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June 17, 2021 | Number 2880

US Supreme Court Allows Challenge to IRS Rule to Go Forward Despite Anti-Injunction Act

The ruling provides a new avenue for parties to bring pre-enforcement challenges to IRS rules and regulations.

Key Points:

- In *CIC Services v. IRS*,¹ the US Supreme Court allowed a pre-enforcement challenge to an IRS reporting rule to go forward, thereby expanding the universe of suits that may survive an Anti-Injunction Act challenge.
- Parties seeking to bring a pre-enforcement challenge must identify a non-tax obligation that will be alleviated through their suit. Pre-enforcement suits by parties who would otherwise need to risk criminal liability are more likely to survive.

Background

Anti-Injunction Act

After a government agency promulgates a new rule or regulation, regulated parties who may be subject to the rule commonly challenge it before it is ever enforced against them.² For tax rules and regulations, however, that path is not necessarily available. The Anti-Injunction Act forbids any suit “for the purpose of restraining the assessment or collection of any tax.”³ The Act was passed to prevent taxpayers from interfering with the flow of tax revenue, and generally requires taxpayers to challenge IRS rules and regulations either through a lawsuit seeking a refund of taxes paid or through a deficiency proceeding in the Tax Court, which permits a challenge without requiring payment of the taxes first.⁴

Reporting Requirement at Issue

The Internal Revenue Code requires taxpayers and “material advisors” who earn income aiding or assisting taxpayers in connection with any “reportable transaction” to provide detailed, timely information in reports to the IRS and to keep lists of those they advise on such transactions.⁵ A reportable transaction is one “with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under [I.R.C. §] 6011, such transaction is of a type which the [IRS] determines as having a potential for tax avoidance or evasion.”⁶ The purpose of this rule is for parties to notify the IRS of certain potentially abusive transactions, so that the agency can respond if

necessary (e.g., through audit activity). This requirement is backstopped by substantial civil penalties,⁷ which — critically — the Internal Revenue Code deems to be taxes,⁸ as well as by criminal penalties.⁹

In 2016, the IRS promulgated Notice 2016-66 (the Notice),¹⁰ which identifies certain micro-captive insurance transactions as potentially abusive reportable transactions. Micro-captive insurance transactions are insurance agreements between a parent company and a controlled (or “captive”) insurer. The Internal Revenue Code treats such agreements favorably. The parent company can deduct its insurance premiums as business expenses, and the insurer can exclude up to US\$2.2 million of the premiums it receives from its taxable income. The Notice is intended to ensure that these micro-captive insurance contracts are real contracts, and not sham transactions designed to avoid tax liability.¹¹

CIC Services’ Challenge

CIC Services is a material advisor to taxpayers with respect to micro-captive insurance transactions that may be subject to the Notice’s reporting requirement. CIC Services has said that it would comply with the Notice, but that such compliance would impose significant costs. It challenged the Notice under the Administrative Procedure Act in US district court, alleging that (i) the IRS promulgated the Notice without notice-and-comment rulemaking, as CIC Services asserted was required, and (ii) the Notice was arbitrary and capricious. The district court declined to address those arguments, however, because it dismissed the lawsuit under the Anti-Injunction Act. The district court held that the Anti-Injunction Act barred CIC Services’ suit because CIC Services was “seek[ing], at least in part, to restrain the IRS’s assessment or collection of a tax,” i.e., the penalty for failing to file reports of reportable transactions that the Internal Revenue Code treats as a tax.¹²

The US Court of Appeals for the Sixth Circuit affirmed in a divided opinion. The majority rejected CIC Services’ argument that the “purpose” of its suit was not to challenge the penalty but rather the burdensome reporting requirement. Despite finding that argument “intuitive at first glance,” the majority concluded that it was inconsistent with Supreme Court precedent, which focused on the “effect of the plaintiff’s suit” and whether “the relief sought would ‘necessarily preclude’ the assessment or collection of the relevant tax.”¹³ Permitting parties to recharacterize their suits as CIC Services sought to do, the majority added, would render the Anti-Injunction Act a dead letter.¹⁴

Judge Nalbandian dissented. He emphasized that CIC Services’ injury was not the civil penalty but the “hundreds of hours of labor and tens of thousands of dollars” it would cost to comply with the reporting requirement.¹⁵ “Put simply,” Judge Nalbandian stated, “this is not a dispute over taxes.”¹⁶ Moreover, as a result of the decision, CIC Services would have to choose between “acquiesc[ing] to a potentially unlawful reporting requirement” and “flout[ing] the requirement,” risking substantial civil and criminal penalties.¹⁷

