ADMINISTRATIVE LAW — JUDICIAL REVIEW OF TREASURY REGULATIONS — FEDERAL CIRCUIT INVALIDATES A TREASURY REGULATION UNDER *STATE FARM* FOR LACK OF CONTEMPORANEOUS STATEMENT OF JUSTIFICATION. — *Dominion Resources, Inc. v. United States*, 681 F.3d 1313 (Fed. Cir. 2012).

For years, generally applicable administrative law was not applied to taxation under the doctrine of tax exceptionalism.[1] Essentially, while cases like *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*[2] and *Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co.*[3] controlled review of most agency action, Treasury regulations[4] were reviewed under different standards — most recently, those developed in *National Muffler Dealers Ass'n v. United States*.[5] Some circuit courts started applying *Chevron* to Treasury regulations beginning in 1989, but the circuits did not reach a consensus regarding which standard should apply.[6] The Supreme Court finally put the issue to rest in *Mayo Foundation for Medical Education & Research v. United States*,[7] holding that *Chevron* was the applicable standard for review of Treasury regulations.[8] Though some in the tax community feared that *Mayo* would usher in

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[1] *See generally* Roger Dorsey, Mayo *and the End of 'Tax Exceptionalism' in Judicial Deference*, 87 PRAC. TAX STRATEGIES 63 (2011); Kristin E. Hickman, *The Need for* Mead*: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537 (2006).

[2] 467 U.S. 837 (1984). *Chevron* analysis involves two steps: First, the reviewing court must determine "whether Congress has directly spoken to the precise question at issue." *Id.* at 842. Second, "if the statute is silent or ambiguous with respect to the specific issue," the court must determine "whether the agency's answer is based on a permissible construction of the statute." *Id.* at 843.

[3] 463 U.S. 29 (1983). In *State Farm*, the Supreme Court established what is now known as "hard look" review under the authority of the Administrative Procedure Act (APA), 5 U.S.C. § 706(2)(a), adding a level of inquiry to arbitrary-and-capricious review, which requires courts to review whether the agency considered "relevant factors" and whether it made a "clear error of judgment," *State Farm*, 463 U.S. at 43 (quoting Bowman Transp., Inc. v. Arkansas-Best Freight Sys., Inc., 419 U.S. 281, 285 (1974)). *State Farm* is often cited for its holding that an agency must articulate a reasoned, contemporaneous justification for its actions, drawing a rational connection between the facts found and the conclusions. *See, e.g.*, ERNEST GELLHORN & RONALD M. LEVIN, ADMINISTRATIVE LAW AND PROCESS 117–18 (5th ed. 2006).

[4] The term "Treasury regulations" refers in particular to regulations issued by the Treasury Department with respect to income taxes.

[5] 440 U.S. 472 (1979). The *National Muffler* standard of review is substantially less deferential to agency action than the *Chevron* test. *See* John F. Coverdale, Chevron*'s Reduced Domain: Judicial Review of Treasury Regulations and Revenue Rulings After* Mead, 55 ADMIN. L. REV. 39, 75 (2003).

[6] *See* Ellen P. Aprill, *Muffled* Chevron*: Judicial Review of Tax Regulations*, 3 FLA. TAX REV. 51, 69–71 (1996) (describing the increasing tendency of appeals courts to apply *Chevron* to Treasury regulations).

[7] 131 S. Ct. 704 (2011).

[8] *Id.* at 713–14.

an era of unprecedented deference to the Treasury,[9] *Mayo* was soon followed by *United States v. Home Concrete & Supply*,[10] in which the Court, for the first time, upheld the invalidation of a Treasury regulation under general administrative law principles, holding that the regulation was an invalid interpretation of an unambiguous statute under *Chevron* step one.[11] Recently, in *Dominion Resources, Inc. v. United States*,[12] the Federal Circuit took another leap forward in applying administrative law to tax cases by invalidating a Treasury regulation that lacked reasoned contemporaneous justification as required under *State Farm*.[13] In applying *State Farm* to invalidate a Treasury regulation for what appears to be the first time at the appeals court level,[14] the Federal Circuit has exposed many technically faulty but nonetheless substantively valid and important Treasury regulations to the risk of invalidation. However, the potential applicability of a developing administrative law doctrine — remand without vacatur, under which faulty rules may remain temporarily in effect while agencies remedy defects — suggests that *Dominion* is unlikely to trigger large-scale invalidation of Treasury regulations.

