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In this article, Ledingham examines the Tax Court's decision in *Valley Park Ranch* and how it could affect any forthcoming Administrative Procedure Act challenges regarding the employee retention credit.

The tax law experienced a significant shift on March 28 arising from the Tax Court's authoritative decision in *Valley Park Ranch*.[1] Treasury has previously shown inadequate regard for the Administrative Procedure Act, frequently labeling its regulations as "interpretative rules" to bypass the APA's notice and comment rulemaking procedures. But after *Valley Park Ranch*, a surge in challenges to notices pertaining to the employee retention credit can be expected.

Agency Rulemaking Requirements: Overview

The APA prescribes procedural requirements for agencies. Before enacting any rule,[2] an agency must: (1) publish a general notice of proposed rulemaking in the *Federal Register*, (2) allow interested parties an opportunity to comment on the proposed rule, (3) consider the relevant comments, and (4) incorporate into any final rule a concise statement of basis and purpose.[3] Courts invalidate rules when agencies fail to follow the procedural requirements of APA section 553.[4] However, these requirements do not apply to interpretive rules[5] or rules for which an agency finds good cause that "notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest."[6]

Generally, interpretive rules serve to clarify preexisting substantive law.[7] In contrast, legislative rules "create rights, impose obligations or effect a change in existing law."[8] Unlike interpretive rules, legislative rules have the force of law.[9] Thus, basis and purpose statements for legislative rules must contain comprehensive information to permit judicial review.[10] Further, agencies must respond to noteworthy comments that raise questions about the reasonableness of the rule adopted.[11]

The good-cause exception permits an agency to forgo the notice and comment period. However, the agency must furnish a concise statement for

[1] *Valley Park Ranch LLC v. Commissioner*, 162 T.C. No. 6 (2024).

[2] Administrative Procedure Act, 5 U.S.C. sections 551-559, 701-706 (2000 and Supp. IV 2004).

[3] 5 U.S.C. section 553; *Altera Corp. v. Commissioner*, 145 T.C. No. 3, at 33 (2015).

[4] *Valley Park Ranch*, 162 T.C. No. 6.

[5] *Id.* at 33.

[6] 5 U.S.C. section 553, subsection (b)(4)(B).

[7] *See Hemp Industries Association v. DEA*, 333 F.3d 1082, 1087 (9th Cir. 2003).

[8] *Id.*

[9] *Id.* (quoting *American Mining Congress v. Mine Safety & Health Administration*, 995 F.2d 1106, 1109 (D.C. Cir. 1993)).

[10] *Valley Park Ranch*, 162 T.C. No. 6, at 13 (quoting *Encino Motorcars LLC v. Navarro*, 579 U.S. 211, 221 (2016)).

[11] *Baltimore Gas and Electric Co. v. United States*, 817 F.2d 108, 116 (D.C. Cir. 1987).

why it deems notice and comment contrary to the public interest.[12] The government's burden to show that good cause exists is a heavy one.[13] The APA's mandate for notice and comment serves two purposes: (1) to promote fairness in the treatment of those affected by the rule and (2) to facilitate judicial review.[14] This highlights the importance of the notice and comment prerequisites and underscores the weight of the government's responsibility to justify any deviation from them.

Evolution of the Courts' Treatment of Regs

The concept of tax exceptionalism, in which regulations and rules governing taxes are viewed differently than other forms of regulation, has existed throughout U.S. tax history. Despite Treasury acknowledging that the APA applied to its regulatory actions, Treasury often viewed its regulations as interpretative rules that were not required to go through the notice and comment rulemaking process outlined by the APA.[15] This changed with the Supreme Court's 2011 rejection of tax exceptionalism in *Mayo*,[16] which led to legal challenges for Treasury regulations and IRS notices.

Mayo represented a movement toward universality between Treasury and other administrative law bodies. Soon after the Court's decision, the Federal Circuit invalidated reg. section 1.263A-11(e)(1)(ii)(B) because Treasury did not comply with the APA's decision-making procedures.[17] *Dominion Resources* put the IRS on notice that Treasury would now have to follow the APA notice and comment procedures, in line with other agencies.

