



Federal Tax ADVISORY ■

MAY 24, 2021

Taxpayers Can Strike First: Supreme Court Allows Pre-Enforcement Challenges to Certain IRS Regulatory Actions

Taxpayers and those subject to IRS enforcement are often stymied in their efforts to prospectively challenge IRS regulatory actions. The Anti-Injunction Act (AIA), originally enacted in 1867, generally restricts any suit “for the purpose of restraining the assessment or collection of any tax.” Case law has historically applied this broad prohibition to effectively restrict legal challenges to a federal tax unless the taxpayer pays the tax and sues the government for a refund.

The Supreme Court’s May 17 holding in *CIC Services LLC v. Internal Revenue Service* narrows the reach of the AIA by opening the door to more pre-enforcement challenges to IRS regulatory action involving reporting requirements backed by civil and criminal penalties. The ruling is a significant win for those subject to IRS regulatory action and provides welcome clarification of the scope of the AIA. Questions remain, however, about the breadth of the Supreme Court’s ruling and its applicability in different circumstances.

Background

CIC Services involved a challenge to the legality of IRS Notice 2016-66 under the Administrative Procedure Act (APA) for failing the APA’s notice-and-comment requirements. The Notice, promulgated under the IRS’s authority to designate certain transactions as “reportable transactions” subject to heightened information reporting requirements, designated certain micro-captive insurance transactions as potentially subject to tax evasion and thus additional reporting requirements by taxpayers or material advisors that aid, assist, or advise in such transactions. Very generally, micro-captive insurance structures targeted by the Notice involve a parent company that seeks to deduct insurance premiums paid to a captive insurer under the parent company’s control as business expenses while the premiums are excluded from the insurer’s gross income under specific rules that apply to premiums received by small insurance companies. Concerned

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with possible tax avoidance underlying the insurance contracts inherent in these structures, the Notice purports to compel taxpayers and their advisors to provide the IRS with information for it to determine whether such micro-captive insurance schemes are structured for tax avoidance purposes.

Importantly, taxpayers participating in covered micro-captive insurance transactions and their material advisors are subject to civil and criminal penalties for failing to comply with the information reporting requirements outlined in the Notice. The petitioner in *CIC Services* was a material advisor to taxpayers that participated in micro-captive transactions the Notice targeted that sought to nullify the Notice for being an unlawful exercise of IRS regulatory authority under the APA. The District Court for the Eastern District of Tennessee and the Sixth Circuit Court of Appeals sided with the IRS and prevented the action from proceeding under the AIA under the rationale that the petitioner sought to prospectively prevent the assessment of the penalties outlined in the Notice for noncompliance without having first been subject to the penalty. These lower court rulings, if upheld, would have required taxpayers and their advisors engaging in micro-captive insurance transactions to violate the directives of the Notice and subject themselves to monetary (and potentially criminal) penalties to challenge its legality.

***CIC Services* Holding**

The Supreme Court in a unanimous decision reversed these lower court judgments and allowed the challenge to proceed free from the AIA's restrictions. In writing for the Court, Justice Kagan's opinion held that the suit in *CIC Services* was a challenge to specific information reporting requirements that apply to material advisors in micro-captive insurance transactions and thus outside the AIA's reach rather than a challenge to the assessment or collection of a tax. Although the reporting requirements in the Notice are backed by monetary penalties that are in the nature of a tax, the Court viewed the penalties as sufficiently "downstream" from the reporting requirements that were ultimately the target of the suit's APA challenge.

The Court noted three features of the Notice that necessitated this result. First, the Court thought the Notice directed the submission of information to the IRS rather than specifically levying a tax and that the purpose of the suit was for the petitioner to be relieved from the non-tax burden and additional costs of reporting additional information to the IRS. Second, being subject to monetary penalties under the Notice was viewed by the court as "several steps removed" from the Notice's ultimate purpose of directing micro-captive transaction participants to provide the IRS with more information. If noncompliance were a condition precedent to the suit from continuing due to the AIA, the petitioner first would withhold the required information. At that point, the IRS would retain discretion to determine a violation and to impose a monetary (and potentially criminal) penalty. The possibility of criminal penalties for willful noncompliance with the Notice's requirements necessitated in the Court's mind a pre-enforcement challenge of the information reporting requirement underlying the Notice—a challenge to the assessment of the monetary penalty would not eliminate the possibility of criminal enforcement for noncompliance under the Notice.

Limitations and Implications

Although unanimous in its holding, Justice Sotomayor penned an important concurring opinion flagging that the Court's holding may have been different had the petitioner in *CIC Services* been a taxpayer participating in a micro-captive transaction rather than a material tax advisor. Justice Sotomayor noted that while the Notice created an information reporting regime backed by penalties in the event of noncompliance, the underlying purpose of that regime is for the IRS to collect additional information to determine if certain micro-captive transactions are potentially abusive or shams subject to challenge. If the petitioner was instead a taxpayer, noncompliance with the information reporting regime under Justice Sotomayor's reasoning potentially could operate as a "rough substitute" for tax that could potentially be evaded as a result of the invalidity of the micro-capital transaction itself, making the purpose of the suit in that instance possibly fall within the ambit of the AIA.

In another concurring opinion, Justice Kavanaugh offered a bright-line test. If the plaintiff challenges "regulatory taxes or traditional revenue-raising taxes," the AIA bars the suit. On the other hand, "suits challenging regulations backed by tax penalties are ordinarily not barred" by the AIA, even though the end result may preclude the collection or assessment of a "tax" as defined by the Internal Revenue Code.

While questions remain about its lasting import, *CIC Services* does subject the numerous IRS reportable transaction reporting requirements to potential pre-enforcement regulatory challenge. A number of pending APA challenges in numerous circuit and district courts involve similar listed transaction regulatory actions governing syndicated conservation easements, which the IRS has clearly established as a near-term enforcement priority. Justice Sotomayor's concurrence in *CIC Services*, however, creates some uncertainty for whether taxpayers engaging in transactions flagged by the IRS as potentially abusive transactions subject to the listed transaction reporting requirements that bring pre-enforcement challenges are subject to a different standard under the AIA than material advisors who are solely the target of monetary penalties for reporting noncompliance. Further, while Justice Kavanaugh's concurrence offers perhaps a more manageable standard, future litigants may argue that it differs from the principles stated in the majority opinion, generating doubt for those who wish to mount a pre-enforcement regulatory challenge.

What is clear from the Court's holding in *CIC Services*, however, is that the AIA is not an absolute prohibition against pre-enforcement challenges to the IRS's vast information reporting and regulatory regimes. Taxpayers and those impacted by IRS regulations now have greater leeway to challenge IRS regulatory schemes before the IRS takes enforcement action, leaving the IRS's rule-making process open to more APA challenges that could have far-reaching implications.

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