

Alert | Tax Audits, Litigation & Criminal Tax Defense



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Court Invalidates IRS Notice 2016-66 on Micro-Captive Transactions, the Second Time an IRS Notice Was Vacated This Month

This GT Alert covers the following:

- Tennessee district court invalidates IRS micro-captive reporting requirements in *CIC Services, LLC v. IRS*.
- Background on disclosure requirements for taxpayers and material advisors.
- *CIC Services* holding: IRS failed to comply with the notice-and-comment procedure under APA; issuance of Notice 2016-66 was arbitrary and capricious.
- Decision's far-reaching implications for IRS's identification of reportable transactions.

In *CIC Services, LLC v. IRS*,¹ the U.S. District Court for the Eastern District of Tennessee invalidated Notice 2016-66 for failing to comply with the Administrative Procedure Act (APA). Notice 2016-66 prescribed disclosure requirements for taxpayers and material advisors involved in certain micro-captive transactions. To remedy the harm caused by Notice 2016-66, the district court ruled the IRS must return information it obtained under the notice to taxpayers and material advisors. On the heels of the Sixth

¹ Case No. 3:17-cv-110 (E.D. Tenn. Mar. 21, 2022).

Circuit's decision in *Mann Construction, Inc. v. U.S.*,² *CIC Services* illustrates that IRS rulemaking is vulnerable to challenge on APA grounds. For a more detailed explanation of the holding in *Mann Construction*, please see, "[6th Circuit Rules IRS Must Follow Administrative Procedure Act in 'Listing' Transactions, Raising Questions on Extent of Case's Application.](#)"

Background on Disclosure Requirements for Taxpayers and Material Advisors

The Internal Revenue Code provides multiple disclosure requirements for reportable transactions: (i) taxpayers who participate in reportable transactions are required to disclose their participation under I.R.C. § 6011; and (ii) material advisors who advise taxpayers in connection with reportable transactions are required to disclose the transactions under I.R.C. § 6011 and maintain a list of advisees under I.R.C. § 6112. A "reportable transaction" is defined as a transaction that has potential for tax avoidance or evasion. Reportable transactions include multiple categories. *CIC Services* concerned a "transaction of interest." A "transaction of interest" is defined as "a transaction that is the same or substantially similar to one of the types of transactions the IRS has identified by notice, regulation, or other form of published guidance as a transaction of interest."³ The failure of taxpayers or material advisors to comply with the disclosure requirements can result in the imposition of civil penalties under I.R.C. §§ 6707A or 6707, respectively. Where the failure to disclose was willful, taxpayers and material advisors may be subject to criminal prosecution under I.R.C. § 7203.

CIC Services Holding

In Notice 2016-66, the IRS identified certain micro-captive transactions as "transactions of interest" for purposes of applying the disclosure requirements for taxpayers and material advisors. According to the notice, micro-captive transactions have a potential for tax avoidance or evasion. *CIC Services* manages captive insurance companies and, therefore, it anticipated that the costs of complying with Notice 2016-66 would be significant. It sought a preliminary injunction to prevent the IRS from enforcing the disclosure requirements. The district court initially denied *CIC Services*'s motion for lack of subject matter jurisdiction under the Anti-Injunction Act (AIA). *CIC Services* appealed, and the Supreme Court ultimately ruled that the AIA did not preclude a pre-enforcement challenge of Notice 2016-66.⁴

On remand, *CIC Services* argued that Notice 2016-66 was invalid on two grounds. First, it argued that Notice 2016-66 was invalid because the IRS failed to comply with the notice-and-comment procedure under the APA. The government argued that: (i) Congress exempted the IRS from complying with the APA in identifying reportable transactions; and (ii) alternatively, the notice-and-comment procedure did not apply because Notice 2016-66 was an interpretive rule instead of a legislative rule. The district court noted that the Sixth Circuit recently rejected both arguments in *Mann Construction*. Because *Mann Construction* was binding here,⁵ the district court invalidated Notice 2016-66 for failing to comply with the APA.

Second, *CIC* argued that the issuance of Notice 2016-66 was arbitrary and capricious. Under the arbitrary and capricious standard, courts evaluate whether an agency analyzed the relevant data and provided a sufficient explanation for its decision.⁶ Typically, a court is limited to the administrative record in evaluating the agency's reasoning. Applying this standard to Notice 2016-66, the district court determined that the administrative record lacked relevant data and facts supporting the IRS's determination that

² No. 21-1500 (6th Cir. Mar. 3, 2022).

³ Treas. Reg. § 1.6011-4(b)(6).

⁴ *CIC Services, LLC v. I.R.C.*, 141 S. Ct. 1582 (2021).

⁵ An appeal of *CIC Services* would lie in the U.S. Court of Appeals for the Sixth Circuit.

⁶ *Motor Vehicles Manufacturers Association v. U.S.*, 463 U.S. 29 (1983).

micro-captives were transactions of interest. Although the administrative record included prior IRS news releases and notices, federal statutes, legislative history, and case law, the IRS did not provide an explanation of its reasoning. According to the court, merely providing examples of cases involving abusive micro-captive transactions was not sufficient under the APA. Therefore, the district court agreed with *CIC Services* that the IRS acted arbitrarily and capriciously in issuing Notice 2016-66.

Having invalidated Notice 2016-66 on both grounds, the district court considered the appropriate remedy. Because the IRS was not entitled to the information collected under Notice 2016-66, the district court ruled that it must return it to taxpayers and material advisors. But the district court refused to issue an injunction preventing agencies from introducing information obtained unlawfully under the notice in judicial and administrative proceedings. Anticipating that the IRS was likely to issue an APA-compliant notice, the district court did not want to create significant litigation about the source of the IRS's information going forward. Given that the IRS may be able to rely on information obtained improperly under Notice 2016-66 in judicial and administrative proceedings, it is unclear how *CIC Services* will affect IRS enforcement.

Conclusion

CIC Services makes it clear that, at least in the Sixth Circuit, the IRS must comply with the APA in identifying reportable transactions. This decision has far-reaching implications because the IRS's identification of reportable transactions governs: (i) the disclosure requirements for taxpayers and material advisors; and (ii) the application of civil and criminal penalties for failing to disclose. It remains to be seen whether other circuit courts will follow *Mann Construction* and *CIC Services*. Taxpayers and material advisors who have current disclosure requirements or who have paid penalties for failing to disclose reportable transactions should consult their tax advisor to understand how these cases may apply to them and what actions might be required to recover their information and obtain a refund of penalties they paid.

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