The requirement that Treasury must follow the APA's decision-making procedures in promulgating regulations was then expanded to notices in two cases.[18] In 2020 Mann Construction Inc. and two of its shareholders filed suit in the Eastern District of Michigan for a refund of penalties levied under section 6707A for the company's involvement in an employee benefit trust that featured a cash-value life insurance element.[19] The IRS categorized this arrangement as a listed transaction in Notice 2007-83, 2007-45 IRB 960. Mann Construction argued that the notice was invalid because the IRS did not follow the notice and comment process. The Sixth Circuit agreed, citing Notice 2007-83's imposition of a reporting requirement, civil and criminal penalties for noncompliance, and explicit delegation of rulemaking authority.[20]

Following this, a federal district court in Tennessee addressed a notice and comment challenge to Notice 2016-66, 2016-47 IRB 745.[21] The court determined that the notice breached the APA by deeming microcaptive arrangements to be reportable transactions.[22] Further, the court concluded that Notice 2016-66 was procedurally deficient because of its noncompliance with notice and comment rulemaking procedures.[23]

In *Liberty Global*, a court once again aligned Treasury with other agencies and struck a regulation invoking the good cause exception to the notice and comment requirements.[24] In what was Treasury's first effort under the Tax Cuts and Jobs Act to justify an exemption from APA-mandated rulemaking procedures, it made four arguments, none of which made the case that a public policy emergency warranted a departure from notice and comment rulemaking.[25]

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[12] 5 U.S.C. section 553, subsection (b)(4)(B).

[13] *United States v. Cain*, 583 F.3d 408, at 421 (6th Cir. 2009).

[14] *Home Box Office Inc. v. FCC*, 567 F.2d 9, 35 (D.C. Cir. 1977).

[15] *See Wing v. Commissioner*, 81 T.C. 17, 26-27 (1983).

[16] *Mayo Foundation for Medical Education and Research v. United States*, 562 U.S. 44 (2011).

[17] *Dominion Resources Inc. v. United States*, 681 F.3d 1313, 1314 (Fed. Cir. 2012).

[18] *See Mann Construction Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022); *CIC Services LLC v. IRS*, 592 F. Supp. 3d 677 (E.D. Tenn. 2022).

[19] *Mann Construction*, 27 F.4th 1138.

[20] Kristin E. Hickman, "Unpacking the Force of Law," 66 *Vand. L. Rev.* 465, 524 (2013).

[21] *CIC Services*, 592 F. Supp. 3d 677.

[22] *Id.* at 687.

[23] *Id.* at 688.

[24] *Liberty Global Inc. v. United States*, No. 1:20-cv-03501 at *1 (D. Colo. 2022).

[25] *Id.*

The Latest Reg Invalidation Caused by the APA

On March 28 the Tax Court in *Valley Park Ranch* took a fresh look at a pivotal regulation affecting the legal landscape of conservation easement deductions.[26] The court boldly invalidated reg. section 1.170A-14(g)(6)(ii) by citing noncompliance with the APA. This regulation was previously instrumental in enabling the IRS to reject deductions claimed by taxpayers under the pretext of conservation easements by imposing strict conditions that required the easements to be perpetual.

In 2016 Valley Park Ranch LLC, a partnership, conveyed a conservation easement over its 45.76-acre property to the Compatible Lands Foundation. However, the IRS rejected the partnership's claim for a $14.8 million tax deduction, saying it did not satisfy all the requirements for deducting a noncash charitable contribution under reg. section 1.170A-14(g)(6)(iii).

Reg. section 1.170A-14(g)(6)(ii) outlines the allocation of condemnation sale proceeds between a donor and donee in extinguishing a conservation easement. These regulations ensure compliance with section 170(h)(5) and the protected-in-perpetuity requirement by mandating a proportional distribution of proceeds between the donor and donee.

The IRS claimed that the deed did not meet the protected-in-perpetuity requirement since it did not follow the specific formula in the event of easement extinguishment. Valley Park Ranch argued that the deed was valid specifically because reg. section 1.170A-14(g)(6)(iii) was invalid on the grounds that it violated the APA. Valley Park Ranch highlighted the fact that Treasury did not address significant comments made during the rulemaking process, as required by the APA.

Initially, in *Oakbrook Land Holdings*,[27] the Tax Court held that Treasury complied with the APA because one could infer that the preamble to the regulations covered the "basis and purpose" of the judicial extinguishment provision. However, in *Hewitt*,[28] the Eleventh Circuit disagreed with this stance, prompting the Tax Court to revisit its prior decision in *Oakbrook* and conclude in *Valley Park Ranch* that reg. section 1.170A-14(g)(6)(ii) was procedurally invalid under the APA for failing to respond to significant comments. The Tax Court thus concluded that the deed in *Valley Park Ranch* met the "restriction (granted in perpetuity)" requirement of section 170(h)(2)(C) and the protected in perpetuity requirement of section 170(h)(5)(A). The court's determination that reg. section 1.170A-14(g)(6)(ii) failed to comply with the APA signifies the latest trend in the landscape of tax regulation.

