpretation is eligible for *Chevron* deference if it satisfies each of the two steps articulated in *United States v. Mead Corp.*<sup>185</sup> In determining whether a Treasury Regulation issued under to section 7805(b)(3) satisfies *Mead's* first step, a court must ask whether Congress delegated authority to Treasury to interpret section 7805(b)(3)'s abuse exception with binding legal effect.<sup>186</sup>

*1. Mead Step 1: Did Congress Delegate to Treasury the Power to Interpret Tax Abuse with the Force of the Law?*

In its 2013 decision, *City of Arlington v. Federal Communications*,<sup>187</sup> the Supreme Court held that when Congress delegates to an agency general authority to administer a particular statute it has vested that agency with authority to make legally binding rules.<sup>188</sup> As section 7805(a) authorizes Treasury to provide "all needful rules and regulations"<sup>189</sup> necessary to

---

is highly detailed, and Customs can bring the benefit of specialized experience to bear on the subtle questions in this case. . . ." *Id.* See also Kristin E. Hickman, *Unpacking Force of Law*, 66 VAND. L. REV. 465, 485 (2013) ("In *Mead*, the Court held that *Chevron* applies only if Congress has given the agency in question the authority to bind regulated parties with 'the force of law' and if the agency has 'in fact acted in the exercise of that authority.' If either of these conditions is lacking, then *Skidmore* provides the appropriate evaluative standard.").

185. 533 U.S. 218 (2001).

186. *Id.* at 226–27 (requiring a court to ask whether "Congress delegated authority to the agency generally to make rules carrying the force of the law.").

187. 133 S. Ct. 1863 (2013).

188. *Id.* at 1874 ("It suffices to decide this case that the preconditions to deference under *Chevron* are satisfied because Congress has unambiguously vested the FCC with general authority to administer the Communications Act through rulemaking and adjudication, and the agency interpretation at issue was promulgated in the exercise of that authority.").

189. I.R.C. § 7805(a).



enforce the Code, interpretations found in Treasury Regulations, including interpretations of section 7805(b)(3)'s abuse exception would seem to easily pass *Mead's* first hurdle.<sup>190</sup> Therefore, these interpretations will be eligible for *Chevron* deference so long as they are “promulgated in the exercise of th[e] authority” granted in section 7805(a),<sup>191</sup> *Mead's* second hurdle.

2. *Mead Step 2: How Does Treasury Exercise its Authority to Interpret Section 7805(b)(3)?*

When Treasury interprets a provision of the Code by issuing a regulation pursuant to notice-and-comment or other formal adjudication procedures, it is clear that Treasury has acted within the exercise of the general authority granted in section 7805(a), and *Chevron* deference is warranted.<sup>192</sup> However, as explained in Section III, when promulgating Regulation section 1.752-6, Treasury explained its reasons for making that regulation retroactive under section 7805(b)(3)'s abuse exception in the preamble. Treasury has not, however, issued any stand-alone regulations that define “abuse” for purposes of section 7805(b)(3). When Treasury interprets section 7805(b)(3) in the preamble of a regulation it intends to apply retroactively, is that interpretation “in the exercise” of the general authority granted by Congress?<sup>193</sup>

The authority on this question appears to be scant.<sup>194</sup> However, since a Treasury Regulation issued pursuant to notice-and-comment carries the force of the law under *Mayo's* procedural safe harbor, there seems a strong argument that Treasury's explanation of why that regulation prevents abuse within the meaning of section 7805(b)(3), made in the preamble to that regulation, should carry the same force so long as that explanation is subject to review during the entire notice-and-comment period.

If this were not so, each time Treasury wished to respond to a tax transaction by invoking its power under section 7805(b)(3) (*e.g.* by issuing

---

190. *Mead*, 533 U.S. at 226–27.

191. *United States v. Mead Corp.*, 533 U.S. 218, 227 (2001).

192. *Mayo Found. v. United States*, 131 S. Ct. 704, 710 (2011).

193. *Mead*, 533 U.S. at 226–27.

194. There are various cases which address the question whether to accord deference to a declaration in the preamble of a regulation that the regulation will preempt state law, but the holdings of these cases are overwhelmed by the special nature of preemption and the problems of allowing a federal agency to declare that federal law trumps state law. *See, e.g.*, *Wyeth v. Levine*, 555 U.S. 555, 577 (2006) (discussing the deference accorded to “an agency's explanation [here, made in a regulatory preamble] of how state law affects the regulatory scheme. . . .”); *Fidelity Federal Savings & Loan Association v. De la Cuesta*, 458 U.S. 141, 154. *See generally* Catherine M. Sharkey, *Preemption by Preamble: Federal Agencies and the Federalization of Tort Law*, 56 DEPAUL L. REV. 227 (2007).

Regulation section 1.752-6) it would have to write a separate regulation declaring that the transaction to which it responded (*e.g.* the COBRA transaction) was abusive within the meaning of section 7805(b)(3). Requiring Treasury to take this additional action seems redundant, though Treasury might wish to avoid this ambiguity in the future by issuing separate regulations interpreting tax abuse.<sup>195</sup>

## V. APPLYING *CHEVRON* TO TREASURY'S INTERPRETATIONS OF TAX ABUSE

If it is determined that Treasury's interpretation of section 7805(b)(3) passes *Mead's* hurdles, that interpretation will be analyzed under *Chevron's* two-part framework. Thus, a court must first apply *Chevron's* first step (discussed *supra*) to determine whether Congress intended Treasury to interpret section 7805(b)(3). Clearly, Treasury's power to issue retroactive regulations to "prevent abuse" is an ambiguous one. When terms in a statute possess ambiguities courts generally infer that Congress intended a relevant agency to clarify them. However, the powers granted in section 7805(b) are purposefully limited and prohibit retroactive regulation unless certain exceptions apply. It is therefore not clear whether Congress intended Treasury to interpret the meaning of these exceptions, including section 7805(b)(3)'s abuse exception, or expected courts to play this role. To answer this question, this Article considers the way in which section 7805(b)(3) fits within the Internal Revenue Code, the legislative history of section 7805(b)(3), and the special expertise of the Treasury and Internal Revenue Service.

---

195. In *Barnhart v. Walton*, the Supreme Court found that in cases where the agency interpretation did not fall within *Mead's* procedural safe harbor, courts should determine the proper level of deference by considering "the interstitial nature of the legal question, the related expertise of the Agency, the importance of the question to administration of the statute, the complexity of that administration, and the careful consideration the Agency has given the question over a long period of time." 535 U.S. 212, 222 (2002). How *Barnhart* and *Mead* fit together — if they do so at all — is the subject of some debate. See generally Bressman, *Mead Has Muddled Judicial Review*, *supra* note 171. However, it seems the *Barnhart* factors could help in determining when an interpretation found in a preamble merits *Chevron* deference.

