IS THE IRS A SORE LOSER?

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ABSTRACT

Like all administrative agencies, the Internal Revenue Service is given a fair amount of authority to enforce the laws enacted by Congress. Taxpayers often question the amount of authority granted to the Internal Revenue Service, and whether such authority is abused. In some situations this questioning of authority leads to litigation, resulting in both wins and losses for the Internal Revenue Service. From time to time, the Internal Revenue Service will respond to losses by creating a new rule or amending an existing one. Recent examples in the judicial system highlight the issue of administrative authority, and beg the question: Is the Internal Revenue Service a sore loser?

JEL: H24, H26, H32, M42, M48

KEYWORDS: Administrative authority, Internal Revenue Service, response to litigation

INTRODUCTION

Congress delegates certain authority to the Treasury Department through the Internal Revenue Code (Code). For example, Congress states that "the administration and enforcement of [the Code] shall be performed by or under the supervision of the Secretary of the Treasury" (26 USC § 7801). In addition, "the Secretary shall prescribe all needful rules and regulations for the enforcement" of the Code (26 USC § 7805). It is pursuant to these grants of power from Congress that the Treasury Department and the Internal Revenue Service (IRS) issue regulations. Taxpayers have questioned the IRS's powers in a series of recent cases, and the IRS has responded by exercising even more authority.

The issue addressed in this paper is whether the Treasury Department and IRS are permitted to change regulations following a loss in court. Prior literature has addressed issues relating to deference, conflict between administrative rules and judicial decisions, proper rulemaking procedures and policy aspects of tax litigation. This paper adds to the literature by describing how courts are responding to regulations that are issued or changed in direct response to adverse litigation. Although the particular issues in these cases relate to taxation, the outcomes relating to the authority of the Treasury Department are wide reaching in that the holdings are not limited to the Treasury Department, but rather are applicable to all administrative agencies.

The next section summarizes previous literature related to the topic. The Recent Cases section describes the facts and outcomes of two judicial proceedings that the Treasury Department directly responded to by issuing or amending regulations. The next sections, Discussion and Unresolved Issues, describe how the courts are responding to these regulations, followed by Concluding Comments.

LITERATURE REVIEW

Much of the literature relates to the deference given by courts to the rules and regulations of administrative agencies. Gans (2002) tracked how the deference standard changed over time in the context of tax law, noting that *Chevron v. U.S.* had a "transformative impact" on administrative authority. His discussion of deference centered on two cases decided by circuit courts of appeals in the 1990s, both having similar generation-skipping tax issues. Although the government had been successful in one of the cases, it had lost the other. Following the loss, it amended the relevant regulation to conform to the arguments that had resulted in success, an act that Gans described as "the government declar[ing] victory

by regulation." The article does not indicate whether a taxpayer sought invalidation of the amended regulation in the court system, but rather the author himself questioned whether the amended regulation was valid given changes to the deference landscape, including the Supreme Court's decision in *Chevron*. Berg (2008) provided a more recent review of judicial deference.

Before the Supreme Court handed down its 2011 decision in *Mayo Foundation*, Pruitt (2011) argued that *National Muffler* rather than *Chevron* provided the correct standard of deference for interpreting Code section 7805(b). In reaching this conclusion he suggested that attempts by the Internal Revenue Service (IRS) "to overturn court decisions through the agency rulemaking process do not warrant heightened deference." Given the ambiguity surrounding the proper deference standard, the American Bar Association Section of Taxation formed the Task Force on Judicial Deference in 2000. The Task Force ultimately recommended that the proper deference standard with regard to regulations should turn on whether the regulation in question was legislative or interpretive in nature. (Salem et al. 2004).

Conflict between Treasury Regulations and court decisions has also been examined. Polsky (2004) argued that the check-the-box regulations are invalid because they conflict with a prior interpretation of the relevant statutory language by the Supreme Court in a decision that was handed down approximately 60 year earlier. He also suggested that the Treasury Department often "attempts to 'fix' a Supreme Court interpretation" that it does not agree with. However, Geyser (2006) argued that an agency could never overrule a judicial decision because agencies act within boundaries that are defined by the judicial system.

Other literature has addressed the requirements for agency rulemaking, which are found in the Administrative Procedure Act of 1946 (APA). Hickman (2007) concluded that the Treasury Department often fails to comply with the APA. She later examined why more taxpayers do not seek to invalidate regulations on procedural grounds (Hickman 2008).

