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Legal Sidebar

Scholl v. Mnuchin and Economic Impact Payments

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Congress established a new temporary refundable tax credit in the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. No. 116-136, codified in Internal Revenue Code (IRC) Section 6428. The CARES Act credit for each "eligible individual" equals up to $1,200, plus an additional $500 per qualifying child. The CARES Act authorized the Treasury Secretary to disburse advance refund payments in 2020 to "eligible individuals" in the amount of the credit allowable on the individual's 2020 tax return. These direct payments are commonly referred to as the first round of Economic Impact Payments (EIPs). Initially, the Internal Revenue Service (IRS) disbursed EIPs to incarcerated individuals. However, the IRS later reversed its position.

On August 1, 2020, in *Scholl v. Mnuchin*, a group of incarcerated individuals and formerly incarcerated individuals who did not receive EIPs (Plaintiffs) filed a lawsuit in the U.S. District Court for the Northern District of California. The Plaintiffs alleged that the Treasury Secretary, the IRS Commissioner, the Treasury Department, the IRS, and the United States (Defendants) failed to comply with the CARES Act when they declared incarcerated individuals ineligible for EIPs and declined to issue EIPs to them. The Plaintiffs' asserted that: (1) Defendants unlawfully withheld EIPs in violation of Section 706(1) of the Administrative Procedure Act (APA); (2) Defendants' denial of EIPs to Plaintiffs was contrary to law, in excess of statutory authority, and arbitrary and capricious under APA Sections 702 and 706(2); and (3) federal courts had jurisdiction to hear Plaintiffs' civil claims against the United States pursuant to the Little Tucker Act, 28 U.S.C. § 1346(a)(2) because Defendants denied payments authorized by the CARES Act. The Plaintiffs sought to certify a nationwide plaintiff class comprised of individuals who met the CARES Act criteria for receipt of EIPs but were denied the payments based solely on their incarcerated status. As relief, the Plaintiffs sought a declaratory judgment that Defendants lacked statutory authority to deny EIPs based solely on incarcerated status and an injunction barring the Defendants from continuing to deny EIPs based solely on incarcerated status.

On September 24, 2020, the district court issued an order that provisionally certified the plaintiff class and granted a preliminary injunction enjoining the Defendants from withholding EIPs based solely on an individual's incarcerated status. On October 14, 2020, the court issued an order certifying the plaintiff class and granting Plaintiffs' motion for summary judgment on their claim alleging that the Defendants' action violated the APA because it was contrary to law, in excess of statutory authority, and arbitrary and capricious. The court therefore converted its preliminary injunction into a permanent injunction, ordering

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the Defendants to terminate their policy of excluding individuals from receiving EIPs solely based on their incarcerated status. Following the permanent injunction, the IRS resumed processing incarcerated individuals' requests for EIPs. The American Rescue Plan Act of 2021, Pub. L. No. 117-2, establishing the third round of economic impact payments, and the Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, establishing the second round of economic impact payments, did not adjust the definition of "eligible individuals" to exclude incarcerated individuals from receiving economic impact payments.

Scholl is one of a few lawsuits brought by groups seeking to clarify their eligibility for relief under the CARES Act. The court's rulings in *Scholl* could impact these other pending cases and could change how Treasury and the IRS issue future guidance for recently enacted legislation. This Legal Sidebar discusses how the CARES Act defined an individual who was eligible for an EIP, how Treasury and the IRS interpreted that definition, and the parties' main arguments in *Scholl*, with an eye to understanding how this litigation might illuminate larger issues surrounding Treasury and IRS guidance interpreting who is eligible for tax benefits under established statutory criteria.

