

Mann Construction: Another Brick in the APA Wall

Tax Alert

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Adding to a growing body of law applying the Administrative Procedure Act (APA) to IRS rulemaking, the U.S. Court of Appeals for the Sixth Circuit has ruled that an IRS notice designating a so-called "listed transaction" was subject to the notice and comment procedures under the APA.

The ruling in *Mann Construction, Inc. v. United States* concerns a 2007 IRS notice that designates certain trust arrangements that use cash value life insurance policies as a "listed transaction" subject to reporting requirements and penalties for non-compliance under Code section 6707A. Section 6707A defines reportable transaction by reference to section 6011, which authorizes Treasury to define and establish reporting requirements by regulation. The relevant regulation, Treas. Reg. § 1.6011-4(b)(2), provides that the IRS can identify listed transactions in a notice, regulation, or other form of published guidance. In Notice 2007-83, the IRS identified these arrangements as a potential tax shelter that was being promoted to small businesses. The IRS asserted that the arrangements purport to generate significant upfront deductions to the employer under an employee welfare benefit plan with little or no income inclusions to the employee beneficiary, often the business owner or key employee.

The IRS determined that Mann Construction and its two co-owners had failed to report their participation in one of the transactions covered by Notice 2007-83 and assessed section 6707A penalties. After paying the penalties, the taxpayers filed a refund suit asserting, *inter alia*, that the IRS had failed to comply with the APA notice and comment procedures when issuing Notice 2007-83. The District Court for the Eastern District of Michigan granted the government's motion for summary judgment, finding that "the text, structure, and history of section 6707A and related Treasury regulations express [Congress's] clear intent that APA notice and comment procedures need not be followed" (Internal quotation marks omitted). *Mann Construction, Inc. v. United States*, 529 F. Supp. 3d 745, 760 (E.D. Mich. 2021). The Sixth Circuit has now reversed the district court's grant of summary judgment in favor of the government.

The APA provides procedural and substantive requirements for agency rulemaking intended to have the force of law. Although seemingly sidestepped or ignored by IRS and Treasury for years, it is now widely accepted that the APA applies equally to tax rulemaking. *Mayo Found. For Med. Educ. & Research v. United States*, 562 U.S. 44, 55 (2011). In general, under the APA, a rule or regulation will be accorded the force of law only if it has been subjected to notice and comment. This means that before the rule takes effect the agency must publish its intent to adopt such a rule, give the public an opportunity to comment on the proposed rule, consider any comments received, and include a concise statement addressing significant comments before finalizing the rule. Notice and comment is meant to assure "that an agency's decisions are both informed and responsive" and to eliminate "the dangers of arbitrariness and irrationality in the formulation of rules." *Am. Bus. Ass'n v. United States*, 627 F.2d 525, 528 (D.C. Cir. 1980) (quoting *Weyerhaeuser Co. v. Costle*, 590 F.2d 1011, 1027-28 (D.C. Cir. 1978)).

The government argued in *Mann Construction* that Notice 2007-83 was exempt from the normal notice and comment requirement for two reasons. The government claimed that the notice was an "interpretive rule" exempt from notice and comment under the APA and, alternatively, that Congress expressly exempted IRS designations of "listed transactions" from those APA requirements. Both arguments were rejected by the Sixth Circuit.

Interpretive vs. Legislative Rules

The court observed that under the APA, the notice and comment requirement generally does not apply to "interpretive rules, general statements of policy, or rules of agency organization, procedure, or practice." 5 USC § 553(b)(3)(A). By contrast, rules intended to have the effect of law – sometimes termed "legislative rules" – are binding only if they have been subject to notice and comment. Here, the government argued that Notice 2007-83 should be considered an "interpretive rule" because it interprets the

term "tax avoidance transaction" in section 6707A. As the court explained the distinction, "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."

The Sixth Circuit readily found that Notice 2007-83 carries all the hallmarks of a legislative rule. Pursuant to a delegation from Congress, the notice "creates new substantive duties" – a duty to disclose – "the violations of which prompt exposure to financial penalties and criminal sanctions." The court thus rejected the government's argument that that Notice 2007-83 merely interprets the term "tax avoidance transaction" under section 6707A. The court further rejected government claims that the primary purpose of the notice was to inform taxpayers that the IRS would challenge tax benefits claimed under these arrangements, not to impose new obligations. Even accepting that this may have been a central purpose of the notice, that does not change the fact that the Notice imposes reporting obligations that would not otherwise exist.

Express Exemption from the APA

The court also rejected the government's arguments that Congress exempted the Notice from the APA notice and comment procedures. The court found that while Congress has in some instances specifically exempted certain agency rulemaking from the APA's notice and comment requirement, and that it need not employ "magical passwords in order to effectuate an exemption," there must be a clear indication that Congress intended to do so. Here, the court was unwilling to infer congressional intent to carve out designations of "listed transactions" from the notice and comment rules. The court also rejected the government's claims that Congress had ratified the IRS's failure to follow the APA by subsequent legislative inaction, stating, "It takes far more than the clanging silence we have here to infer that Congress has expressly altered the prerequisites for creating a rule that imposes financial and criminal penalties." Lastly, the court refused to find an exemption to notice and comment in the legislative history of section 6707A, even accepting congressional concern about tax shelters, noting that "the Supreme Court has rejected the idea that tax law deserves special treatment under the APA," citing *Mayo Found. For Med. Educ. & Rsch. V. United States*.

Observations

The Sixth Circuit ruling appears to effectively nullify section 6707A penalties for any taxpayer that failed to disclose participation in the trust arrangements described in Notice 2007-83, at least in that circuit. The reasoning would also seem to apply to other notices designating transactions as listed or reportable transactions where the government failed to follow notice and comment procedures. One example is Notice 2016-66, which designated certain micro-captive transactions as a Transaction of Interest under Treas. Reg. § 1.6011-4 and imposed reporting requirements on taxpayers and material advisors. Whether the IRS was required to comply with notice and comment is at issue in *CIC Services, LLC v. IRS*, which is current pending in the District Court for the Eastern District of Tennessee and would be appealable to the Sixth Circuit. Another example is Notice 2017-10, which designates syndicated conservation easements as a listed transaction.

More generally, this ruling is important because IRS and Treasury often claim that tax regulations are interpretive regulations exempt from notice and comment under the APA. For example, a 2019 Treasury policy statement seems to perpetuate this view, even while conceding that it will subject even interpretive regulations to notice and comment "as a matter of sound regulatory policy." Policy Statement on the Tax Regulatory Process (March 5, 2019). As the Sixth Circuit observed here, rules or regulations that impose new duties or change the legal status of the parties subject to them, particularly when the rule carries out an express delegation of authority from Congress, are legislative rules subject to notice and comment. And while this case presents a clear example of new legally enforceable obligations, namely a penalty for failure to report a transaction, many other rules and regulations affect the legal rights, duties, and status of taxpayers suggesting that the scope of "interpretive" rules is narrower than IRS and Treasury claim. Indeed, in other recent cases courts have held that Treasury and the IRS were required to follow notice and comment requirements, despite IRS arguments that the regulations at issue were interpretive and thus exempt. *See, e.g., Oakbrook Land Holdings, LLC v. Comm'r*, 154 T.C. 180, 189 (2020); *Chamber of Commerce of U.S.A. v. IRS*, 2017 BL 358853 (W.D. Tex. Sept. 29, 2017); *Altera Corp. v. Comm'r*, 145 T.C. 81, 116-17 (2015), *rev'd on other grounds*, 926 F.3d 1061.

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