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Listed Transactions and the APA - The Potential Fallout from Mann Construction

In brief

The IRS did not follow notice-and-comment procedures when it issued Notice 2007-83.

Introduction

A theme underlying a number of court decisions since the Supreme Court's decision in *Mayo Foundation* [1] is that the Administrative Procedure Act (APA) does apply to the IRS - just like it applies to every other administrative agency. The IRS appears to be slowly coming to recognize this reality, but for many, many years, the agency acted as if the APA did not apply to its actions. The Sixth Circuit's recent decision in *Mann Construction, Inc. v. United States* [2] illustrates the importance of the IRS' prior failures in this regard, in this case in the context of listed transactions.

Background

In 2004, Congress added Section 6707A to the IRS's arsenal of tools for identifying tax avoidance transactions and creating a reporting and penalty system related to such transactions. Designed to shed light on potentially illegal tax shelters, Section 6707A permits the IRS to penalize the failure to provide information concerning "reportable" and "listed" transactions. A "reportable transaction" is one that has the "potential for [illegal] tax avoidance or evasion." [3] A "listed transaction" is one that "is the same as, or substantially similar to, a transaction" that the IRS has identified as a "tax avoidance transaction." [4] The statute authorizes monetary penalties and criminal sanctions for noncompliance with these reporting requirements. [5]

In 2007, the IRS issued Notice 2007-83 , entitled "Abusive Trust Arrangements Utilizing Cash Value Life Insurance Policies Purportedly to Provide Welfare Benefits." [6] The Notice designates certain employee-benefit plans featuring cash-value life insurance policies as listed transactions. A cash-value life insurance policy combines life insurance coverage with a cash-value investment account. As the IRS saw it, these transactions run the risk of allowing small business owners to receive cash and other property from the business "on a tax-favored basis." [7]

Brook Wood and Lee Coughlin collectively own Mann Construction, which is based in Michigan. The company provides general contracting, construction management, and similar services. From 2013 to 2017, Mann Construction established an employee-benefit trust that paid the premiums on a cash-value life insurance policy

benefitting Wood and Coughlin. The company deducted these expenses, while Wood and Coughlin reported as income part of the insurance policy's value. Neither the individuals nor the company reported this arrangement to the IRS as a listed transaction.

In 2019, the IRS concluded that this structure fit the description identified in Notice 2007-83 . The agency imposed penalties on the company ($10,000) and both of its shareholders ($8,642 and $7,794) for failing to disclose their participation in the trust. All three paid the penalties for the 2013 tax year and sought administrative refunds, claiming the IRS lacked authority to penalize them. When the administrative process for challenging the penalties left the taxpayers empty-handed, they turned to federal court. In 2020, the taxpayers sued the federal government to recover the penalties. They challenged the validity of the Notice and penalties on four grounds: (1) the Notice failed to comply with the notice-and-comment requirements of the Administrative Procedure Act; (2) it constituted unauthorized agency action; (3) it was arbitrary and capricious; and (4) even if the Notice was valid, the arrangement at issue did not fall within its scope.

The district court ruled for the government on all fronts, and the taxpayers appealed to the Sixth Circuit.

The Sixth Circuit's Opinion

The Sixth Circuit limited its discussion to only one of the arguments raised by the taxpayers - whether or not the IRS had followed the notice and comments procedures in the APA in this situation. Before an agency may promulgate a regulation that has the force of law - in this instance requiring taxpayers to report a transaction or face hefty financial penalties and criminal sanctions - the APA requires it to run through a light shedding process of its own. Under normal circumstances, the agency must publish a notice about the proposed rule, allow the public to comment on the rule, and, after considering the comments, make appropriate changes and include in the final rule a "concise general statement of" its contents.[8] The process serves regulated parties and the agency alike. "Notice and comment gives affected parties fair warning of potential changes in the law and an opportunity to be heard on those changes - and it affords the agency a chance to avoid errors and make a more informed decision."[9] The process also shines a light on delegations of authority from Congress to an executive-branch agency to ensure they remain subject to public scrutiny. Courts must "set aside" agency actions that fail to follow these requirements.[10]

The IRS did not follow these notice-and-comment procedures when it issued Notice 2007-83 . The IRS offered two explanations for declining to follow the notice-and-comment process: (1) It says that Notice 2007-83 is merely an interpretive rule (which does not require notice and comment) as opposed to a legislative rule (which does require notice and comment); and (2) it says that, even if the Notice amounts to a legislative rule, Congress exempted the IRS from the APA's requirements with respect to these disclosure rules. The court addressed each defense in turn.

