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TAX LITIGATION ISSUES

Expert Analysis

Will 'CIC Services' Open the Floodgates to Tax Challenges?

By Jeremy H. Temkin

Under the Anti-Injunction Act, 26 U.S.C. §7421(a), taxpayers are barred from bringing suits "for the purpose of restraining the assessment or collection of any tax." Accordingly, a taxpayer wishing to challenge a tax provision is generally required either to pay the tax and bring a suit seeking a refund in federal district court or dispute an assessment in Tax Court.

This past term, the U.S. Supreme Court addressed the scope of the Anti-Injunction Act in *CIC Services v. Internal Revenue Service*, 141 S. Ct. 1582 (2021). There, the court unanimously rejected the government's argument that the Anti-Injunction Act barred a challenge to an IRS Notice requiring both taxpayers and their advisors to disclose information regarding transactions the government views as abusive on pain of both civil tax penalties and criminal prosecution. This column analyzes the court's decision in *CIC Services* and considers its ramifications for future challenges to tax-related provisions.

Background

Under the Internal Revenue Code, taxpayers and "material advisors" are required to provide detailed information regarding "reportable transaction[s]," which have "a potential for tax avoidance or evasion." While delegating the identification of such transactions to the IRS, Congress provided stiff monetary penalties for failing to comply with the reporting requirements. Thus, material advisors are subject to initial penalties of $50,000 for failing to provide information regarding the transactions plus daily penalties of up to $10,000 for failing to give the IRS a list of people they advised with respect to the transactions. In addition to these monetary penalties, which are deemed taxes for purposes of the Internal Revenue Code, Congress also provided that willful failures to comply with the reporting provisions are subject to criminal sanctions.

In 2016, the IRS issued Notice 2016-66 classifying certain micro-captive insurance arrangements as reportable transactions. CIC Services, which served as a material advisor to captive transactions, filed a preemptive suit in the U.S. District Court for the Eastern District of Tennessee challenging Notice 2016-66 as violative of the Administrative Procedures Act. CIC sought an injunction declaring the Notice invalid and prohibiting the IRS from enforcing its disclosure requirements.

The government moved to dismiss CIC's suit under the Anti-Injunction Act and the district court granted the motion,

JEREMY H. TEMKIN *is a principal in Morvillo Abramowitz Grand Iason & Anello, PC.* NICOLE L. BUSEMAN, *an associate at the firm, assisted in the preparation of this article.*

concluding that the Notice's penalty provisions could be considered a "tax" that was exempt from pre-enforcement challenge under the Anti-Injunction Act. *CIC Servs. v. Internal Revenue Serv.*, No. 3:17-cv-110, 2017 WL 5015510, at *3 (E.D. Tenn. Nov. 2, 2017). The U.S. Court of Appeals for the Sixth Circuit affirmed, finding that challenges to so-called regulatory taxes, which are designed to influence private conduct as opposed to raising revenue, fall within the purview of the Anti-Injunction Act "because a challenge to the regulatory aspect of a regulatory tax is necessarily also a challenge to the tax aspect of a regulatory tax." *CIC Servs. v. Internal Revenue Serv.*, 925 F.3d 247, 257 (6th Cir. 2019). In a dissenting opinion, however, Judge Nalbandian concluded that the Anti-Injunction Act is inapplicable to CIC's attempt to enjoin the reporting requirement, as distinguished from a dispute over the collection of taxes.

The Supreme Court's Decision

On May 17, the Supreme Court unanimously reversed the Sixth Circuit and allowed CIC's challenge to proceed on the merits. Writing for the court, Justice Kagan defined the issue as "whether the Anti-Injunction Act bars CIC's suit complaining that Notice 2016-66's reporting requirements violate the APA" by virtue of the existence of the tax penalty, ultimately concluding that CIC was seeking to enjoin the reporting requirement as opposed to the statutory tax penalty applicable to breaches of the reporting requirement.

In arguing that the Anti-Injunction Act was inapplicable, CIC had relied heavily on *Direct Marketing Ass'n v. Brohl*, 575 U.S. 1 (2015), in which the court held that the Tax Injunction Act, which bars federal courts from enjoining state tax provisions, did not preclude a challenge to a Colorado requirement that out-of-state retailers report sales to state residents on which they had not collected tax. In *Direct Marketing*, the court had distinguished between suits about reporting requirements and those aimed at the assessment or collection of taxes and concluded, as Justice Kagan put it, that "[a] reporting requirement is not a tax; and a suit brought to set aside such a rule is not one to enjoin a tax's assessment or collection. That is so even if the reporting rule will help the IRS bring in future tax revenue—here, by identifying sham insurance transactions."