The ERC Explained

Now that the APA scene is set, we turn to an area ripe for controversy — the ERC. On March 27, 2020, Congress enacted the Coronavirus Aid, Relief, and Economic Security Act to provide relief to businesses in need by incorporating the ERC as part of its provisions. Specifically, section 2301 of the CARES Act, which has since been modified and integrated into the code,[29] allows eligible employers to receive a credit against applicable employment taxes if they paid qualified wages (which includes some healthcare expenses) to their employees between March 12, 2020, and, in certain cases, before January 1, 2022.

The ERC is a refundable payroll tax credit that can be as high as $5,000 per employee in 2020 and as high as $21,000 per employee in 2021. Employers qualify in three ways by being either: (1) recovery start-up businesses, (2) employers that experienced a qualifying decline in quarterly gross receipts, or (3) business operations that were suspended under governmental orders.[30]

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[26] *Valley Park Ranch*, 162 T.C. No. 6.

[27] *Oakbrook Land Holdings LLC v. Commissioner*, 154 T.C. 180 (2020), *aff'd*, 28 F.4th 700 (6th Cir. 2022), *cert. denied*, 143 S. Ct. 626 (2023).

[28] *Hewitt v. Commissioner*, 21 F.4th 1136 (11th Cir. 2021).

[29] The CARES Act's section 2301 went through multiple amendments. First, the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Division EE of the Consolidated Appropriations Act, 2021) sections 206 and 207 (1) permitted eligible employers who received forgivable Paycheck Protection Program loans to also claim the ERC, (2) extended the ERC to include qualified wages paid before July 1, 2021, and (3) allowed eligible employers to claim a higher amount. The American Rescue Plan Act of 2021 introduced another amendment, which codified the ERC in section 3134. It also extended the ERC to the remainder of 2021 and introduced the recovery start-up business category. Lastly, the Infrastructure Investment and Jobs Act limited eligibility for wages paid after September 30, 2021, to only eligible employers who qualified as recovery start-up businesses.

[30] Section 3134.

An employer qualifies as a recovery start-up business if it began carrying on any trade or business after February 15, 2020, and before September 31, 2021, with gross receipts not exceeding $1 million.[31] An employer qualifies under the gross receipts test if its gross receipts declined more than 50 percent in one quarter compared with 2019.[32] An employer remains eligible until its gross receipts experience a less than 20 percent decline in revenue compared with 2019.[33] An employer qualifies in 2021 until September 30, 2021, if its gross receipts declined at least 20 percent compared with 2019.[34] For an employer to be deemed eligible based on a suspension of operations, its trade or business must have been partially or fully suspended because of governmental orders limiting commerce, travel, or group gatherings for commercial, social, religious, or other purposes as a result of the COVID-19 pandemic.

To modify the ERC the IRS issued administrative guidance in the form of notices, revenue procedures, chief counsel advisories, frequently asked questions, checklists, temporary regulations, and final regulations.[35] On July 29, 2020, it issued temporary regulations amending the employment tax regulations under sections 3111 and 3221.[36] Further, on September 10, 2021, the IRS issued temporary regulations amending the employment tax regulations under sections 3131 through 3134.[37] Then on July 24, 2023, Treasury and the IRS issued final regulations.[38]

Notice and Comment Challenge

In the extensive administrative guidance issued by the IRS, Notice 2021-20, 2021-11 IRB 922, and the final regulations stand out. These directives are expected to incite a significant amount of litigation, as shown by a current challenge in *Southern California Emergency Medicine.*[39] In that case, the taxpayer used Form 941-X, "Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund," and claimed ERCs for six quarters in 2020 and 2021 on the grounds that its operations experienced a partial suspension under an appropriate government order.[40] However, the IRS issued notices of disallowance for all quarters based on Notice 2021-20, resulting in denied refunds.

Notice 2021-20 offers additional guidance on the definition of governmental orders and partial suspension of trade or business operations when qualifying for the ERC. Specifically, the notice provides guidance on partial suspensions. For example, Section III, Part D, Q&A 11 of the notice says that if an employer operating an essential business has more than a nominal portion of its operations suspended by a governmental order, it may be considered to have a partial suspension of operations.[41]

Southern California Emergency Medicine thus filed suit requesting that the court rule Notice 2021-20 invalid under the APA notice and comment procedures. It contends that Notice 2021-20 has the force and effect of law and imposes penalties when taxpayers deviate from that guidance. Thus, the notice is not an interpretative rule and is subject to the notice and comment rulemaking process required under the APA. This is analogous to *Mann Construction*, as the notice exercised an express and binding delegation of rulemaking power.