The first question addressed by the court was whether Notice 2007-83 was a legislative rule. The APA distinguishes between "legislative rules" and "interpretive rules." Only the former are subject to the Act's notice-and-comment

requirements. By statute, Congress has exempted interpretive rules from notice and comment. [11] Binding "substantive agency regulations" by contrast must satisfy the required procedures. [12] Legislative rules have the "force and effect of law"; interpretive rules do not. [13] Legislative rules impose new rights or duties and change the legal status of regulated parties; interpretive rules articulate what an agency thinks a statute means or remind parties of pre-existing duties. [14] When rulemaking carries out an express delegation of authority from Congress to an agency, it usually leads to legislative rules; interpretive rules merely clarify the requirements that Congress has already put into place. [15]

Measured by these metes and bounds, the Sixth Circuit concluded that Notice 2007-83 amounts to a legislative rule. The Notice has the force and effect of law. It defines a set of transactions that taxpayers must report, and that duty did not arise from a statute or a notice-and-comment rule. It springs from the IRS's own Notice. Taxpayers like Mann Construction had no obligation to provide information regarding listed transactions like this one to the IRS before the Notice. They have such a duty after the Notice. Obeying these new duties can "involve significant time and expense," and failure to comply comes with the risk of penalties and criminal sanctions, all characteristics of legislative rules. [16] The Notice also stems from an express and binding delegation of rulemaking power. Congress tasked the IRS with determining "by regulations" how taxpayers must "make a return or statement" and the information they must provide to the IRS when doing so. [17] Under the penalty provision for failing to report certain types of transactions, the statute delegates to the Secretary of the Treasury authority to "determine[]" which transactions have "a potential for tax avoidance or evasion" or are "the same as, or substantially similar to, a transaction" deemed "a tax avoidance transaction." [18] The long and the short of it is that Congress "delegates to the Secretary of the Treasury, acting through the IRS, the task of identifying particular transactions with the requisite risk of tax abuse." [19] In identifying a new type of transaction purportedly satisfying these demands, Notice 2007-83 purports to carry out this congressional delegation. The court concluded that in every relevant way, the Notice has the stripes and colors of a legislative rule subject to the notice-and-comment process.

Attempting to fend off this conclusion, the IRS argued that Notice 2007-83 merely interprets the term "tax avoidance transaction" of the Notice. But the Court believed that the substance of the Notice is legislative. It creates new substantive duties, the violations of which prompt exposure to financial penalties and criminal sanctions. Those are hallmarks of a legislative, not an interpretive, rule. The government's argument also overlooks the reality that the relevant statutory terms are not self-defining, which explains why Congress delegated to the IRS authority to "determine[]" and "identif[y]" which transactions need to be reported. [20] That feature of the Notice, once again, represents a quality of a quintessential legislative rule. [21]

The IRS also argued that Notice 2007-83 showed the IRS's intention to challenge claimed tax benefits arising from transactions like this one, confirming that the "primary purpose" of the Notice was to inform taxpayers of its plans, not to impose new obligations. That may indeed have been a central purpose of the Notice. But this purpose does not alter the reality that the portion of the regulation at issue - the determination that a certain transaction is one

taxpayers must report on pain of penalty - retains the essential qualities of a legislative rule subject to notice-and-comment procedures. [22] All perspectives considered, the Notice is a legislative rule.