A. *Chevron 1: Did Congress Intend for Treasury to Interpret Tax Abuse?*

1. *Section 7805(b)(3)'s Role in the Code*

In addition to section 7805(b)(3), there are multiple other provisions in the Code that grant Treasury open-ended power to police tax abuse. For example, the Code allows the Treasury Secretary to reapportion “gross income, deductions, credits, or allowances . . . among [commonly controlled] organizations . . . if he determines that . . . [it] . . . is necessary . . . to prevent evasion of taxes . . . .”<sup>196</sup> The Code also allows the Treasury Secretary to require taxpayers to provide information about transactions determined to “hav[e] a potential for tax avoidance or evasion.”<sup>197</sup> In this way, section 7805(b)(3) is one of many instances where Congress sought to give broad power to Treasury to prevent abuse of the tax laws, at least suggesting that Congress intended Treasury to interpret what it means to “prevent abuse.” This conclusion is greatly bolstered by the legislative history of section 7805(b)(3).<sup>198</sup>

2. *Legislative History*

As discussed previously, section 7805(b) does not explicitly define “abuse” and its legislative history does not elaborate further.<sup>199</sup> The Joint Committee Report adds little, stating only that the “abuse” to which section

---

196. I.R.C. § 482.

197. I.R.C. § 6707A.

198. *Chevron* instructs courts to determine “whether Congress has directly spoken to the precise question at issue,” applying the “traditional tools of statutory construction.” *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842, n. 9 (1984). This Article therefore assumes that legislative history may be used in determining whether an agency interpretation satisfies *Chevron*’s first step. For an interesting discussion on this matter, see e.g. Lisa Schultz Bressman, *Chevron’s Mistake*, 58 DUKE L. J. 549 (2009).

199. See, e.g., *Murfam Farms, LLC v. United States*, 88 Fed. Cl. 516, 526 (2009) (“Unfortunately, ‘abuse’ is not defined by the statute.”). See also *Sala v. United States*, 552 F. Supp. 2d 1167, 1201 (D. Colo. 2008) (“The question of what constitutes ‘abuse’ is not clarified by the statute.”) (citing Edward A. Morse, *Reflections on the Rule of Law and “Clear Reflection of Income:” What Constrains Discretion?*, 8 CORNELL J.L. & PUB. POL’Y 445, 488 (1999) (“The scope of this exception is unclear and it remains to be seen whether it will be exercised independently of Congress’ power to authorize retroactive regulations.”)).

7805(b)(3) refers to “abuse of the statute.”<sup>200</sup> Nonetheless, the legislative history of section 7805(b) provides useful information about Congress’ intent in enacting section 7805(b)(3)’s “abuse exception.”

Section 7805(b) is part of the Taxpayer Bill of Rights 2 [hereinafter “TBOR 2”]. The idea for the original Taxpayer Bill of Rights [hereinafter “TBOR 1”] appears to have emanated from the first speech then-Democratic Representative Harry Reid<sup>201</sup> delivered to the House of Representatives.<sup>202</sup> In his “maiden address,”<sup>203</sup> Representative Reid expressed the need for legislation that would “give the average taxpayer . . . additional rights in dealing with the Internal Revenue Service.”<sup>204</sup> Immediately after hearing Reid’s speech, Republican Senator David Pryor communicated to Reid his desire to partner in the effort to write and pass this legislation.<sup>205</sup>

The final version of TBOR 1 was signed into law by President Ronald Regan in 1988<sup>206</sup> and enumerated certain rights of American taxpayers.<sup>207</sup> TBOR 1 required the Treasury Secretary to issue a “simple and nontechnical”<sup>208</sup> statement describing the taxpayer’s rights, as well as an explanation of the audit process, the method of appeal available to the taxpayer, and the methods by which the IRS may collect unpaid tax

---

200. STAFF OF JOINT COMM. ON TAXATION, 104TH CONG., BACKGROUND AND INFORMATION RELATING TO THE TAXPAYER BILL OF RIGHTS 22 (Comm. Print 1995).

201. Harry Reid first became Senator of Nevada in 1986.

202. 138 CONG. REC. 2831 (1992) (statement of Sen. Harry Reid, recounting that “the first speech [he] gave on the House Floor...related to the taxpayer bill of rights.”).

203. *Id.* at 2822 (statement of Sen. David Pryor, referring to Reid’s “maiden address”).

204. *Id.* See also *IRS Implementation of the Taxpayers’ Bill of Rights: Hearing Before the Subcomm. on Private Retirement Plans and Oversight of the Internal Revenue Service of the S. Comm. on Finance, 101st Cong., 2d Sess., 3* (1990) (statement of Harry Reid).

205. This event is recounted several times by Senators Pryor and Reid. See, e.g., 138 CONG. REC. 2822, 2831 (1992) where Senators Pryor and Reid recount the formation of their partnership. For instance, Pryor recounts: “I will never forget at the conclusion of [Reid’s maiden address] I sent the distinguished Senator a note saying I want to be your partner, I want to join with you because we need to give the average taxpayer in our country additional rights in dealing with the Internal Revenue Service.” *Id.* at 2822.

206. Pub. L. 100-647, 102 Stat. 3342, 3730-52 (1988).

207. The Taxpayer Bill of Rights was enacted in sections 6226 through 6247 of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. 100-647, 102 Stat. 3342, 3730-52 (1988).

208. Pub. L. 100-647, §§ 6247-51, 102 Stat. 3342, 3730-52 (1988).

liabilities.<sup>209</sup> TBOR 1 also expanded the rights of taxpayers by, for instance, allowing a taxpayer to recover previously unrecoverable administrative and litigation costs from the IRS,<sup>210</sup> creating “the right of the taxpayer to rely on the written advice of the Internal Revenue Service,”<sup>211</sup> by abating penalties under certain circumstances when the relied-upon advice was erroneous,<sup>212</sup> creating new causes of action against the IRS for negligently failing to release a taxpayer lien,<sup>213</sup> and for recklessly or negligently disregarding provisions of the Code and/or regulations.<sup>214</sup>

In 1996, the Taxpayer Bill of Rights 2, of which new section 7805(b) is part, was enacted to improve upon and increase the taxpayer protections provided by TBOR 1.<sup>215</sup> Senator Pryor and now-Senator Reid were again at the forefront in advocating this legislation.<sup>216</sup>

The issue of retroactive regulation was not discussed in the first hearing relating to TBOR 2. This first hearing, held by the Senate Finance Committee in April 1990, was held to evaluate whether the IRS was implementing TBOR 1 in a manner which set “the individual rights of the

---

209. For the full document explaining these items, see Internal Revenue Service, *Declaration of Taxpayer Rights*, Publication 1, <http://www.irs.gov/pub/irs-pdf/p1.pdf>. As explained at the beginning of this publication “[t]he first part . . . explains some of [the] taxpayer’s most important rights . . . . The second part explains the examination, appeal, collection, and refund processes.” *Id.*

210. I.R.C. § 7430 (2006). *See also* 142 CONG. REC. 17371 (1996) (Senator Pryor explains TBOR 1 and states that it provided “the right of the taxpayer to recover, for the first time, civil damages and attorney’s fees from the Internal Revenue Service.”).

211. *Id.*

212. Pub. L. 100-647, § 6229, 102 Stat. 3342, 3733 (1988) (amending I.R.C. § 6404(f)(1) which reads: “The Secretary shall abate any portion of any penalty or addition to tax attributable to erroneous advice furnished to the taxpayer in writing by an officer or employee of the Internal Revenue Service, acting in such officer’s or employee’s official capacity.”)

213. I.R.C. § 7432 (2006).

214. I.R.C. § 7433 (2006).

215. *See, e.g., Reforms to Establish Taxpayer Safeguards and Protect the Rights of Taxpayers Under the Internal Revenue Code: Hearings Before the Subcomm. on Oversight of the H.R. Comm. on Ways and Means*, 102d Cong. [hereinafter *1991 House Hearings*] (press release July 12, 1991) (“The Honorable J. J. Pickle (D. Texas) Chairman of the Subcommittee on Oversight, Committee on Ways and means, U.S. House of Representatives announced today that the Subcommittee will conduct hearings to review reforms to establish taxpayers safeguards in dealing with the Internal Revenue Service (IRS) and to protect the rights of taxpayers under the Internal Revenue Code (IRC).”)

