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Fall 2011

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Steve R. Johnson

Florida State University College of Law

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Recommended Citation

Steve R. Johnson, *Cohen: Hard Case Makes (Semi) Bad Law*, 31 *NEWSQUARTERLY* 12 (2011),

Available at: <http://ir.law.fsu.edu/articles/247>

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Cohen: Hard Case Makes (Semi) Bad Law

By Steve R. Johnson*

The first Justice Harlan famously cautioned that hard cases can lead to bad law. *United States v. Clark*, 96 U.S. 37, 49 (1878) (dissenting opinion). This aphorism captures the reality that, when confronted with litigating equities strongly favoring one party, judges tend to massage doctrine as necessary to support judgment for that party.

The July 1, 2011, decision of the D.C. Circuit in the *Cohen* case (hereafter “*Cohen III*”) is a recent example of the hard case/bad law tendency in the tax arena. *Cohen v. United States*, ___ F.3d ___, 2011 WL 2600672 (D.C. Cir. 2011). The D.C. Circuit appropriately reaffirmed that the Administrative Procedure Act (APA) governs rulemaking by the Treasury and the Service. But it then distorted APA principles in an apparent desire to punish the Service for a succession of perceived misdeeds and maladministration.

Tax lawyers should be aware of *Cohen* for four reasons. First, *Cohen* confirms the developing trend that tax rulemaking is governed by general requirements of administrative law. Second, *Cohen* affirms substance over form in applying administrative law to tax. Third, *Cohen* involves principles not routinely encountered by tax attorneys, and thus dilates our angle of vision. Fourth, *Cohen* reminds us of the continuing validity of

the hard cases/bad law principle. These points are developed below after the background is described.

Background

The *Cohen* saga involves the excise tax imposed by section 4251 on certain telephone calls. Telephone users are not required to maintain documentation or to calculate and pay their liabilities for the tax. Instead, telephone service providers collect the tax and pay it over to the Service. Under section 4252(b), tax is imposed on communications based on distance and transmission time. As a result of the telecommunications revolution, many customers now pay based on time only, with distance playing no role.

Nonetheless, the Service continued to collect the excise tax from all long-distance communications customers. Many time-only customers challenged the legality of the practice. Undeterred by

initial losses, the Service continued to litigate the issue until it had lost in five circuits.

When it finally declared “no mas,” the Service issued Notice 2006-50, 2006-1 C.B. 1141. The notice announced discontinuance of collection of the excise tax for telephone charges based wholly on transmission time. The notice (complemented by Notice 2007-11, 2007-1 C.B. 405) established a mechanism by which taxpayers could claim refunds of improperly collected excise taxes.

This mechanism was challenged in court. The plaintiffs purported to represent a class of taxpayers who lacked the resources to seek refunds under the notices or whose amounts at stake were too small to make individual actions worthwhile. The plaintiffs maintain that the Service’s refund mechanism is substantively flawed because it undercompensates many and that it is procedurally flawed for several

* University Professor, Florida State University College of Law, Tallahassee, FL.

reasons, including that, in promulgating Notice 2006-50, the Service failed to satisfy the notice-and-comment requirements of the APA. 5 U.S.C. § 553. Central to the controversy is whether individual taxpayers must pursue traditional refund suits under section 7422 or whether, as the plaintiffs maintain, the courts have jurisdiction to hear challenges based on the APA right of review provision, 5 U.S.C. § 702.

The district court dismissed the cases on the grounds that the plaintiffs had failed to exhaust administrative remedies and had failed to state claims on which relief could be granted. *In re Long-Distance Tel. Serv. Fed. Excise Tax Refund Litigation (Cohen I)*, 539 F. Supp. 2d 281, 287 (D.D.C. 2008). In addition, the district court held that Notice 2006-50 is an internal policy of the Service, did not directly affect the plaintiffs, and so was unreviewable under the APA. *Id.* The district court also held that the plaintiffs' APA claims for declaratory and injunctive relief were rendered moot by the Service's decision to cease collecting the tax on telephone charges based on time only. *Cohen I*, 539 F. Supp. 2d at 287.

A divided panel of the D.C. Circuit reversed. The panel majority first rejected challenges to the courts' jurisdiction to hear the claims. With stated exceptions, section 7421(a), the Anti-Injunction Act, provides that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person." The Declaratory Judgment Act provides that the federal courts may not hear declaratory judgment actions brought "with respect to Federal taxes." 28 U.S.C. § 2201(a). The panel majority held that the Anti-Injunction Act and the Declaratory Judgment Act did not remove jurisdiction to hear challenges to Notice 2006-50. *Cohen v. United States (Cohen II)*, 578 F.3d 1, 4–14 (D.C. Cir. 2009). The panel majority also held that the notice constituted final agency action reviewable under the APA. *Id.*

The panel dissent maintained that the Declaratory Judgment Act barred the plaintiffs' APA claims. It also argued that the claims were not ripe because the plaintiffs had not requested refunds under Notice 2006-50. *Id.* at 20 (Kavanaugh, J., dissenting).

The Government petitioned for rehearing *en banc*. Rehearing was granted but was limited to issues bearing on jurisdiction and whether a claim had been stated on which relief could be granted. *Cohen v. United States*, 599 F.3d 652 (D.C. Cir. 2010).

On rehearing, the circuit court, by a vote of six to three, affirmed in part, reversed in part, and remanded. The majority held that (1) the refund mechanism established by the notices was a substantive rule that bound the Service, and thus was final and reviewable under the APA; (2) section 7421 does not bar the class action; (3) section 7421 and the Declaratory Judgment Act must be read coterminously; (4) the plaintiffs had no adequate remedy of law; and (5) the suit was ripe.

