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State Administrative Procedure Acts: Procedural Avenues to Attack Faulty Regulations and Assessments

Taxpayers and practitioners alike should be on the lookout for potential APA violations in any dispute with a state department of revenue.

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During a panel discussion at the fall 2008 meeting of the American Bar Association Section of Taxation, U.S. Tax Court Judge Mark V. Holmes stated that the country is entering a "golden age" for tax litigators. When the panel discussion turned to the issue of when taxpayers may ignore Internal Revenue Service (IRS) regulations or guidance, Judge Holmes suggested that tax practitioners not rely solely on that guidance during litigation. As a result of Judge Holmes' candid remarks, the authors began to contemplate when *state* taxpayers (and their advisors) should rely on regulations or other statements issued by state departments of revenue. As discussed below, taxpayers need not always rely on or consider themselves bound by those statements, which may be invalidated when they were not promulgated pursuant to the particular state's administrative procedure act ("APA").

Comparison of Federal APA With State APAs

After the U.S. Supreme Court's landmark decision in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,[1] a nontax case, federal courts have struggled to define precise limits on the Treasury Department's delegated rulemaking authority and the degree of deference accorded to Treasury regulations.[2] Nevertheless, the IRS has exercised quasi-legislative authority to promulgate intricate and far-reaching regulations, such as the 1996 "check-the-box" rules for classifying various business entities,[3] and the Subchapter K "anti-abuse" regulations.[4]

Such "legislation" by an administrative agency charged with tax law enforcement would be unthinkable under most state administrative procedure acts. As noted in the "Background & Issues Statement" to the draft 2008 Model State Administrative Procedure Act, state legislatures in recent years have increased oversight and created mechanisms and procedures to overrule agency action, thereby circumscribing both the adjudicatory and rulemaking authority of administrative agencies. [5] For example, Florida's APA now provides:

"A grant of rulemaking authority is necessary but not sufficient to allow an agency to adopt a rule; a specific law to be implemented is also required. An agency may adopt only rules that implement or interpret the specific powers and duties granted by the enabling statute. No agency shall have authority to adopt a rule only because it is reasonably related to the purpose of the enabling legislation and is not arbitrary and capricious or is within the agency's class of powers and duties, nor shall an agency have the authority to implement statutory provisions setting forth general legislative intent or policy. Statutory language granting rulemaking authority or generally describing the powers and functions of an agency shall be construed to extend no further than implementing or interpreting the specific powers and duties conferred by the same statute." [6]

Thus, although the terminology is similar in both the state and federal systems, [7] the validity of state tax regulations will generally be decided on substantive principles that may differ significantly from their federal counterparts.

Revenue Departments Are Subject to APA Provisions

An APA applies only to state agencies. Therefore, in order for an APA to apply to a particular state governmental entity, that entity must be an "agency." Absent a statute—and sometimes even with a statute—there is no general agreement as to precisely which governmental authorities are covered "agencies." For example, the current (adopted in 1981) Model State Administrative Procedure Act (MSAPA) generally defines an agency as "a board, commission, department, officer, or other administrative unit of this State...." [8]

There is no disagreement that the IRS is an agency under the federal definition of an "agency." [9] Similarly, state departments of revenue generally qualify as agencies. Therefore, they usually are subject to the provisions of their respective state APAs. [10] Once it is determined that a particular governmental entity is an agency covered by a state's APA, the next step is to determine whether that agency's policy statement or interpretation is a "rule" for purposes of the state's APA.

Determining whether a revenue department position is a "rule."

If an agency's policy statement or interpretation is a rule, it is subject to the promulgation requirements (discussed below) of the state's APA. Any rule that fails to meet the set requirements is likely invalid, thereby rendering any assessment issued in reliance on it likewise invalid. Note, however, that at least at the administrative level, a valid legislative rule conclusively settles the matter it addresses, though it is not immune from judicial review. [11]

In general, a rule is "the whole or a part of an agency statement of *general applicability* that implements, interprets, or prescribes (i) law or policy, or (ii) the organization, procedure, or practice requirements of an agency." [12] The key element of this definition is that the statement must have general applicability. For an agency statement to constitute a rule, it must impact a broad segment of the population to which it is addressed.

In contrast, intra-agency memoranda or statements that concern only the internal management of an agency and do not affect the rights or procedures available to the public at-large likely do not fall within the definition of a rule. [13] In addition, letter rulings, attorney general opinions, or requests for rulings on a particular set of facts unique to a single taxpayer are not considered rules under most state APAs, because they lack general applicability to all taxpayers. [14]

The most obvious example of a rule is a revenue department's regulations promulgated pursuant to an enabling statute. Generally, these are the most important and familiar types of revenue department rules; having the "force and effect of law," they should always be "rooted in a grant of power by the [state legislature]." [15] In addition, a rule also includes "the amendment, repeal, or suspension of an existing rule." [16] Interestingly, under the MSAPA definition, as well as under similar state definitions, agency forms (e.g., tax return forms and instructions) are considered rules. Thus, if a department of revenue takes a position contrary to its own forms or instructions, it arguably is acting unlawfully by not following its own rules. [17]

A long-standing principle of administrative law holds that the definition of the term "rule" is to be interpreted broadly. [18] Indeed, rules are not limited solely to regulations and other more formal interpretive pronouncements from administrative agencies, but encompass any agency standard or policy (including informal interpretations of more formal rules and regulations) that has general applicability to the public. [19] Not all courts are as liberal in construing what constitutes a rule, however, and in some instances, courts have concluded that an agency statement is merely a guideline instead of a rule, thereby allowing the statement to escape the requirements of the state's APA. [20]

Rulemaking

Although there are four methods by which an agency can make a rule, [21] this discussion focuses primarily on what is referred to as "informal rulemaking," since it is the most common method used by state revenue departments. In the absence of an express directive to the contrary in an agency's enabling legislation, informal rulemaking likely will apply. [22] Informal rulemaking generally requires an agency to adhere to an APA's public "notice and comment" procedures; some states, however, also impose other requirements (e.g., the issuance of an economic impact study). Thus, where a statute merely authorizes the department of revenue to issue regulations and those regulations will affect the legal rights of private parties, at a minimum the agency likely will be required to follow the notice-and-comment procedures.