216. *See generally IRS Implementation of the Taxpayers’ Bill of Rights: Hearing Before the Subcomm. on Private Retirement Plans and Oversight of the Internal Revenue Service of the S. Comm. on Finance*, 101st Cong., 2d Sess. (1990).

American taxpayer [as] a high priority,”<sup>217</sup> and whether TBOR 1 was itself providing adequate protections to taxpayers.<sup>218</sup> Following Senator David Pryor’s brief opening statement, Senator Reid recited a poem based on T.S. Elliot’s “The Wasteland:”

April is the cruelest month, sending 1040’s [sic] across the land . . . And as the IRS was churlish, crafting new abuses, Congress, it passed a Bill of Rights. The Agency’s leash was tightened. They had to say, taxpayers you have rights. The IRS must follow rules. In the meantime, all citizens are free to inquire about their rights and keep their legal wage.<sup>219</sup>

After this recital, Reid encouraged the committee to “keep [sic] the pressure on” the IRS to ensure it took “both the spirit and the letter of the Taxpayers’ Bill of Rights seriously and [was] incorporat[ing TBOR’s] philosophy into all its activities.”<sup>220</sup>

The hearings commenced with statements by and the questioning of various employees of the IRS who testified generally as to the measures taken to comply with TBOR 1. The committee also heard statements by public witnesses who had been mistreated by the IRS.<sup>221</sup> Some of these statements were extremely emotional, including for instance, a statement by an individual taxpayer whose husband’s experience with the IRS had allegedly caused him to commit suicide.<sup>222</sup> This initial hearing, therefore, seemed to be devoted to information collection.

In July 1991, the Subcommittee on Oversight of the House on Ways and Means announced in a press release its intention to hold two more substantive hearings that would “review reforms to establish taxpayer safeguards in dealing with the Internal Revenue Service (IRS) and to protect the rights of taxpayers under the Internal Revenue Code (IRC).”<sup>223</sup> This press release invited interested parties to participate either through the filing of written statements or by testifying at the scheduled hearings.

---

217. *Id.*

218. *Id.* at 2 (statement of Sen. Pryor, chairman of the subcommittee): “This brings me to the second subject of today’s hearing, a look at the legislation itself to see if it is providing the necessary protections for the taxpayers.” *Id.*

219. *Id.* at 3–4.

220. *Id.* at 5.

221. *Id.* at 18–21.

222. *Id.* at 18–19.

223. Press Release, Subcomm. on Oversight of the H.R. Comm. on Ways and Means House of Representatives, Hearings on Reforms to Establish Taxpayer Safeguards (July 12, 1991) (on file with author).

Chairman Jake Pickle identified thirteen reforms that would be discussed at the two hearings. Most of these reforms seemed to be an extension of the reforms made in TBOR 1. For instance, the press release stated that the Subcommittee would consider reforms that would require the IRS to formalize its appeals procedures,<sup>224</sup> allow the taxpayer to appeal court decisions regarding certain penalties,<sup>225</sup> and shift the burden of proof to the IRS on certain issues.<sup>226</sup>

The press release also stated that the Subcommittee would consider reforms that would “provide protections for taxpayers who make ‘good faith’ efforts to comply with the tax laws during the period between enactment of the law and issuance of clear guidelines and final regulations.”<sup>227</sup> It is to this category of “good faith reforms” that the issue of retroactive regulation would be linked.

While there seemed ample opportunity to discuss the issue of retroactive regulation at the two hearings that followed, the subject was discussed only at the second by representatives of two professional organizations both of whom supported a flat prohibition on retroactive rulemaking.

At the first hearing in July 1991, Damon Holmes, then-IRS Taxpayer Ombudsman was invited to “share his views on the problems affecting taxpayers and the possible remedies for those problems.”<sup>228</sup> The Office of the Taxpayer Ombudsman was originally created by the IRS and later codified in TBOR 1<sup>229</sup> “to serve as the primary advocate, within the IRS, for taxpayers,”<sup>230</sup> and “to issue Taxpayer Assistance Orders (TAOs) when taxpayers were suffering or about to suffer significant hardships because of the way the Internal Revenue laws were being administered.”<sup>231</sup> At these July 1991 hearings, Mr. Holmes laid out various ways to reduce the burdens on taxpayers, focusing on simplification, communication, modernization, and

---

224. *Id.*

225. *Id.*

226. *Id.*

227. *Id.*: “The [other] reforms under consideration would: (a) require [the] IRS to establish formal taxpayer appeal procedures covering the IRS collection process; (b) allow taxpayers to challenge in Tax Court [the] assessment [sic] of additional interest that are [sic] based on IRS determinations that underpayments were tax-motivated; (c) shift the burden of proof from taxpayers to [the] IRS in certain situations [and] (d) improve taxpayers’ access to reimbursements for attorneys’ fees . . . .”

228. *1991 House Hearings, supra* note 215, at 11.

229. Pub. L. 100-647, §§ 6247–51, 102 Stat. 3342, 3730–52 (1988).

230. INTERNAL REVENUE MANUAL, Part 13, <http://www.irs.gov/irm/part13/index.html>.

231. *Id.*

other procedural improvements.<sup>232</sup> The issue of retroactive regulation was not discussed in these hearings, perhaps because substantive tax matters might have been seen as falling outside of the Taxpayer Ombudsman's role.

However, at the second hearing in September 1991, Kenneth Gideon, Assistant Secretary of Tax Policy at the U.S. Department of Treasury, and Fred Goldberg, Commissioner of the IRS, both testified and answered questions.<sup>233</sup> The Subcommittee questioned neither Gideon nor Goldberg on his views regarding a ban on retroactive regulation, despite the clear substantive tax expertise of each.

Retroactivity was mentioned in the later testimony of the Chairman for the American Institute of Certified Public Accountants<sup>234</sup> who indicated the AICPA's "strong support"<sup>235</sup> for a reform that would protect taxpayers from retroactive rulemaking.<sup>236</sup> The Tax Executives Institute, a professional association who, at the time of the hearings, consisted of 4,700 individuals who work primarily in large corporations,<sup>237</sup> submitted comments to the Subcommittee suggesting that the goals underlying the "good faith reforms" listed in the press release would be advanced if Congress made statutes effective only after regulations had been finalized, particularly in instances "when [sic] broad grants of authority are given to the Treasury Department to promulgate [these] regulations."<sup>238</sup>

Thus, as of July 1991, it appeared that representatives of the U.S. government — *e.g.* the Administration and IRS — had not expressed their views on banning retroactive regulation. Nonetheless, in November 1991, Senator Pryor announced that "in the coming month [he] plan[ned] to

---

232. *1991 House Hearings, supra* note 215, at 11.

233. *Id.* at 311–17, 323–54.

234. *Id.* at 441 (statement of AICPA Chairman).

235. *Id.* "This is a very important issue which the AICPA strongly supports." *Id.*

236. "We commend the Subcommittee for its consideration of a reform that would provide protection for taxpayers who make "good faith efforts" to comply with the tax laws during the period between of enactment of the law and issuance of clear guidelines and final regulations. Such a reform would recognize taxpayers' [sic] needs for early guidance in complex areas of the tax law, while at the same time stimulate the IRS and Treasury to accelerate for the issuance of such guidance." *Id.*

237. *See id.* at 584 (statement of Timothy J. McCormally, Tax Counsel, Tax Executives Institute). For more information about the Tax Executives Institute TEI, see: <http://www.tei.org/Pages/default.aspx>.