The dissent maintained that the suit was barred because (1) tax refund litigation provides an adequate alternative judicial remedy and (2) filing refund claims with the Service is prerequisite to ripeness. 2011 WL 20600672, at *17–24 (Kavanaugh, J., dissenting).

Administrative Law in Tax

Cohen is significant in part because of its reaffirmation that tax is subject to general rules of administrative law. Some tax professionals—both in Government and in the private sector—have resisted this fact. After all, keeping up with change in the Code is hard enough. To require tax practitioners to also carry knowledge of general administrative law may strain even strong backs.

Yet that burden is ours. This spring, the Supreme Court emphasized "we have expressly [r]ecogniz[ed] the importance of maintaining a uniform approach to judicial review of administrative action," and it saw "no reason why

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our review of tax regulations should not be guided by [*Chevron* principles] to the same extent as our review of other regulations." *Mayo Foundation for Med. Educ. & Research*, 131 S. Ct. 704, 713 (2011) (citation and punctuation omitted).

Cohen III is animated by the same spirit. In concluding that the Service may be sued under the APA (at least in actions not immediately seeking money judgment), the majority remarked: "The IRS is not special in this regard; no exception exists shielding it—unlike the rest of the Federal Government—from suit under the APA," and it buttressed that assertion with citations to three prior decisions allowing APA challenges to revenue rulings or Treasury regulations. 2011 WL 2600672, at *4 (citations omitted).

Substance over Form

As part of its finality discussion, the *Cohen III* majority reaffirmed that the binding character of Notice 2006-50 is what matters, not the fact that it is set out in the format of a notice, rather than a regulation. *Cohen III*, 2011 WL 2600672, at *4 (quoting *Cohen II*, 578 F.3d at 8).

This emphasis on substance over form can be significant in other areas of administrative law/tax interaction. For example, unless a stated exception applies, the APA requires that an agency must publish notice of rules it proposes and give interested persons opportunity to comment. 5 U.S.C. § 553(b) & (c). Some attention has been trained on this requirement recently in the context of tax regulations. *E.g.*, *Intermountain Ins.*

Interpretive rules, general agency policy statements, and the like are excepted from the notice-and-comment rules. 5 U.S.C. § 553(b)(A).

Serv. of Vail, LLC v. Commissioner, 134 T.C. 211, 238–47 (2010) (Halpern & Holmes, JJ., concurring in result only), *rev'd*, ___ F.3d ___, 2011 WL 2451011 (D.C. Cir. 2011).

Interpretive rules, general agency policy statements, and the like are excepted from the notice-and-comment rules. 5 U.S.C. § 553(b)(A). In deciding whether an agency position fits within the exception, substance should control over form. That is, what counts is whether the position has binding effect, not the nomenclature used by the agency in labeling the position. *E.g.*, *Chrysler Corp. v. Brown*, 441 U.S. 281, 301–02 & n.31 (1979); *Syncor Int'l Corp. v. Shalala*, 127 F.3d 90, 94 (D.C. Cir. 1997). *Cohen III* is compatible with this principle.

Expanding Our Angle of Vision

Much in the *Cohen* opinions is terrain tax lawyers do not usually tread. We occasionally deal with the Anti-Injunction Act and exhaustion of administrative remedies, but not often with the Declaratory Judgment Act or doctrines like finality and ripeness. Such rules mattered in *Cohen* because the action was brought under the APA rather than as a traditional section 7422 refund suit. As administrative law penetrates more deeply into tax law, we will have to grapple with these and many other rules. Like it or not, we will have to expand our angle of vision.

Hard Cases and Bad Law

I welcome *Cohen*'s reaffirmation of the relevance of the APA. My enthusiasm is tempered, however, by a conviction that the *Cohen III* majority misapplied the APA.

APA section 703 provides: “The form of proceeding for judicial review is the special statutory review proceeding relevant to the subject matter.” There *is* a “statutory review proceeding relevant to” the *Cohen* controversy—it’s section 7422 refund suits.

APA section 703 makes an exception if the statutory review proceeding is “inadequa[te]”; *see also* 5 U.S.C. § 704 (making reviewable “final agency action for which there is no other adequate remedy in a court”). Section 7422 refund suits are adequate to the occasion. All the *Cohen* plaintiffs’ substantive and procedural arguments could be advanced by individual taxpayers bringing refund suits. Some taxpayers may deem the amount of overpaid tax not worth pursuing or may find themselves without evidence to document entitlement to bigger refunds. But such considerations are possible in any tax overpayment context. They are not unique to the *Cohen* situation.

The *Cohen III* majority argued that the suit was not a refund suit because it challenged administrative procedures

rather than seeking refunds. 2011 WL 2600672, at *12. But the challenge to the procedures is the wedge that, the plaintiffs hope, will lead to bigger refunds. The hypertechnicality of this portion of the majority opinion conflicts with its emphasis elsewhere on substance over form.

I think the majority made this error in part because *Cohen*'s unusual circumstances will render its precedent less dangerous and in part because the majority disliked what it perceived as a pattern of abuse by the Government, including the Service's continued litigation of the issue despite repeated losses and its fashioning of an onerous refund mechanism. *See id.* at *17 (“The litigation position of the IRS throughout the history of the excise tax has been startling.”). In short, a hard case made (semi) bad law.

The case will now return to the district court for adjudication of the substantive issues, which may lead to further appeals. The next stages of the *Cohen* saga will be worth watching. For more discussion of *Cohen*, see Note, *No More Excuses: A Case for the IRS's Full Compliance with the Administrative Procedure Act*, 76 BROOK. L. REV. 837 (2011). ■