CHAPTER 8

Recent Successful Challenges to IRS Actions and Positions

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Synopsis

§ 8.01 INTRODUCTION

In recent years, the Internal Revenue Service ("IRS") has not fared well before our nation's highest tribunal.[1] In 2018, in *Wisconsin Central Ltd. v. United States*, a divided Supreme Court, interpreting the Railroad Retirement Tax Act of 1937 reversing the Court of Appeals for the Seventh Circuit and disagreeing with IRS, held that nonqualified stock options were not a form of compensation under that act, which

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[1] In additional to judicial setbacks, the IRS has also of its own accord limited its regulatory options. In a March 5, 2019, "Policy Statement on the Tax Regulatory Process," the IRS stated that in litigation before the Tax Court, as a matter of policy, the IRS will not seek judicial deference under *Auer v. Robbins*, 519 US 452 (1997) or *Chevron USA, Inc. v. Natural Resources Defense Council, Inc.*, 467 US 837 (1984) to interpretations set forth in subregulatory guidance. For this purpose, subregulatory guidance includes revenue rulings, revenue procedures, notices, and announcements.

(Rel. 2022-10/2022 Pub.1646)

defined compensation as "money remuneration."[2] In 2019, *Kisor v. Wilkie*,[3] while not directly affecting the IRS, the Supreme Court in a divided decision, limited the application of Auer deference, a doctrine often cited by IRS and which provided broad deference to an agency's interpretation of its own regulations.[4] In 2021, in *CIC Services, LLC v. IRS*,[5] the Supreme Court unanimously held that the Anti-Injunction Act[6] does not bar preenforcement judicial review of reporting mandates enforced by tax penalties, at least where a mandate is also enforced by criminal punishment. In *Boechler, PC v. Commissioner of Internal Revenue*,[7] the Supreme Court, reversing the Court of Appeals for the Eighth Circuit, held that the 30-day deadline under Section 6330(d)(1) of the Internal Revenue Code of 1986, as amended ("Code") for taxpayers to seek review of collection due process is a nonjurisdictional claims processing rule that is subject to equitable tolling.[8] While none of those four decisions directly involved employee benefit plans under ERISA or individual retirement accounts or individual retirement annuities (IRAs), some recent defeats by the IRS involved such plans and are the focus of this article.

§ 8.02 BACKGROUND

Code Section 4965, added to the Code by the Tax Increase Prevention and Reconciliation Act ("TIPRA"),[9] provided for two new excise taxes and disclosure rules that target potentially abusive tax shelter transactions to which a tax-exempt entity is a party. First, Code Section 4965(a)(1) imposes an excise tax[10] on certain tax-exempt

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[2] 138 S Ct 2067, 121 AFTR 2d 2018–2102 (2018).

[3] 139 S Ct 2400, 204 L Ed 2d 841 (2019).

[4] Under Kisor, Auer deference does not apply unless the regulation is genuinely ambiguous after applying all of the traditional tools of statutory construction. The fact that two parties can offer sensible interpretations of a regulation does not necessarily mean that it is ambiguous. Second, the agency's reading of the regulation must itself be reasonable, and must be one that is actually made by the agency (i.e., its authoritative official position and not one that is ad hoc). Additionally, its interpretation of the regulation must in some way implicate its substantive expertise, and must reflect its "fair and considered judgment."

[5] 141 S Ct 1582 (2021).

[6] The Anti-Injunction Act, 26 USC § 7421(a) provides that, "with certain exceptions, no suit for the purpose of restraining the assessment or collection of tax shall be maintained in any court by any person." The term tax in that provision is deemed also to refer to any penalties provided by Subchapter 68B of the Code.

[7] 129 AFTR 2d 2022-1489 (2022).

[8] How equitable tolling will develop in the limited context of collection due process is beyond the scope of this article. For a discussion of equitable tolling principles in a more familiar context, see Salkin, "Equitable Tolling in the ERISA Context," 22 Benefits Law Journal 39 (Summer 2009).

