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CIC Services and Its Impact on Tax Practice

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In *CIC Services, LLC*,[1] a unanimous Supreme Court allowed a tax advisor to proceed with a pre-enforcement challenge to the reportable transaction regime. CIC Services, LLC ("CIC") complained that the IRS violated the Administrative Procedures Act ("APA") when it issued Notice 2016-66, rendering micro-captive insurance transactions "reportable" and requiring taxpayers and their advisors to provide detailed information to the IRS. CIC requested relief in the form of an order enjoining enforcement of the Notice and declaring it to be unlawful. The IRS sought to avoid judicial review by hiding behind the Anti-Injunction Act's bar on suits brought "for the purpose of restraining the assessment or collection of any tax."[2] The Supreme Court allowed CIC's suit to proceed, finding that CIC was challenging a regulatory mandate separate from any tax. As the Court explained, "the tax appears on the scene—as criminal penalties do too—only to sanction that mandate's violation."[3] By choosing to address their concerns about micro-captive transactions by imposing a non-tax reporting obligation, Congress and the IRS "took suits to enjoin their regulatory response outside the Anti-Injunction Act's domain."[4]

The Court's decision leaves open questions that the lower courts must now address, while also providing meaningful clues about how the Court may approach future disputes over IRS enforcement strategies.

Does the Reportable Transaction Regime as the IRS Currently Administers It Violate the APA?

While the Supreme Court allowed CIC's challenge to proceed—and that first step is critical—this decision does not reach the merits of the claim. CIC asserts that the IRS violated the APA by issuing Notice 2016-66 without following notice-and-comment procedures and that the Notice is arbitrary and capricious because it imposes new reporting requirements without proven need. If CIC's arguments ultimately succeed, the resulting legal rule could upend the way the IRS implements the reportable transaction scheme created in Code Secs. 6707A and 6011. That result would have far-ranging consequences, but the Court's decision merely opened the door to those arguments and did not decide them.

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Just days before the Supreme Court issued its decision in CIC, a district court addressed the merits of the argument that the IRS was required to provide public notice and an opportunity for comment before promulgating a notice identifying a transaction as "reportable" or "listed." In *Mann Construction, Inc. et al.*,[5] the Eastern District of Michigan weighed cross-motions for summary judgement involving Notice 2007-83, which identified trust arrangements utilizing cash value life insurance policies to provide welfare benefits as a listed transaction. In that case, the Government argued that: (1) the Notice was an interpretive rule rather than a legislative rule and thus exempt from notice-and-comment rulemaking, and (2) even if the Notice were a legislative rule Congress authorized its promulgation by a procedure other than notice and comment. The court rejected the first argument, but ultimately agreed with the second.

The Government argued that Congress authorized the IRS to depart from APA procedures by incorporating into Code Sec. 6707A a reference to Reg. §1.6011-4, which allows the IRS to identify listed transactions "by notice, regulation, or other form of published guidance." Acknowledging that this conclusion "would seem problematic because neither section 6707A nor the relevant regulations reference the APA," the court in *Mann Construction* nevertheless sided with the Government based on its view that the text, structure and history of Code Sec. 6707A "endorsed the flexible reporting regime that the IRS had already developed" and expressed a clear intent to "displace the norm."[6]

The court in *Mann Construction* noted that no argument had been made that "Congress has exceeded its constitutional authority to legislate."[7] This is likely a reference to a potential argument that Congress exceeded its authority to delegate legislative power. With a Supreme Court that is showing increasing skepticism of agency power, reviving the nondelegation doctrine may be helpful for litigants seeking to challenge the reportable transaction regime.

There are arguments on both sides of the legal issues that impact the validity of the reportable transaction regime, including whether Congress exceeded its authority to delegate legislative power to the IRS, whether notice-and-comment rulemaking is required before the IRS may impose onerous requirements by defining categories of reportable transactions, and whether any particular notice was the result of arbitrary and capricious action by the IRS. It will take time for these issues to work through the lower courts now that the Supreme Court has given a green light to pre-enforcement challenges.

Would the Anti-Injunction Act Bar a Suit to Enjoin Enforcement of a Reporting Obligation Brought by a Taxpayer?

