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Justices' Nod To Preemptive Tax Challenges May Caution IRS

By **Robert Carney** (May 26, 2021, 5:10 PM EDT)


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The U.S. Supreme Court's May 17 decision in CIC Services LLC v. Internal Revenue Service opened new possibilities for challenges to compliance with the Administrative Procedure Act with respect to U.S. Department of the Treasury regulations.[1] The government has generally attempted to prevent such challenges by asserting the so-called Anti-Injunction Act as a jurisdictional bar.[2]

Use of the Administrative Procedure Act in Tax Controversies

Historically, there was ambiguity regarding the review of tax rules and regulations issued by the U.S. Department of the Treasury and the Internal Revenue Service. This was often referred to as tax exceptionalism, whereby courts would apply a somewhat lenient six-factor test in determining the validity of tax regulations,[3] while applying the more stringent two-prong Chevron test[4] to regulations and rulings issued by other government agencies.

In addition, prior to the Supreme Court's 2011 decision in Mayo Foundation for Medical Education & Research v. U.S.,[5] the IRS' adherence to the Administrative Procedure Act was often inconsistent with respect to notice and comment, and other requirements.

In Mayo, the Supreme Court agreed with the government's argument that the validity of tax regulations should be determined under the same standards as those used with respect to the regulations of other government agencies. For the government, this was a somewhat Pyrrhic victory because, in the aftermath of Mayo, taxpayers frequently raised the Administrative Procedure Act as a basis for invalidating tax regulations.[6]

Those challenges, however, have generally arisen in post-enforcement proceedings, after the IRS has made an assessment of a tax or has sent a notice of deficiency. By contrast, CIC Services involved a challenge to an IRS notice before any tax had been assessed — or even asserted.

CIC Services: Pre-Enforcement Review of Administrative Procedure Act Compliance

The IRS almost always seeks protection under the Anti-Injunction Act to preclude any challenges to the validity of Treasury regulations in pre-enforcement proceedings, e.g., under the procedural requirements of the Administrative Procedure Act. The AIA is simple and succinct in form, which is somewhat uncustomary in the Internal Revenue Code.

Section 7421(a) states:

> Except as provided in … no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed.[7]

Congress passed the AIA in 1867 to ensure the free flow of revenue to the federal government to cover the costs of the Civil War. With the AIA, Congress dictated that a taxpayer wishing to challenge the amount or validity of a tax must first pay the tax and litigate later. The AIA has been enforced by the courts, with few exceptions, since its enactment.

CIC Services was seeking an injunction against the enforcement of a notice — IRS Notice 2016-66 — not a

tax statute or even a regulation. The notice was allegedly issued pursuant to a statutory delegation of authority allowing the Treasury and the IRS to identify tax structures or transactions deemed to be abusive.[8]

In the notice, the IRS identified transactions involving the creation of so-called microcaptive insurance companies — as subsidiaries of operating parent companies — as reportable transactions. The effect of this designation was to require taxpayers and material advisers to file tax statements identifying the taxpayer and describing the transactions.[9]

Failure to file a required report could result in civil and criminal penalties. The AIA was potentially implicated because any penalty asserted for a reporting violation was deemed by the statute to be a tax.[10]

CIC Services was a material adviser to companies that had established microcaptive insurance companies pursuant to its advice and consultation. Thus, CIC Services was forced to incur substantial compliance costs in following the requirements of the notice. Obviously, unlike an invalid or excessive tax, these compliance costs could not be recovered after-the-fact by litigation of the validity of the notice in the event a penalty was assessed.

Although potential criminal penalties could be nullified by a successful challenge to the notice, the requirement to break the law and risk prison time in order to file the case clearly troubled the court both in oral arguments and in its opinion.

Proceedings in the Courts Below

In 2017, the U.S. District Court for the Eastern District of Tennessee denied CIC Service's request for an injunction to prevent enforcement of the notice, determining that it lacked jurisdiction under the AIA. In 2019, the U.S. Court of Appeals for the Sixth Circuit affirmed in a 2-1 opinion.[11] The Sixth Circuit panel was primarily influenced by the U.S. Court of Appeals for the District of Columbia Circuit's 2015 decision in Florida Bankers Association v. U.S. Department of the Treasury, which applied the AIA to tax reporting requirements.[12]

In Florida Bankers, the court considered an IRS regulation that imposes a penalty on U.S. banks that fail to report interest paid to certain foreign account holders.[13] That penalty, like the one considered in CIC Services, would also be treated as a tax under the Internal Revenue Code. The circuit court held that "the Anti–Injunction Act ordinarily applies because the suit, if successful, would invalidate the regulation and thereby directly prevent collection of the tax."[14]

The Sixth Circuit struggled to reconcile a 2015 Supreme Court decision in Direct Marketing Association v. Brohl,[15] which was decided before Florida Bankers, with the result reached in Florida Bankers.