[9] PL 109-222. For some of the legislative history with respect to Code Section 4965, see *Austin Firefighters Relief and Retirement Fund v. Brown*, 760 F Supp 2d 662 (SD Miss 2010).

[10] The amount of the excise tax depends on whether the entity knew or had reason to know that the

entities, referred to as nonplan entities,[11] that are parties to prohibited tax shelter transactions.[12] Although there are a number of nonplan tax-exempt entities[13] whose activities are subject to Code Section 4965(a), from an employee benefits perspective, the relevant nonplan entity is a VEBA described in Code Section 501(c)(9).[14] Second,

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transaction was a prohibited tax shelter transaction at the time the entity became a party to the transaction. If the tax-exempt entity did not know (and did not have reason to know), as discussed in greater detail, infra, that the transaction was a prohibited tax shelter transaction at the time that the entity became a party to the transaction, the tax is the highest rate of tax under Code Section 11 (currently 37%) multiplied by the greater of: (i) the entity's net income with respect to the prohibited tax shelter transaction (after taking into account any other applicable taxes with respect to such transaction) for the taxable year, or (ii) 75 percent of the proceeds received by the entity for the taxable year that are attributable to such transaction. Code Section 4965(b)(1)(A). If the tax-exempt entity knew or had reason to know that the transaction was a prohibited tax shelter transaction at the time that the entity became a party to the transaction, the tax is the greater of: (i) 100 percent of the entity's net income with respect to the transaction, after taking into account any other applicable taxes with respect to such transaction for the taxable year, or (ii)75 percent of the proceeds received by the entity for the taxable year that are attributable to such transaction. Code Section 4965(b)(1)(B). Notice 2016-65, 2006-2 CB102, Q & A 8. Treas Reg § 53.4965-7(a)(1)(i). However, in the case of a subsequently listed transaction, the tax exempt entity's income and proceeds allocable to the transaction are allocated between the period before the before the transaction became listed and the period beginning on the date that the transaction became listed. Treas Reg § 53-4965-7(a)(1)(ii)(A). Additionally, the 100 percent excise tax does not apply to any subsequently listed transaction entered into by the entity before the transaction was identified by the Secretary as a prohibited transaction. Treas Reg § 53.4965-7(a)(1)(ii)(B). The calculation of net income and proceeds is defined in Treas Reg § 53.4965-8, but is beyond the scope of this article.

[11] Treas Reg § 53.4965-2(a), (b).

[12] A tax-exempt entity is a party to a prohibited tax shelter transaction if the entity either facilitates a prohibited tax shelter transaction by reason of its tax-exempt, tax indifferent, or tax-favored status, or is identified in published guidance by type, class, or role as a party to a prohibited tax shelter transaction. The published guidance may identify which tax-exempt entities, by type, class, or role, will not be treated as a party to a prohibited tax shelter transaction. The proposed regulations also included in the definition of a party entering into a prohibited tax shelter transaction entering into a listed transaction and reflecting on its tax return a reduction or elimination of its liability for federal employment, excise, or unrelated business taxable income taxes that is derived directly or indirectly from tax consequences or tax strategy described in the published guidance that lists the transaction. However, in the preamble to the final regulations in explaining its reasons for eliminating that provision, the IRS stated that it believed "as a general rule, a tax-exempt entity that engages in a prohibited tax shelter transaction should not be considered a party to a prohibited tax shelter transaction for purposes of Code Section 4965." 75 FR 38700 (July 6, 2010).

[13] Tax exempt entities include entities described in Code Section 501(c), which would include churches, hospitals, museums, schools, scientific research organizations, and other charities described in Code Section 501(c)(3); religious or apostolic associations or corporations described in Code Section 501(d); entities described in Code Section 170(c) including states, possessions of the United States, the District of Columba; political subdivisions of states and political subdivisions of possessions of the United States (but not including the United States); and Indian tribal governments within the meaning of Code Section 7701(a)(40). Notice 2006-65, Q&A 2, and Treas Reg § 53.4965-2(b).