The policy implications of tax litigation were addressed by Howard (2002). He argued that the IRS changes its rules as a response to expensive litigation and adverse decisions, thereby making the tax system more efficient and equitable. Another aspect of litigation was covered by Lavoie (2008), who examined the factors that should be considered when developing the IRS's controversy position standards. He described the dual roles of the IRS – to collect revenue through enforcement of the Internal Revenue Code while maintaining an efficient and fair tax system – and noted the link between taxpayer compliance and perceptions as to whether the tax system is fair.

RECENT CASES

FICA and Medical Residents

In recent years the Internal Revenue Service (IRS) has been battling with hospitals over whether stipends paid to medical residents are subject to Federal Insurance Contributions Act (FICA) taxes. A "student" that works for a "school, college, or university" is exempt from FICA under an exception in the Internal Revenue Code (Code), and many hospitals have claimed that their residents are students and are therefore eligible for the exemption (26 USC § 3121(b)(10)). The argument rests on the fact that the purpose of a residency program is to train new doctors and provide them with the experience necessary to obtain their licenses to practice medicine.

Regulations previously in effect expanded on the statutory language. The prior regulation stated that the determination of whether an employee was a student would be based on "the relationship of [the] employee with the organization for which services are performed." Further, an individual who performed services "in the employ of a school, college, or university, as an incident to and for the purpose of pursuing a course of study at such school, college, or university" would be considered a student (26 CFR

§ 31.3121(b)(10)-2(c)(2003)). In addition, the prior regulation held that the term "school, college, or university" should be "taken in its commonly or generally accepted sense" (26 CFR § 31.3121(b)(10)-2(d)(2003)).

Mayo Foundation is a not-for-profit organization having medical education and scientific research as its charitable purposes. Under the umbrella of Mayo Foundation is the Mayo Graduate School of Medicine, which operates roughly 150 residency programs. Approximately 1,000 residents participate in the programs at any given time, with a typical residency lasting from three to seven years. Residents are required to attend lectures, read and take examinations, however the bulk of their learning is clinical in nature and occurs from doing rounds with attending physicians. Residents spend anywhere from fifty to eighty hours each week doing rounds. They are not hired or fired, but rather must apply and be admitted into the program. Further, there is no expectation of continued employment after the residency program is completed. Residents do not pay tuition but instead receive a stipend, which for the years at issue ranged from $40,000 to $60,000. The taxation of these stipends was the issue in *Mayo Foundation v. U.S.* (131 S.Ct. 704, 2011).

Both Mayo Foundation and the IRS agreed that the stipends were subject to income tax. However, they disagreed as to whether the stipends were subject to FICA. Mayo Foundation believed that the residents were within the student exception and the stipends were not subject to FICA. Mayo Foundation argued that it was a "school, college, or university" and that its residents were "students," as those terms are used in the Code and interpreted by Treasury Regulations then in effect. Since the regulations provided that the term "school, college, or university" should be taken in its generally accepted sense, Mayo Foundation provided dictionary definitions to show that it easily fell within the terms. It also provided credible testimony from residents that the only reason they enrolled in the residency program was to learn.

The government argued, on the other hand, that a "primary purpose" test should be applied in order to determine whether an organization is a school, college or university. Since Mayo Foundation's primary purpose was patient care, argued the government, it should not be treated as a school, college or university. With regard to whether residents could be considered students, the government argued in the negative because the services performed by the residents were not "incident to learning" as the regulation required. The government argued that the opposite was true; because the residents worked between fifty and eighty hours per week, the learning was incident to the services, and therefore the statutory exception was not satisfied.

The Federal District Court for the District of Minnesota held for the taxpayer (*Mayo Foundation*, 282 F.Supp. 2d 997, 2003). Mayo Foundation was considered by the court to be a school, college or university and the residents were considered to be students. Therefore, the stipends paid to them were not subject to FICA. In its opinion, the court specifically rejected the arguments put forth by the government. First, the district court pointed out that a "primary purpose" test shouldn't be read into the regulation because it did not in fact contain such requirement. The court further note that *even if* a "primary purpose" test applied, the taxpayer would satisfy the test because the taxpayer is a non-profit institution having medical education and scientific research as its charitable purposes. With regard to the government's argument as to why residents could not be considered students, the district court stated that "[t]ime alone cannot be the sole measure of the relationship between services performed and a course of study" (*Mayo Foundation*, 282 F.Supp. 2d 997, 2003).

Within a few months of its loss in *Mayo Foundation*, the Treasury Department and IRS issued amended regulations. Pursuant to the amended regulation, an organization is a school, college or university as that term is used in the Code "if its primary function is the presentation of formal instruction, it normally maintains a regular faculty and curriculum, and it normally has a regularly enrolled body of students in

attendance at the place where its educational activities are regularly carried on" (26 CFR § 31.3121(b)(10)-2(c)).