CIC Services sought rehearing en banc, which the Sixth Circuit denied. Seven judges dissented from the denial of rehearing en banc, and two judges wrote separate opinions concurring in the denial of rehearing en banc. One of those concurring opinions, written by Judge Sutton, specifically acknowledged that CIC Services’ position “seem[ed] to be right as an original matter” but noted that the “key complexity” in the case was “how to interpret Supreme Court decisions interpreting” the Anti-Injunction Act, something the Supreme Court was in a better position to do.¹⁸ The Supreme Court granted CIC Services’ petition for a writ of certiorari.¹⁹

The Supreme Court's Decision

The Supreme Court reversed in a unanimous decision written by Justice Kagan. The Court focused on the objective “purpose” of CIC Services’ suit — rather than CIC Services’ subjective motivations — as revealed by the face of the complaint and with particular emphasis on the relief sought.²⁰ The Court found three aspects of the lawsuit significant for determining that it was not barred by the Anti-Injunction Act:

- The reporting requirement is itself burdensome and costly. As the Court had held in a related context, a reporting requirement *precedes* the assessment and collection of a tax but does not itself fit within those terms.²¹ And CIC Services’ suit was focused on setting aside the Notice, which imposed “independently onerous reporting mandates,” not on the civil penalty for violating those mandates.²² Indeed, CIC Services maintained that it would comply with the Notice as long as it remained on the books, and thus would never become liable for the penalty.²³
- “[T]he Notice’s reporting rule and the statutory tax penalty are several steps removed from each other.”²⁴ For CIC Services to owe the tax penalty, it would first have to violate the reporting rule. The IRS would then have to determine that CIC Services had violated the rule and “make the — entirely discretionary — decision to impose a tax penalty.”²⁵ That causal chain is “too attenuated” for the Anti-Injunction Act to apply.²⁶
- Violations of the reporting requirement created by the Notice are enforced not only through a civil penalty deemed to be a tax but also through a non-tax criminal penalty.²⁷ “That fact clinche[d] the case for treating a suit brought to set aside the Notice as different from one brought to restrain its back-up tax.”²⁸ Because the criminal penalty would exist even in the absence of any civil tax penalty, a suit to restrain the collection of the penalty would not resolve CIC Services’ injury. Moreover, CIC Services should not be forced to risk criminal sanctions to challenge this reporting requirement.²⁹

Justice Sotomayor concurred, writing separately to emphasize that the case might have come out differently if CIC Services were a taxpayer instead of an advisor.³⁰ Taxpayers incur lower costs in reporting their financial information, and for some taxpayers, the noncompliance penalty may roughly approximate the tax liability that the taxpayer avoided by failing to provide the required information.

Justice Kavanaugh also concurred, “writ[ing] separately to underscore what remains (and does not remain)” of two Supreme Court cases that looked to the “effects,” rather than the “purpose,” of the suit.³¹ Like the Sixth Circuit, other lower courts had interpreted those cases as barring any pre-enforcement suit that would “‘necessarily preclude’ the assessment or collection of a tax.”³² Indeed, while he was on the D.C. Circuit, Justice Kavanaugh wrote an opinion adopting that construction of the case law.³³ Justice Kavanaugh agreed that the “effects” test is hard to square with the text of the Anti-Injunction Act — which, he said, does not bar “pre-enforcement suits challenging a regulation backed by a tax penalty.”³⁴

Implications for the Viability of Other Pre-Enforcement Actions

CIC Services Does Not Sanction Pre-Enforcement Challenges Generally

Commentators differ on how broadly the Supreme Court’s decision sweeps. While the decision offers a new avenue for bringing pre-enforcement challenges to IRS regulations, it is also narrowly drafted.³⁵ The Supreme Court took seriously the government’s concern that allowing CIC Services’ suit to proceed would open the “floodgates” to such challenges.³⁶ The Court emphasized that the relief CIC Services sought “d[id] not run against a tax at all.”³⁷ Instead, “[t]he suit contests, and seeks relief from, a separate legal mandate” — the reporting provision — and the tax “appears on the scene” “only to sanction that

mandate's violation."³⁸ The Court explained that its decision did not pertain to "the run-of-the-mine suits" in which a taxpayer directly challenges a tax rule.³⁹

Some Considerations When Applying *CIC Services*

Nonetheless, *CIC Services* does allow some pre-enforcement challenges that courts previously barred. The authors of this *Alert* expect that pre-enforcement challenges seeking to take advantage of *CIC Services* will be brought by advisors or other non-taxpayers, and will attempt to identify a *non-tax* obligation that would be alleviated through the suit. *CIC Services*' lawsuit, for example, was aimed at an "onerous" reporting requirement imposed on material advisors, not taxpayers' underlying income tax obligations or the downstream civil penalty that *CIC Services* never expected to incur.⁴⁰ Prior to *CIC Services*, at least one US district court had allowed a pre-enforcement action to go forward in similar circumstances. There, the plaintiff organizations — which were not themselves taxpayers — did "not seek to restrain assessment or collection of a tax against or from them or one of their members," but instead challenged a regulation "so that a reasoned decision c[ould] be made about whether to engage in a potential future transaction."⁴¹ For that reason, the district court concluded that the lawsuit was not barred by the Anti-Injunction Act.⁴²