The Sixth Circuit then turned to the IRS' argument that Congress had expressly exempted the IRS from the APA's requirements with respect to the designation of listed transactions. Before an agency may regulate without the protections of the notice and-comment process, it must show that Congress "expressly" carved out the exception. [23] "Exemptions from the terms of the Administrative Procedure Act are not lightly to be presumed." [24]

That is not to say that Congress must "employ magical passwords in order to effectuate an exemption from the Administrative Procedure Act." Modifications of the APA in a given area may take more than one form. Indeed, Congress may "exempt the current statute from the earlier statute" and can "express any such intention either expressly or by implication as it chooses." [25] What is needed is an "express" indication of congressional intent. [26] That leaves courts with the task of determining whether the statute at hand indicates that Congress intended to abrogate the APA's notice-and-comment requirements in a "clear" or "plain" way in a later statute. [27]

After discussing some of the cases in which the courts had considered claims by an administrative agency that Congress had exempted certain situations from the APA, the court turned its analysis to the case at hand. The court emphasized that two relevant provisions exist, one with respect to reportable transactions, the other with respect to listed transactions. "The term 'reportable transaction' means any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion." [28] "The term 'listed transaction' means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011." [29] On top of that, Congress more generally tasked the IRS with determining "by regulations" how taxpayers must "make a return or statement" and the information they must provide to the IRS when doing so. [30]

The court emphasized the absence of any express variation of the APA's notice-and-comment procedures. The statutes do not say anything, expressly or otherwise, that modifies the baseline procedure for rulemaking established by the APA. Nor did Congress expressly displace those requirements by creating a new procedure for these regulations. The statutes do not provide *any* "express direction to the" agency "regarding its procedure" for identifying reportable and listed transactions, let alone procedures "that cannot be reconciled with" notice-and-comment requirements or any other indication within the statutory text that "plainly expresses a congressional intent to depart from" the normal APA procedures. [31] The statutes merely establish a disclosure and penalty regime for the IRS to administer.

As to the statutory text, Congress did not change the background procedural requirements of the APA or otherwise indicate an exemption from those requirements in a "clear" or "plain" way that would make the APA's procedures inapplicable to the IRS. [32]

To counter this argument, the IRS emphasized the cross-reference language in the reportable transaction definition, which describes such transactions as those "determined under regulations prescribed under section 6011." [33] It then adds that, at the time Congress enacted § 6707A, one such regulation provided that the IRS could identify reportable and listed transactions by "notice, regulation, or other form of published guidance." [34] Because a "notice" is the type of IRS action at issue, it claims that the statute contains an express exception from the APA's notice-and-comment process.

The Sixth Circuit rejected this argument. The court stated that the agency's reference to its apparent rules of process, without more, does not show that Congress exempted Notice 2007-83 from notice-and-comment rulemaking. The question is whether Congress amended the APA's prerequisites, not whether the IRS did. While the cross reference is probative of whether Congress was aware of the IRS's transaction-listing procedures, it does not alone suffice to show an express exemption from the APA procedures. Even on its own terms, moreover, the argument falls short. Section 6707A deals with penalties for not reporting certain transactions to the IRS. The statute's key feature is to describe the "type[s]" of "transaction[s]" subject to penalties for non-reporting, namely the ones "determined" by "the Secretary" "because" they have a "potential for tax avoidance or evasion." [35] The statute thus addresses a "which transactions" question, not a "what process" question. That does not suffice to create an express modification of the APA's background assumption that rulemaking will go through the notice-and-comment requirements.

Statutory context reinforces the point. The cross-reference featured in Section 6707A appears in the "definitions" portion of the statute and appears there only to show reportable transactions, not listed transactions. The regulations prescribed under section 6011 contain *all* information that taxpayers must report. One way or another, Congress had to cross-reference those regulations - to incorporate the list of covered transactions - undermining the idea that the cross-reference somehow expressly changes the procedure for issuing legislative rules.

The driving inquiry is whether Congress "clearly" departed from the APA's baseline rule. [36] Potential inferences layered on top of conjectural implications do not suffice. The government, notably, has not identified any case in which Congress exempted an agency from the APA's requirements via such a winding and elaborate route. Accepting the government's approach "would require us to create § 559 precedent that itself could prove disruptive by too readily permitting other agencies to depart from uniform APA requirements." [37]

The IRS also argued that Congress had ratified by inaction the IRS' noncompliance with the APA. The court acknowledged that there are situations in which inaction can result in ratification of prior agency action. However, the court emphasized that inaction may, but does not always, mean ratification. And it rarely suffices to show express modification of the APA's bedrock procedural guarantees given the raft of potential explanations for inaction on Capitol Hill. The government identifies nothing beyond Congress's "mere acquiescence" to the IRS's non-conforming practices over the years, which does not suffice. [38] Implied ratification also would be odd in this context. It may be the case in some settings that Congress is "presumed to be aware of an administrative or judicial interpretation of a

statute and to adopt that interpretation when it re-enacts a statute without change." [39] But Congress presumably is equally aware of the APA's requirement that it must "expressly" override the normal notice-and-comment rules. [40] It takes far more than "clanging silence" to infer that Congress has expressly altered the prerequisites for creating a rule that imposes financial and criminal penalties.