In Direct Marketing, the Supreme Court considered a state reporting requirement that was in aid of collecting state sales tax. There, the court held that a statute similar to AIA, the Tax Injunction Act,[16] which precluded federal injunctions against the assessment or collection of state tax, did not preclude injunctions against those reporting requirements.

The Supreme Court in Florida Bankers distinguished Direct Marketing on the ground that the penalty in Direct Marketing was not specifically denominated as a tax.[17]

Following Supreme Court precedent, the Sixth Circuit in CIC Services concluded that the AIA and the Tax Injunction Act should apply in the same manner.[18] Nevertheless, the Sixth Circuit held that the reporting requirements of the notice could not be enjoined because the injunction would effectively preclude the assessment of a tax penalty for violation.

The circuit court thus followed the reasoning in Florida Bankers that the penalty in Direct Marketing was not deemed to be a tax, and therefore that case was distinguishable. Based on that distinction, the Sixth Circuit affirmed the district court's dismissal of CIC's complaint for lack of jurisdiction under the AIA. A motion for rehearing en banc was denied with seven judges dissenting.

The Supreme Court's Unanimous Decision

In reversing the Sixth Circuit by unanimous decision, the Supreme Court identified three factors that avoided the application of the AIA.

First, the relief sought was to avoid reporting costs — which could not be recovered in a later challenge — and was not to avoid the payment of a tax.

Second, the tax penalty was several steps removed from the reporting obligation. If CIC complied, the so-called tax — the penalty — would never be incurred; and, if CIC did not comply, the IRS would first need to determine that a violation had occurred and then determine to assess the penalty.

Finally, and perhaps most importantly, because of the criminal penalty attached to reporting violations, CIC would be required to break a criminal law in order to have any day in court — i.e., post-enforcement. It is clear in the opinion, as well as in oral argument, that many — perhaps all — of the justices viewed this position as untenable.

Looking Ahead

Will the CIC decision result in more pre-enforcement challenges of Treasury regulations as the government asserted? Time will tell.

It is not unforeseeable that tax practitioners will seek pre-enforcement review of Treasury regulations or sub-regulatory guidance — e.g., revenue procedures, notices, FAQs, etc. — that do not directly require the payment of a tax, but that might involve a penalty that is deemed to be a tax under the Internal Revenue Code.

Justice Elana Kagan's opinion dismissed the government's "opening the floodgates" argument because injunctions against tax assessments, as opposed to reporting requirements, will still be barred under the AIA.[19] Perhaps the government's concern about more pre-enforcement litigation in tax-related cases will result in more caution from the Treasury when issuing regulations and other guidance to ensure compliance with the Administrative Procedure Act.

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[1] CIC Services LLC v. Internal Revenue Service, case number 19-930.

[2] 26 U.S.C. § 7421 . All section references herein are to the Internal Revenue Code of 1986, as amended.

[3] See National Muffler Dealers Ass'n v. United States, 440 U.S. 472 (1979).

[4] Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 468 U.S. 837 (1984).

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

[6] For example, in Altera Corp. v. Comm'r, 145 T.C. 91 (2015), the Tax Court (in a unanimous 15-0 opinion) invalidated Treasury Regulations that it determined were promulgated without full compliance with the Administrative Procedure Act. Although the Ninth Circuit reversed the Tax Court's application of the APA (926 F.3d 1061 , 1079 (2019)), it upheld the requirement that the regulation must first be tested under the APA before performing a Chevron deference analysis.

[7] IRC § 7421(a).

[8] Although the statute (IRC § 6707A(c)) prescribes that the identification of "reportable transactions" (those with special reporting requirements) may be made "under regulations" pursuant to Section 6011, the relevant regulation (§ 6011-4(b)(6)) allows the IRS to identify one category of reportable transactions, i.e., "transactions of interest," by notice or other guidance. The reportable transaction at issue was identified in Notice 2016-66. Whether the notice in issue was valid under the statutory delegation was not an issue in the case.

[9] IRC § 6111(b)(1)(A).

[10] IRC § 6671 .

[11] 925 F.3d 247 (2019).

[12] Florida Bankers Ass'n v. U.S. Dep't of the Treasury, 799 F.3d 1065 (2015). Interestingly, the majority opinion in Florida Bankers was written by former Judge Brett Kavanaugh, who filed a concurring opinion in CIC.

[13] See 26 C.F.R. §§ 1.6049–4 , 1.6049–8 (reporting requirement); 26 U.S.C. § 6721(a) (penalty).

[14] 799 F.3d at 1067.

[15] 575 U.S. 1.

[16] 28 U.S.C., § 1341 .

[17] 799 F.3d at 1069.

[18] 925 F.3d at 252.

[19] See Part II. B.