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## Supreme Court Raises the Bar for Taxpayer Challenges to Tax Regulations

By Linda A. Arnsbarger (Morrison & Foerster LLP)

On January 11, 2011, the Supreme Court issued a landmark tax ruling on judicial deference to IRS interpretive regulations that will significantly restrict a taxpayer's ability to challenge the validity of an IRS interpretive regulation. *Mayo Foundation for Medical Education & Research v. United States*<sup>1</sup> ostensibly was a case about whether the student FICA exception applies to medical residents. However, the decision reaches much more broadly than teaching hospitals, and will potentially affect any taxpayer seeking to challenge a tax regulation.

At its core, *Mayo Foundation* imposed a highly deferential standard of judicial deference to interpretive Treasury regulations, and emphatically rejected the commonly held view that tax regulations, and specifically interpretive regulations promulgated under Treasury's general authority to enact "needful rules," are entitled to less deference than other agency regulations or legislative regulations.

### Background

The issue in *Mayo Foundation* involved a regulation enacted to stem a flood of refund claims resulting from a series of IRS losses during 20 years of litigation. When medical students become "residents" in teaching hospitals, they are paid to provide supervised patient care. For decades, hospitals took the position that "residents" were exempted from payroll taxes under a student exemption enacted in 1939—work performed by students that is "incident" to the student's education qualifies for the exemption. The Treasury Department did nothing to change the longstanding interpretation of the student exemption for 65 years. After 50 years of not collecting payroll taxes on residents, in 1990, the government reversed course and began to try to collect payroll taxes

from teaching hospitals. That litigation continued through most of the 1990s until the 8th Circuit ruled against the government. Faced with thousands of refund claims from residents and hospitals for payroll tax refunds, Treasury amended the regulation in 2004. The amended regulation provided that employment of more than 40 hours a week is, per se, not "incident" to the worker's education, and included an example in which a medical resident did not qualify as a student.

Thus the regulation was promulgated 65 years after the law was enacted, reflected an about-face in the

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IRS's treatment of residents for over half a century, and expressly stated that it was intended to bolster its failed litigating position. The taxpayer and its university hospital supporters argued that this history strongly suggested that the regulation was motivated more by maximizing revenue than by objectively implementing the law enacted by Congress.

### Agency Regulations to Receive Judicial Deference

In its decision, the Supreme Court ruled unanimously that that judicial review of interpretive tax regulations is to be governed by the extremely deferential standard of *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), and not the much less deferential

multi-factor review of *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979). For decades, the tax community has debated whether *Chevron* governs judicial review of tax regulations, much less interpretive regulations issued under Treasury's general authority to enact rules under section 7805(a) (as opposed to legislative regulations promulgated under a specific grant of regulatory authority).

The *National Muffler* analysis invited the court to weigh a number of factors, including: whether the regulation was a contemporaneous interpretation of the statute; the manner of its evolution; the agency's consistency in interpreting the regulation; whether the regulation had existed for a long time; the extent of reliance on the regulation; and to what extent Congress had reviewed and in essence ratified the regulation in amending or re-enacting the related Code section. *Chevron* is a two-step analysis: first, is the underlying statute ambiguous? (If not, the court is to follow the plain meaning of the statute.) Second, if the statute is ambiguous, is the regulation reasonable or permissible? This is a very low bar, inasmuch as the Court stated, "we may not disturb an agency rule unless it is 'arbitrary or capricious in substance, or manifestly contrary to the statute.'"

The Tax Court and most Circuit Courts have long resisted application of the *Chevron* deference in tax cases. Even the Supreme Court had continued to use *National Muffler* factors in analyzing tax cases in the 25 plus years since *Chevron*. The Supreme Court's continued use of *National Muffler* for tax cases appeared to suggest tax regulations were subject to *National Muffler* review, while other government regulations were subject to *Chevron* review.

In *Mayo*, Justice Roberts resolved this question conclusively, writing, "[W]e are not inclined to carve out an approach to administrative review good for tax law only.... The principles underlying our decision in *Chevron* apply with full force in the tax context." The Court also contradicted the Tax Court's view that *National Muffler*

is simply a focused application of *Chevron*, confirming that they are very different analyses and that the *National Muffler* factors (consistency, longevity, history, etc.) are irrelevant to the review of an agency regulation. The Court also clarified that a court owes the same deference to an interpretive regulation as to a legislative regulation.

The minimal judicial scrutiny promised by the *Mayo* decision may prompt the IRS to be even more aggressive than it has been in attempting to overturn court losses by promulgating regulations, or enacting regulations with the intent to influence pending litigation.

### Implications

This decision also raises the question of how deferential the Court would be to IRS guidance that does not take the form of notice and comment rulemaking under the Administrative Procedures Act. Treasury issues significant non-regulation tax guidance (such as revenue rulings, revenue procedures, and notices) without notice and comment procedures. When it suits its purposes, the IRS contends that such authority has the same authoritative weight as regulations, although court decisions have been inconsistent on this point. The IRS also takes the position that such non-regulation guidance is not subject to the Administrative Procedure Act requirements. Yet at the same time, the IRS litigating position in many cases is that such guidance should receive the same *Chevron* deference as regulations adopted under the APA. *Mayo* suggests that the argument that "tax guidance is different than other agencies'" may no longer be acceptable to this Supreme Court, and perhaps the IRS will find that it cannot have it both ways.

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<sup>1</sup>*Mayo Foundation for Medical Education & Research v. United States*, Sup. Ct. Dkt. No. 09-837 (Jan. 11, 2011), affirming 568 F.3d 675 (8th Cir. 2009), accessed at <http://www.supremecourt.gov/opinions/10pdf/09-837.pdf>.