Dominion Resources, Inc. is a Virginia corporation in the business of generating and selling electric power.[15] In 1996, a Dominion subsidiary performed renovations on two of its generating plants and was forced to take the plants out of service temporarily.[16] At the time, Dominion was paying interest on debt unrelated to the renovations,[17] an expense ordinarily deductible from income in the year incurred.[18] However, § 263A of the Internal Revenue Code (I.R.C. or Tax Code)

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[9] *See, e.g.*, Michael Hall, *From* Muffler *to* Mayo*: The Supreme Court's Decision to Apply* Chevron *to Treasury Regulations and Its Impact on Taxpayers*, 65 TAX LAW. 695, 706–07 (2012).

[10] 132 S. Ct. 1836 (2012).

[11] *Id.* at 1843–44.

[12] 681 F.3d 1313 (Fed. Cir. 2012).

[13] *Id.* at 1319.

[14] Before *Dominion*, *State Farm* had been cited in a dissenting opinion as reason for invalidating a Treasury regulation. *See* Mannella v. Comm'r, 631 F.3d 115, 127 (3d Cir. 2011) (Ambro, J., dissenting). For discussion of *State Farm*'s applicability in the tax context, see Patrick J. Smith, Manella*,* State Farm*, and the Arbitrary and Capricious Standard*, 131 TAX NOTES 387 (2011).

[15] Dominion Resources, Inc. v. United States, 97 Fed. Cl. 239, 241 (2011).

[16] *Id.*

[17] *Dominion*, 681 F.3d at 1314.

[18] I.R.C. § 163(a) (2006). The Internal Revenue Code provides for different treatment for different types of expenditures. Expenditures that are "ordinary and necessary . . . in carrying on any trade or business" can usually be deducted from income in determining the final amount of taxable income. MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION 229–30 (6th ed. 2009) (quoting I.R.C. § 162). Other types of expenditures, most commonly those associated with creating, improving, or acquiring a business asset, particularly an asset that produces income in future years, must be capitalized — that is, added to the accounting value or "basis" of the asset. Capitalized expenditures may be deducted from income, only incrementally and in future years, via depreciation or similar cost-allocation methods, or when the asset is sold or otherwise disposed of. *Id.* at 294–95; *see also* I.R.C. § 263.

provides that, in addition to capitalizing the direct costs of an improvement, a taxpayer must also capitalize — and therefore may not presently deduct — *indirect* costs allocable to the improved property, including interest that would otherwise be presently deductible under § 163, to the extent that the cost of the taxpayer's then-existing debt could have been reduced had he not spent money on "production expenditures" for the improvement.[19] The effect of § 263A is thus to deny the taxpayer a present deduction, in the amount of his weighted-average interest rate on debt during the time of production, multiplied by accumulated production expenditures.[20] To give color to the term "production expenditures," the Treasury promulgated, inter alia, the "associated-property rule," which required that the adjusted basis of property taken out of service during the course of the improvement be included in accumulated production expenditures.[21] For Dominion, this rule meant that the bases of two entire generation units were included and that thus a total of $3.3 million of present interest deductions were disallowed.[22] Dominion disputed the amount of interest that needed to be capitalized as related to property taken out of service, and in August 2007 reached a settlement agreement with the Internal Revenue Service (IRS) to capitalize half of the amount in dispute and deduct the other half.[23] Dominion reserved the right to file a refund suit over the capitalized amount.[24]

Dominion filed suit in the Court of Federal Claims, challenging the associated-property rule of Treasury Regulation § 1.263A-11(e)(1)(ii)(B) under both *Chevron* and *State Farm*.[25] The Court of Federal Claims upheld the rule, holding that it was a permissible interpretation of I.R.C. § 263A(f)(2)(A)(ii) and thus survived the deferential *Chevron* test,[26] and that the Treasury did not act in an "arbitrary and capricious manner" under *State Farm*, since the "path" it took in the rulemaking could be "discerned."[27]