[14] While VEBAs are a type of tax-exempt entity under Code Section 501(c) and file a Form 990, for

Code Section 4965(a)(2) imposes an excise tax[15] on entity managers[16] of tax-exempt entities[17] who approve the entity as a party (or otherwise cause the entity to be a party) to a prohibited tax shelter transaction and know or have reason to know that the transaction is a prohibited tax shelter transaction.[18]

ERISA purposes they are also employee benefit plans that file a Form 5500.

[15] The amount of the tax is $20,000 for each approval or other act causing the entity to be a party to the prohibited tax shelter transaction. Code Section 4965(b)(2); Notice 2006-65, Q & A 11; Treas Reg § 53.4965-7(b)(1). If more than one entity manager approved or caused a tax exempt entity to become a party to a prohibited tax shelter transaction while knowing or having reason to know that the transaction was a prohibited tax shelter transaction, then each entity manager is separately liable, not jointly and severally liable, for the entity manager tax with respect to the transaction. Treas Reg § 53.4965-7(b)(4).

[16] There are two types of entity managers under Code Section 4965(d). The entity manager of a nonplan entity such as a VEBA is the person with authority or responsibility similar to that exercised by an officer, director, or trustee of an organization, and with respect to any act, the person having authority or responsibility with respect to such act. As in other areas of the Code, such as the top-heavy provisions under Code Section 416, Treas Reg § 53.4965-5(a)(2) defines an officer of a nonplan entity as a person who either is specifically designated as such under the certificate of incorporation, by-laws, or other constitutive document of the nonplan entity, or regularly exercises general authority to make administrative or policy decisions on behalf of the nonplan entity. With respect to a plan entity, an entity manager is a person who approves or otherwise causes the plan to be a party to the prohibited tax-shelter transaction. There is, however, a special rule applicable to IRAs and fully self-directed tax qualified plans. In such circumstance, if the plan participant or beneficiary selected a certain option and therefore approved the plan becoming a party to the prohibited tax shelter transaction, then the plan participant or beneficiary is treated as the entity manager. Treas Reg § 53.4965-5(b)(2)(i). Further, if the plan participant or beneficiary is offered a limited menu of investment options from which to choose, the person responsible for determining the preselected investment options is the entity manager, rather than the plan participant or beneficiary. Treas Reg § 53-4965-5(b)(2)(ii). The regulations also define the term "approves or otherwise causes" a tax-exempt entity to become a party to a prohibited tax shelter transaction if the person has the authority to commit the entity to a transaction, either individually, or as a member of a collective body such as a committee. If a person is a member of a committee, he or she will be considered to have exercised such authority if the person voted in favor of the entity becoming a party to the transaction. However, if the committee member voted against the approval, abstained from voting on the proposal, or otherwise failed to vote in favor of the proposal making the plan a party to a prohibited tax shelter transaction, such person will not be treated as an entity manager. Treas Reg § 53.4965-5(c).

[17] The other tax-exempt entities, referred to as plan entities, include tax-qualified plans under Code Section 401(a); annuity plans described in Code Section 403(a); annuity contracts described in Code Section 403(b); qualified tuition programs described in Code Section 529; retirement plans described in Code Section 457(b) maintained by a governmental employer; individual retirement accounts within the meaning of Code Section 408(a); Archer Medical Savings Accounts within the meaning of Code Section 220(d); individual retirement annuities within the meaning of Code Section 408(b); Coverdell Education Savings Accounts within the meaning of Code Section 530; and health savings accounts under Code Section 223.