The issue in *CIC Services* was, however, complicated by the existence of the statutory tax penalty applicable to violations of Notice 2016-66. Thus, unlike the reporting scheme at issue in *Direct Marketing*, Notice 2016-66 was not merely designed to identify additional sources of revenue, it also subjected individuals who failed to comply with the reporting requirements to substantial monetary penalties.

In evaluating whether a suit had been brought for the prohibited purpose of "restraining the assessment or collection of any tax," the court focused on the relief requested as opposed to the plaintiff's subjective motive. The court rejected the government's assertion that "there is no real difference between a suit to invalidate the Notice and one to preclude the tax penalty," and concluded that CIC's complaint contested the legality of the Notice and its regulatory provisions, "not of the statutory tax penalty that serves as one way to enforce it."

In ruling for CIC, the court identified three aspects of the regulatory scheme that "refute the idea that this is a tax action in disguise." *First*, the Notice compels taxpayers and material advisors who engage in micro-captive transactions to spend "significant time and expense" obeying the reporting obligations thereby subjecting them to substantial compliance costs "separate and apart from the statutory tax penalty."

Second, the court noted the attenuated connection between the Notice and the tax: Before CIC could be subject to the tax penalty it first must withhold the required information about its micro-captive transactions, the IRS next must determine that a violation of the Notice has occurred,

and then make the discretionary decision to impose a tax penalty. As Justice Kagan put it, "[b]etween the upstream Notice and the downstream tax, the river runs long," undermining the government's characterization of the purpose of CIC's suit as enjoining a tax.

Third, the presence of separate criminal penalties for willful failure to comply with the Notice "clinches the case for treating a suit brought to set aside the Notice as different from one brought to restrain its back-up tax." The court recognized that "the existence of criminal penalties explains why an entity like CIC must bring an action in just this form, framing its requested relief in just this way," as "no ordinary person" would risk criminal punishment to challenge a regulation. The court further rejected the government's claim that these concerns are theoretical because no known prosecutions have occurred; the threat of prosecution was sufficient.

Significantly, the court rejected the government's argument that allowing CIC's pre-enforcement challenge would "open the floodgates" to pre-enforcement tax litigation in contravention of the Anti-Injunction Act. The court noted that the government's argument was predicated on disputes over taxes imposed on lawful behavior such as earning income, selling stock, or other business transactions, where the target of the litigation is the requirement to pay a tax. Because in each of these cases "the legal rule at issue is a tax provision," such actions will always fall within the Anti-Injunction Act. By contrast, CIC's suit sought relief from a separate legal mandate, as opposed to the tax that serves as a sanction to the violation of the mandate, and thus falls outside of the prohibition on suits "for the purpose of restraining the assessment or collection of any tax."

Finally, the court addressed the decision's impact on regulatory taxes. While the Court of Appeals had expressed concern that "allow[ing] Plaintiff's argument to succeed would 'reduce the [Anti-Injunction Act] to dust' for challenges to regulatory taxes," Justice Kagan emphasized that CIC was challenging "a regulatory mandate—a reporting requirement—separate from any tax," and "the tax functions, alongside criminal penalties, only as a sanction for noncompliance with the reporting obligation."

In their concurring opinions, Justice Sotomayor and Kavanaugh took pains to note the limitations on the court's ruling. Justice Sotomayor noted that the outcome of the case might have been different if the challenge had been brought by taxpayers who had engaged in a micro-captive transaction, as opposed to a material advisor such as CIC. And Justice Kavanaugh stressed the distinction between "pre-enforcement suits challenging regulatory taxes or traditional revenue-raising taxes" that will continue to be barred by the Anti-Injunction Act and "pre-enforcement suits challenging regulations backed by tax penalties" that will be permitted "even though those suits, if successful would necessarily preclude the collection or assessment of what the Tax Code refers to as a tax."

Conclusion

Notwithstanding the government's concerns that failure to apply the Anti-Injunction Act to CIC's compliant will lead to numerous challenges to tax-related provisions, whether plaintiffs will be able to use *CIC Services* to overcome application of the Anti-Injunction Act will depend on their ability to couch their suits as challenges to IRS regulations on their conduct as opposed to the tax penalties to which violators of the regulations are subject. Especially in light of the concurring opinions, it remains to be seen whether *CIC Services* will provide taxpayers with additional opportunities to dispute tax provisions. At a minimum, however, counsel representing taxpayers and their advisors will undoubtedly explore the outer limits of the court's decision.