The amended regulation also changed the definition of student. Although the regulation still states that an employee shall be treated as a student if the services provided are incident to and for the purpose of pursing a course of study, it now says that the educational aspect of the relationship between the employer and employee must be "predominant." The regulation expands on this predominance factor, stating that "[t]he evaluation of the service aspect of the relationship is not affected by the fact that the services performed by the employee may have an educational, instructional, or training aspect" (26 CFR § 31.3121(b)(10)-2(d)(3)). Further, the regulation states that a full-time employee – defined as someone who regularly works forty hours or more per week – cannot be considered a student because the services of a full-time employee are not incident to education (26 CFR § 31.3121(b)(10)-2(d)(3)(iii)).

It is interesting to note that the Treasury Department and IRS's new interpretations of the terms "school, college, and university" and "student" were those specifically rejected by the Federal district court in *Mayo Foundation*.

<u>Statute of Limitations</u>

The IRS is currently litigating an issue relating to the statute of limitations for audits. Generally, the IRS has three years from the filing of a Federal income tax return to assess an additional tax (26 USC § 6501(a)). However, the Code provides that the statute of limitations is extended to six years when a taxpayer "omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return" (26 USC § 6501(e)(1)(A)). If a taxpayer improperly overstates the tax basis of an asset, the result is an understatement of income from the sale of the asset. The issue in these cases is whether the understatement of income that results from an overstatement of basis is considered an omission of income, thereby triggering the six-year statute of limitations.

The U.S. Supreme Court addressed this issue in 1958 in *Colony v. Commissioner* (357 U.S. 28, 1958). *Colony* involved a corporation in the real estate business that overstated the basis of land it sold. The result was an understatement of gross income that was more than twenty-five percent of the gross income shown on the return. The IRS argued that the extended statute of limitations applied, and the Court of Appeals for the Sixth Circuit agreed (*Colony*, 244 F.2d 75, 1957). However, the U.S. Supreme Court reversed on appeal. The Court examined the legislative history of the statutory language and determined that Congress intended the extended statute of limitations to apply only in situations where a taxpayer "actually omitted" an item of income and not when there are "errors in computation arising from other causes" (*Colony*, 357 U.S. 28, 1958). The Court further explained:

> Congress manifested no broader purpose than to give the Commissioner an additional [number of] years to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors. In such instances the return on its face provides no clue to the existence of the omitted item. On the other hand, when, as here, the understatement of a tax arises from an error in reporting an item disclosed on the face of the return the Commissioner is at no such disadvantage. And this would seem to be so whether the error be one affecting "gross income" or one, such as overstated deductions, affecting other parts of the return (*Colony*, 357 U.S. 28, 1958).

Accordingly, the Court held that the extended statute of limitations does not apply to understatements of gross income due to overstatements of basis.

In 2007, the U.S. Tax Court addressed whether *Colony* applies outside the context of a trade or business in *Bakersfield v. Commissioner* (128 T.C. 207, 2007). *Bakersfield* involved a limited partnership that overstated its basis in oil and gas property. The IRS claimed that *Colony* only applied in the context of a trade or business, and since *Bakersfield* involved an investment the six-year statute of limitations should apply because the taxpayer's basis error resulted in a substantial omission of gross income. However, the Tax Court held against the IRS on the basis that it was bound by *Colony* and therefore the three-year statute of limitations applied (*Bakersfield*, 128 T.C. 207, 2007). The IRS appealed to the Court of Appeals for the Ninth Circuit, which affirmed the Tax Court (*Bakersfield*, 568 F.3d 767, 2009). In so holding, the Ninth Circuit noted that the Supreme Court in *Colony* "did not even hint that its interpretation of [the Code] was limited to cases in which the taxpayer was engaged in a 'trade or business.' There is no ground for suggesting the Court intended the same language…to apply differently to taxpayers in a trade or business than to other taxpayers" (*Bakersfield*, 568 F.3d 767, 2009).

The IRS didn't give up, however. In 2009, the IRS asked the Tax Court to reconsider its *Bakersfield* holding in *Intermountain v. Commissioner* (98 TCM 144, 2009). The taxpayer in *Intermountain*, a partnership, filed its 1999 Federal income tax return on September 15, 2000, which contained a loss that was overstated due to an overstated basis. On September 14, 2006, just one day less than six years later, the IRS issued a notice of Final Partnership Administrative Adjustment (FPAA). The taxpayer claimed that the FPAA was untimely because the three-year statute of limitations had long expired. Further, the taxpayer cited *Bakersfield* for the proposition that an overstatement of basis does not trigger the six-year statute of limitations. The IRS, however, claimed that the Tax Court had incorrectly decided *Bakersfield*.