Notice of proposed rule adoption.

Public notice requirements in rulemaking proceedings are essential to ensure that affected taxpayers have an opportunity to participate in the process. [23] Without adequate notice, taxpayers will not know of the existence of pending revenue department rules, which may affect them, and therefore, will be unable to voice their concerns or to submit useful data to the department of revenue contemplating such action. In that way, the notice requirement encourages information-gathering by the department of revenue and enables taxpayers to express their opposition to (or support for) a proposed rule.

Under the MSAPA: "At least [30] days before the adoption of a rule an agency shall cause notice of its contemplated action to be published in the [administrative bulletin]. The notice of proposed rule adoption must include: (1) a short explanation of the purpose of the proposed rule; (2) the specific legal authority authorizing the proposed rule; (3) ... the text of the proposed rule; (4) where, when, and how persons may present their views

on the proposed rule; and (5) where, when, and how persons may demand an oral proceeding on the proposed rule if the notice does not already provide for one." [24]

Timing of notice. Any bracketed text in the MSAPA is intended to be merely a suggestion. Hence, where the MSAPA (in §3-103(a), as quoted above), suggests that the public be given "At least [30] days" advance notice of a proposed rule adoption, states may select a suitable alternative. For instance, Alabama requires 35 days' advance written notice of a proposed rule change, whereas Florida's statute requires only 21 days. [25] Therefore, it is important for taxpayers and practitioners alike to review their individual state's APA to determine its notice period and ensure that public comments are timely submitted.

Publication of notice. MSAPA §3-103(a) also requires timely notice of a proposed rule to be published in the state's official medium for such notices, usually an administrative bulletin. Many state APAs contain a similar provision and require notice of proposed rule adoption to be published in an official state publication. [26] Furthermore, the MSAPA, as well as many states, impose an additional requirement: "Within [3] days after its publication in the [administrative bulletin], the agency shall cause a copy of the notice of proposed rule adoption to be mailed to each person who has made a timely request to the agency for a mailed copy of the notice." [27]

Failure by a state department of revenue to timely publish notice of a proposed rule can lead to the rule's invalidation by the courts. For instance, in *Stiff v. Alabama Alcoholic Beverage Control Board,* [28] the Alabama Supreme Court held that the state's Alcoholic Beverage Control (ABC) Board violated the Alabama Administrative Procedure Act by failing to establish a procedure by which the price of table wine is marked-up and by failing to publish that procedure in the *Alabama Administrative Monthly* "so that 'interested persons' would have an opportunity to submit to the ABC Board comments or proposals about the procedure."

Another example is a pending case in North Carolina, a taxpayer has requested leave to amend its complaint to include, inter alia, certain APA arguments, alleging that the North Carolina Department of Revenue has "used either 'secret law,' or no legal standards at all, to arbitrarily increase the taxes and penalties assessed against [the taxpayer]." [29] Essentially, the taxpayer alleges that the North Carolina Department of Revenue failed to provide taxpayers with notice of what criteria it uses in determining whether affiliated corporations will be forced to file on a combined basis. [30] The motion to amend the taxpayer's complaint, which reads like a John Grisham novel, includes particularly damning quotes by Department of Revenue officials whereby they flatly refuse to provide such guidance to taxpayers or their representatives. [31] Ironically, the motion to amend the taxpayer's complaint includes a copy of an e-mail from one Department of Revenue official to another explaining his reluctance to issue guidance *even to their own auditors*: "[I]f we communicate 'guidelines' to our audit staff ... [the guidelines] will eventually fall into the hands of the dreaded Jung Hoard (also know [sic] as [taxpayers] and their representatives) and will be used against us." [32] Needless to say, it will certainly be interesting to see how this case progresses.

Public participation. The underlying idea behind requiring an agency to give notice to the public is that interested members of the public should have a meaningful opportunity to contribute to the rulemaking process by submitting data and argument in order to ensure that those responsible for making the rule obtain all the information, facts, and probabilities necessary to make decisions that are both intelligent and fair. In addition, the opportunity for public comment allows an unrepresented or underrepresented minority to voice concerns that the agency may have failed to consider in drafting the rule. Under the MSAPA, for a period of "at least [30] days" after publication of a notice of

the proposed adoption of a rule, an agency must allow persons to submit information and comment on the proposed rule.[33] Based on the authors' experience, most departments of revenue permit the information or comments to be submitted electronically or in writing.

Time for rule adoption. Needless to say, the public's right to participate would be meaningless if the agency could adopt the rule before the period for public participation expired or if the agency was not required to consider adverse written and oral submissions on a proposed rule. Therefore, under the MSAPA, an agency must wait until the periods for making written or oral submissions on a proposed rule have expired before adopting the proposed rule.[34] Finally, the MSAPA imposes a 180-day time limit on the effectiveness of the published notice of proposed rulemaking, so that an agency must either adopt the proposed rule or terminate the rulemaking proceeding by publication of a notice to that effect.[35]

Regulatory analysis, including an economic impact statement, may be required. In addition to the notice-and-comment requirements discussed above, many states require that certain rules be accompanied by a regulatory analysis. Under the MSAPA, an agency must prepare a regulatory analysis of a proposed rule if, within a specified time period (typically 20 days), a written request for the analysis is filed in the office of the secretary of state by the governor, an agency, or 300 persons signing the request.[36] A regulatory analysis generally must contain: (1) a description of the classes of persons affected by the rule; (2) a description of the rule's probable impact, economic or otherwise; (3) an estimate of the probable costs and benefits of the rule as compared with the probable costs and benefits of inaction; and (4) a determination of whether there are less costly or less intrusive methods of achieving the rule's purpose.