The Supreme Court was also heavily influenced by the presence of criminal penalties, including the possibility of up to one year in prison.⁴³ As the Court explained, such penalties "practically necessitate a pre-enforcement, rather than a refund, suit — if there is to be a suit at all," since the "ordinary person" does not "risk[]" jail time, "even to contest the most burdensome regulation."⁴⁴ The criminal penalty at issue in *CIC Services* is a broad provision that is not specific to the reporting of reportable transactions. And there are other criminal tax provisions that could arguably come into play when someone disobeys a tax rule or regulation it believes to be invalid. Thus, this may be an area of further interest and development for those seeking to pursue pre-enforcement challenges to IRS rules.

Other Exceptions to the Anti-Injunction Act

CIC Services is not the only exception to the Anti-Injunction Act. Courts have allowed pre-enforcement suits to go forward when there is no other adequate remedy, such as when the usual procedure for challenging taxes and tax rules — a refund or deficiency proceeding — is not available.⁴⁵ And of course, the Anti-Injunction Act does not bar pre-enforcement suits that involve civil penalties *not* deemed to be taxes.⁴⁶ Parties considering a pre-enforcement suit should assess whether these other exceptions may apply to their case as well.

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The authors would like to thank Christine C. Smith for her contribution to this Client Alert.

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Endnotes

¹ *CIC Servs., LLC v. Internal Revenue Serv.*, 141 S. Ct. 1582 (2021).

² See, e.g., *Nat'l Org. of Veterans' Advocs., Inc. v. Sec'y of Veterans Affs.*, 981 F.3d 1360, 1379 (Fed. Cir. 2020) (“[P]reenforcement review of agency rules and regulations has become the norm, not the exception.” (citation omitted)).

³ I.R.C. § 7421(a). The Declaratory Judgment Act has a similar restriction, which courts generally interpret conterminously. See 28 U.S.C. § 2201(a) (allowing federal courts to provide declaratory judgments “except with respect to Federal taxes”); *Cohen v. United States*, 650 F.3d 717, 727-31 (D.C. Cir. 2011) (en banc).

⁴ See, e.g., *Starr Int'l Co. v. United States*, 910 F.3d 527, 536 (D.C. Cir. 2018).

⁵ I.R.C. §§ 6111, 6112.

⁶ *Id.* § 6707A(c)(1).

⁷ *Id.* §§ 6707, 6708.

⁸ See *id.* § 6671(a) (requiring all penalties in chapter 68, subchapter B of the Internal Revenue Code — including those in §§ 6707 and 6708 — to “be assessed and collected in the same manner as taxes”).

⁹ *Id.* § 7203.

¹⁰ 2016-47 I.R.B. 745 (Nov. 21, 2016), <https://www.irs.gov/pub/irs-irbs/irb16-47.pdf>.

¹¹ See *id.* at 745-76; see also *CIC Servs.*, 141 S. Ct. at 1587.

¹² *CIC Servs., LLC v. Internal Revenue Serv.*, No. 3:17-cv-110, 2017 WL 5015510, at *4 (E.D. Tenn. Nov. 2, 2017), *aff'd*, 925 F.3d 247 (6th Cir. 2019), *rev'd and remanded*, 141 S. Ct. 1582.

¹³ *CIC Servs.*, 925 F.3d at 256 (quoting *Bob Jones Univ. v. Simon*, 416 U.S. 725, 732 (1974)).

¹⁴ *Id.* at 256-57.

¹⁵ *Id.* at 259 (Nalbandian, J., dissenting).

¹⁶ *Id.*

¹⁷ *Id.* at 263.

¹⁸ *CIC Servs., LLC v. Internal Revenue Serv.*, 936 F.3d 501, 504-05 (6th Cir. 2019) (Sutton, J., concurring in the denial of rehearing en banc); see also *id.* at 502 (Clay, J., concurring in the denial of rehearing en banc); *id.* at 505 (Thapar, J., dissenting from the denial of rehearing en banc, joined by Kethledge, Bush, Larsen, Nalbandian, Readler, and Murphy, JJ.).

¹⁹ *CIC Servs., LLC v. Internal Revenue Serv.*, 140 S. Ct. 2737 (2020).

²⁰ *CIC Servs.*, 141 S. Ct. at 1589-90.