The Tax Court disagreed with the IRS, stating that *Bakersfield* "is directly on point" (*Intermountain*, 98 TCM 144, 2009). Expressly declining the IRS's "invitation to overrule it," the Tax Court reaffirmed its holding in *Bakersfield*, which had since been affirmed by the Ninth Circuit (568 F.3d 767, 2009), and held once again that the six-year statute of limitations is not triggered by an overstatement of basis.

The IRS issued temporary regulations in September 2009, less than a month after the Tax Court ruled against it in *Intermountain*. The temporary regulations state that "an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income" for purposes of the extended statute of limitations (26 CFR §§ 301.6229(c)(2)-1T and 301.6501(e)-1T). These regulations have since been finalized.

These cases present interesting questions. Specifically, is the IRS permitted to create or change a rule following a loss in the judicial system? If so, can the new rule reflect a position that contradicts a court's previous interpretation of a statute?

DISCUSSION

The U.S. Supreme Court recently answered the first question with a resounding "yes" (*Mayo Foundation*, 131 S.Ct. 704, 2011). The Court was not troubled at all in *Mayo Foundation v. U.S.* by the fact that the Treasury Department changed the regulations relating to the student exception to Federal Insurance Contributions Act (FICA) as a response to adverse litigation. To the contrary, the Court stated that it "found it immaterial to [its] analysis that a 'regulation was prompted by litigation'" (*Mayo Foundation*, 131 S.Ct. 704, 2011). The Court amplified the point by noting that in the past it has "expressly invited the Treasury Department to 'amend its regulations' if troubled by the consequences of [its] resolution of the case" (*Mayo Foundation*, 131 S.Ct. 704, 2011).

The Supreme Court has stated that an administrative agency's interpretation will be upheld if Congress did not speak directly to the question at issue and if the regulation is a permissible interpretation of the statute (*Chevron*, 467 U.S. 837, 1984). It has been noted, however, that more than one permissible

interpretation can exist (*Mayo Foundation*, 568 F.3d 675, 2009). Accordingly, the Treasury Department can amend an otherwise reasonable regulation in response to adverse litigation as long as the amended regulation is also a permissible, albeit different, interpretation (*Mayo Foundation*, 568 F.3d 675, 2009). Ultimately, *Mayo Foundation* was resolved by the Supreme Court in favor of the government (131 S.Ct. 704, 2011). The Court concluded that the amended regulation is a reasonable interpretation of the statutory language. The result is that medical residents are not students, and the stipends they receive are subject to FICA.

The current status of *Intermountain* also favors the government. Reversing the Tax Court opinion, the Court of Appeals for the District of Columbia recently upheld the current regulation which states that an overstatement of basis triggers the six-year statute of limitations (*Intermountain*, 650 F.3d 691, 2011). However, that result may change once the Supreme Court hands down its decision in a similar case described below.

UNRESOLVED ISSUE

What if the court that had previously interpreted the statutory language was the Supreme Court of the United States, and it had held that the statutory language is clear and unambiguous such that an administrative interpretation is unnecessary? Can the Treasury Department still issue a regulation in response to the adverse litigation? Such was the situation in *Intermountain*. The current regulation appears to conflict with the Supreme Court's holding in *Colony* (357 U.S. 28, 1958). The government argues that no conflict exists because *Colony* involved an overstatement of basis within the context of a trade or business, whereas *Intermountain* occurred outside of such context.

This statute of limitations issue has arisen in other factually similar cases in several circuits with varying results. In February 2011 the Fourth Circuit Court of Appeals held for the taxpayer in one such case, *Home Concrete & Supply, LLC v. Commissioner* (634 F.3d 249, 2011). Following its loss, the government filed a Petition for a Writ of Certiorari with the U.S. Supreme Court, which was granted on September 27, 2011 (S.Ct., Docket #11-139, 2011). Oral arguments were heard on January 17, 2012 and a decision is expected by the end of June 2012.

CONCLUDING COMMENTS

The Supreme Court has recently reiterated that the Treasury Department is permitted to create or amend a regulation following a loss in court. As long as the regulation is a reasonable interpretation of the statute, it is not inappropriate for the new regulation to conflict with a court's previous holding. Whether that also applies to holdings of the High Court remains to be seen as the Supreme Court's imminent decision in *Home Concrete* will finally resolve the issue for all circuits. Future research may address how the Supreme Court's holdings in *Mayo Foundation* and *Home Concrete* will affect areas of law outside of taxation, where agencies other than the Treasury Department interpret federal statutory law.

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