Justice Sotomayor wrote a concurring opinion in *CIC Services* to highlight her view that the result might not be the same if the challenge were brought by a taxpayer as opposed to a tax advisor. She agreed with the majority that three factors took CIC's suit outside the ambit of the Anti-Injunction Act: the Notice imposes substantial compliance costs that are unconnected to (and possibly far greater than) CIC's potential tax liability; the causal chain connecting the Notice's reporting requirement to any tax is attenuated; and the Notice is enforced by criminal as well as tax penalties. Justice Sotomayor explained that, for a taxpayer, a penalty for noncompliance with a reporting requirement, which Congress has deemed a tax, "may operate as a rough substitute for the tax liability she has evaded by withholding the required information."[8] She also noted that a taxpayer may incur less expense than tax advisors in collecting and reporting their own financial information. As a result of these differences, she clarified that this case "provides no occasion for the Court to inquire into the full quantity or variety of IRS reporting requirements that are backed by tax penalties" and the issue of whether a taxpayer's challenge would be allowed to proceed "will depend on a context-specific inquiry into 'the relief the suit requests' and the 'aspects of the regulatory scheme' at issue."[9]

While leaving open the question of whether a taxpayer's challenge could survive a motion to dismiss based on the Anti-Injunction Act, Justice Sotomayor's concurrence highlights the elements attorneys should consider in selecting which requirements a taxpayer may be able to challenge. A burdensome requirement with a noncompliance penalty that is disproportionate to the underlying tax exposure, disconnected from the tax itself, and backed by criminal exposure would be the best target for a pre-enforcement injunction suit.

How Onerous Must the Challenged Requirement Be?

As highlighted by Justice Sotomayor, one key fact that convinced the Court to allow CIC's suit to proceed is that the challenged reporting requirement inflicts costs that are both substantial and distinct from the tax. CIC estimated that it would have to spend hundreds of hours

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of labor and in excess of $60,000 per year to comply with the Notice. The Court found that "[c]osts of that kind may well exceed, or even dwarf, the tax penalties for a violation."[10] The existence of "compliance costs whose amount is not tied to, and often goes beyond, any tax" supported the conclusion that CIC's suit targets the "independently onerous reporting mandates" of the Notice rather than the tax penalty.[11]

Both the degree of the burden imposed on the challenger and the proportional relationship between that burden and the challenger's tax exposure will likely influence the lower courts' view of whether the actual object of the suit is relief from a mandate or a forbidden restraint of tax. While it will be easier to demonstrate that the object of the suit is relief from a mandate when the challenger's tax exposure is small and remote, that does not necessarily mean that a taxpayer facing a significant tax liability will be unable to prove that a suit targets a mandate rather than a tax. Litigants bringing pre-enforcement challenges should emphasize the existing and definite burdens of compliance, along with the collateral consequences of the IRS mandate, to demonstrate that the suit targets the mandate and not the tax.

How Disconnected from the Tax Penalty Must the Challenged Requirement Be?

The Court also found it important that "the Notice's reporting rule and the statutory tax penalty are several steps removed from each other."[12] The Court explained that, before CIC would owe a tax to the IRS, CIC would need to withhold required information, the IRS would need to determine that a violation occurred, and the IRS would need to make the entirely discretionary decision to impose a penalty. In the Court's view, that "threefold contingency" makes it hard to characterize the suit's purpose as enjoining a tax.

Justice Kavanaugh wrote separately to underscore that the Anti-Injunction Act is best read as directing courts to look at the stated object of a suit rather than the suit's downstream effects. In his view, the rule going forward is that pre-enforcement suits challenging taxes, whether regulatory or revenue-raising, are ordinarily barred by the Anti-Injunction Act, while pre-enforcement suits challenging regulations backed by tax penalties are ordinarily not barred even if a successful suit would necessarily preclude the collection or assessment of a tax.[13] This is in line with the Court's explanation that when the legal rule at issue is a tax provision, there is no target for an injunction other than the command to pay the tax and thus no non-tax legal obligation to restrain. When the tax is actually a "backstop to the violation of another law that independently prohibits or commands an action," a suit challenging that prohibition or command "targets not a regulatory tax, but instead a regulation that is not a tax."[14]

As a practical matter, the "threefold contingency" the Court found persuasive will exist in many situations where a penalty is an enforcement mechanism for a separate obligation but treated as a tax in the Code. If there is a mandated or prohibited action enforced by a tax penalty, the three steps of noncompliance, determination that a violation occurred, and discretionary decision to impose the penalty will separate the challenged rule from the tax penalty.

Is the Existence of Criminal Penalties Sufficient and/or Necessary to Exempt a Challenge from the Anti-Injunction Act?

The Court found that the existence of separate criminal penalties "clinches the case for treating a suit brought to set aside the Notice as different from one brought to restrain its back-up tax."[15] The availability of criminal penalties was the fatal flaw in the Government's position that a party should disobey the Notice, pay a resulting tax penalty, and then bring a refund suit. Unlike "the Anti-Injunction Act's familiar pay-now-sue-later procedure," this would require "lawbreaking at the start."[16] The criminal penalties "practically necessitate a pre-enforcement, rather than a refund, suit—if there is to be a suit at all."[17] The Court's reasoning suggests that the existence of criminal penalties—standing alone—may exempt a suit from the Anti-Injunction Act because barring any pre-enforcement challenge would too thoroughly insulate IRS action from judicial review.