Often, state laws (or political exigencies) require that department of revenue rules be revenue neutral. Therefore, if the economic impact statement, often termed the "fiscal note," indicates that a rule will likely increase taxes, the rule may be subject to challenge.

When Revenue Departments Fail to Follow Rulemaking Procedures

Possible rulemaking violations may include adopting a rule that differs from the proposed rule; that enlarges, modifies, or contravenes a statute; or that is retroactive.

Adopted rules that differ from the proposed rules. In general, an agency may not adopt a rule that is substantially different from the rule the agency proposed in the notice of proposed rule adoption, unless the version being adopted is a *logical outgrowth* of the rule proposed in the notice.[37] Essentially, the MSAPA creates a functional test that draws upon similar provisions in various states[38] and is designed to determine whether the proposed rule's publication gave the public fair notice that the result of the rulemaking proceeding might be the rule actually adopted by the agency. The following factors are to be considered in determining whether the adopted rule is "substantially different" from the proposed rule contained in the published notice: (1) the extent to which all persons affected by the adopted rule should have understood that the published proposed rule would affect their interests; (2) the extent to which the subject matter of the adopted rule or the issues determined by that rule are different from the subject matter or issues involved in the published proposed rule; and (3) the extent to

which the effects of the adopted rule differ from the effects of the published proposed rule had it been adopted instead. [39]

Practitioners should pay careful attention when evaluating the text of an adopted rule to determine whether it is the logical outgrowth of the proposed rule. This concern is one of the most frequently litigated issues in administrative law. [40]

Rules that enlarge, modify, or contravene a statute. Another way in which a state revenue department can fail to follow administrative procedures is by issuing a rule that either expands the scope of a statute or directly contradicts the statute. Some states, like Florida, have statutes that define an "invalid exercise of delegated legislative authority" to include, inter alia, any rule that "enlarges, modifies, or contravenes the specific provisions of law implemented." [41] This, arguably, is the tool most frequently used by taxpayers to invalidate a revenue department's statement. [42]

For instance, in *Agnew v. California State Board of Equalization,* [43] the California Supreme Court invalidated the State Board of Equalization's policy requiring a taxpayer to pay both accrued interest on a tax assessment and the tax itself as a prerequisite to Board consideration of the taxpayer's claim for refund of sales and use taxes. The court found such an administrative policy to be inconsistent with the underlying statute, which stated simply that a refund action could be maintained "after payment of a tax," and there was no evidence that any definition of "tax" included "interest."

In contrast to the pro-taxpayer holding in *Agnew,* the Georgia Court of Appeals, in *Georgia Department of Revenue v. Georgia Chemistry Council, Inc.,* [44] took a view more lenient toward the state's Department of Revenue when considering a claim for an income tax credit. The Georgia court upheld a rule that engrafted onto a tax credit statute a requirement calling for three years of positive taxable income. Of course, statutes granting tax credits, in contrast to statutes imposing taxes, are typically construed against the taxpayer, and this likely affected the court's decision.

Retroactive rules. From the standpoint of general notions of due process, administrative rules should govern only future conduct, not conduct occurring prior to the rule's adoption. According to the U.S. Supreme Court, a rule cannot be retroactive unless its authorizing statute explicitly empowers the agency to adopt a retroactive rule. [45] Some state APAs contain express prohibitions against retroactive rulemaking, at least in the absence of specific legislative authority. [46]

Taxpayers have had some success in invalidating assessments or receiving refunds when they could show that the department of revenue was attempting to retroactively apply a rule. For instance, in *Motiva Enterprises, LLC v. Alabama Department of Revenue,* [47] the taxpayer successfully demonstrated that the Alabama Department of Revenue was, in effect, attempting to retroactively apply a new rule. In this case, the Department, in response to the taxpayer's claim for a refund of wholesale oil license tax, sent a letter requiring the taxpayer to provide copies of motor fuel tax returns and sales records belonging to the distributors to whom the taxpayer sold the diesel fuel in question. Shortly *after* sending the letter, the Department promulgated Ala. Admin. Code r. 810-8-1-.06, which adopted, almost verbatim, the recordkeeping/gathering requirements set forth in the letter. In granting the taxpayer's refund petition, the administrative law judge stated: "The Department concedes that the regulation was enacted after the fact and does not apply to the period in issue. It nonetheless is in substance attempting to make those recordkeeping requirements retroactive to the subject year. But even if the regulation had been in effect in the subject year, the requirement. . . would still be rejected.... The recordkeeping requirements ... are clearly unreasonable."

Exempted Rulemaking

As discussed above, the MSAPA, as well as most state APAs, generally requires that the issuance of rules be preceded by a notice-and-comment process. Certain interpretative statements and general statements of policy, however, are often exempted as "guidance documents." [48] For purposes of the 2006 draft revision of the MSAPA, a "guidance document" is "a record developed by an agency that informs the general public of an agency's current approach to, or opinion of, law, including, where appropriate, the agency's current practice, procedure, or method of action based upon that agency's current approach or opinion." [49] Many states recognize such documents under the label "general statements of policy" or "interpretative statements." [50]

General statement of policy. A "general statement of policy" explains how the agency intends to use its lawmaking power in the future but does not attempt to bind anyone immediately. In theory, these are exempt from the rulemaking procedures because they do not alter anyone's rights, but merely demonstrate an agency's intentions. Nevertheless, courts do not always take at face value an agency's representations as to its intentions. If the language of the statement, or the way in which the agency implements it, suggests that the agency will not give opposing parties a genuine opportunity to reopen the issue, the court may conclude that the agency is trying to give its statement the force and effect of law, which would make notice and comment essential. [51] In addition, courts may require an agency to go through the notice-and-comment process when the agency intends to change a longstanding policy. [52]