238. *1991 House Hearings, supra* note 215, at 587. The Institute referenced and supported the Majority Tax Staff of the Ways and Means Committee's 1990 proposal to "make all rules and regulation[s] implementing broad guidelines effective on a prospective-only basis," *Id.* at 587–88. This 1990 proposal was part of a much larger proposal to simplify the tax system. The results of that effort were published as STAFF OF HOUSE COMM. ON WAYS AND MEANS, 101ST CONG., WRITTEN PROPOSALS ON TAX SIMPLIFICATION (Comm. Print 1990).



introduce the taxpayer bill of rights 2 . . . .”<sup>239</sup> As one of eight examples of reforms to be addressed, Senator Pryor stated that “all regulations issued by the Treasury Department [should] be prospective unless expressly provided otherwise by Congress,”<sup>240</sup> and conveyed a strong belief that this was “one of the critical elements of the Taxpayer Bill of Rights 2.”<sup>241</sup>

On February 20, 1992,<sup>242</sup> Senator Pryor officially introduced TBOR 2.<sup>243</sup> The first version of what would become new section 7805(b) provided that all regulations would “apply prospectively from the date of publication of such regulation in the Federal Register.”<sup>244</sup> The only exception to this prohibition on retroactivity was that Congress could expressly authorize the Secretary to issue certain regulations retroactively.<sup>245</sup>

On the following day, hearings were held before the Senate Finance Committee Subcommittee on Private Retirement Plans and Oversight of the IRS.<sup>246</sup> The U.S. government finally expressed its opinions about reforms that would ban retroactive regulation in the absence of express Congressional

---

239. 137 CONG. REC. 30,415 (1991) (statement of Sen. Pryor).

240. *Id.*

241. 138 CONG. REC. 2822–23 (1992). He continued: “It is almost unimaginable . . . that we have an agency of the U.S. Government, the Internal Revenue Service, that has the authority and the power to issue regulations that apply retroactively. But the Internal Revenue Service does it all the time. We are going to eliminate that authority.” *Id.* The summary description of the proposals (hereinafter *Summary Proposal*) for the Taxpayer Bill of Rights 2 stated that:

T2 will generally require that all regulations issued by the Treasury Department to implement broad legislative guidelines be effective prospectively from the date of issuance in final, temporary or proposed form. To keep such a presumption from providing shelter for abusive transaction, and to provide for administration of tax laws in the interim between the effective date of a statute and the effective date of the associated regulations, taxpayers would be deemed to have satisfied the necessary requirements if they made a good-faith effort to utilize a reasonable interpretation of the statute that resulted in substantial compliance. This general rule requiring that regulations be prospective could be superseded by a specific legislative grant authorizing the Treasury Department to prescribe the effective date of regulations with respect to statutory provision. 137 CONG. REC. at 30,417.

242. *See generally* 1992 TBOR 2 Hearings, *supra* note 2.

243. 138 CONG. REC. 2822 (1992).

244. *Id.* at 2828 (1992).

245. *Id.* The material introduced by Senator Pryor restated the language of the Summary Proposal verbatim. *See* 138 CONG. REC., *supra* note 241, at 1910.

246. *See* 1992 TBOR 2 Hearings, *supra* note 2.

authorization. The Administration and the IRS both opposed the prohibition.<sup>247</sup>

Fred T. Goldberg, Jr., now-Assistant Secretary for Tax Policy for the Department of the Treasury explained that “there are numerous situations where the retroactive application of regulations is a substantial benefit to taxpayers.”<sup>248</sup> For instance, retroactive regulations promote consistency<sup>249</sup> and can operate to “protect the taxpayer”<sup>250</sup> rather than leaving her “to the mercy of individual revenue agent[s] or IRS employee[s],”<sup>251</sup> each of whom might have different interpretations of the law.

Yet, Mr. Goldberg seemed most gravely concerned that the ban would greatly weaken the IRS’s power to respond to aggressive taxpayer behavior:

If the IRS is precluded from asserting positions retroactively in cases where taxpayers have taken questionable positions, the tax system will lose an implicit restraint. As a consequence, sophisticated taxpayers will tend to take more aggressive positions and revenue will be lost . . . .[T]he government should not be foreclosed from issuing retroactive regulations in situations in which sophisticated taxpayers have engaged in questionable transactions with the knowledge that they are subverting the Congressional purpose in enacting a statutory provision.<sup>252</sup>

In her prepared statement, Shirley D. Peterson, then-Commissioner of the IRS, succinctly explained the IRS’s reasons for opposing the

---

247. *See id.* at 121 (“The Administration opposes this provision on revenue and policy grounds.”). *See also id.* at 212 (“We [the Internal Revenue Service] oppose this provision. We believe current procedures already address this concern. Also, the provision would deny [the] IRS the ability to address attempted abuses of the statutory provision by sophisticated taxpayers.”).

248. *Id.* at 58.

249. “I would point out that there are situations where regulations by their nature require choices. Some taxpayers may be benefitted[;] others may be harmed. A consistent rule is in the system’s best interest.” Commissioner Peterson also commented on uniformity, stating “[B]etween the time the statute is enacted and the regulations are issued, one taxpayer will interpret the law one way, another taxpayer will interpret it another way, and you may have 15 different approaches to the application of that statute. You absolutely abolish uniformity between the date of enactment of the statute and the date the regulations are issued if you go forward with this provision.” *Id.* at 59.

250. *Id.*

251. *Id.*

252. *Id.* at 122.

prohibition of retroactive regulations, also focusing on how the ban would “deny [the] IRS the ability to address attempted abuses of the statutory provision by sophisticated taxpayers.”<sup>253</sup>

Representatives of the Taxpayer Executive Institute,<sup>254</sup> the American Supply Association (“the not-for-profit national organization serving wholesale distributors and their suppliers in the plumbing, heating, cooling and industrial and mechanical pipe, valves and fittings industries”),<sup>255</sup> and the National Association of Enrolled Agents (a professional organization consisting of members sanctioned by Congress to represent taxpayers)<sup>256</sup> filed statements expressing their support of the prohibition on retroactive regulation.<sup>257</sup>

In March 1992, a conference agreement was reached which included an exception to the presumption of retroactivity, permitting the Treasury to “issue retroactive temporary or proposed regulations to prevent abuse of the statute.”<sup>258</sup> Two versions of TBOR 2 incorporating the amended section 7805(b) passed both Houses of Congress in 1992, but each bill was vetoed by President George H. W. Bush for reasons unrelated to the legislation.<sup>259</sup>

From 1992 until 1996, when TBOR 2 was signed into law, the House of Representatives and Senate proposed various versions of what would become new section 7805(b). Each of these proposals generally prohibited retroactive regulation, but included an exception that allowed regulations to “apply retroactively to prevent abuse of the statute to which the regulation relates.”<sup>260</sup>

In 1996, the final version of TBOR 2 passed unanimously through both the House of Representatives and the Senate.<sup>261</sup> President Bill Clinton

---

253. *Id.* at 212

254. *See* 1992 TBOR 2 Hearings, *supra* note 2, at 244 (statement of Timothy J. McCormally, Tax Counsel, Tax Executives Institute).

255. <http://www.asa.net/About-ASA.aspx>.

256. <http://www.naea.org/>.

257. Other professional organizations filed statements but did not discuss the retroactive prohibition.

258. *See* H.R. REP. NO. 102-460, 102d. Cong., 2d. Sess. (1992) (accompanying H.R. 4210).

