

## **Federal Tax Guidance Overturned Under Administrative Procedure Act**

*By: Elliot Pisem and David E. Kahen*

When a Federal agency wishes to promulgate a new "legislative rule," the Administrative Procedure Act generally requires the agency to publish a notice of proposed rulemaking in the Federal Register at least 30 days before the rule's effective date, and interested persons must be provided the opportunity to submit comments before the rule becomes effective (5 U.S.C. § 553). The government has suffered defeat in two recent cases -- one involving temporary Treasury Regulations, and the other an IRS notice -- where it short-circuited this procedure and then failed to persuade a court that the "notice-and-comment" requirement did not apply.

### **Mann Construction**

In *Mann Construction, Inc. v. United States*, 129 AFTR 2d 2022-885 (6<sup>th</sup> Cir.), *reversing* 127 AFTR 2d 2021-2000, an S corporation (Mann Construction) had established in 2013 two trusts (collectively, the "benefits trust") as part of a complex arrangement. The benefits trust used funds provided by Mann Construction to pay premiums on whole life insurance policies on the lives of employees who were also the shareholders of the corporation. Contributions by Mann Construction under the arrangement to fund the insurance premiums were purportedly deductible.

Years earlier, the IRS had issued Notice 2007-83 (the Notice) to identify arrangements of this nature as "listed transactions" for purposes of Sections 6111 and 6112 of the Internal Revenue Code (IRC or Code) and Reg. Section 1.6011-4. That regulation requires that "listed transactions" be disclosed on Form 8886, "Reportable Transaction Disclosure Statement," to be completed and attached to tax returns and otherwise filed in the manner required by the regulation. The Notice further provided that persons who failed to disclose these transactions as required under the regulation would be subject to penalty under IRC Section 6707A.

Mann Construction included with its Form 1120S tax return for 2013 a Form 8275 with an attachment that disclosed its contributions to the benefits trust and its legal rationale for deducting contributions. Form 8275 is used generally for disclosure of return positions with respect to which an understatement penalty might otherwise be asserted, but its use does not relieve a taxpayer of the obligation to file Form 8886 with respect to listed transactions. The IRS asserted penalties on Mann Construction and the two employee/shareholders under Section 6707A, for each year of a 5-year period commencing in 2013, for failure to disclose participation in the specific manner required by Reg. Section 1.6011-4. Mann Construction and its shareholders paid the penalties for 2013 and brought an action in a U.S. District Court after filing a claim for refund.

One argument made by the plaintiffs to the court, in the context of cross-motions for summary judgment regarding the validity of the Notice, was that the Notice was a legislative rule, because it created specific duties (in this case, reporting requirements) with respect to transactions not defined by any statutory provision and applied substantial penalties for failure to comply with those requirements. As a legislative rule, the Notice was subject to the notice-and-comment requirement of the APA. Because the Notice was issued without compliance with the notice-and-comment requirement, the Notice was ineffective and the penalty under Section 6707A therefore did not apply.

The District Court opinion discussed the plaintiff's argument and the government's counterargument to the effect that the statutory provisions relating to the definition of listed transactions, the legislative history of Section 6707A, and the subsequent expansion by Congress of the listed transaction regime without any attempt to overturn the IRS practice of identifying listed transactions through notices that did not meet the notice-and-comment requirement of the APA, all indicated that Congress intended that the notice-and-comment requirement of the APA not apply in the context of the identification of listed transactions by the IRS. The court found the government's arguments to be more compelling.

On appeal by the plaintiffs, the Court of Appeals for the Sixth Circuit reversed the lower court's decision. The Court of Appeals found that, under relevant precedent, the notice-and-comment requirement of the APA applies except where Congress has expressly provided that the APA does not apply; and that Congress had not expressly provided that the APA requirement would not apply with respect to IRS notices issued to identify listed transactions.

The appellate court specifically rejected, in particular, the government argument that Congress had ratified the IRS view that the APA did not apply to the Notice through inaction, with the opinion stating that "far more than the clanging silence we have here" would be needed to infer that Congress had overridden the application of the APA in this context. Consequently, the penalty imposed on the plaintiffs premised on the validity of the Notice was overturned.