Interpretive rules. An interpretive rule differs from a legislative rule because it is not intended to alter legal rights but, rather, merely to state the agency's view of what the existing law already requires (e.g., an opinion issued by a state attorney general). Again, these "interpretations" of the law are not generally subject to the APA notice-and-comment requirements. Nevertheless, a court is more likely to conclude that the agency is trying to establish a new legal obligation, thereby making compliance with APA procedures necessary, if the rule expresses a position that does not seem directly rooted in the statutory language, particularly if the rule sharply departs from a previously accepted interpretation or effectively amends a prior legislative rule. [53]

Often, a revenue department will claim that it is relying on an "interpretative rule" in issuing an assessment, as a defense to a taxpayer's assertion that the department failed to follow the state APA's public notice-and-comment procedures. In *Wisne v. Michigan Department of Treasury,* [54] Michigan taxpayers moved to Florida, sold their business, and allocated the gain to Florida. Relying on a Department-issued Revenue Administrative Bulletin ("RAB"), [55] the Michigan Tax Tribunal affirmed the Department's imposition of a 25% penalty for intentional disregard of the law. The RAB provided that the taxpayer bore the burden of establishing facts to negate a finding of intent if the taxpayer objected to a discretionary penalty. The Michigan Court of Appeals overturned the decision, however, concluding that the Tribunal incorrectly relied on the RAB to allocate the burden of proof to the taxpayer. The court concluded that the RAB was not a rule and therefore did not have the force and effect of law because it was not adopted under the APA; RABs are simply "bulletins that explain the current department interpretations of current state tax laws." [56] By shifting the burden of proof to the taxpayer, the RAB exceeded the boundaries of an interpretative rule because it had general applicability to all taxpayers.

In contrast to department of revenue statements that affect taxpayers' legal burdens, departments of revenue are frequently given more latitude and greater judicial deference

when issuing statements affecting procedural and ministerial matters such as maintenance of taxpayer records. [57]

Administrative Rules Review Committee

The MSAPA provides that a state may allow for an "administrative rules review committee," [58] often the last chance to prevent a rule's adoption. Such a review committee should be bipartisan, generally consisting of members of the state legislature (both the House and the Senate, as applicable). [59] The committee will examine proposed agency rules and review existing rules on an ongoing basis to determine whether a rule is proper. If the committee determines that the rule is improper in any way, it may cause the agency to withdraw or amend the rule. [60]

Despite the existence of a model act, the actual review procedures for each state vary widely. [61] Often, legislative review committees consist of many individuals and it may be difficult for them to meet on short notice. This can pose additional problems in states like Alabama, where each rule adopted is effective 35 days after filing with the legislative review committee, unless the committee votes to disapprove it or proposes an amendment. [62] Consequently, practitioners are advised to regularly monitor state revenue department bulletins to make use of the notice-and-comment period, since relying on an administrative rules review committee not only to timely meet (with the requisite quorum) but also to vote to reject a rule, may be a risky proposition.

Should Department of Revenue Rules Receive Deference in Tax Cases?

Consider a tax imposition statute that follows the familiar pattern by providing: "A tax is hereby imposed on A, B, and C," with the statute defining terms "A," "B," and "C" generally. A particular transaction, "X," arguably could either come within or fall outside the definition of "B." That is, the definition of "B" is fairly susceptible to two different meanings as applied, and one cannot determine from the language of the statute whether the legislature intended transaction X to be taxable. Thus, the statutory definition of "B" is ambiguous as applied to the transaction in question. If the state taxing authorities, *by rule,* have defined "B" so as to include that transaction among the taxable transactions, would the rule be valid?

In the absence of such a rule, a court confronted with this situation would likely follow the customary rule of strict construction of tax imposition statutes, and thus resolve the statutory ambiguity in favor of the taxpayer. [63] In contrast, with regard to regulatory statutes (as opposed to tax statutes), courts generally defer to administrative agency expertise. [64] Thus, an agency is free in rulemaking to adopt a reasonable construction of an ambiguous statute. In litigating taxability issues, tax agencies often will cite this rule in arguing that their statutory interpretation should be entitled to deference.

Should tax statutes, however, be treated differently from regulatory statutes in this respect? In state constitutions, taxation is customarily entrusted exclusively to the legislature. One common constitutional formulation states: "No tax shall be levied except in pursuance of law." [65] Arguably, this constitutional structure underlies the rule of strict construction of tax statutes. As noted by one Florida court, "The Department of Revenue has no power to tax. That power is reposed solely in the legislature. A tax sought to be imposed without legislative authority is a nullity." [66] In the regulatory context, there is a logical basis for the rule of deference to agency expertise. Agency personnel, who regularly deal with technical matters such as air pollution, medical licensing, or insurance

company capital requirements, may be uniquely equipped to fill in the gaps, and to resolve any ambiguities in legislative pronouncements. In the tax realm, an administrative agency may similarly possess technical expertise in *procedural* aspects of taxation, such as required taxpayer records, audit processes, application for dealer registration, etc. [67]

There is no reason to believe, however, that any administrative agency possesses unique expertise in determining whether the legislature intended a particular transaction or event to be within, or without, the boundaries of an ambiguous tax imposition statute. This suggests an arguable, if implicit, constitutional basis for the rule of strict construction of tax statutes in favor of the taxpayer. Few reported judicial decisions even suggest this analysis, and the authors are not aware of any reported case that articulates such analysis in addressing the validity of a regulation that purports to resolve an ambiguity in a tax statute.