259. 142 CONG. REC. 17,371 (1996) (statement of Sen. Pryor, explaining that TBOR 2 “passed Congress twice that year, [but] . . . was ultimately vetoed because it was included as part of two large tax bills with which President Bush did not agree.”).

260. *See, e.g.* Revenue Act of 1992, 102 H.R. 11, § 5803 (1992) (containing language *alluded to in* H.R. REP. NO. 102-460, at 380); 104 S. 258, § 903 (1996).

261. 142 CONG. REC. 17,371 (1996) (Statement of Sen. Pryor) (“In making its way to the Senate, [TBOR 2] passed the House of Representatives by a unanimous 425 to 0 vote. I applaud the action of the House of Representatives, and I

signed TBOR 2 into law on July 30, 1996.<sup>262</sup> This final version of section 7805(b) contained an abuse exception that allowed the Treasury Secretary to “provide that any regulation may take effect or apply retroactively to prevent abuse.”<sup>263</sup>

It is therefore clear that section 7805(b)(3)’s abuse exception was a direct response to the concerns expressed by the Administration and IRS that a flat ban on retroactive regulation would compromise the Treasury and IRS’s ability to adequately respond to egregious tax positions, especially those taken by sophisticated taxpayers seeking to subvert the purposes of the Code. This history strongly suggests that Congress intended to grant Treasury substantial leeway to interpret this exception. This argument becomes even stronger once one considers the specialized expertise possessed by the employees of Treasury and the IRS.

### 3. Agency Expertise

When determining whether Congress intended to delegate a certain power to an agency, courts have considered whether that agency possesses special expertise to exercise that authority.<sup>264</sup> As Justice Marshall wrote in *Martin v. Occupational Safety and Health Review Commission*,<sup>265</sup>

“Because historical familiarity and policymaking expertise account in the first instance for the presumption that Congress delegates interpretive lawmaking power to the

---

am proud that this Thursday, because of a strong bipartisan coalition, the Senate has now followed suit by unanimously passing taxpayer bill of rights 2.”).

262. Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996).

263. *Id.* at 1468, § 1101, codified at I.R.C. § 7805(b)(3).

264. *See, e.g.*, Cass Sunstein, *Agencies as Common Law Courts*, 47 DUKE L.J. 1013, 1056 (1998) [hereinafter Sunstein, *Agencies as Common Law Courts*] (“The central idea behind *Chevron* is that where underlying statutes are ambiguous, Congress should be taken to have decided that agencies are in a better position to make judgments about their meaning than are courts.”). *See also* Rafael I. Pardo & Kathryn A. Watts, *The Structural Exceptionalism of Bankruptcy Administration*, 60 UCLA L. REV. 384, 423 (2012) (“Administrative law teaches that broad delegations of policymaking power to agencies may well be desirable--and, hence, will generally be tolerated as a constitutional matter--because of a variety of functional considerations relating to agencies’ institutional structures and capacities. These functional considerations include the expertise that many agencies enjoy in specialized areas of the law . . .”).

265. 499 U.S. 144 (1991). *See also* *Gonzales v. Oregon*, 546 U.S. 243, 266–67 (2006) (quoting the best actor rule articulated in *Martin*).

agency rather than to the reviewing court . . . .<sup>266</sup> we presume here that Congress intended to invest interpretive power in the administrative actor in the best position to develop these attributes.<sup>267</sup>

There are a large number of cases that have considered this factor.<sup>268</sup> For instance, in *Babbitt v. Sweet Home Chapter of Communities for a Great Oregon*,<sup>269</sup> the Court held that it “owe[d] some degree of deference”<sup>270</sup> to the Secretary of the Interior’s “reasonable interpretation”<sup>271</sup> of the Endangered Species Act pointing, *inter alia*, to the “degree of regulatory expertise necessary to” enforce that Act.<sup>272</sup>

By contrast, in *Gonzales v. Oregon*<sup>273</sup> the Attorney General interpreted the Controlled Substance Act to prohibit physicians from prescribing legal medicine to terminally ill patients for the purpose of committing suicide. The Supreme Court declined to apply deference to this interpretation, believing it to be extremely unlikely that Congress would have granted to the Attorney General the authority to make “quintessentially medical judgments.”<sup>274</sup>

Aside from the United States Tax Court, lower courts may hear at most several tax cases a year. On the other hand, employees of Treasury and the IRS possess tax-specific expertise and devote their daily attention to issues of federal taxation law. “The IRS is engaged in extensive efforts to

---

266. *Martin*, 499 U.S. at 153 (citing *Mullins Coal Co. v. Director, Office of Workers’ Comp. Programs*, 484 U.S. 135, 159, 108 S. Ct. 427, 440, 98 L. Ed.2d 450 (1987); *Ford Motor Credit Co. v. Milhollin*, 444 U.S. 555, 566, 100 S. Ct. 790, 797; *INS v. Stanisic*, 395 U.S. 62, 72, 89 S. Ct. 1519, 1525, 23 L. Ed.2d 101 (1969)).

267. *Id.*

268. In addition to the cases discussed, *see, e.g.*, *Nat’l Cable & Telecomm. Ass’n v. Brand X Internet Services et al.*, 545 U.S. 967, 1002–03 (2005) (Breyer, J., concurring) (“The questions the Commission resolved in the order under review involve a ‘subject matter [that] is technical, complex, and dynamic.’ The Commission is in a far better position to address these questions than we are. Nothing in the Communications Act or the Administrative Procedure Act makes unlawful the Commission’s use of its expert policy judgment to resolve these difficult questions.” (citing *Nat’l Cable & Telecomm. Ass’n, Inc. v. Gulf Power Co.*, 534 U.S. 327, 339 (2002))).

269. 515 U.S. 687 (1995).

270. *Id.* at 703–04.

271. *Id.*

272. *Id.* “The latitude the ESA gives the Secretary in enforcing the statute, together with the degree of regulatory expertise necessary to its enforcement, establishes that we owe some degree of deference to the Secretary’s reasonable interpretation.” *Id.*

273. 546 U.S. 243 (2006).

274. *Id.* at 267.

curb abusive tax shelter schemes and transactions,”<sup>275</sup> and to identify and respond to “tax avoidance” transactions as quickly as possible.<sup>276</sup> Thus, employees of Treasury (of which the IRS is part) are generally in the best position to determine whether a transaction constitutes abuse of the Code — for instance, whether transactions, such as the COBRA transaction, result in duplicated losses or produce other results that run against fundamental principles of the tax law. Congress, in enacting section 7805(b)(3), was certainly aware of these facts, creating further evidence that Congress intended to trust Treasury (and not courts) with the authority to interpret tax abuse under section 7805(b)(3).

Because it seems clear that Congress intended to grant Treasury substantial leeway to interpret tax abuse, a Treasury Regulation’s interpretation of section 7805(b)(3) will generally satisfy *Chevron’s* first step.

Before turning to *Chevron’s* second step, however, this Part will discuss cases which seem to analyze *Chevron* Step 1 in a different manner.

4. *Even if Congress Intended Treasury to Interpret Tax Abuse, Did Congress Unambiguously Foreclose any Particular Interpretation of that Term?*

In *Food and Drug Administration v. Brown & Williamson Tobacco Corporation*,<sup>277</sup> the Supreme Court held that the FDA’s interpretation of an ambiguous statutory term could not clear *Chevron’s* first step. While Congress intended to delegate interpretive authority to the FDA to interpret the ambiguous language at issue, the Court found that Congress clearly did not intend the FDA to adopt the particular interpretation it had.

