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May 2022

North America: IRS' Failure to Comply with APA Results in Regulation Invalidity in *Hewitt*

In brief

The Eleventh Circuit's decision in Hewitt should serve as a reminder to all taxpayers and tax practitioners of the importance of submitting comments with respect to proposed Treasury regulations.

Introduction

On 29 December 2021, the Eleventh Circuit issued an important decision in *Hewitt v. Commissioner*, No. 20-13700 (11th Cir. 2021), rev'g T.C. Memo 2020-89. In *Hewitt*, the court invalidated regulations (concerning conservation easements) that the IRS had issued decades ago (Treas. Reg. § 1.170A-14(g)(6)(ii) , "Regulation") because the IRS had failed to comply with the requirements of the Administrative Procedure Act (APA) in connection with the issuance of the Regulation. In particular, the IRS and Treasury failed to respond to significant comments when the final regulations were promulgated, so the Regulation was invalidated for that reason.

When the Regulation was issued in 1985, the IRS publicly took the position that the APA did not apply to Treasury regulations, but that position did not help the IRS because of the Supreme Court's decision in *Mayo Foundation for Medical Ed. and Research v. United States*, 562 U.S. 44 (2010) (refusing to apply a different standard of review to Treasury Regulations than the rules of any other agency). Given the IRS's long-standing failure to recognize that the APA applies equally to Treasury regulations, many other such rules and regulations are equally (if not more) susceptible to challenge on similar grounds.

Summary of Facts and Holding

The taxpayers, David and Tammy Hewitt, lived in Alabama. David and his sister owned approximately 1,325 acres of land that were used as a cattle ranch. The Hewitts created an easement on 257 acres. The easement prohibited future development of the land. The deed listed the purpose of the easement as "to assure that the Property will be retained forever predominately in the natural condition and to prevent any use of the Property that will impair or interfere with the Conservation Values as set forth in the Easement." The deed included a list of prohibited uses and a separate list of permitted uses. In 2012, the Hewitts donated an easement (the "Easement") on over 250 acres of

land in Alabama to a conservatory and claimed a $2.8 million charitable deduction. Hewitts carried forward the deduction to 2013 and 2014.

The IRS issued a notice of deficiency disallowing the deduction asserting the Easement did not meet the requirement of Treas. Reg. § 1.170A-14(g)(6)(ii) to be protected-in-perpetuity. Specifically, the IRS focused on the provision of the easement governing the extinguishment of the Easement. Section 1.170A-14(g)(6), titled "Extinguishment," provides:

> ((i)) In general. If a subsequent unexpected change in the conditions surrounding the property that is the subject of a donation under this paragraph can make impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding and all of the donee's proceeds (determined under paragraph (g)(6)(ii) of this section) from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution.
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> ((ii)) Proceeds. . . . [F]or a deduction to be allowed under this section, at the time of the gift the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time. . . . For purposes of this paragraph (g)(6)(ii), that proportionate value of the donee's property rights shall remain constant. Accordingly, when a change in conditions give rise to the extinguishment of a perpetual conservation restriction under paragraph (g)(6)(i) of this section, the donee organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction.

The extinguishment provision of the deed transferring the Easement to the conservatory governed the judicial resolution of the Easement if the purpose of the Easement became impossible to be accomplished, as follows:

> Extinguishment. If circumstances arise in the future such as render the purpose of this Easement impossible to accomplish, this Easement can only be terminated or extinguished, whether in whole or in part, by judicial proceedings in a court of competent jurisdiction, and the amount of the proceeds to which Conservancy shall be entitled, after the satisfaction or prior claims, from any sale, exchange, or involuntary conversion of all or any portion of the Property subsequent to such termination or extinguishment (herein collectively "Extinguishment") shall be determined to be at least equal to the perpetual conservation restriction's proportionate value unless otherwise provided by Alabama law at the time, in accordance with Subsection 15.2 . . . .

The extinguishment provision allocated the proceeds of the termination or extinguishment between the donor and the donee.