In *Lowney v. Commissioner of Revenue,* [68] a Massachusetts lodging tax applied to any "occupancy," which was defined as possession or the right to possession of premises "for a period of ninety consecutive calendar days or less." The issue was whether a hotel operator should collect *any* tax from guests who stayed longer than 90 days. An administrative regulation attempted to resolve this arguable statutory ambiguity by requiring the hotel operator to collect tax on up to the first 90 days of any occupancy, including those occupancies that exceeded 90 days. The Massachusetts appellate court applied the rule of strict construction in favor of taxpayers, and rejected the Commissioner's interpretation of the statute. The court distinguished between the procedural aspects of tax collection, for which deference would be due to the administrative interpretation, and the question of taxability, for which less deference applied. Nonetheless, the court's treatment of the issue did not suggest that a tax agency would be treated any differently from any other state agency: "The commissioner's interpretation in this instance, however, relates to more than implementation or administration of the statutory scheme. It is a determination of the underlying basis of taxability created by the Legislature, and we conclude that the commissioner's interpretation imputes added terms to [the statute's] plain language defining the activity that triggers a tax. In such a case, where a term in a statute is allegedly ambiguous, courts have found that an agency's interpretation of a statute is, at best, entitled to 'some deference,' albeit not 'the "great weight" given to a duly promulgated administrative regulation which lends specificity to a broad statutory scheme.'" (Internal citations omitted.)

While *Lowney* arguably supports the notion that an administrative rule may not resolve a statutory ambiguity in favor of taxability, the Massachusetts court also premised its ruling on its finding that the statute was clear as applied to the facts and the Commissioner's interpretation was "strained."

The opposite result was reached in *Appalachian Power Co. v. State Tax Department of West Virginia,* [69] where a statute provided that a tax on electricity applied to the "net generation available for sale." The question was whether power generated but lost to resistance in the transmission and distribution system (known as "line loss") was "available for sale." Logically, it would appear that the statute could be read either way. An administrative regulation, however, provided that in computing the tax, "[k]ilowatt hours of net generation available for sale ... shall not be reduced by ... line loss." The taxpayer argued that the regulation was invalid, in part because "it attempts to improperly exercise the authority of the Legislature." The West Virginia Supreme Court upheld the regulation, applying a *Chevron* [70] analysis and deferring to the state tax department's expertise in developing this "legislative" rule. According to the court: "Our power to review the Tax Commissioner's decisions on policy grounds is extremely limited.

We are not at liberty to affirm or overturn the Commissioner's regulation or decision merely on the basis of our agreement or disagreement with his policy implications, *even when important issues of taxation are at stake.*" (Emphasis added.)

The West Virginia court acknowledged that the statute was ambiguous, but treated the state tax commissioner no differently from any other administrative official, noting that "if the statute is silent or ambiguous with respect to the specific issue, the question for the Court is whether the Tax Commissioner's answer is based on a *permissible construction* of the statute." [71] In view of the special rule requiring strict construction of tax statutes, we question whether administrative rules in such cases should be afforded any greater judicial deference than the taxing agency's statutory interpretation in the absence of any promulgated rule.

Conclusion: Considerations When Facing a Potential APA Issue in a State Tax Case

In this "golden age for tax litigators," taxpayers and practitioners alike should be on the lookout for potential APA violations in any dispute with a state department of revenue. Although a regulation or other department rule may not favor the taxpayer, the taxpayer nevertheless may be able to avoid an assessment where that regulation or rule was not properly promulgated. Therefore, when confronted with an assessment or an appeal in a tax case where an APA violation may be present, practitioners are faced with a number of considerations.

When taxpayers face a potential APA issue, the following questions should be considered:

> (1) Has the department of revenue applied, or changed, its application of a long-standing or otherwise consistent policy or interpretation of a statute?
> (2) Is the department of revenue's position a "rule" under the state's APA definition?
> (3) If the position is a rule, was it formally promulgated? Was it required to be promulgated?
> (4) Did the department of revenue follow all the necessary rulemaking procedures (i.e., notice and comment)?
> (5) If all the procedures were properly followed, does the adopted rule differ substantially from the proposed rule? Is it a logical outgrowth of the proposed rule?
> (6) Does the rule enlarge, modify, or contravene the enabling statute?
> (7) Is the rule vague or arbitrary or does it vest the department of revenue with near unlimited discretion?
> (8) Is the rule expressly retroactive? Is the department of revenue attempting to apply it retroactively?
> (9) Is there a specific legislative delegation of rulemaking authority? Is one required for this rule under the state's APA?
> (10) If there is a delegation statute, does it contain adequate standards?
> (11) Does the rule resolve an ambiguous tax imposition statute in the state's favor? Is this proper? **[]**

Sidebar

Practice Note: Looking for Potential APA Violations

When should—or must—taxpayers and their advisors rely on regulations or other statements issued by state departments of revenue? As discussed in the accompanying article, they need not always rely on or consider themselves bound by such pronouncements, which may be invalidated when the pronouncement is not promulgated pursuant to the particular state's administrative procedure act ("APA").

Taxpayers and practitioners alike should be on the lookout for potential APA violations in any dispute with a state department of revenue. When one is confronted with a potential APA issue, the following questions should be considered:

(1) Has the department of revenue applied, or changed, its application of a long-standing or otherwise consistent policy or interpretation of a statute?
(2) Is the department of revenue's position a "rule" under the state's APA definition?
(3) If the position is a rule, was it formally promulgated? Was it required to be promulgated?
(4) Did the department of revenue follow all the necessary rulemaking procedures (i.e., notice and comment)?
(5) If all the procedures were properly followed, does the adopted rule differ substantially from the proposed rule? Is it a logical outgrowth of the proposed rule?
(6) Does the rule enlarge, modify, or contravene the enabling statute?
(7) Is the rule vague or arbitrary or does it vest the department of revenue with near unlimited discretion?
(8) Is the rule expressly retroactive? Is the department of revenue attempting to apply it retroactively?
(9) Is there a specific legislative delegation of rulemaking authority? Is one required for this rule under the state's APA?
(10) If there is a delegation statute, does it contain adequate standards?
(11) Does the rule resolve an ambiguous tax imposition statute in the state's favor? Is this proper?