The Federal Circuit reversed.[28] Writing for the panel, Chief Judge Rader[29] held that the associated-property rule was an impermissible interpretation of § 263A under *Chevron* step two because it contradict-

19 *See* I.R.C. § 263A(a), (f).
20 *See Dominion*, 681 F.3d at 1316.
21 *Id.* at 1318–19 (internal quotation marks omitted); Treas. Reg. § 1.263A-11(e) (2012).
22 *See Dominion*, 681 F.3d at 1314.
23 *Id.*; Dominion Resources, Inc. v. United States, 97 Fed. Cl. 239, 244–45 (2011).
24 *Dominion*, 97 Fed. Cl. at 244.
25 *See* Brief of Plaintiff-Appellant at 2, *Dominion*, 681 F.3d 1313 (No. 08-CV-195).
26 *Dominion*, 97 Fed. Cl. at 257–58.
27 *Id.* at 259 (quoting Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983)) (internal quotation marks omitted).
28 *Dominion*, 681 F.3d at 1319.
29 Chief Judge Rader was joined by Judge Reyna.

ed the "avoided-cost rule that Congress intended the statute to implement,"[30] and also because the Treasury failed to justify its action by demonstrating a rational connection between the choice it made and the facts found, as required under *State Farm*.[31]

Applying *Chevron* step one to the regulation, Chief Judge Rader held that the statute was circular and "opaque" in that it failed to define "production expenditures" beyond assuming that they must be available to pay down existing debt.[32] At step two, Chief Judge Rader compared the regulation's associated-property rule with the "avoided-cost" principle he deemed to be the central intent of I.R.C. § 263A(f)(2).[33] He found that the associated-property rule did not implement the avoided-cost rule because it would be absurd to assume the taxpayer could have used the property taken out of service to pay down existing debt.[34] To do so, he noted, would require that the taxpayer sell the property, an extraordinarily unreasonable proposition both because power-generation units are difficult to sell and because selling the units would defeat the purpose of the improvement.[35]

Chief Judge Rader next applied the *State Farm* test and found that the IRS provided no rationale for its rule beyond the conclusory statement in the notice of proposed rulemaking that the regulations would implement the avoided-cost principle.[36] Further, he held that the final regulations did not explain how use of adjusted basis in the associated-property rule would implement the avoided-cost principle and that the rule thus violated the *State Farm* requirement that final regulations "articulate a satisfactory or cogent explanation."[37]

Judge Clevenger filed a opinion concurring in part and concurring in the result, departing from the court's conclusion that the regulation failed *Chevron* step two and arguing that the court should have invalidated the rule solely because it failed to advance a statement of justification as required by *State Farm*.[38] Judge Clevenger disagreed that

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[30] *Dominion*, 681 F.3d at 1317.

[31] *Id.* at 1319.

[32] *Id.* at 1317.

[33] *Id.* Chief Judge Rader examined the legislative history of § 263A(f)(2) and found that Congress expressed the intent that taxpayers capitalize "the portion of the total interest expense incurred during the construction period that could have been avoided if funds had not been expended for construction." *Id.* at 1315–16 (quoting J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT (Comm. Print 1987)). Under the avoided-cost principle, the taxpayer must capitalize interest only to the extent he would have actually been able to avoid incurring that interest by paying down his existing debt with funds he instead elected to use for the improvement. *See id.*

[34] *Id.* at 1318–19.

[35] *Id.*

[36] *Id.* at 1319.