Eligibility for EIPs Under the CARES Act

Under the CARES Act, an "eligible individual" is "any individual" other than (1) a nonresident alien, (2) an individual who can be claimed as a dependent on another taxpayer's return, and (3) an estate or trust. On May 6, 2020, the IRS published responses to frequently asked questions (FAQs) on its website, which included a response that declared incarcerated individuals ineligible for EIPs. Question 15 asked, "Does someone who is incarcerated qualify for the [EIP]?" The IRS responded:

> A15. No. A Payment made to someone who is incarcerated should be returned to the IRS by following the instructions about repayments. A person is incarcerated if he or she is described in one or more of clauses (i) through (v) of Section 202(x)(1)(A) of the Social Security Act (42 U.S.C. § 402 (x)(1)(A)(i) through (v)). For a Payment made with respect to a joint return where only one spouse is incarcerated, you only need to return the portion of the Payment made on account of the incarcerated spouse. This amount will be $1,200 unless adjusted gross income exceeded $150,000.

On June 18, 2020, the IRS updated its Internal Revenue Manual to reflect this policy. The IRS also took steps to intercept EIPs to incarcerated individuals and updated its FAQs to instruct incarcerated individuals to return EIPs.

In a report dated June 30, 2020, the Treasury Inspector General for Tax Administration (TIGTA) raised concerns about paying EIPs to incarcerated individuals. The TIGTA report stated that the IRS's initial response to TIGTA's inquiries was that incarcerated individuals were eligible for EIPs because the CARES Act did not prohibit them.

Standing and Ripeness

Article III, Section 2, clause 1 of the U.S. Constitution authorizes federal courts to adjudicate actual "cases" and "controversies." Under this constitutional provision, federal courts are limited to hearing cases in which the plaintiff has suffered an actual injury, thereby establishing that the party has "standing" and that the issues are "ripe" for judicial review. The Defendants in *Scholl* argued both standing and ripeness were absent because the Plaintiffs did not sustain an injury in 2020. The Defendants contended that, even though the Plaintiffs were denied EIPs in 2020, they would sustain an injury only after they claimed the new temporary refundable tax credit on their 2020 tax returns (to be filed in 2021) and the IRS denied their claims. The district court rejected that argument, applying the same analysis to hold that the IRS's policy of withholding EIPs from incarcerated individuals, including the FAQ response, and its deprivation of EIPs in 2020 were injuries that satisfied both Article III conditions.

The Defendants also argued the Plaintiffs' claims failed to meet the distinct "prudential" ripeness requirement for obtaining judicial review. The APA authorizes judicial review of a "final agency action for which there is no other adequate remedy in a court." Administrative actions satisfy the prudential ripeness requirement under the APA when the challenging party feels the effects of an administrative decision in a concrete way. In *Scholl,* the Defendants asserted the district court lacked subject matter jurisdiction to hear the case because the FAQ response was not a "final" agency action within the meaning of the APA. The district court disagreed with the Defendants' analysis. Quoting Supreme Court precedent, the district court held that an agency's actions under the APA are final and reviewable when two conditions are met: "First, the action must mark the consummation of the agency's decision-making process–it must not be of a merely tentative or interlocutory nature. And second, the action must be one by which rights or obligations have been determined, or from which legal consequences will flow." In the preliminary injunction order, the court highlighted several facts it believed conveyed that the Defendants' decision to exclude EIPs to incarcerated individuals was final. The court reasserted these facts in the permanent injunction order. The court found: the FAQ response described the IRS's unequivocal change in position that incarcerated individuals did not qualify for EIPs; the Defendants submitted a declaration repeating the position taken in the FAQ response; the IRS changed the Internal Revenue Manual to reflect the change in position; and the CARES Act's requirement to disburse all EIPs by December 31, 2020 made more changes to the Defendants' position unlikely.

APA Claims

Following the district court's preliminary injunction order, the Plaintiffs filed a motion for summary judgment on their first two causes of action: (1) violation of APA Section 706(1); and (2) violation of APA Sections 702 and 706(2). The district court already had determined in the order granting the preliminary injunction that it need not defer to the Defendants' interpretation of who was eligible for EIPs because the Defendants had not issued regulations and did not follow APA notice-and-comment rulemaking procedures when the IRS issued its FAQ response on incarcerated individuals.