END NOTES

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[1]

467 US 837, 81 L Ed 2d 694 (1984) (the Supreme Court declared that a regulation is valid if (1) it is not contrary to the unambiguously expressed intent of Congress, and (2) the regulation is a reasonable construction of the statute).

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[2]

See, e.g., U.S. v. Cleveland Indians Baseball Co., 87 AFTR 2d 2001-1706, 532 US 200, 149 L Ed 2d 401, 2001-1 USTC ¶50341, 2001-2 CB 90 (2001); Swallows Holding, Ltd. v. C.I.R., 126 TC 96 (2006), *rev'd* 101 AFTR 2d 2008-876, 515 F3d 162, 2008-1 USTC ¶50188 (CA-3, 2008); McNamee v. Dept. of the Treasury, 99 AFTR 2d 2007-2871, 488 F3d 100, 2007-1 USTC ¶50515 (CA-2, 2007); Wolpaw v. C.I.R., 75 AFTR 2d 95-1110, 47 F3d 787, 95-1 USTC ¶50104 (CA-6, 1995); Central Pennsylvania Savings Ass'n v. C.I.R., 104 TC 384 (1995). The Internal Revenue Code contains both a general delegation of rulemaking authority, IRC §7805(a), and a host of specific delegations in varying terms, e.g., §§514(g), 884(g), and 7874(g).

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[3]

Treas. Reg. §301.7701-1 *et seq.*

[4]

Treas. Reg. §1.701-2.

[5]

See "2008 Model State Administrative Procedure Act: Background and Issues Statement," available on the website of the National Conference of Commissioners on Uniform State Laws, at www.nccusl.org (click on "NCCUSL Committees," "Drafting Committees," select "State Administrative Procedure—View Details," and click on "Background & Issues Statement 7/5/08"). The NCCUSL is a nonprofit, unincorporated association created in 1892 and comprised of more than 300 "uniform law commissioners," all members of the bar qualified to practice law. The commissioners are practicing lawyers, judges, law professors, and legislators who are appointed by the states (as well as by the District of Columbia, Puerto Rico, and the U.S. Virgin Islands) to research and draft uniform and model laws on matters where state uniformity is desirable and practical, and they work toward enactment of those models by the state legislatures.

[6]

Fla. Stat. §120.536(1).

[7]

For example, as discussed in the text below, many states distinguish "legislative" from "interpretive" regulations for purposes of the judicial deference to be afforded them; a similar distinction is made in the federal courts. See, e.g., cases cited in note 2, *supra.*

[8]

MSAPA §1-102(1). The 1981 "Model State Administrative Procedure Act" is available online at, e.g., www.nmcpr.state.nm.us/acr/presentations/1981MSAPA.htm (the website of the New Mexico Commission of Public Records).

[9]

5 USC §551(1).

[10]

See, e.g., Ala. Code §40-2A-7(a)(5), which expressly subjects the Alabama Department of Revenue to the state's APA; and Fla. Stat. §120.52(1), which defines an "agency" to include most state officials, departments, commissions, boards, etc., excluding only the legislature and the courts.

[11]

Pierce, *Administrative Law Treatise,* (4th ed., Aspen Publishers, 2002), Vol. I, §6.6 (citations omitted).

[12]

MSAPA §1-102(10) (emphasis added); see also Fla. Stat. §120.52(16), and Wash. Rev. Code §34.05.010(16).

[13]

See, e.g., Ala. Code §41-22-3(9); Fla. Stat. §120.52(16).

[14]

See, e.g., McDonald v. Dept. of Banking and Finance, 346 So 2d 569 (Fla. Ct. App. 1st Dist., 1977).

[15]

Chrysler Corp. v. Brown, 441 US 281, 60 L Ed 2d 208 (1979).

16

MSAPA §1-102(10).

17

See Florida Hi-Lift v. Dept. of Revenue, 571 So 2d 1364 (Fla. Ct. App. 1st Dist., 1990) (the Department "must honor its own rules until they are amended or abrogated"). Internal citation and quotation marks omitted.

18

See generally Bonfield, *State Administrative Rule Making* (1st ed., Little Brown & Co., 1986), §3.3.4. Citations omitted.

19

See Ala. Code §41-22-3(9); Ex parte Traylor Nursing Home, Inc., 543 So 2d 1179 (Ala., 1988), and Hartford Healthcare, Inc. v. Williams, 751 So 2d 16 (Ala. Civ. App., 1999).

20

See Duke Energy Arlington Valley, LLC v. Arizona Dept. of Revenue, 193 P3d 330 (Ariz. Ct. App. Div. 1, 2008) (taxpayer argued that tables used in preparing property valuations were rules and that the Department of Revenue failed to comply with the Arizona APA's promulgation requirements; the court held that the tables were *not* rules but were merely *guidelines,* because of how the tables operated and because the enabling statute referred to the tables as guidelines).

21

The four ways that an agency can make a rule are: (1) formal rulemaking; (2) informal rulemaking; (3) exempted rulemaking; and (4) adjudication.

22

See Fla. Stat. §120.54(1), which states: "Rulemaking is not a matter of agency discretion. Each agency statement defined as a rule ... shall be adopted by the rulemaking procedure ... as soon as feasible and practicable.... Rulemaking shall be presumed feasible [and] practicable...."

23

Several states have enacted public notice provisions quite similar to those of the MSAPA. Some states, however, merely authorize agencies to seek informal input before proposing a rule; several of them indicate that the purpose of this type of provision is to promote negotiated rulemaking. Those states include: Idaho (Idaho Code §67-5220); Montana (Mont. Code Ann. §2-4-304); and Wisconsin (Wis. Stat. §227.13). Illinois, however, has two rounds of mandatory notice and comment to ensure that all interested persons are fully apprised of the proposed rule and any changes subsequently made by the agency. See generally 5 ILCS §100/5-10 *et seq.*

24

MSAPA §3-103(a).