> Proceeds. This Easement constitutes a real property interest immediately vested in Conservancy. For the purposes of this Subsection, the parties stipulate that this Easement shall have at the time of Extinguishment a fair market value determined by multiplying the then fair market value of the Property unencumbered by the Easement (minus any increase in value after the date of this grant attributable to improvements) by the ratio of the value of the Easement at the time of this grant to the value of the Property, without deduction for the value of the Easement, at the time of this grant. . . . For the purposes of this paragraph, the ratio of the value of the Easement to the value of the Property unencumbered by the Easement shall remain constant.

The IRS argued that the division of the proceeds described above violated Treas. Reg. § 1.170A-14(g)(6)(ii) . The IRS objected to the fact that the provision allowed the donor to keep the value of any improvements made after the donation. The Tax Court upheld the IRS position. The Tax Court explained that this provision "subtracts the value of post easement improvements before determining the Conservancy's share of the extinguishment proceeds and fails to allocate the extinguishment proceeds in accordance with" Treas. Reg. § 1.170A-14(g)(6)(ii) . The Tax Court further explained that Treas. Reg. § 1.170A-14(g)(6)(ii) "does not permit the value of post easement improvements to be subtracted from the proceeds before determining the donee's share." The Tax Court held that "[f]or purposes of the extinguishment provisions, the subject property may change, but the donee's property right to the extinguishment proceeds may not." The Tax Court rejected the Hewitts' argument that the Regulation only requires the donee to receive the proceeds based on the relative value of the easement at the time of donation and that the Regulation was invalid. The Hewitts appealed.

On appeal, the Hewitts argued that (1) the extinguishment clause met the requirements of Treas. Reg. § 1.170A-14(g)(6)(ii) and (2) Treas. Reg. § 1.170A-14(g)(6)(ii) was procedurally invalid under the APA and substantively invalid under *Chevron.* [1] Based on prior precedent, the Eleventh Circuit rejected the first argument. The Court explained:

> As to this interpretation argument, we recently determined, in *TOT Property Holdings, LLC v. Commissioner*, that § 1.170A-14(g)(6)(ii) "does not indicate that any amount, including that attributable to improvements, may be subtracted out." 1 F.4th 1354, 1363 (11th Cir. 2021) (quoting *PBBM-Rose Hill, Ltd. v. Comm'r*, 900 F.3d 193, 208 (5th Cir. 2018)).

The taxpayer in *TOT* did not argue the Regulation was invalid.

The Eleventh Circuit then addressed the Hewitts' invalidity argument. The Hewitts argued that the Regulation was invalid because the IRS and Treasury failed to respond to significant comments received and did not provide any explanation in the preamble related to the Regulation. The Court explained the APA review as follows:

> Under the APA, a "reviewing court shall . . . hold unlawful and set aside agency action, findings, and

conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). Our review standard is "narrow," and we "will not substitute [our] judgment for that of the agency." *Lloyd Noland Hosp. & Clinic v. Heckler*, 762 F.2d 1561, 1565 (11th Cir. 1985). However, "[i]n employing this deferential standard of review," we do "not rubber stamp the action of the agency." *Port of Jacksonville Mar. Ad Hoc Comm., Inc. v. U.S. Coast Guard*, 788 F.2d 705, 708 (11th Cir. 1986). Rather, "[w]e must determine whether the decision was based on a consideration of the relevant factors and whether there was a clear judgment error." *Lloyd Noland*, 762 F.2d at 1565 (citing *Motor Vehicles Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983)). Furthermore, "[w]e may not supply a reasoned basis for the agency's action that the agency itself has not given," although we will "uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned." *State Farm*, 463 U.S. at 43 (first quoting *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1974), then quoting *Bowman Transp. Inc. v. Ark.-Best Freight Sys.*, 419 U.S. 281, 286 (1974)); accord *Judulang v. Holder*, 565 U.S. 42, 52-55 (2011). And "courts may not accept . . . counsel's post hoc rationalizations for agency actions," as "an agency's action must be upheld, if at all, on the basis articulated by the agency itself." *State Farm*, 565 U.S. at 50.