In the motion for summary judgment, the Plaintiffs asked the district court to compel the Defendants to disburse EIPs to incarcerated individuals who met the CARES Act criteria, pursuant to APA Section 706(1). Section 706(1) authorizes a reviewing court to "compel agency action unlawfully withheld or unreasonably delayed." Although the court agreed with the Plaintiffs that the CARES Act compelled Treasury and the IRS to take a discrete agency action with regard to EIPs, it denied the motion for summary judgment on this claim on the ground that the Plaintiffs were challenging *how* Treasury and the IRS carried out the action—i.e., issued EIPs to incarcerated individuals, then reversed course and sought to claw back EIPs that were issued—instead of a failure to act.

The district court granted Plaintiffs' motion for summary judgment on their second claim that the Defendants' decision to exclude payments to incarcerated individuals was contrary to law and in excess of statutory authority. Under APA Section 706(2), a reviewing court can hold unlawful and set aside an agency action, finding, or conclusion that is: "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law"; "in excess of statutory jurisdiction, authority, or limitations, or short of statutory right"; or "without observance of procedure required by law." Relying on the language and structure of the CARES Act, the court concluded that the Act requires the IRS to issue EIPs to individuals meeting the statutory criteria. In the preliminary injunction order, the court determined that the definition of "eligible individual" was not open-ended and that the Treasury Secretary lacked the discretion to change the definition. In the permanent injunction order, the court reiterated the facts it found persuasive. It noted that a previous version of IRC Section 6428, passed in response to the 2008 financial crisis, demonstrated Congress knew how to exclude payments to incarcerated individuals if desired, and Congress had not done so here. The court also found persuasive the fact that the IRS had asserted three different interpretations of who constituted an "eligible individual," both publicly and in the litigation. The court observed that the IRS first disbursed EIPs to incarcerated individuals, later declared incarcerated individuals ineligible for EIPs in its FAQs and Internal Revenue Manual, and then, during litigation, stated that it planned to issue EIPs to individuals who were only incarcerated for part of the year. Thus, the court ruled the definition of "eligible individual" under the CARES Act does not exclude incarcerated individuals, and the Defendants' decision to exclude incarcerated individuals was contrary to law and in excess of statutory authority in violation of Section 706(2).

The district court also granted Plaintiffs' motion for summary judgment on their second claim on the alternative ground that the Defendants' decision to deny payments to incarcerated individuals without stating an adequate reason for that decision was arbitrary and capricious under APA Section 706(2). In its preliminary injunction order, the court noted that the Defendants did not direct the court to any evidence that provided a reason for Treasury and the IRS's decision to exclude EIPs to incarcerated individuals. In the permanent injunction order, the court remarked that the Defendants had "not advanced any convincing explanation or reason to deviate from the court's prior finding." As an example, the court cited the Defendants' explanation that Treasury and the IRS adopted the policy as an anti-fraud measure. The court held that the Defendants' explanation constituted an impermissible post hoc rationalization because the Defendants did not publicly advance this explanation when they decided to deny EIPs to incarcerated individuals.

Considerations for Congress

The district court's orders in *Scholl*, and other CARES Act relief eligibility cases pending in courts around the country, could have long-lasting effects on how and when Treasury and the IRS respond to rapidly developing situations following the enactment of tax legislation. After the enactment of the CARES Act, the IRS issued FAQs to provide the public with timely guidance on EIP eligibility and information on how to obtain EIPs. The IRS might delay issuing similar tax guidance in the future out of concern that courts are more likely to find that judicial deference is unwarranted when Treasury and the IRS's interpretations of statutes are conveyed in tax guidance other than regulations and do not provide an explanation of the agencies' reasoning. *Scholl* suggests that in order to ensure that the intended recipients of tax benefits receive them quickly, Congress could consider whether to define precisely in the statute whom the legislation is and is not intended to benefit, leaving little room for judicial or agency misinterpretation.

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