[18] In the case of a nonplan entity such as a VEBA that is a party to a prohibited tax shelter transaction, the entity level tax and the entity manager tax may both apply to the transaction. Notice 2006-65, Q & A 12. Further, the excise taxes imposed by Code Section 4965 are in addition to any other tax, addition to

There are two types of prohibited tax shelter transactions under Code Section 4965(e). One type is listed transactions within the meaning of Code Section 6707A(c)(2),[19] including subsequently listed transactions,[20] which are transactions that are the same as, or substantially similar to any transaction which has been specifically identified by the Secretary of the Treasury as a tax avoidance transaction for purposes of Code Section 6011. The second type of prohibited tax shelter transaction is a prohibited reportable transaction, which is either a confidential transaction within the meaning of Treasury Regulation 1.6011-4(b)(3), or a transaction with contractual protection within the meaning of Treasury Regulation 1.6011-4(b)(4).

Whether an entity manager knew or had reason to know that a transaction was a prohibited tax shelter transaction is a facts and circumstances determination.[21] The entity manager must have knowledge of sufficient facts reasonably available to the entity manager at the time of approving the transaction that would lead a reasonable person to conclude that the transaction was a prohibited tax shelter transaction. The regulations provide a list of nonexclusive factors that an entity manager should take into account in making this determination: the presence of tax shelter indicia; whether the entity manager received a disclosure statement prior to the consummation of the transaction that indicated that the transaction might be a prohibited tax shelter transaction; and whether the entity manager made appropriate inquiries into the transaction. The regulations then provide greater detail with respect to each of these three factors.

Tax shelter indicia include, without limitation, whether the transaction is extraordinary for the entity considering its prior investment history; whether the transaction promises an economic return for the organization that is exceptional considering the amount invested by, the participation of, or the absence of risk to the entity; or the transaction is of significant size relative to the receipts of the entity.[22]

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tax, or penalty imposed under the Code. Ibid, Q & A 13.

[19] Code Section 4965(e)(1)(B).

[20] A subsequently listed transaction for purposes of Code Section 4965 is a transaction that is identified by the Secretary of the Treasury as a listed transaction after the tax-exempt entity has entered into the transaction and that was not a prohibited reportable transaction at the time that the transaction was entered into. Treas Reg § 53.4965-3(b).

[21] Treas Reg § 53.4965-6(b)(1). The determination that an entity manger approved or caused a tax exempt entity to be a party to a prohibited tax shelter transaction by itself, does not establish liability under Code Section 4965(a)(2). Treas Reg § 53.4965-5(c)(5). Further, an entity manger will not be treated as knowing or having reason to know that a transaction, other than a prohibited reportable transaction, is a prohibited tax shelter transaction if the entity enters into the transaction before the date on which the transaction is identified by the Secretary as a listed transaction. Treas Reg § 53.4965-6(d).

[22] Treas Reg § 53.4965-6(b)(2).

With respect to the effect of disclosure statements, the receipt by an entity manager of a statement in advance of a transaction that such transaction may be a prohibited tax shelter transaction is a factor to be taken into account in determining whether an entity manager knew or should have known that a transaction was a prohibited tax shelter transaction. However, an entity manager is not treated as knowing or having reason to know that a prohibited tax shelter transaction has occurred solely because the entity manager received such a disclosure.[23]

What inquiries are appropriate is another facts and circumstances determination.[24] While it is likely in most instances when an entity manager needs to determine if a transaction is a prohibited tax shelter transaction, he or she will seek professional advice, an entity manager is not required to obtain the advice of a professional tax adviser to establish that the entity manager made appropriate inquiry. Further, not seeking professional advice in and of itself does not give rise to an inference that the entity manager had a reason to know that a transaction was a prohibited tax shelter transaction.[25] In the more common instance in which an entity manager sought the written opinion of a professional tax adviser, an entity manager may establish that he or she did not have a reason to know that a transaction was a prohibited tax shelter transaction at the time that the tax-exempt entity entered into the transaction if the entity manager reasonably and in good faith relied on the written opinion of a professional tax advisor. Whether the reliance by the entity manager on the written opinion of the professional tax advisor was reasonable and in good faith is a facts and circumstances determination.[26] Further, three (3) conditions must be satisfied for an entity manager to be able to reasonably rely upon a written opinion of a professional tax adviser. First, the advice must be based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances.[27] Second, the advice must not be based on

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[23] Treas Reg § 53.4965-6(b)(3).