Under this line of analysis, if a court were to find that Congress unambiguously foreclosed Treasury’s interpretation of section 7805(b)(3)’s abuse exception — *e.g.* if a court found that Congress clearly did not intend Treasury to interpret COBRA transactions as an abuse of the Code — then that interpretation would fail *Chevron* Step 1, and regulations enacted

---

275. EP ABUSIVE TAX TRANSACTIONS, <http://www.irs.gov/Retirement-Plans/EP-Abusive-Tax-Transactions>.

276. *Id.* “The parties who participate in listed transactions may be required to disclose the transaction as required by the regulations, register the transaction with the IRS, or maintain lists of investors in the transactions and provide the list to the IRS on request.” *Id.*

277. 529 U.S. 120 (2000). For further discussion of this case, see generally Sunstein, *Agencies as Common Law Courts*, *supra* note 264. See also Sunstein, *Chevron Step Zero*, *supra* note 174, at 240–42.

retroactively in reliance on that interpretation could only apply prospectively.<sup>278</sup>

Because Congress failed to define “abuse,” one might naturally wonder how a court could find that Congress unambiguously foreclosed any particular interpretation of tax abuse. This Part identifies two factors to guide this inquiry.

a. *How Does the Interpretation Fit Within the Statutory Scheme?*

In *Food and Drug Administration v. Brown & Williamson Tobacco Corporation*,<sup>279</sup> the Supreme Court assessed the Food and Drug Administration’s (FDA’s) interpretation of the Food, Drug, and Cosmetic Act. The Food, Drug, and Cosmetic Act grants the FDA “the authority to regulate, among other items, ‘drugs’ and ‘devices.’”<sup>280</sup> The Food and Drug Administration had long maintained that it did not have jurisdiction to regulate tobacco products. Years later, however, it changed this position and issued regulations related to those goods. In the Federal Register, the Food and Drug Administration claimed authority to do so by interpreting nicotine to be a “drug” and cigarettes and smokeless tobacco to constitute “drug delivery devices.”<sup>281</sup> The Court found this regulation could not pass *Chevron*’s first step because Congress clearly did not intend the FDA to interpret these ambiguous terms (*i.e.* “drug” and “drug delivery device”) in this way.

In so finding, the Court parsed through the legislative history of the Food, Drug, and Cosmetic Act as well as “the tobacco related legislation that Congress ha[d] enacted over . . . the 35 years”<sup>282</sup> preceding the decision. Reaching as far back as 1929, the Court chronicled the various instances in which Congress declined to grant the FDA jurisdiction over tobacco products.<sup>283</sup> It also discussed the various pieces of tobacco-related legislation that Congress enacted “against the backdrop of the FDA’s consistent and repeated statements that it lacked authority under the FDCA to regulate tobacco. . . .”<sup>284</sup>

---

278. *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843 (1984).

279. 529 U.S. 120 (2000). For further discussion of this case, *see generally* Sunstein, *Agencies as Common Law Courts*, *supra* note 264. *See also* Sunstein, *Chevron Step Zero*, *supra* note 174, at 240–42.

280. 529 U.S. at 126.

281. *Id.* at 127 (citing 61 Fed. Reg. 44418 (1996)).

282. *Id.* at 143.

283. *Id.* at 137–40.

284. *Food and Drug Admin. v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 144 (2000).

The Court also emphasized the importance of a contextual analysis of the Food, Drug, and Cosmetic Act,<sup>285</sup> examining not just the provision of the Food, Drug, and Cosmetic Act that defined the FDA's authority, but "viewing the FDCA as a whole."<sup>286</sup> The Court found that if the FDA were to have jurisdiction to regulate cigarettes, other provisions of the Food, Drug, and Cosmetic Act would require that cigarettes be removed from the market.<sup>287</sup> Because Congress had "foreclosed the removal of tobacco products from the market" in other legislation,<sup>288</sup> the Court concluded that Congress could not have intended the FDA to interpret their jurisdiction in a way that overrode that result.<sup>289</sup>

In the 2001 decision, *Whitman v. American Trucking Associations Inc.*,<sup>290</sup> the Supreme Court used similar tools of statutory construction to determine whether the Environmental Protection Agency's (EPA's) interpretation of the Clean Air Act (CAA) satisfied *Chevron* Step 1.<sup>291</sup> The CAA required the Administrator of the EPA to set air quality standards at a level that was "requisite to protect the public health."<sup>292</sup> In making these air quality calculations, the EPA claimed it could consider the costs that industries would incur in complying with the applicable standards.

The Court looked at the CAA as a whole and found that air quality standards were "the engine that [drove] nearly all of . . . the CAA."<sup>293</sup> The Court therefore found it unlikely that Congress intended to delegate to the EPA the authority to interpret these standards in the way it had. "Congress," the Court wrote "does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions."<sup>294</sup>

Thus, when determining whether Congress clearly foreclosed Treasury's interpretation of section 7805(b)(3), courts should look holistically at how that interpretation fits within the Code. To illustrate,

---

285. *Id.* at 132 ("The meaning—or ambiguity—of certain words or phrases may only become evident when placed in context.").

286. *Id.* at 133.

287. *Id.* at 137.

288. *Id.*

289. *Food and Drug Admin. v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 137 (2000).

290. 531 U.S. 457 (2001).

291. *Whitman*, 531 U.S. at 481. "We cannot agree with the Court of Appeals that Subpart 2 clearly controls the implementation of revised ozone NAAQS . . . because we find the statute to some extent ambiguous. We conclude, however, that the [EPA]'s interpretation goes beyond the limits of what is ambiguous and contradicts what in our view is quite clear. We therefore hold the implementation policy unlawful." *Id.* (citations omitted).

292. *Id.* at 465 (quoting 42 U.S.C. § 7409(b)(1)).

293. *Id.* at 458.

294. *Id.* at 468.



Regulation section 1.752-6 held that transactions such as the COBRA transaction abused the Code. As the government argued in the cases discussed in Section III, this interpretation is consistent with other anti-abuse provisions of the Code. The COBRA transactions were similar to the *Coltec* transaction to which Congress responded in section 358. Further, the COBRA transactions would likely have been deemed abusive under other sections of the Code. Finally, section 358(h) might have been rendered “impotent”<sup>295</sup> without Regulation 1.752-6. Thus, far from “alter[ing] the fundamental details”<sup>296</sup> of the Code, it appears that Regulation section 1.752-6’s interpretation of section 7805(b)(3) actually complemented and enforced other provisions of the tax laws.

b. *The Importance of the Question Presented*

In a seminal article, Justice Breyer suggests that courts “[a]sk whether the legal question [an agency interpretation addresses] is an important one”<sup>297</sup> [since] “Congress is more likely to have focused upon, and answered, major questions, while leaving interstitial matters to answer themselves in the course of the statute’s daily administration.”<sup>298</sup>

Thus, in *Brown & Williamson*,<sup>299</sup> discussed above, the Court found that a decision to prohibit the marketing of tobacco products (the result of granting the FDA the jurisdiction it claimed) was one of great “economic and political significance.”<sup>300</sup> The Court, therefore, felt “confident that Congress could not have intended to delegate [this decision] to an agency in so cryptic a fashion.”<sup>301</sup>

The Court also looked at the importance of the questions presented in other cases, such as *MCI Telecommunications Corp. v. American Telephone & Telegraph Company*<sup>302</sup> (MCI) and *Gonzales v. Oregon*.<sup>303</sup> In *MCI*, the Federal Communications Commission (FCC) claimed that because the Communications Act of 1934 gave it authority to “modify any requirement” of that Act, the FCC could completely eliminate the

---

295. *United States v. Sala*, United States’ Supplemental Brief. *supra* note 138, at 9.