## **Liberty Global**

In *Liberty Global, Inc. v. United States*, 129 AFTR 2d 2022-\_\_\_\_, No. 1:20-cv-03501-RBJ (D. Ct.), a corporation which was an affiliate of the plaintiff (LGI) had sold its interest in a Belgian company (TGH) in December 2018 to LGI's parent company. LGI was required to recognize income equal to its share of gain from the TGH transaction. The circumstances described in the opinion, and a filing by the government with the District Court on December 22, 2021, in opposition to LGI's motion for summary judgment, indicate that the affiliate was a "controlled foreign corporation" as defined in IRC Section 957, and that LGI was a U.S. shareholder of the affiliate treated under IRC Section 964(e) as having received a dividend from it.

LGI asserted that it met the requirements for a deduction under IRC Section 245A that would offset this income. Section 245A was added to the Code as part of the law commonly known as the Tax Cuts and Jobs Act (P.L. 115-97, also known as the "TCJA") enacted on December 22, 2017. Section 245A and other TCJA provisions were intended to transition the U.S. tax system to a "participation-exemption system" in which income of foreign affiliates is, under Section 951A and related provisions, subject to tax at a reduced rate under the global intangible low-taxed income (GILTI) regime when earned, but not subject to further tax when repatriated to the United States.

Certain gaps between Section 245A and Section 951A left open the potential that a deemed distribution of income after 2017 might effectively be excluded from the U.S. shareholder's income under Section 245A, without such income's ever having been subjected to the GILTI tax. The TGH transaction was apparently designed to achieve these results.

Treasury issued in June 2019 temporary regulations (set forth in TD 9865) that by their terms applied with retroactive effect and were intended to preclude the application of Section 245A in the circumstances described in *Liberty Global*. By reason of the temporary regulations, LGI initially reported GILTI income substantially greater than its deduction under Section 245A, and paid additional tax for its 2018 tax year. LGI filed suit to seek a refund of this tax, and moved for summary judgment that the temporary regulations were invalid.

LGI made several arguments in support of the invalidity of the temporary regulations, but the court found that it needed to consider only one of the arguments -- namely, that the temporary regulations had been issued without satisfaction of the notice-and-comment requirement as generally applicable under the APA to the issuance of legislative regulations.

Treasury did not dispute LGI's assertions that the temporary regulations were legislative in nature and that the manner in which those regulations were issued did not meet the notice-and-comment requirement generally applicable under the APA. Section 553(b)(3) of the APA provides in substance, however, that the notice-and-comment requirement will not apply if "the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest." The government attempted to persuade the court that there was "good cause" for failure to comply with the notice-and-comment requirement.

The court did not find the government's arguments to be persuasive. In particular, the court concluded that publication with an opportunity to comment before the regulations became effective would not have improperly encouraged taxpayers to engage in the conduct intended to be prevented by the temporary regulations.

The potential for such transactions was apparently known to the government within 10 months after enactment of the TCJA, and IRC Section 7805(b), which limits the extent to which regulations may be retroactive, specifically provides that regulations issued within 18 months of the date of enactment of the statutory provision to which the regulation relates may be applied with retroactive effect. Thus, the court concluded, the Treasury had sufficient time to issue the regulations in a manner such that the minimum 30-day period for notice and comment would end by June 22, 2019, which would in turn permit retroactivity to the date of enactment of the TCJA.

The court also rejected the government argument that Section 7805(e), which authorizes temporary regulations that could be effective for a period of up to 3 years, implicitly indicated that such temporary regulations were not subject to the APA notice-and-comment requirement. The opinion noted that an essentially identical argument by the government had been rejected in another case (*Chamber of Commerce of U.S.A. v. Internal Revenue Service*, No. 1:16-CV-944-LY (D. Ct. 2017)) concerning the validity of temporary regulations, and analogous authority concerning non-tax regulations that was contrary to the government's position in this case.

The *Liberty Global* opinion also cited with approval *Mann Construction* in support of the view that an exemption from the notice-and-comment requirement may be created only by clear expression from Congress. Ultimately, the court found no such clear expression in the statutory provision concerning temporary regulations, and granted LGI's motion for summary judgment as to the invalidity of the temporary regulations.

## Observations

It remains to be seen whether the government will respond to its losses in *Mann Construction* and *Liberty Global* by seeking legislative action to broaden the exemptions from the notice-and-comment requirement under the APA. Regardless, taxpayers and their advisers should be mindful of the possibility that failure to comply with this requirement (or other requirements of the APA applicable to the issuance of federal rules) may cause a rule or regulation of the IRS or Treasury to be unenforceable.

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