As a last resort, the IRS pointed to the legislative history, noting that tax shelters were a rampant problem that Congress wanted the IRS to address, presumably without the procedural burdens imposed by the APA. However, this argument could not be squared with the Supreme Court's conclusion that the IRS is subject to the APA unless Congress specifically provided an exception - the same rule that applies to every Federal agency. Furthermore, the court concluded that legislative history standing alone cannot supply the "express," "plain," or "clear" direction needed to show that Congress modified the APA's procedures in this area. "Legislative history, for those who take it into account, is meant to clear up ambiguity, not create it." [41]

Because the Sixth Circuit concluded that the IRS failed to satisfy the requirements of the APA when it issued Notice 2007-83 , the court ruled in favor of the taxpayer without reaching the other arguments that the taxpayer had raised.

Analysis

The Sixth Circuit's decision in *Mann Construction* is a logical outgrowth of the Supreme Court's conclusion that the IRS is subject to the APA. Needless to say, the IRS will not like this conclusion, because it will impose additional procedural requirements that the IRS must follow when it wants to "list" a transaction or treat it as "reportable." However, the decision is consistent with the law that has developed under the APA for numerous other agencies; so the IRS may have no choice but to comply, unless it can convince Congress to pass legislation that specifically exempts these types of notices from the requirements of the APA. (And as every reader of this article is aware, getting Congress to pass any tax legislation at this time is a Herculean task.)

The impact of this decision is likely to be far-reaching. Already, taxpayers have cited to *Mann Construction* in connection with cases involving penalties imposed for failure to disclose other "reportable" or "listed" transactions. The IRS has requested that other courts delay ruling on this issue, pending the IRS decision to appeal this decision (presumably to the entire Sixth Circuit or the Supreme Court). Indeed, it can be anticipated that in every situation in which a taxpayer is potentially subject to a penalty under Section 6707A , the taxpayer will contend that the designation of the transaction failed to satisfy the APA, so that no penalty can be applied.

On March 21, 2022, the Eastern District of Tennessee followed *Mann Construction* and held that the IRS failed to follow the APA notice and comment procedures with respect to another "listed transaction" related to micro-captive insurance transactions. [42] The court held that Notice 2016-66 was also a legislative rule that should have followed the notice and comment rules for the APA. The advisors involved in the *CIC* litigation had previously won in the Supreme Court for allowing a pre-enforcement challenge against the regulation in which the Anti-Injunction Act did not apply to

the challenge to Notice 2016-66 . [43]

But the impact of this decision may go well beyond reportable and listed transactions. As noted earlier, the IRS has for decades operated as if it were exempt from the requirements of the APA, even though no such exemption ever existed. As a result, the IRS has issued guidance in many formats, including particularly Notices, in which it failed to comply with the APA. Any taxpayer who does not like the result imposed by such guidance should carefully review the manner in which the guidance was issued; if the APA was not followed, the guidance would be subject to potential challenge. Taxpayers can be expected to make these arguments with more and more regularity.

However, even if a Notice or similar guidance failed because the APA was not followed, the IRS could always take the position that the answer is clear under the statutory language. As *Mann Construction* illustrates, this argument will not succeed if the challenged guidance relies upon a distinction of the IRS' own creation. This will particularly be the case in situations in which the IRS has by Notice required taxpayers to take action not expressly required by Congress, with penalties being imposed as a result of any taxpayer's failure to comply with such requirements.

[1] 562 U.S. __ (2011).

[2] 129 AFTR 2d 2022-885, 6th Cir. March 3, 2022.

[3] *Id.* Section 6707A(c)(l).

[4] *Id.*

[5] Sections 6707A(b) , 7203 and 6707A(c)(2); *see also* Sections 6662A and 6707 .

[6] 2007-2 C.B. 960.

[7] *Id.*

[8] *Perez v. Mortg. Bankers Ass'n.*, 575 U.S. 92, 96 (2015).