296. *Whitman v. American Trucking Ass’n Inc.*, 531 U.S. 457, 468 (2001).

297. Stephen Breyer, *Judicial Review of Questions of Law and Policy*, 38 ADMIN. L. REV. 363, 370 (1986).

298. *Id.* (cited in *Food and Drug Admin. v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 159 (2000)).

299. 529 U.S. 120.

300. *Id.* at 147.

301. *Id.* at 160.

302. 512 U.S. 218 (1994).

303. 546 U.S. 243 (2006).

requirement that long distance carriers file their rates.<sup>304</sup> The Court found it “highly unlikely that Congress would leave the determination of whether an industry will be entirely, or even substantially, rate-regulated to agency discretion—and even more unlikely that it would achieve that through such a subtle device as permission to ‘modify’ rate-filing requirements.”<sup>305</sup>

In *Gonzales*,<sup>306</sup> the Supreme Court held that the Attorney General did not have the authority to interpret the Controlled Substance Act to prohibit physicians from prescribing legal medicine to terminally ill patients for the purpose of committing suicide. The Court found the “issue of physician-assisted suicide [to be] the subject of an ‘earnest and profound debate’ across the country.”<sup>307</sup> The Court therefore found it unlikely that Congress would have delegated to the Attorney General the authority to resolve that issue.<sup>308</sup>

Thus, when determining whether Congress foreclosed Treasury’s interpretation of section 7805(b)(3), courts might also look at the importance of the question that the interpretation would purport to resolve. It is unlikely that many of the questions addressed by Treasury would have the same “economic and political significance”<sup>309</sup> as the questions presented in *Brown & Williamson* and *Gonzales*. Nonetheless, there certainly may be situations in which Treasury’s retroactive application of a regulation implicates a “major” issue of taxation law.

In fact, with respect to Regulation section 1.752-6, had Congress not already decided through its enactment of section 358 that contingent liabilities reduced a transferee’s basis in the transferor-corporate stock received in a section 351 exchange, Regulation section 1.752-6, which provided for the same adjustments in partnership exchanges, may have been seen to resolve a “major” question of taxation law. As it were, however, Regulation section 1.752-6 simply extended section 358’s requirements, which applied to certain section 351 corporate transactions to analogous partnership transactions. Thus, the questions resolved in Regulation section 1.752-6 seem far closer to the interstitial questions that Congress generally intends agencies to answer.

In sum, by considering how the Treasury Department’s interpretation of “abuse” fits (or fails to fit) with the other provisions of the Code and the importance of the question the interpretation purports to resolve, courts can come to an informed conclusion about whether Congress foreclosed Treasury’s interpretation of section 7805(b)(3)’s abuse exception (and thus

---

304. *MCI*, 512 U.S. at 221.

305. *Id.* at 231.

306. *Gonzales*, 546 U.S. 243.

307. *Id.* at 267.

308. *Id.*

309. *Food and Drug Admin. v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 147 (2000)

whether that interpretation can withstand scrutiny under *Brown & Williamson's* formulation of *Chevron* Step 1).

*B. Applying Chevron Step 2 to Treasury's Interpretations of Section 7805(b)(3)*

If Treasury's interpretation of section 7805(b)(3)'s abuse exception clears *Chevron's* first step, it should be upheld so long as it is a "permissible construction"<sup>310</sup> of section 7805(b)(3) that is not "arbitrary, capricious or manifestly contrary to"<sup>311</sup> the plain language of the statute.

*1. Is Treasury's Interpretation of Tax Abuse within the Range of Permissible Choices?*

In applying *Chevron* Step 2, the Supreme Court asks whether the interpretation chosen by the agency issuing the regulation is in the range of permissible alternatives.<sup>312</sup> While this standard is high, it is "not necessarily insurmountable."<sup>313</sup> For instance, in *Raponos v. United States*<sup>314</sup> the Supreme Court considered the validity of the U.S. Army Corps of Engineers' (Corps) interpretation of the Clean Water Act (CWA), which prohibits pollution of "navigable waters."<sup>315</sup> "Navigable waters" is defined in the CWA to include "the waters of the United States, including the territorial seas."<sup>316</sup> While the Corps initially interpreted "waters of the United States" to include only those waters that are "'navigable in fact' or readily susceptible of being rendered so,"<sup>317</sup> it later adopted a far more expansive definition which included "[a]ll

---

310. *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843 (1984).

311. *Id.* at 844.

312. *See, e.g., Raponos v. United States*, 547 U.S. 715, 731–32 (2006). "We need not decide the precise extent to which the qualifiers 'navigable' and 'of the United States' restrict the coverage of the [Clean Water] Act. Whatever the scope of these qualifiers, the [Clean Water Act] authorizes federal jurisdiction only over 'waters.' 33 U.S.C. § 1362(7). The only natural definition of the term 'waters,' our prior and subsequent judicial constructions of it, clear evidence from other provisions of the statute, and this Court's canons of construction all confirm that 'the waters of the United States' in § 1362(7) cannot bear the expansive meaning that the [U.S. Army Corps of Engineers] would give it." *Id.*

313. Lederman, *Fighting Regs.*, *supra* note 26, at 697 (citing *Judulang v. Holder*, 132 S. Ct. 476, 479 (2011)).

314. 547 U.S. 715 (2006).

315. *Id.* at 723.

316. *Id.*

317. *Raponos v. United States*, 547 U.S. 715, 723 (2006).

interstate waters including interstate wetlands.”<sup>318</sup> The Supreme Court found that,

[t]he only natural definition of the term ‘waters,’ our prior and subsequent judicial constructions of it, clear evidence from other provisions of the [CWA], and this Court’s canons of construction all confirm that ‘the waters of the United States’ cannot bear the expansive meaning that the Corps would give it.<sup>319</sup>

Instead, the Court found that the term “waters of the United States” could only be interpreted to include “relatively permanent, standing or continuously flowing bodies of water” and did not include “channels through which water flows intermittently or ephemerally, or channels that periodically provide drainage for rainfall.”<sup>320</sup> As a result, the Court held that interpreting “waters of the United States” to include wetlands was not “based on a permissible construction of the statute.”<sup>321</sup>

Thus, in determining whether Treasury had adopted a “permissible construction” of section 7805(b)(3)’s abuse exception, courts would apply a very similar analysis as the one described in Section IV(A)(4), asking whether Congress had unambiguously foreclosed any particular interpretation of “tax abuse.” In other words, the analysis at *Chevron* Step 2 might be seen to “fold in” on the inquiry used by the *Brown & Williamson* Court at *Chevron* Step 1, an effect observed by prominent administrative law scholars.<sup>322</sup> Regardless of whether the inquiry falls at *Chevron* Step 1 or 2, if Treasury enacts a retroactive regulation which interprets section 7805(b)(3)’s abuse exception in a way which permits too great an alteration to current tax laws, courts should not hesitate to invalidate that regulation. The

---

318. *Id.* at 724.

319. *Id.* at 731–32.

320. *Id.* at 739.