[24] Treas Reg § 53.4965-6(b)(4). As an illustrative case, the regulations provide that if one or more tax shelter indicia are present or if the entity manager receives a disclosure statement indicating that a transaction may be a prohibited tax shelter transaction, the entity manager would have an obligation to make further inquiry. *Ibid.*

[25] Treas Reg § 53.4965-6(c)(1).

[26] The regulations indicate that the entity manager's education, sophistication, and business experience are relevant factors in determining whether the entity manager's reliance was reasonable and made in good faith. On the other hand, an entity manager's reliance may not be reasonable and in good faith if the entity manager knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law. Treas Reg § 53.4965-6(c)(2). Moreover, an entity manager's reliance upon a written opinion of a professional tax advisor will not be considered reasonable if the advisor is, or is related to, a person who is a material advisor with respect to the transaction within the meaning of Code Section 6111 and 6112. Treas Reg § 53.4965-6(c)(3).

[27] Treas Reg § 53.4965-6(c)(2)(i).

unreasonable factual or legal assumptions and must not unreasonably rely on the representations, statements, findings, or agreements of the entity manager or any other person.[28] Third, the written opinion must conclude that the transaction was not a prohibited tax shelter transaction at a "more likely than not" level of certainty at the time that the entity manager approves the entity to be a party to the transaction.[29]

§ 8.03 EFFECT OF ABUSIVE TAX AVOIDANCE TRANSACTIONS[30] UNDER EPCRS[31]

With respect to self-correction, in the event that the plan or the plan sponsor has been a party to an abusive tax avoidance transaction, self-correction is not available to correct any operational failure or plan document failure that is directly or indirectly related to the abusive tax avoidance transaction.[32] With respect to VCP, if the IRS determines that a plan or plan sponsor may have been a party to an abusive tax avoidance transaction, the matter will be discussed and coordinated with appropriate IRS personnel. The actions that the IRS may take may depend upon the relationship between the plan failures and the abusive tax avoidance transaction. The IRS may determine that the Plan or plan sponsor has been a party to an abusive tax avoidance transaction, and that the failures addressed in the VCP submission are related to that transaction. In that circumstance, the IRS will conclude the review of the submission without issuing a compliance statement, and will refer the case for examination. However, if the IRS determines that the plan failures are unrelated to the abusive tax avoidance transaction, or that no abusive tax shelter transaction occurred, then the IRS will permit the VCP submission to address the failures addressed in the VCP submission, and may issue a compliance statement with respect to those failures.[33] Finally, with respect to Audit Cap and self-correction for plans under examination, if the IRS determines that the plan or plan sponsor was or may have been a party to an abusive tax avoidance transaction, the matter may be discussed and coordinated with

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28 Treas Reg § 53.4965-6(c)(2)(ii).

29 Treas Reg § 53.4965-(c)(2)(iii).

30 Except with respect to plans under examination, an abusive tax avoidance transaction means any listed transaction under Treas Reg 1. 6011-4(b)(2) and other transactions identified as abusive transactions on the IRS website entitled EP Abusive Tax Transactions. With respect to plans under examination, an abusive tax shelter transaction also includes any other transaction that the IRS determines was designed to facilitate the impermissible avoidance of tax.