The other administrative guidance that presents APA challenges are the final regulations published July 24, 2023.[42] The regulations closely resemble the temporary and proposed regulations promulgated in 2020 and 2021.[43]

[31] Section 3134(c)(5).

[32] CARES Act, section 2301(c)(2)(A)(i); Notice 2021-20, Section III.E.

[33] CARES Act, section 2301(c)(2)(A)(i); Notice 2021-20, Section III.E.

[34] Section 3134(c)(2)(A)(ii)(II); Notice 2021-23, 2021-16 IRB 1113, Section III.C.

[35] *See*, *e.g.*, Notice 2020-22, 2020-17 IRB 664; Notice 2021-20; Notice 2021-23; Notice 2021-24, 2021-18 IRB 1122; Notice 2021-49, 2021-34 IRB 316; T.D. 9904; T.D. 9953; T.D. 9978.

[36] T.D. 9904.

[37] T.D. 9953.

[38] T.D. 9978.

[39] Complaint for Injunctive Relief, *Southern California Emergency Medicine v. Werfel*, No. 5:23-cv-02450 (C.D. Cal. 2023).

[40] T.D. 9904.

[41] The IRS explains that an employer that maintains both essential and nonessential business operations, each of which are more than nominal portions of the business operations, may be considered to have a partial suspension of its operations if a governmental order restricts the operations of the nonessential portion of the business, even if the essential portion of the business is unaffected.

[42] T.D. 9978.

[43] T.D. 9953.

Moreover, the final regulations contain a comprehensive preamble. As a result, a notice and comment challenge similar to the one in *Valley Park Ranch* is unlikely.

Possible APA Challenge to ERC Regs

While a notice and comment challenge may not be forthcoming, it is expected that a *Chevron*[44] challenge will arise in relation to reg. sections 31.3134-1(a), 31.3111-6(b), and 31.3221-5(b). Those sections provide that any claimed ERCs that a taxpayer is not entitled to will be considered an underpayment of employment taxes. Consequently, the IRS can recover the underpayment through an assessment. Even more detrimental is that penalties under sections 6662 and 6663 could apply to any erroneous refunds.[45]

The preamble to the regulations seeks to preempt any potential notice and comment challenges by indicating that only two comments were received in response to proposed regulations under sections 3111 and 3221, with none received for sections 3131 through 3134.[46] Regrettably, the comments did not address the critical issue of erroneous refunds of credits under the Families First Coronavirus Response Act and the CARES Act,[47] meaning that notice and comment challenges are not applicable to the ERC's assessment and recapture regulations. Still, a *Chevron* challenge to these sections of the final regulations may be a suitable option.

Treasury and the IRS justified their authority to publish regulations concerning the assessment and recapture of ERC funds in section 2301 of the CARES Act and section 3134.[48] According to the preamble, section 2301(I) grants Treasury the authority to publish regulations that deter the circumvention of the restrictions specified in section 2301 of the CARES Act.[49] Further, the IRS relies on section 3134(j)(B), which enables the direct assessment of erroneous funds of advance payments.[50]

The final regulations appear to broaden the authority Congress delegated to Treasury and the IRS. According to these regulations, any excess ERC is classified as a tax increase, rather than solely advanced ERC payments. As a result, the IRS is authorized to assess the underpayment and impose related underpayment penalties. Therefore, a *Chevron* challenge arises from the possibility that Congress did not grant Treasury and the IRS the power to consider an erroneous refund as a form of underpayment of tax that can be penalized for underpayment and subject to assessment procedures.

Conclusion

Valley Park Ranch marks a decisive blow to tax exceptionalism and underscores the trend of federal courts holding the IRS and Treasury to a higher standard than ever. The effect of this standard is significant, providing taxpayers with a stronger foundation to challenge ERC administrative guidance. In particular, taxpayers have the opportunity to succeed in a notice and comment challenge to Notice 2021-20 or a *Chevron* challenge to reg. sections 31.3134-1(a), 31.3111-6(b), and 31.3221-5(b). Considering the IRS's intensified enforcement, taxpayers must consider their defense strategies. To do so effectively, it is imperative that they seek the guidance of qualified tax attorneys who are free from any conflicts of interest. These professionals can help assess the various options available and prepare for any necessary defense. ■

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[44] *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984).

[45] Reg. sections 31.3134-1(a), 31.3111-6(b), and 31.221-5(b).

[46] T.D. 9978, Preamble, Section V.

[47] T.D. 9978, Preamble, Summary of Comments and Explanation of Revisions.

[48] T.D. 9978, Preamble, Section V.

[49] *Id.*

[50] *Id.*