The APA "prescribes a three-step procedure for so-called 'notice-and-comment rulemaking.'" *Perez v. Mortg. Bankers Ass'n*, 575 U.S. 92, 96 (2015); accord 5 U.S.C. § 553. First, an agency "must issue a '[g]eneral notice of proposed rulemaking,' ordinarily by publication in the Federal Register." *Perez*, 575 U.S. at 96 (alteration in original) (quoting § 553(b)). Second, "if 'notice [is] required,' the agency must 'give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments,'" and the agency "must consider and respond to significant comments received during the period for public comment." Id. (alteration in original) (quoting § 553(c)). Third, in promulgating the final rule, the agency "must include in the rule's text 'a concise general statement of [its] basis and purpose.'" Id. (alteration in original) (quoting § 553(c)). As the Supreme Court has explained, "Rules issued through the notice-and comment process are often referred to as 'legislative rules' because they have the 'force and effect of law.'" *Id.* (quoting *Chrysler Corp. v. Brown*, 441 U.S. 281, 302-03 (1979)).

Thus, "[t]he APA requires the agency to incorporate into a new rule a concise general statement of its basis and purpose." *Lloyd Noland*, 762 F.2d at 1566. As we have explained, "statement[s] may vary, but should fully explain the factual and legal basis for the rule." Id. Indeed, "[b]asis and purpose statements must enable the reviewing court to see the objections and why the agency reacted to them as it did," *id.*, as "[o]ne of the basic procedural requirements of administrative rulemaking is that an agency must give adequate reasons for its decisions," *Encino Motorcars, LLC v. Navarro*, 579 U.S. 211, 221 (2016). And, in the statement, the agency must rebut "vital relevant" or significant comments. See *Lloyd Noland*, 762 F.2d at 1567; *Hussion v. Madigan*, 950 F.2d 1546, 1554 (11th Cir. 1992)

> ("Under the 'arbitrary and capricious' standard of review, an agency is . . . required to respond to significant comments that cast doubt on the reasonableness of the rule the agency adopts." (quoting *Balt. Gas & Elec. Co. v. United States*, 817 F.2d 108, 116 (D.C. Cir. 1987))). The purpose of notice- and comment rulemaking is to "give[] affected parties fair warning of potential changes in the law and an opportunity to be heard on those changes" while "afford[ing] the agency a chance to avoid errors and make a more informed decision." *Azar v. Allina Health Servs.*, 139 S. Ct. 1804, 1816 (2019).

The IRS and Treasury promulgated the proposed Section 170 regulations in 1983. The proposed regulations included Prop. Treas. Reg. § 1.170A-14(g)(6)(ii), which was finalized without significant change as Treas. Reg. § 1.170A-14(g)(6)(ii) . During the notice and comment period for the Regulation, the IRS and Treasury received ninety comment letters overall. Thirteen of the comment letters discussed Treas. Reg. § 1.170A-14(g)(6)(ii) . The Hewitts argued that seven comment letters addressed allocation issues under Treas. Reg. § 1.170A-14(g)(6)(ii) . The Hewitts argued that these comments "expressed concern that allocation of post-extinguishment proceeds under the proposed Proceeds Regulation was unworkable, did not reflect the reality of the donee's interest, or could result in an unfair loss to the property owner and a corresponding windfall for the donee."

One comment letter specifically addressed the allocation of value on extinguishment when there had been improvements on the land. The commenter argued that the allocation of proceeds should be eliminated from the Regulation. The commenter was concerned about the Regulation negatively affecting the incentives for landowners to make such easement donations. The commenter argued, if the provision is retained, that there should be a carve-out of value for post-donation improvements on the land - the same argument the Hewitts made. The Eleventh Circuit noted that the six other comment letters criticized or urged caution about Treas. Reg. § 1.170A-14(g)(6)(ii) .