[9] *Azar v. Allina Health Servs.*, 139 S. Ct. 1804, 1816 (2019).

[10] 5 U.S.C. § 706(2)(D); *see Tenn. Hosp. Ass'n v. Azar,* 908 F.3d 1029, 1042 (6th Cir. 2018).

[11] 5 U.S.C. § 553(b)(3)(A).

[12] *Chrysler Corp. v. Brown*, 441 U.S. 281, 295, 313-315 (1979).

[13] *Perez*, 575 U.S. at 96-97 (quoting *Shalala v. Guernsey Mem 7 Hosp.*, 514 U.S. 87, 99 (1995)).

[14] *Tenn. Hosp. Ass'n*, 908 F.3d at 1042.

[15] *Id.* at 1043.

[16] *CIC Servs., LLC v. IRS*, 141 S. Ct. 1582, 1591 (2021); *see also Id.* at 1592; Kristin E. Hickman, "Unpacking the Force of Law," 66 V and. L. Rev. 465, 524 (2013) (characterizing penalties as a leading indicator that a regulation is legislative rather than interpretive).

[17] Section 6011(a) .

[18] *Id.*; Section 6707A(C)(1) -(2).

[19] *CIC Servs.*, 141 S. Ct. at 1587.

[20] Section 6707A(c)(1)-(2); see *CIC Servs.*, 141 S. Ct. at 1587.

[21] *Hoctor v. U.S. Dep't of Agric.*, 82 F.3d 165, 169-70 (7th Cir. 1996) (deeming a binding rule promulgated pursuant to a delegation of legislative authority "the clearest possible example of a legislative rule").

[22] *See Cmty. Nutrition Inst. v. Young*, 818 F.2d 943, 946-17 (D.C. Cir. 1987) (per curiam) (characterizing an agency pronouncement as a legislative rule, rather than a policy statement, because language used in the document gave it present binding effect).

[23] 5 U.S.C. § 559.

[24] *Marcello*, 349 U.S. 302 310 (1955); *see also Dickinson v. Zurko*, 527 U.S. 150, 155 (1999) (recognizing consistent processes as a goal of the APA and requiring a clear indication in the relevant statute to deviate from that norm).

[25] *Dorsey v. United States*, 567 U.S. 260, 274 (2012).

[26] *Marcello*, 349 U.S. at 310.

[27] *Cf. Lockhart v. United States*, 546 U.S. 142, 145-46 (2005); *see also Dorsey,* 567 U.S. at 274 ("Statutes enacted by one Congress cannot bind a later Congress.").

[28] Section 6707A(c)(l).

[29] Section 6707A(c)(2) .

[30] *Id.*

[31] *Asiana Airlines*, 134 F.3d at 398.

[32] *See Lockhart*, 546 U.S. at 145-16.

[33] Section 6707A(c)(1) .

[34] Reg. § 1.6011-4(b)(1) -(2) (2003).

[35] Section 6707A(c)(l).

[36] *Lockhart*, 546 U.S. at 145; *see also Ass'n of Data Processing,* 745 F.2d at 685-86.

[37] *Dickinson*, 527 U.S. at 162.

[38] *Hannah v. Larche*, 363 U.S. 420, 438-39 (1960).

[39] *Lorillard v. Pons*, 434 U.S. 575, 580 (1978); *cf. Boeing Co. v. United States*, 537 U.S. 437, 457 (2003).

[40] 5 U.S.C. § 559.

[41] *Milner v. Dep't of Navy*, 562 U.S. 562, 574 (2011).

[42] *CIC Services, LLC v. IRS*, Dkt. No. 3:17-cv-110 (E.D. Tenn. Mar. 21, 2022).

[43] Blaine Saito, *On Tax Day, Unanimous Court Green-Lights Company's Lawsuit Against IRS*, scotusblog.com (May 18, 2021), https://www.scotusblog.com/2021/05/on-tax-day-unanimous-court-green-lights-companys-lawsuit-against-irs/; Lee A. Sheppard, *Successful Challenges to IRS Guidance After CIC Services?*, 171 Tax Notes Federal 1349 (2021); Kristin A. Parillo, *Supreme Court's CIC Services Opinion Clarifies Scope of AIA*, 171 Tax Notes Federal 1286 (2021).

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