While it is unclear whether criminal penalties are necessary for a suit to fall outside the domain of the Anti-Injunction Act, that issue may be academic. The criminal penalty referenced by the Court is Code Sec. 7203, a misdemeanor that punishes the willful failure to "make a return, keep any records, or supply any information" if required to do so by Title 26 or "regulations made under authority thereof."[18] Other tax crimes are similarly broad and disconnected from any specific tax due. For example, Code Sec. 7204 punishes failure to make required statements to employees, Code Sec. 7210 punishes failure to obey a summons, and Code Sec. 7212 punishes interference with administration of the tax laws. Countering the Government's argument that criminal liability would not

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attach if a taxpayer or advisor refused to comply out of a good faith objection to the validity of the requirement, the Court noted that it previously "held in no uncertain terms" that a defendant's views about the validity of a tax provision do not negate willfulness or provide a defense to criminal prosecution.[19] When the broad statutory language of several of the Title 26 crimes is combined with the longstanding legal principle that a good faith challenge to the validity of a provision is not a defense to criminal prosecution, a decision to violate virtually any obligation imposed by the IRS triggers potential criminal penalties.

Tax Exceptionalism Is Narrow and Does Not Insulate All IRS Action from Pre-Enforcement Review

The APA generally allows pre-enforcement judicial review of executive branch rules, but the Anti-Injunction Act carves out an important exception for suits filed "for the purpose of restraining the assessment or collection of any tax." The Government often reads that exception expansively, as if it insulates everything the IRS does from pre-enforcement review simply because the IRS is the agency responsible for assessment and collection of tax. The Court disabused the Government of that notion, using an example put forth by the Government to underscore that the IRS does not occupy a preferred position among the agencies. As explained by the Court:

> Environmental Protection Agency (EPA) regulations governing the resale of diesel fuel are enforced in part through a penalty that Congress has deemed a tax, in just the way it has the penalty here. The Government concedes that "a court might well conclude" that a suit to enjoin the enforcement of the EPA regulations is "not one 'for the purpose of restraining' tax assessment or collection, even if" a ruling for the plaintiff would "have an eventual downstream impact on the IRS's collection of the [tax] penalty." But that example is no different from this case, save that here the IRS, not the EPA, administers the regulatory mandate. And that one variance should not matter. As explained above, an IRS reporting requirement absent a tax penalty no more triggers the Anti-Injunction Act than an EPA rule does. So adding an identical tax penalty to each of those regulatory schemes should affect the Anti-Injunction Act analysis in the same way—which is to say, not at all.[20]

While the Supreme Court previously rejected the notion that tax operates under a different framework than other regulatory areas in the context of administrative deference,[21] this decision goes an important step further in communicating to the lower courts that the Anti-Injunction Act does not shield the IRS from review.

Tax Lawyers Need to Understand the APA

Use of the APA to challenge aspects of the tax law and IRS enforcement has become increasingly common in recent years. With confirmation from the Supreme Court that pre-enforcement challenges to certain IRS actions may proceed, it is critically important for tax lawyers to consider the APA when developing legal positions and procedural strategies. When the IRS implements an enforcement strategy designed to eliminate effective judicial review of its rules and actions, tax professionals should be thinking about how to utilize the APA to challenge that process.

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ENDNOTES

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1 Slip Op. issued May 17, 2021.
2 Code Sec. 7421(a).
3 Slip Op. at 13.
4 Slip Op. at 15.
5 Opinion and Order Granting Defendant's Motion for Summary Judgement, Denying Plaintiffs' Motion for Summary Judgement, and Dismissing the Complaint, E.D. Mich. Case No. 1:20-cv-11307 (May 13, 2021).
6 *Id.*, at 18, 23.
7 *Id.*, at 26.
8 Slip Op. (Sotomayor, J.)
9 *Id.*
10 Slip Op. at 10.
11 *Id.*
12 Slip Op. at 10.
13 Slip Op. (Kavanaugh, J.), at 3.
14 Slip Op. at 14–15.
15 Slip Op. at 11.
16 *Id.*, at 12.
17 *Id.*
18 Code Sec. 7203.
19 Slip Op. at 12; citing *J.L. Cheek*, SCt, 91-1 USTC ¶50,012, 498 US 192, 204, 206, 111 SCt 604.
20 Slip Op. fn.2 (citations omitted).
21 *Mayo Foundation for Medical Education & Research*, 562 US 44 (2011).

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