Following notice and comment, IRS and Treasury finalized Treas. Reg. § 1.170A-14(g)(6)(ii) without substantive change. The preamble of the final regulations did not discuss Treas. Reg. § 1.170A-14(g)(6)(ii) at all and failed to address the seven comment letters. The Eleventh Circuit summarizes the government's action as follows:

> After a public hearing, Treasury adopted the proposed regulations with revisions. 51 Fed. Reg. at 1496. In the preamble to the final rulemaking, Treasury stated that "[t]hese regulations provide necessary guidance to the public for compliance with the law and affect donors and donees of qualified conservation contributions" and that it had "consider[ed] . . . all comments regarding the proposed amendments." Id. In the subsequent "Summary of Comments" section, however, Treasury did not discuss or respond to the comments made by NYLC or the other six commenters concerning the extinguishment proceeds regulation. See Id. at 1497- 98; *Oakbrook*, 154 T.C. at 188 ("The 'judicial extinguishment' provision is not among the amendments specifically addressed in the 'Summary of Comments.'"). And Treasury stated that "[a]lthough a notice of proposed rulemaking which solicited public comments was issued, the Internal Revenue Service concluded when the notice was issued that the regulations are interpretative and that the notice and public comment procedure requirement of 5 U.S.C. [§] 553 [of the APA] did not apply." 51 Fed. Reg. at 1498.

The government offered two arguments addressed by the court. First, the government argued that the comments received were insignificant and did not warrant a response. The Eleventh Circuit explained:

> The Hewitts assert that these seven comments - in particular, NYLC's comment - were significant such that they warranted a response from Treasury in promulgating the final extinguishment proceeds regulation. In response, the Commissioner asserts that none of the thirteen comments were significant to require a response from Treasury because they did not raise any point casting doubt on the regulation's reasonableness.

The Eleventh Circuit held that the comments were significant and should have been addressed by the preamble to the final regulations.

Second, the government cited to the general language that all comments were considered.

> The Commissioner additionally asserts that Treasury's revisions to the proposed proceeds regulation in the final regulation support Treasury's representation that it considered "all comments" in the final regulations' preamble. But, as the Commissioner concedes, the revisions were simply "clarifications" in response to other comments "expressing uncertainty" about the regulation's meaning "rather than substantive changes." . . . But this revision does not provide any indication that Treasury was responding to NYLC's significant comment about the post-donation improvements issue. See *Lloyd Noland*, 762 F.2d at 1567; Hussion, 950 F.2d at 1554. We therefore reject this argument.

The Eleventh Circuit held that the failure to address significant comments failed the arbitrary and capricious standard under the APA. The Eleventh Circuit reversed the case and remanded it to the Tax Court.

Analysis

The Eleventh Circuit's decision in *Hewitt* is important for a number of reasons. *First*, the court confirmed that Treasury regulations are indeed subject to the APA, without regard to when the Treasury regulations were issued. *Second*, the court emphasized that Treasury and the IRS are required to consider and respond to *all* significant comments when they issue regulations. *Third*, the court refused to defer to the government's contention that a comment was not significant; instead, the court looked at the substance of the comment and made its own, independent judgment as to whether or not the comment was significant. Finally, the court flatly rejected the IRS' attempt to use the broad "we considered all comments" preamble statement as sufficient grounds to demonstrate compliance with the APA's requirements.

Turning first to the application of the APA to Treasury regulations, for decades the IRS took the position that its regulations were not subject to the APA. The Supreme Court put that canard to rest with its decision in *Mayo*, and the IRS has been attempting (sometimes in fits and starts) to bring the APA into its regulatory guidance projects. However, there are many regulations - including the regulation at issue in *Hewitt*, which was issued in 1986 - which

were issued by the IRS before the IRS understood that it had to fully comply with the APA. The IRS' unwillingness to respond to significant comments when it was issuing pre-*Mayo* regulations came back to haunt the IRS in *Hewitt*, and this will likely continue as the validity of other regulations is challenged in years to come. Indeed, any tax advisor who is confronted with a problematic result due to the potential application of pre-*Mayo* regulation should carefully review the manner in which the regulation was issued in order to determine whether a challenge to the validity of that regulation would be likely to succeed.