[37] *Id.*

[38] *Id.* at 1322 (Clevenger, J., concurring in part and concurring in the result).

the rule necessarily failed to apply the avoided-cost principle. He reasoned that when a company takes a plant out of service, it ceases to generate revenue with that plant — revenue that could have been used to pay down its existing debt.[39] Although he acknowledged that using adjusted basis as a proxy to compute avoided cost was an exercise in fiction, some fiction was inevitable in the calculation, and thus the rule might have been upheld under *Chevron* step two.[40] Judge Clevenger agreed with the majority that the Treasury's failure to justify the rule ab initio was sufficient grounds to overturn it, but he would have restricted the holding to *State Farm* alone.[41] Thus, the panel unanimously agreed to apply *State Farm* to invalidate a Treasury regulation, in what seems to be the first such ruling at the appeals court level.

Though not doctrinally shocking given *Mayo*'s eradication of tax exceptionalism, *Dominion* may represent a watershed moment for judicial review of Treasury regulations in its application of *State Farm* to invalidate a tax regulation. In light of the Treasury's spotty record of Administrative Procedure Act (APA) compliance[42] — possibly a result of tax exceptionalism's long reign — opportunistic taxpayers might now attempt to use *State Farm* to invalidate many critical Treasury regulations, thereby threatening the stability and administrability of the Tax Code. This comment first addresses the vulnerability of Treasury regulations to *State Farm* challenges and then explains how courts may apply the relatively new doctrine of remand without vacatur to mitigate the potentially destabilizing effects that the continued application of *State Farm* to Treasury regulations may have on tax administration.

The Treasury has, put mildly, a checkered history of compliance with the APA. In a study of Treasury regulations promulgated over a three-year period, Professor Kristin Hickman finds that the Treasury failed to follow APA notice-and-comment requirements in over forty percent of regulatory projects.[43] In a recent report, Patrick Smith points to an explicit Treasury policy not to provide justification when adopting regulations — justification that would be necessary to survive a challenge under *State Farm*.[44] The policy Smith describes is set

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[39] *See id.* at 1320–21.

[40] *See id.* at 1320–22.

[41] *Id.* at 1322.

[42] *See generally* Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 82 NOTRE DAME L. REV. 1727 (2007).

[43] *Id.* at 1748.

[44] Patrick J. Smith, *The APA's Arbitrary and Capricious Standard and IRS Regulations*, 136 TAX NOTES 271, 274 (2012) (citing INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL § 32.1.5.4.7.3(1) (2011)). Patrick Smith was counsel to the plaintiff in *Dominion*. 681 F.3d at 1314.

forth in the Internal Revenue Manual, which states that "[i]t is not necessary to justify the rules that are being proposed or adopted or alternatives that were considered."[45] Though certainly not fatal to all Treasury regulations — regulation drafters may well decide on their own to provide acceptable justification for any particular rule — this policy indicates that many regulations may be vulnerable to *State Farm* challenges, especially where they involve nonobvious choices of policy or applications of factual findings. Most significantly, this policy may implicate many regulations on which both the IRS and taxpayers have come to rely.[46] The potential implications of *Dominion* are therefore profound. If, as Smith suggests and the Internal Revenue Manual seems to corroborate, the Treasury regularly fails to include *State Farm*–compliant justifications in its regulatory preambles, *Dominion* may signal open season on Treasury regulations — welcome news for taxpayers seeking to avoid liabilities, but potentially dangerous news for the tax community at large, which has come to rely on the regulations to provide guidance on complex matters.[47]

Fortunately for both the IRS and the tax community, one particular administrative law doctrine suggests that *Dominion*'s impact may be less than catastrophic. Important Treasury regulations may be spared under the doctrine of remand without vacatur, developed in a relatively recent line of cases, beginning in the D.C. Circuit with *Allied-Signal, Inc. v. U.S. Nuclear Regulatory Commission*.[48] Under this doctrine, a court may remand a faulty rule to an agency to fix a defect, but still allow the rule to remain in effect temporarily.[49] Since the D.C. Circuit announced its standards for remand without vacatur in

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[45] INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL § 32.1.5.4.7.3(3) (2011), *available at* http://www.irs.gov/irm/part32/irm_32-001-005.html#d0e382. Compare this policy with the *State Farm* rule: "[T]he 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." Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983) (internal quotation marks omitted).