31 Rev Proc 2021-30, 2021-31 IRB 172.

32 Rev Proc 2021-30, Section 4.12(1)(a).

33 Rev Proc 2021-30, Section 4.12(1)(b). The Revenue Procedure further states that in no event may a compliance statement be relied upon for the purposes of concluding that the plan or plan sponsor was not a party to an abusive tax shelter transaction. Further, even if IRS concludes that the failures can be addressed pursuant to a VCP submission, the IRS reserves the right to make a referral of the abusive tax avoidance transaction for examination. *Ibid.*

appropriate IRS personnel. Upon receiving a response from appropriate IRS personnel, (i) if the IRS determines that a failure is related to an abusive tax avoidance transaction, the IRS reserves the right to conclude that neither Audit Cap or self-correction is available for that failure, and (ii) if the IRS determines that satisfactory corrective actions have not been taken with regard to the transaction, the IRS reserves the right to conclude that neither Audit Cap nor SCP is available to the plan.[34]

§ 8.04 DISCLOSURE

Section 516(b) of TIPRA amended Code Section 6033 to require every tax-exempt entity, whether a plan entity or a nonplan entity, that is a party to a prohibited tax shelter transaction to disclose to IRS (a) that such entity is a party to a prohibited tax shelter transaction and (b) the identity of any other party to the transaction which is known to the tax-exempt entity.[35] This information is provided on Form 8886-T, which is generally filed on or before May 15 of the calendar year following the year that the entity entered into the prohibited tax shelter transaction.[36] There is a monetary penalty under Code Section 6652(c) for the failure to disclose information required under Code Section 6033(a)(2).[37] The penalty for failure to include information with respect to a prohibited tax shelter transaction is $105 for each day during which the failure continues, not to exceed $54,000 for each required disclosure. In addition, the IRS is authorized to make a written demand on the entity or entity specifying a future date by which the required disclosure must be filed. If there is a failure to comply with the demand, there is an additional penalty in the amount of $105 per day after the expiration of the time specified in the demand, not to exceed $10,500 for each required disclosure. These penalties are adjusted for inflation.[38] In the case of a nonplan entity such as a VEBA, the penalty is imposed on the tax-exempt entity, the entity with responsibility for filing Form 8886-T.[39] In the case of a plan entity, the penalty is

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[34] Rev Proc 2021-30, Section 4.12(1)(c).

[35] Notice 2006-65, Q & A 14, and Treas Reg § 1.6033-5(a). A single filing is required for each prohibited tax shelter transaction. Treas Reg § 1.6033-5(b). TIPRA also requires a taxable party to a prohibited tax shelter transaction to disclose to the tax exempt entity that is a party to the transaction that it is a prohibited tax shelter transaction. Treas Reg § 301.6011(g)-1(a)(1).

[36] *Ibid.* In the case of a subsequently listed transaction, the disclosure must be made on or before May 15 of the calendar year following the close of the calendar year in which transaction was identified. Treas Reg § 1.6033-5(d).

[37] Treas Reg § 1.6033-5(e).

[38] Instructions for Form 8886-T.

[39] Treas Reg § 1.6033-5(c)(1).

imposed upon the entity manager,[40] the party with responsibility for filing Form 8886-T.[41]

§ 8.05 *MANN CONSTRUCTION, INC. V. UNITED STATES OF AMERICA*[42]

In 2007, IRS published Notice 2007-83,[43] "Abusive Trust Arrangements Utilizing Cash Value Life Insurance Policies Purportedly to Provide Welfare Benefits." From 2013–2017, plaintiffs established an employee benefit trust that paid the premiums on a cash value life insurance policy benefiting the owners of Mann Construction. They did not report this transaction to the IRS as a listed transaction. In 2019, the IRS concluded that the arrangement adopted by Mann Construction was identified in Notice 2007-83 and assessed penalties on both the company and its owners for failure to disclose the participation in the trust. They paid the penalties, then sued for a refund. When the refund claims were rejected, they proceeded to federal court. They challenged the validity of Notice 2007-83 on four grounds: (1) the notice failed to comply with the Notice and Comment provisions of the Administrative Procedure Act ("APA"); (2) it constituted unauthorized agency action; (3) it was arbitrary and capricious; and (4) even if the Notice was valid, the arrangement at issue was not within its scope. The district court found for IRS on all fronts, but the Sixth Circuit reversed,[44] focusing solely on the notice and comment claim.[45]

The Sixth Circuit began by stating that before an agency may issue a regulation that has the force of law, in this case, either report a transaction or face hefty financial penalties and criminal sanctions, the APA requires a notice and comment period. The IRS did not follow the notice and comment requirements of the APA, but it offered two explanations for refusing to do so. First, it claimed that Notice 2007-83 was merely an interpretive rule, which does not require notice and comment. Second, even if the

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[40] See also Notice 2006-65, Q & A 16.