Second, the court confirmed that Treasury and the IRS must consider all significant comments when it finalizes regulations. This rule was quite clear before *Hewitt*, but it is very helpful that the court re-emphasized this point. Prior to *Mayo*, the IRS often declined to specifically address significant comments that it received in its rulemaking notices (again, on the basis of the belief that the APA did not apply to IRS regulations); if those comments were significant, the validity of the regulation is inherently suspect.

The third point may be the most important, because the court refused to blindly accept Treasury's and the IRS' assertion that a comment was not significant. Instead, the Eleventh Circuit carefully reviewed the specific terms and nature of the comment that was made, and the court made its own, independent judgment that the comment was significant and thus had to be addressed in the rulemaking process. The court rejected the contention that a comment was "insignificant" by looking at the specific points raised in the comments, and rejected the attempt to make a *post hoc* rationalization as to why the comment was not significant.

Fourth, the court rejected Treasury's and the IRS' attempt to save the regulation by referring to the statement in the preamble to the final regulations that they had considered all comments not otherwise addressed. This type of comment was particularly common with respect to pre-*Mayo* regulations, and perhaps the government thought (wishful thinking) that such blanket statements would satisfy the courts with respect to APA compliance. The Eleventh Circuit flatly rejected this argument, again emphasizing that Treasury and the IRS are under a duty to consider all significant comments and respond thereto - a blanket assertion that it has done so is not sufficient.

Key Takeaways

The final word in *Hewitt* will need to wait for another day, as the panel's decision is not yet final. Nevertheless, the principles articulated in *Hewitt* are hardly ground-breaking, but for the fact that the case involves tax. Regardless of the final outcome, it can be anticipated that the Eleventh Circuit's decision will further embolden other taxpayers to challenge the validity of Treasury regulations, particularly pre-*Mayo* Treasury regulations. Indeed, as noted above, tax practitioners would be well advised to include research into the terms of the issuance of any Treasury regulation which reaches an undesired conclusion, particularly when the regulation does not directly follow the terms of the underlying statute. Treasury and the IRS are permitted under *Chevron* to issue regulations which address ambiguities in the Code, but when they do so, they must follow the requirements of the APA and respond to all significant comments. Will Treasury and the IRS attempt to prospectively cure procedurally-defective regulations by reissuing them in an APA-compliant manner? While this is certainly possible, the more likely answer is no. And even

if Treasury and the IRS do attempt such prospective fixes, their retrospective problems remain, particularly where, as here, the IRS has shown little recent interest in audit cycle currency.

Practitioners should feel comfortable holding the government's feet to the fire, and *Hewitt* is merely the tip of the iceberg: Treasury and the IRS have long chosen to ignore significant comments in promulgating final rules. Many of these rules have been on the books for decades, if not longer. Moreover, the general six-year statute of limitations applicable to APA claims has no relevance in the context of a traditional deficiency or refund tax litigation, as the Supreme Court has made clear that an APA-defective regulation is entitled to no deference. *See Encino Motocars, LLC v. Navarro*, 579 U.S. ___ (2016).

The Eleventh Circuit's decision in *Hewitt* should serve as a reminder to all taxpayers and tax practitioners of the importance of submitting comments with respect to proposed Treasury regulations. If there are no comments submitted (and in recent years, that has occurred many times), then Treasury and the IRS have carte blanche to finalize the regulations as proposed. The IRS could not substantively change the regulations before finalization, of course, but if there are no comments submitted, then none of the comments could be significant, so the regulation clearly could be finalized as proposed. Hopefully practitioners (and their professional organizations, such as the ABA Tax Section and the AICPA) will view *Hewitt* as a call to action that comments should be submitted whenever a Treasury regulation is proposed, particularly in any situation when tax practitioners do not agree with the guidance in light of the underlying statute. Just as Treasury and the IRS have only themselves to blame for their failure to follow the APA, tax practitioners will only have themselves to blame if they do not submit comments concerning proposed Treasury regulations when such comments are appropriate.

[1] *Chevron, U.S.A., Inc. v. Nat. Res. Def Council, Inc.*, 467 U.S. 837 (1984).

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