²¹ See *Direct Mktg. Ass'n v. Brohl*, 575 U.S. 1, 7-12 (2015). *Direct Marketing* construed the Tax Injunction Act, which prevents federal courts from “enjoin[ing], suspend[ing] or restrain[ing] the assessment, levy or collection of any tax under State law where

- a plain, speedy and efficient remedy may be had in the courts of such State.” 28 U.S.C. § 1341. The Tax Injunction Act was modeled on the Anti-Injunction Act, and the two are often interpreted similarly. See, e.g., *CIC Servs.*, 141 S. Ct. at 1589 n.1.
- ²² *CIC Servs.*, 141 S. Ct. at 1591.
- ²³ See *id.* at 1588; Br. for Pet’r 30, *CIC Servs.*, 141 S. Ct. 1582 (No. 19-930), https://www.supremecourt.gov/DocketPDF/19/19-930/147841/20200715150705823_19-930%20Opening%20Brief.pdf.
- ²⁴ *CIC Servs.*, 141 S. Ct. at 1591.
- ²⁵ *Id.*
- ²⁶ *Id.* (quoting Tr. of Oral Arg. 38-39).
- ²⁷ *Id.* at 1591-92 (citing I.R.C. § 7203).
- ²⁸ *Id.* at 1592.
- ²⁹ *Id.*
- ³⁰ *Id.* at 1594-95 (Sotomayor, J., concurring).
- ³¹ *Id.* at 1595 (Kavanaugh, J., concurring) (citing *Alexander v. “Americans United” Inc.*, 416 U.S. 752 (1974), and *Bob Jones*, 416 U.S. 725).
- ³² *Id.* (quoting *Bob Jones*, 416 U.S. at 732).
- ³³ *Fla. Bankers Ass’n v. U.S. Dep’t of Treasury*, 799 F.3d 1065, 1070-72 (D.C. Cir. 2015).
- ³⁴ *CIC Servs.*, 141 S. Ct. at 1596 (Kavanaugh, J., concurring).
- ³⁵ See, e.g., Kristen A. Parillo, *Limitations of CIC Services Opinion Are Unclear*, 102 Tax Notes Int’l 1255, 1255 (2021) (“[Professor Kristin] Hickman said the opinion was carefully written to avoid putting the Court in too tight of a box when deciding future cases, while also giving the justices some flexibility to expand the range of Treasury and IRS rules and regulations eligible for pre-enforcement review.”), <https://www.taxnotes.com/tax-notes-international/information-reporting/limitations-cic-services-opinion-are-unclear/2021/05/31/67zkr>; Andrew Velarde, *IRS Sees CIC Services’ Applicability as “Rather Narrow,”* 171 Tax Notes 1652, 1652 (2021) (noting that an IRS official viewed the holding of *CIC Services* as “rather narrow,” but that that “view is far from universal”), <https://www.taxnotes.com/tax-notes-federal/litigation-and-appeals/irs-sees-cic-services-applicability-rather-narrow/2021/06/07/76k5l>.
- ³⁶ *CIC Servs.*, 141 S. Ct. at 1593.
- ³⁷ *Id.*
- ³⁸ *Id.*
- ³⁹ *Id.*
- ⁴⁰ Commentators have suggested that other reporting requirements may be amenable to similar pre-enforcement challenges. See, e.g., Andrew Velarde, *Biden Reporting Scheme Could Be on CIC Services Collision Course*, 171 Tax Notes Fed. 1465, 1465 (2021), <https://www.taxnotes.com/tax-notes-federal/information-reporting/biden-reporting-scheme-could-be-cic-services-collision-course/2021/05/31/67zljz>.
- ⁴¹ *Chamber of Com. of the U.S. v. Internal Revenue Serv.*, No. 1:16-cv-944-LY, 2017 WL 4682050, at *3 (W.D. Tex. Oct. 6, 2017).
- ⁴² *Id.* The Government appealed, but the case was rendered moot pending appeal after the IRS changed the regulation at issue.
- ⁴³ *CIC Servs.*, 141 S. Ct. at 1591-92.
- ⁴⁴ *Id.* at 1592.
- ⁴⁵ *South Carolina v. Regan*, 465 U.S. 367 (1984). In *Regan*, the State of South Carolina sought an injunction and other relief against a statute that affected its ability to issue tax-exempt bonds. The Supreme Court held that the suit was not barred by the Anti-Injunction Act because South Carolina had no adequate alternative remedy. Since the state does not pay federal income taxes, it could not challenge the statute in refund or deficiency proceedings. *Id.* at 378.
- ⁴⁶ *Nat’l Fed’n of Indep. Bus. v. Sebelius*, 567 U.S. 519, 543-46 (2012) (“*NFIB*”). While most penalties in the Internal Revenue Code are assessable and collectable as taxes, there are a few, like the one in *NFIB*, that are not. See, e.g., Velarde, *supra* note 40, 171 Tax Notes Fed. at 1467 (noting that one commentator has argued that *NFIB* “could be read as extending the inapplicability of the [Anti-Injunction Act] to chapter 61 penalties”).