[41] Treas Reg § 1.6033-5(c)(2).

[42] 27 F. 4th 1138 (6th Cir 2022). Cf. *Liberty Global, Inc. v. United States*, 129 AFTR 2d 2022-1373 (D Col April 4, 2022) (Temporary IRS regulations require notice and comment period absent a showing of good cause).

[43] 2007-2 CB 960.

[44] *CIC Services, LLC v. IRS,* 129 AFTR 2d 2022-1373 (ED Tenn March 21, 2022) followed the Mann decision and invalidated Notice 2016-66.That decision also ordered IRS to return disclosure documents obtained from taxpayers and material advisors participating in such arrangements. However, on June 2, the District Court, on procedural grounds and in response to an IRS motion for reconsideration, changed its position and held the IRS was not required to disclose documents to nonparty taxpayers and their material advisors.

[45] For a comment disagreeing with the Sixth Circuit opinion, see Jack Townsend, Federal Tax Procedure (March 3, 2022), "Sixth Circuit Invalidates Notice Identifying Listed Transaction Requiring Reporting and Potential Penalties."

Notice amounted to a legislative rule, Congress exempted the IRS from the APA with respect to these disclosure rules. The Sixth Circuit addressed and rejected both of these IRS positions.[46]

With respect to the distinction between interpretive and legislative rules, the Sixth Circuit explained that legislative rules have the force and effect of law, which interpretive rules do not.[47] Legislative rules impose new rights or duties and change the legal status of regulated parties; interpretive rules articulate what an agency thinks that a statute means or reminds parties of pre-existing duties.[48] Further, when rulemaking carries out an express delegation of authority from Congress to an agency, it usually leads to legislative rules; interpretive rules merely clarify the requirements that Congress has already put in place.[49] The Court, citing *CIC Services, LLC*,[50] noted that obeying these new duties can "involve significant time and expense" and failure to comply comes with the risk of penalties and criminal sanctions, all characteristics of legislative rules.[51] With respect to the argument that Congress had excepted the notice provisions from the APA, the Sixth Circuit indicated that Congress' intent to make a substantive change must be clear, and this case fell on the failure to be express side of the line.[52] In cases arising in the Sixth Circuit,[53] the IRS is obligated to follow the Mann decision,[54] but the IRS presumably will maintain its positions in cases heard outside of the Sixth Circuit.

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[46] The District Court concluded that the IRS guidance was legislative in nature, but then concluded that Congress had clearly excepted this legislation from the notice and comment requirements of the APA.

[47] *Perez v. Mortgage Bankers Association*, 575 US 92 at 96–97 (2015).

[48] *Tennessee Hospital Association v. Azar*, 908 F3d 1029, 1042 (6th Cir 2018).

[49] *Id.* at 1043.

[50] 141 S Ct 1582, 1591–92 (2021).

[51] See Kristin E. Hickman, "Unpacking the Force of Law," 66 Vand. L. Rev. 465,524 (2013) (characterizing penalties as a leading indicator that a regulation is legislative rather than interpretive). Other cases in which courts have found that IRS actions are legislative rather than interpretive include *Oakbrook Land Holdings v. Commissioner*, 154 TC 180, 189 (2020); *Chamber of Commerce v. United States*, 2017 BL 358853 (WD Tex Sept 29, 2017); *Altera v. Commissioner*, 145 TC 81, 116–117, rev'd on other grounds, 926 F3d 1061 (2019).