[46] The most important examples of relied-upon regulations are the Treasury's many "safe harbor" regulations, which aid taxpayers in planning complex transactions by providing regulatory certainty. *See, e.g.*, Treas. Reg. § 1.1031(b)-2 (2012) (establishing safe harbors for qualified intermediaries in like-kind exchanges).

[47] *See* Hickman, *supra* note 42, at 1800 (describing a general sense of satisfaction within the tax community with the IRS's handling of administrative and regulatory matters, and noting taxpayers' interest in receiving regulatory guidance).

[48] 988 F.2d 146 (D.C. Cir. 1993).

[49] *See* GELLHORN & LEVIN, *supra* note 3, at 121–22; Ronald M. Levin, *"Vacation" at Sea: Judicial Remedies and Equitable Discretion in Administrative Law*, 53 DUKE L.J. 291, 308 (2003); Kristina Daugirdas, Note, *Evaluating Remand Without Vacatur: A New Judicial Remedy for Defective Agency Rulemakings*, 80 N.Y.U. L. REV. 278, 279 (2005) (discussing the evolution of this doctrine in the D.C. Circuit).

Allied-Signal, the doctrine has been adopted by other circuits.[50] Remand without vacatur has never been addressed by the Supreme Court.[51] Furthermore, a few scholars — and even some judges — have suggested that the doctrine conflicts with the text of the APA,[52] which, by use of the word "shall," might seem to require that courts vacate any rules they remand.[53] Nonetheless, many scholars have justified remand without vacatur as a valid exercise of courts' traditional equitable discretion.[54] Remand without vacatur is generally applicable when courts review agency action under § 706(2),[55] but its most important function is as a counterweight to the relatively intrusive probe of hard look review under § 706(2)(a) and *State Farm*[56] — the very threat tax administration now faces after *Dominion*.

Under *Allied-Signal*, courts considering remand without vacatur weigh two factors: the severity of the deficiency, and the disruptive consequences of vacatur.[57] On the issue of severity, the D.C. Circuit has generally asked, in applying the *Allied-Signal* test, how difficult the defect would be for the agency to cure,[58] which, in *State Farm* cases, becomes an analysis of whether an agency will be able to justify the identical rule if given a chance to articulate a satisfactory explanation upon remand.[59] Relevant considerations for the "disruptive conse-

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[50] *See, e.g.*, Cal. Cmtys. Against Toxics v. EPA, 688 F.3d 989, 992 (9th Cir. 2012); Nat'l Org. of Veterans' Advocates, Inc. v. Sec'y of Veterans Affairs, 260 F.3d 1365, 1380 (Fed. Cir. 2001); Cent. Me. Power Co. v. FERC, 252 F.3d 34, 38 (1st Cir. 2001); Cent. and S.W. Servs., Inc. v. EPA, 220 F.3d 683, 692 (5th Cir. 2000).

[51] *See* Daniel B. Rodriguez, *Of Gift Horses and Great Expectations: Remands Without Vacatur in Administrative Law*, 36 ARIZ. ST. L.J. 599, 627 (2004).

[52] *See id.* Professor Daniel Rodriguez discusses numerous instances of scholarly and judicial condemnation of remand without vacatur, *id.* at 625–26, most notably citing *Milk Train, Inc. v. Veneman*, 310 F.3d 747, 758 (D.C. Cir. 2002) (Sentelle, J., dissenting), and *Checkosky v. SEC*, 23 F.3d 452, 466 (D.C. Cir. 1994) (Randolph, J., concurring), for the textual argument.

[53] 5 U.S.C. § 706 (2006) ("[A reviewing court] shall . . . hold unlawful and set aside agency action . . . found to be . . . arbitrary, capricious, . . . or otherwise not in accordance with the law . . . .").

[54] *See, e.g.*, Levin, *supra* note 49, at 314–15; Rodriguez, *supra* note 51, at 625–26.

[55] *See, e.g.*, 33 CHARLES ALAN WRIGHT & CHARLES H. KOCH, JR., FEDERAL PRACTICE AND PROCEDURE § 8312, at 81 (2d ed. 2005) (describing remedies for "agency action that falls short of the various listed review standards" of § 706(2)). *See generally* Levin, *supra* note 49.