25

Ala. Code §41-22-5; Fla. Stat. §120.54(3)(a)1.

26

For instance, the Alabama Legislative Reference Service, pursuant to Ala. Code §41-22-7, publishes the *Alabama Administrative Monthly,* which contains notices by state agencies of the intent to adopt, amend, or repeal rules. Similarly, the Michigan Bureau of

Tax Policy, a division of the state's Department of Treasury, publishes directives known as Revenue Administrative Bulletins ("RABs"). The stated purpose of an RAB is to promote uniform application of tax laws by Bureau personnel and to provide information and guidance to taxpayers. An RAB states the official position of the Department, has the status of precedent in the disposition of cases unless and until revoked or modified, and may be relied on by taxpayers in situations where the facts, circumstances, and issues presented are substantially similar to those set forth in the Bulletin. For more information on RABs, see the Department's website at www.michigan.gov/treasury and click on "Revenue Administrative Bulletins."

27

MSAPA §3-103(b). Also see "Revised Model State Administrative Procedure Act—2006 Draft, with Prefatory Note and Comments" (for purposes of discussion at NCCUSL annual meeting, 7/7-14/06), Comment to §304, available online at www.nccusl.org (click on "NCCUSL Committees," "Drafting Committees," select "State Administrative Procedure—View Details," and click on "2006 Annual Meeting Draft"). Hereinafter, "2006 Draft RMSAPA."

28

878 So 2d 1138 (Ala., 2003).

29

Delhaize America, Inc. v. Hinton, N.C. Super. Ct., Wake County, Dkt. No. 07 CVS 020801 ("Plaintiff's Memorandum in Support of Its Motion to Amend Complaint," filed 1/16/09), available online via the website of the North Carolina Business Court, at www.ncbusinesscourt.net. The North Carolina Business Court, as described on that site, is a specialized forum of the North Carolina State Courts' trial division. Cases involving complex and significant issues of corporate and commercial law in the state are assigned by the Chief Justice of the North Carolina Supreme Court to a special superior court judge who oversees resolution of all matters in the case through trial.

30

Id.

31

Id.

32

Id., pages 3-4 (quoting a 3/21/06 e-mail from David Simmons to Gene Davis, et al.).

33

MSAPA §3-104(a).

34

MSAPA §3-106(a).

35

MSAPA §3-106(b).

36

MSAPA §3-105(a). See also 2006 Draft RMSAPA, *supra* note 27, §§305(a) and (b) (including a similar requirement for a requested regulatory analysis, and also requiring such analysis to be prepared, even absent a request, if the economic impact is above a certain to-be-specified dollar amount, as determined by each state).

37

MSAPA §3-107(a).

38

See, e.g., Miss. Code Ann. §25-43-3.107 (variance between adopted rule and published notice of proposed rule adoption); Minn. Stat. §14.05 (Administrative Procedure, general authority).

39

MSAPA §3-107(b).

40

The following cases discuss and analyze the logical outgrowth test: First American Discount Corp. v. Commodity Futures Trading Comm'n, 222 F3d 1008 (CA-D.C., 2000); Arizona Public Service Co. v. E.P.A., 211 F3d 1280 (CA-D.C., 2000); American Water Works Ass'n v. E.P.A., 40 F3d 1266 (CA-D.C., 1994); Trustees for Alaska v. Dept. of Natural Resources, 795 P2d 805 (Alaska, 1990); Sullivan v. Evergreen Healthcare Ltd., L.P., 678 NE2d 129 (Ind. Ct. App., 1997); Iowa Citizen/Labor Energy Coalition, Inc. v. Iowa State Commerce Comm'n, 335 NW2d 178 (Iowa, 1983); Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. Jorling, 152 Misc 2d 405, 577 NYS2d 346, 21 ELR 21447, 1991 WL 252642 (N.Y. Sup. Ct., 1991), *aff'd* 181 App Div 2d 83, 585 NYS2d 596, 1992 WL 143585 (App. Div. 3d Dept., 1992); Tennessee Environmental Council v. Solid Waste Disposal Control Bd., 852 SW2d 893 (Tenn. Ct. App., 1992); Texas Workers' Compensation Comm'n v. Patient Advocates of Texas, 136 SW3d 643 (Tex., 2004); Petition of Dept. of Public Service Respecting Application of General Order 65 and Rule 4.100 to Small Power Projects, 632 A2d 1373 (Vt., 1993); American Bankers Life Assur. Co. of Florida v. Division of Consumer Counsel, 263 SE2d 867 (Va., 1980). MSAPA §3-107 seeks to incorporate the factors identified in these cases. In addition, these judicial opinions convey the wide acceptance and use of the logical outgrowth test in the states.

41

Fla. Stat. §120.52(8)(c).

42

See, e.g., Fisher Broadcasting, Inc. v. Dept. of Revenue, 898 P2d 1333 (Ore., 1995) (court held an income tax apportionment rule invalid because it contradicted the statute); Guardian Industries Corp. v. Dept. of Treasury, 621 NW2d 450 (Mich. Ct. App., 2000) (court held an interpretive rule was invalid because the rule conflicted with a statute); 1 Stop Auto Sales, Inc. v. Ind. Dept. of State Revenue, 779 NE2d 614 (Ind. Tax Ct., 2002) (court invalidated a bad-debt rule because it added a requirement to the statute); Golden West Financial Corp. v. Fla. Dept. of Revenue, 975 So 2d 567 (Fla. Ct. App. 1st Dist., 2008) (court invalidated an income tax rule limiting net operating loss deductions for an affiliated group, because the rule was contrary to the governing statute); and Ala. Dept. of Revenue v. Jim Beam Brands Co., Inc., Ala. Civ. App., No. 2070768, 12/19/08, 2008 WL 5265050 (although the statute in question has since been repealed, the court held that the Department of Revenue's regulation for apportioning interest expense deductions to Alabama, employing the standard three-factor formula, conflicted with the statutorily prescribed "gross income ratio" formula and was therefore void).