321. *Id.*

322. See Matthew C. Stephenson & Adrian Vermeule, *Chevron Has Only One Step*, 95 VA. L. REV. 597, 599 (2009) “Step One is therefore nothing more than a special case of Step Two, which implies that all Step One opinions could be written in the language of Step Two. Consider, as an example, *FDA v. Brown & Williamson Tobacco*, in which the Supreme Court struck down the FDA’s assertion of statutory jurisdiction over tobacco products. The Court reached this conclusion under Step One, asserting that Congress had expressed an intention on the ‘precise question’ of whether the FDA could regulate tobacco. It would have been equally easy, however, for the Court to find under Step One that the full scope of the FDA’s statutory jurisdiction is ambiguous . . . but to declare that the FDA’s assertion of jurisdiction over tobacco products was unreasonable under *Chevron* Step Two, for precisely the same reasons the Court advanced in the actual opinion.” *Id.* at 599–600.

interpretation of abuse found in the preamble of Regulation 1.752-6, however, would not seem to come close to doing so.

## 2. *Chevron Step 2 as “Hard Look” Review*

When reviewing agency rules under the Administrative Procedure Act (APA), courts must determine whether the agency action was “arbitrary or capricious. . . .”<sup>323</sup> In this context, a court reviews the process by which the agency arrived at the rule, sometimes referred to as “hard look” review.<sup>324</sup> This review process was articulated in *Motor Vehicle Manufacturers Association of United States, Inc. v. State Farm Mutual Automobile Insurance Company*:<sup>325</sup>

the agency must examine the relevant data and articulate a satisfactory explanation for its action including a “rational connection between the facts found and the choice made.” . . . In reviewing that explanation, we must consider whether the decision was based on a “consideration of the relevant factors and whether there has been a clear error of judgment.” . . . Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.<sup>326</sup>

Although the Supreme Court has not formally adopted this process-focused formulation in determining whether an agency interpretation is “arbitrary and capricious” under *Chevron* Step 2, it seems to have equated

---

323. 5 U.S.C. § 706(2)(A) (2000).

324. See Kathryn A. Watts, *Proposing a Place for Politics in Arbitrary and Capricious Review*, 119 YALE L.J. 2, n.1 (2009). (“The term ‘hard look’ review developed in the D.C. Circuit as a judicial gloss on the meaning of the APA’s arbitrary and capricious test.”) (citing Matthew Warren, *Active Judging: Judicial Philosophy and the Development of the Hard Look Doctrine in the D.C. Circuit*, 90 GEO. L.J. 2599 (2002)).

325. 463 U.S. 29 (1983).

326. *Id.* at 43 (citing *Burlington Truck Lines v. United States*, 371 U.S. 156, 83 S. Ct. 239, 9 L. Ed.2d 207 (1962); *Bowman Transportation, Inc. v. Arkansas-Best Freight System*, 419 U.S. 281, 285, 95 S. Ct. 438, 442 (1974); *Citizens to Preserve Overton Park v. Volpe*, 401 U.S. 402, 416, 91 S. Ct. 814, 823 (1971)).

the two inquiries in dicta.<sup>327</sup> Furthermore, the Federal Circuit recently found that a Treasury Regulation was an impermissible interpretation of the Code under *Chevron*'s second step because, *inter alia*, it "violate[d] the *State Farm* requirement that Treasury provide a reasoned explanation for adopting a regulation."<sup>328</sup>

For Treasury's interpretation of the abuse exception within section 7805(b)(3) to survive this alternative formulation of *Chevron* Step 2, Treasury must engage in deliberate efforts to distinguish "abusive" from "non-abusive" transactions and show this analysis in the Federal Register, explaining its rationale for concluding that a particular transaction (or set of transactions) constitutes abuse. To illustrate, Treasury might have bolstered its analysis in the preamble of Regulation section 1.752-6 by incorporating the strong arguments advanced by the Department of Justice in the *Son-of-Boss* litigation described in Section IV. Treasury might have, for example, stated that Regulation section 1.752-6 was necessary to prevent abuse for the following reasons:

- The transaction addressed by Regulation section 1.752-6 is the partnership analogue to the *Coltec* transaction to which Code section 358 responds, and without it, section 358 would be rendered "impotent."<sup>329</sup>
- "Abuse" should be interpreted broadly like the other anti-abuse provisions found in the Code and Regulations. In fact, it is likely that COBRA transactions also violate some of these rules.<sup>330</sup>
- "Abuse" is not synonymous with a lack of economic substance. "Statutes can be operated so as to produce various types of abuse" to the point where the

---

327. *But see* *Judulang v. Holder*, 132 S. Ct. 476, 476 n.7 (2011). ("The Government urges us instead to analyze this case under the second step of the test we announced in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, . . . to govern judicial review of an agency's statutory interpretations. . . . Were we to do so, our analysis would be the same, because under *Chevron* step two, we ask whether an agency interpretation is "arbitrary or capricious in substance.") (citing *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 104 S. Ct. 2778, 81 L. Ed.2d 694 (1984)).

328. *Dominion Resources Inc. v. United States*, 681 F.3d 1313, 1319 (2012).

329. *United States v. Sala*, United States' Supplemental Brief. *supra* note 138, at 9.

330. *See generally* *In re COBRA Tax Shelters Litigation*, M.D.L. Docket No. 1727, United States Supplemental Memorandum of Law in Opposition to Plaintiff's Motion for Partial Summary Judgment as to the Validity of Treasury Regulation 1.752-6 (S.D. Ind.) (Apr. 21, 2008).

Treasury is “engaged in a perpetual game of catch up with the innovative geniuses” who seek to subvert the tax system and Congressional intent.<sup>331</sup> In light of this known environment, Congress intended “abuse” to be defined expansively when enacting section 7805(b)(3).

In addition to looking at Treasury’s analytical process, courts applying this “hard look” version of *Chevron*’s second step might look at the circumstances under which the retroactive regulation has been promulgated. For instance, Professor Leandra Lederman has suggested that if a regulation is promulgated in the course of (or in anticipation of) litigation — as retroactive regulations may relatively often be — courts should consider whether this timing “reflect[s] opportunism rather than careful application of the agency’s expertise.”<sup>332</sup>

## VI. CONCLUSION

Before 1996, Treasury had broad authority to regulate retroactively. In 1996, however, this authority was dramatically curtailed. As part of the Taxpayer Bill of Rights 2, section 7805(b) prohibited Treasury from issuing retroactive regulations unless certain exceptions were met. Section 7805(b)(3) allows a regulation issued by Treasury to operate retroactively “to prevent abuse.”<sup>333</sup> But Congress failed to explicitly define “abuse” or designate to any specific actor the power to do so.

Generally, when an agency interprets the statute it is entrusted to administer — such as when Treasury interprets section 7805(b)(3) of the Code — that interpretation is entitled to some level of deference. However, courts that have analyzed whether a Treasury Regulation may operate retroactively to prevent abuse used administrative law principles recently rejected by the Supreme Court in *Mayo Foundation v. United States*.<sup>334</sup> This Article provides the first comprehensive look at the level of deference owed Treasury’s interpretation of section 7805(b)(3)’s abuse exception after *Mayo*.

This analysis offers a significant contribution. Granting Treasury some power to issue retroactive regulations can help police and prevent the most egregious tax transactions. However, case law suggests that the courts and Treasury have very different interpretations of the Code’s abuse exception. The fate of future retroactive tax regulations may, therefore, turn largely on which actor possesses the primary authority to define tax abuse.

---

331. Internal Revenue Service v. CM Holdings, Inc., 254 B.R. 578, 624 (D. Del. 2000), *aff’d*, 301 F.3d 96 (3d Cir. 2002).

332. Lederman, *Fighting Regs*, *supra* note 26, at 698.

333. I.R.C. § 7805(b)(3) (2006).

334. 131 S. Ct. 704 (2011).