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6th Circuit Rules IRS Must Follow Administrative Procedure Act in ‘Listing’ Transactions, Raising Questions on Extent of Case’s Application

This GT Alert covers the following:

- Background on I.R.C. § 6707A - Penalty for Failing to Disclose Listed and Reportable Transactions
- Background on the Administrative Procedure Act and IRS rulemaking
- 6th Circuit’s holding in *Mann Construction, Inc. v. U.S.*
- Open questions after *Mann Construction, Inc. v. U.S.*

On March 3, 2022, the U.S. Court of Appeals for the Sixth Circuit ruled in *Mann Construction, Inc. v. U.S.*¹ the IRS must follow the Administrative Procedure Act (APA) when identifying “listed transactions” for purposes of applying the I.R.C. § 6707A penalty. *Mann Construction* may have far-reaching implications for taxpayers penalized for failing to disclose listed transactions. Moreover, the decision further clarifies the types of IRS guidance that must comply with the APA.

¹ No. 21-1500 (6th Cir. Mar. 3, 2022).

Background on I.R.C. § 6707A - Penalty for Failing to Disclose Listed and Reportable Transactions

I.R.C. § 6011 requires taxpayers to disclose their participation in reportable transactions by: (i) attaching a Form 8886, Reportable Transaction Disclosure Statement, to his or her tax return; and (ii) in the case of listed transactions, sending a copy of the Form 8886 to the Office of Tax Shelter Analysis (OTSA). A “reportable transaction” is defined as a transaction that has potential for tax avoidance or evasion. Listed transactions, which were at issue in *Mann Construction*, are one category of reportable transactions. I.R.C. § 6707A(c)(2) defines a “listed transaction” as one that is the same or substantially similar to a transaction identified by the IRS as a “tax avoidance transaction.” The IRS has identified listed transactions in multiple types of guidance, including Treasury regulations, revenue rulings, and notices. I.R.C. § 6707A imposes a civil penalty for failing to disclose listed or reportable transactions equal to 75% of the reduction in tax attributable to the transaction. The maximum penalty for reportable transactions is \$50,000 (or \$10,000 for individual taxpayers.) In cases involving listed transactions, the maximum penalty is increased to \$200,000 (or \$100,000 for individual taxpayers). Where the failure to disclose a listed transaction was willful, a taxpayer may have criminal exposure under I.R.C. § 7203.

Background on the APA and IRS Rulemaking

The APA governs rulemaking by federal agencies. Generally, federal agencies are required to: (i) publish a notice of a proposed rule; and (ii) provide the public with an opportunity to comment (referred to as the “notice and comment procedure”). Once a rule is finalized, it must be published with a concise general statement of its contents. The failure to follow the notice and comment procedure can result in the invalidation of the rule. The APA differentiates “legislative rules” from “interpretive rules.” Whereas legislative rules must comply with the notice and comment procedures, interpretive rules are exempt. For many years, the prevailing view was that the APA did not apply to IRS rulemaking. The Supreme Court rejected this view in *Mayo Foundation for Medical Education and Research et al. v. U.S.*² and concluded that the IRS is required to comply with the notice and comment procedure. Since *Mayo Foundation*, courts have applied administrative law principles to IRS regulations and guidance.

Mann Construction Holding

Mann Construction concerns the application of the APA to IRS Notice 2007-83, which identified certain employee benefit plans using cash-value insurance policies as listed transactions. The IRS issued Notice 2007-83 without following the notice and comment procedure. In *Mann Construction*, two small business owners established an employee benefit trust that paid premiums on cash-value life insurance policies benefitting the owners. The IRS determined that Notice 2007-83 applied and imposed I.R.C. § 6707A penalties against the owners and company. In a refund action in district court, the taxpayers challenged the penalty on multiple grounds, including that Notice 2007-83 failed to comply with the notice and comment procedure in the APA. The district court ruled in favor of the government. The taxpayers appealed the case to the Sixth Circuit.

On appeal, the government argued that: (i) Notice 2007-83 is an interpretive rule exempt from the notice and comment procedure; and (ii) even if Notice 2007-83 is a legislative rule, Congress exempted the IRS from complying with the notice and comment procedure in the statute. The Sixth Circuit rejected both arguments. First, it concluded that Notice 2007-83 is a legislative rule because: (i) it created a substantive duty to report a specific type of transaction, the violation of which could result in civil or criminal penalties; and (ii) it was issued pursuant to a specific delegation of legislative authority by Congress.

² 562 U.S. 44 (2011).

Second, the Sixth Circuit concluded there was no express language in the statute that exempted the IRS from complying with the APA. According to the Sixth Circuit, such an exemption must be plain and clear in the statute. The government argued legislative history supported applying an exemption because the IRS had to act quickly to prevent the proliferation of tax shelters. The Sixth Circuit determined that legislative history alone does not supply the express language required to circumvent the APA requirements. According to the Sixth Circuit, if the government disagrees about the application of the APA to the disclosure requirements, it can address the issue with Congress. The Sixth Circuit invalidated Notice 2007-83 and abated the I.R.C. § 6707A penalties.

Open Questions after *Mann Construction, Inc. v. U.S.*

Mann Construction may have far-reaching implications. For the most part, the IRS has not complied with the APA in identifying listed transactions. Thousands of taxpayers have been penalized for failing to disclose listed transactions. It remains to be seen how this case will be applied. The case raises multiple questions, including:

- Will other circuit courts follow this decision?
- What is the impact of this case on taxpayers who have already been penalized for failing to disclose listed transactions?
- Where the IRS has not followed the notice and comment procedure, do taxpayers have an ongoing obligation to report transactions under I.R.C. § 6011?
- Does this decision apply to the disclosure requirements for material advisors under I.R.C. § 6111 and the failure to disclose penalty under I.R.C. § 6707?
- *Mann Construction* involved an IRS notice. In construing the meaning of “legislative rules,” will the same reasoning apply to other IRS non-regulatory guidance such as revenue rulings?

Taxpayers who have received penalties for failing to disclose listed transactions or are required to disclose listed transactions should consult with their tax advisor to determine how *Mann Construction* may apply to them.

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