

Court Boosts Actions to Avoid or Recover a Listed Transaction Penalty

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For some time, the IRS has "listed" certain transactions as suspect. Based on a recent Sixth Circuit decision, a taxpayer against whom the IRS proposes a penalty for failure to report participation in a *listed* transaction may have a viable argument to dispute imposition of the penalty. Similarly, a taxpayer that paid a penalty for participation in a *listed* transaction may have a meritorious position to recover the penalty.

In *Mann Construction, Inc. v. United States*, 2022 WL 619822 (6th Cir. March 3, 2022), the United States Court of Appeals for the Sixth Circuit decided that the procedure used by the IRS to list the transaction at issue violated the Administrative Procedure Act, 5. U.S.C. §§551 *et seq.* Although refund of the penalty awaits remand of the case to the trial court, a taxpayer against whom the IRS now is proposing a penalty for participation in a listed transaction should protest the proposal in the IRS Independent Office of Appeals within the period allowed for the protest.

A taxpayer who has paid a penalty for participation in a listed transaction and seeks to recover it must timely file an administrative refund claim with the IRS stating the facts and grounds of claim, which in this case is that the listing of the transaction by notice violated the Administrative Procedure Act. Treas. Reg. §301.6402(b). If the IRS disallows the claim, the taxpayer should thereafter file suit, within the time-period allowed, in federal district court or the Court of Federal Claims to recover the penalty. (Suit in the United States Tax Court prior to paying the penalty is not allowed except, perhaps, in a collection due process proceeding.) The taxpayer must not have previously litigated and lost imposition of the penalty, nor must the taxpayer have signed a closing agreement with the IRS finally determining the liability for the tax period.

To give visibility to what might be meritless tax avoidance transactions, Congress required taxpayers to *report* participation in such transactions at the time that they file their tax returns. A taxpayer that fails to report a reportable transaction is subject to a penalty, subject to a capped amount, equal to 75 percent of the decrease in tax shown on the return as a result of the transaction regardless of the outcome of an IRS challenge to the transaction. IRC §6707A.

The elements of certain reportable transactions ("confidential," "contractual protection," "loss") are spelled out by the Treasury Department in a tax regulation. Treas. Reg. §301.6011-4(b). The Treasury Department recognized, however, that taxpayers might develop new tax avoidance transactions after the tax regulation was published. The regulation consequently authorizes the IRS to identify new reportable transactions by spelling out their elements in a "notice" or other means of publication. These added reportable transactions are "listed" transactions. The tax regulation, itself, was not amended to describe the elements of these new listed transactions.

The process of publishing a tax regulation typically is subject to the Administrative Procedure Act, which requires a federal agency to use a notice and comment procedure. A tax regulation published pursuant to that procedure typically has the force and effect of law. The procedure requires the agency to publish the regulation in proposed form, receive public comments about the proposed regulation, change the proposed regulation to the extent appropriate in accordance with the public comments, and explain in a preamble to the final regulation why the final regulation was, or was not, changed based on any "significant" comments.

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In contrast to a tax regulation, a notice is a public pronouncement by the IRS that may contain guidance involving substantive *interpretations* of the Internal Revenue Code. An IRS notice is not a treasury regulation and is not treated by the IRS as subject to the Administrative Procedure Act. The public is not provided the opportunity to comment on the transaction in a notice.

In *Mann Construction*, at issue was the listed transaction, "Abusive Trust Arrangements Utilizing Cash Value Life Insurance Policies Purportedly to Provide Welfare Benefits." The transaction was listed in Notice 2007-83. The details of the transaction are not important for this Alert, but what is important is that the IRS believed that the Administrative Procedure Act did not apply to publication of a notice, and the IRS did not use the Administrative Procedure Act notice and comment procedure to publish it. The IRS's reasons were that a listed transaction does not have the force and effect of law because it merely *interprets* the law that Congress enacted, or even if the listed transaction does have the force and effect of law, Congress *exempted* the IRS from the Administrative Procedure Act by expressly authorizing it to identify a transaction as "listed."

The taxpayer in *Mann Construction* did not report to the IRS that it engaged in the transaction listed in Notice 2007-83. The IRS assessed the penalty for the reporting failure. The taxpayer paid the penalty and sued for refund, which the federal district court denied. On appeal, the Sixth Circuit reversed, rejecting the IRS's reasons for excluding the listed transaction from the notice and comment procedure of the Administrative Procedure Act. The Sixth Circuit classified the listed transaction as a *legislative* rule, and not an *interpretive* rule, because the listing of the transaction imposed new rights and duties on the taxpayer that previously were nonexistent. Additionally, the Sixth Circuit decided that Congress had not exempted the listing of a transaction from the Administrative Procedure Act. Congress expresses such an exemption clearly, and for listed transactions, Congress made no such clear expression. The reversal may eventually result in a refund of the penalty, because as the case now stands, the taxpayer's failure to report the transaction did not violate a duly promulgated rule that had the force and effect of law.

The IRS currently lists 36 listed transactions, many of which are identified by notices or other published guidance not subjected to the notice and comment procedure. (<https://www.irs.gov/businesses/corporations/listed-transactions>) The Sixth Circuit opinion in *Mann Construction* is more like the first step than the last step in concluding that the listing of a transaction is not subject to a penalty if the listing did not comply with the Administrative Procedure Act. The IRS might file for rehearing, petition the Supreme Court for review, or pursue the issue in other circuits to obtain a more favorable decision. Nonetheless, taxpayers who have paid, or may pay, penalties for not reporting participation in listed transactions should give thought now to protective actions they may take.

Please contact the author if you wish to discuss these developments further.