[56] *See* Rodriguez, *supra* note 51, at 601. Rodriguez describes remand without vacatur as implemented "to temper the draconian impact of hard look review." *Id.* It stands to reason that *Dominion*'s extension of hard look review to tax cases justifies the offsetting extension of remand without vacatur. *See also* Daugirdas, *supra* note 49, at 283 ("The D.C. Circuit typically applies [remand without vacatur] to cases where an agency's rules are arbitrary and capricious on account of 'inadequate explanation' . . . .").

[57] Allied-Signal, Inc. v. U.S. Nuclear Reg. Comm'n, 988 F.2d 146, 150–51 (D.C. Cir. 1993).

[58] *E.g.*, Heartland Reg'l Med. Ctr. v. Sebelius, 566 F.3d 193, 198 (D.C. Cir. 2009).

[59] *Allied-Signal*, 988 F.2d at 151; *see also, e.g.*, Milk Train, Inc. v. Veneman, 310 F.3d 747, 756 (D.C. Cir. 2002) (weighing whether the agency could justify its decision on remand); Fox Television Stations, Inc. v. FCC, 280 F.3d 1027, 1048 (D.C. Cir. 2002) (same).

quences" factor include the degree of reliance on the regulation,[60] and whether vacatur will be "unduly disruptive of the agency's regulatory program."[61] Vacatur is likely to be disruptive of a regulatory program if, for example, no other regulations exist to govern the relevant conduct.[62] In practice, the disruptive consequences factor is often glossed over where the first factor strongly counsels against vacatur.[63] Thus, any regulation that can easily be remedied by reasoned justification is a potential candidate for remand without vacatur.

State Farm review of Treasury regulations seems poised for application of remand without vacatur. In many cases — including, according to Judge Clevenger, *Dominion* itself — defects may be easily remedied by simple explanation of the Treasury's reasoning, and thus would pass the severity prong of the *Allied-Signal* test. Turning to the disruptive consequences prong, millions of taxpayers depend on Treasury regulations for guidance, but because of a historical accident that led to bad institutional practice, many good rules may be at risk of invalidation, threatening the stability of the tax system. Affording the Treasury the opportunity to clarify its justifications of challenged rules instead of reflexively invalidating them will therefore preserve the benefits of increased accountability of the Treasury vis-à-vis taxpayers resulting from application of *State Farm* review without threatening to destabilize the system of tax administration.

Ideally, the Treasury should comply with the APA, in both notice and comment and in providing reasoned justification in promulgating all regulations. However, despite the Treasury's relative lack of compliance, many of its improperly promulgated regulations are still necessary to provide guidance on how to comply with the increasingly complex I.R.C. Courts should therefore seek to apply remand without vacatur where doctrinally allowable, in order to ensure that *Dominion*'s extension of *State Farm* review to Treasury regulations will not destabilize tax administration.

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[60] *See* Levin, *supra* note 49, at 300 (listing protection of reliance interests as a major impetus for remand without vacatur). Professor Ronald Levin cites *A.L. Pharma, Inc. v. Shalala*, 62 F.3d 1484, 1492 (D.C. Cir. 1995), which cited the reliance of a regulated drug manufacturer on the existing regulatory regime as grounds for remand without vacatur. The *Allied-Signal* court even considered the potential disruptions to the agency itself. 988 F.2d at 152; *see also* Daugirdas, *supra* note 49, at 294.

[61] Comcast Corp. v. FCC, 579 F.3d 1, 9 (D.C. Cir. 2009).

[62] *See, e.g.*, Davis Cnty. Solid Waste Mgmt. v. EPA, 108 F.3d 1454, 1458–59 (D.C. Cir. 1997) (retaining a portion of the challenged rule to avoid creating a regulatory vacuum).

[63] *See, e.g.*, *Fox Television*, 280 F.3d at 1049 (remanding without vacatur despite finding "the disruptive consequences of vacatur might not be great" since, given the high likelihood of justification on remand, the level of disruption was "barely relevant").