43

981 P2d 52 (Cal., 1999).

44

607 SE2d 207 (Ga. Ct. App., 2004).

45

Bowen v. Georgetown University Hospital, 488 US 204, 102 L Ed 2d 493 (1988) (the Court struck down, for lack of explicit statutory authorization to apply retroactively, a federal Department of Health and Human Services rule that changed the charges—including with regard to charges previously incurred—for certain procedures for which the Department would reimburse hospitals under the Medicare program).

46

See 2006 Draft RMSAPA, *supra* note 27, §316 and comment; Fla. Stat. §120.54(1)(f).

47

Ala. Dept. of Rev., Admin. L. Div., Dkt. No. Misc. 08-410, 2/19/09 (app. pending).

48

See, e.g., 2006 Draft RMSAPA, *supra* note 27, §102(26)(H) (specifically excluding "guidance documents" from the definition of "rule").

49

Id., §102(10). This definition is derived from the APA's of Michigan (see Mich. Comp. Laws Ann. §24.203(6)) and Virginia (see Va. Code Ann. §2.2-4001).

50

See, e.g., Wash. Rev. Code §§34.05.010(8) ("interpretive statement") and (15) ("policy statement").

51

See, e.g., Community Nutrition Institute v. Young, 818 F2d 943 (CA-D.C., 1987).

52

See, e.g., Logan's Roadhouse, Inc. v. State of Alabama Dept. of Rev., Ala. Dept. of Rev., Admin. L. Div., Dkt. No. S. 08-700, 5/28/09 (in a case involving the application of the use tax to peanuts provided by a restaurant to its customers at no additional charge, the administrative law judge, considering the parties' views regarding the restaurant's "condiment packets," stated: "I respectively disagree with the Department's position that condiment packets offered by ... restaurants are being sold to the customers," but noted: "Because of the Department's longstanding policy that condiment packets are being resold [and are therefore exempt from sales or use tax], the Department must follow that policy unless and until it properly promulgates a regulation to the contrary").

53

See, e.g., Hoctor v. U.S. Dept. of Agriculture, 82 F3d 165 (CA-7, 1996), and Jerri's Ceramic Arts, Inc. v. Consumer Products Safety Comm'n, 874 F2d 205 (CA-4, 1989).

54

Mich. Tax Trib., No. 297661, 12/20/05, 2005 WL 3837691 , *rev'd* Mich. Ct. App., No. 270633, 5/20/08, 2008 WL 2117136 .

55

For more on RABs, see *supra* note 26.

56

Internal quotation marks omitted. See also By Lo Oil Company v. Michigan Dept. of Treasury, 703 NW2d 822 (Mich. Ct. App., 2005) (similarly holding that an RAB is an interpretive rule and not subject to the procedural requirements of public notice and comment).

57

See, e.g., Community Bancshares, Inc. v. Secretary of State, 43 SW3d 821 (Mo., 2001) (court upheld a rule adopting a particular statute of limitations for franchise tax refunds, where it was unclear which statute applied); but see Motiva Enterprises, *supra* note 47.

58

See MSAPA §§3-203 and 3-204.

59

MSAPA §3-203.

60

MSAPA §3-204.

61

See, e.g., Ala. Code §§41-22-6 and 41-22-22, and Fla. Stat. §120.54.

62

Ala. Code §41-22-6(c)(4).

63

See, e.g., GTE Mobilnet of Tampa, Inc. v. City of Tampa, 774 So 2d 725 (Fla. Ct. App. 2d Dist., 2000); Ex parte Fleming Foods of Alabama, Inc., 648 So 2d 577 (Ala., 1994), *cert. den.* U.S.S.Ct., 4/17/95; Eagerton v. Terra Resources, Inc., 426 So 2d 807 (Ala., 1982); State v. Bankhead Mining Co., 188 So 2d 527 (Ala., 1966). See also, Ala. Admin. Code r. 810-6-3-.35.02.

64

See, e.g., Florida Dept. of Education v. Cooper, 858 So 2d 394 (Fla. Ct. App. 1st Dist., 2003) (stating that "if the statutory language is ambiguous, the interpretation given the statute by the agency charged with its enforcement is entitled to great deference and should not be overturned unless it is clearly erroneous").

65

Ariz. Const. Art. IX, §3; Ark. Const. Art. 16, §11; Fla. Const. Art. VII, §1(a); Kan. Const. Art. 11, §5; N.Dak. Const. Art. X, §3; Ohio Const. Art. XII, §5; S.Dak. Const. Art. XI, §8; Wash. Const. Art. VII, §5; Wyo. Const. Art. 15, §13.

66

Dept. of Revenue v. Young American Builders, 358 So 2d 1096 (Fla. Ct. App. 1st Dist., 1978).

67

See Garrison v. Dept. of Revenue, 200 P3d 126 (Ore., 2008) (upholding rule requiring tax court filing fee to be paid at time complaint filed; statute imposed fee but was silent as to timing); Community Bancshares, Inc., *supra* note 57 (upholding rule adopting a particular statute of limitations for franchise tax refunds, where it was unclear which statute applied).

68

856 NE2d 879 (Mass. Ct. App., 2006).

69

466 SE2d 424 (W.Va., 1995).

70

Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., *supra* note 1.

71

Emphasis in original. See also Tivolino Teller House, Inc. v. Fagan, 926 P2d 1208 (Colo., 1996).

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