[52] *Marcello v. Bonds*, 349 US 302, 310 (1955) ("Exemptions from the terms of the Administrative Procedure Act are not lightly to be presumed") and *Dickinson v. Zurko*, 527 US 150, 155 (1999) (recognizing consistent process as a goal of the Administrative Procedure Act and requiring a clear indication in the relevant statute to deviate from that norm).

[53] Tennessee, Kentucky, Ohio, and Michigan. Generally speaking, the Golsen rule (*Golsen v. Commr.*, 54 TC 742 (1970), aff'd 445 F2d 985 (10th Cir 1971) requires that if the United States Court of Appeals to which an appeal would be made in a given case before the Tax Court has already established precedent on a legal matter to be decided by the Tax Court, the Tax Court will adhere to that precedent in making that decision.

[54] In *GBX Associates, LLC v. United States*, 129 AFTR2d 2022-1392 (D Ohio), April 5, 2022), the

§ 8.06 ILLUSTRATIONS OF OTHER EMPLOYEE BENEFITS LISTED TRANSACTIONS

Notice 2004-8[55] identifies listed transactions involving Roth IRAs. These transactions generally involve a preexisting business owned by an individual, a Roth IRA, and a corporation, substantially all the shares of which are owned or acquired by the Roth IRA. An arrangement shifting business property to the corporation for less than fair value would be abusive. One example would be a sale of business receivables to the corporation that is not negotiated at arm's length. A second illustration would be a management services agreement that is not fairly negotiated and shifts excessive fees from the business to the corporation.[56] In addition to the listed transactions described in Notice 2004-8 and Notice 2007-83, there have been several other listed transactions involving either employee benefit plans or executive compensation arrangements.[57]

§ 8.07 SUBSTANCE OVER FORM[58]

While the Tax Court will generally respect the form of a transaction, it will apply the substance over form principles when warranted.[59] This qualification is clearly warranted, because it is a fundamental principle of the United States federal income tax law that taxation must be based upon the substance and not the form of the transaction.[60]

District Court denied a motion requesting a speedy hearing and an expedited treatment with respect to another listed transaction, Notice 2017-10, 2017-4 IRB 544. In its response to the request, the IRS indicated this was a different notice; that an action for declaratory judgment is not the same as an action for a tax refund; and that the IRS had not yet made a decision on whether to appeal the Mann decision.

[55] 2004-4 IRB 333; IR 2011-39 (April 7, 2011).

[56] Chief Counsel's Advice 200929005 (July 17, 2009). In *United States v. Stover*, 108 AFTR 2d 2011-5837 (8th Cir 2011) the Court of Appeals for the Eighth Circuit upheld a permanent injunction against a promoter of transactions that were perfectly described in Notice 2004-8.

[57] See, for example, Revenue Ruling 90-105, Certain Acceleration Deductions for Contributions to a Qualified Cash or Deferred Arrangement or Matching Contributions to a Defined Contribution Plan; Notice 95-34, Voluntary Employee Beneficiary Association; Notice 2000-60, Stock Compensation Transactions; Revenue Ruling 2003-6, Abuses Associated with S Corp ESOPs; Notice 2003-22, Offshore Deferred Compensation Arrangements; Notice 2003-24, Certain Trust Arrangements Seeking to Qualify for Exception for Collectively Bargained Welfare Plans; Notice 2003-47, Transfer of Compensatory Stock Options to Related Persons; Revenue Ruling 2004-4, S Corporation ESOP; and Revenue Ruling 2004-20, Abusive Transactions Involving Insurance Policies in IRC 412(i) Retirement Plans.

[58] Substance over form is one of five related anti-avoidance doctrines applied by IRS: substance over form, sham transaction, business purpose, economic substance, and step transaction. See "Doctrinal Tools the IRS Will Use to Challenge Claimed Tax Benefits of Micro Captive Insurance Companies." 25 Westlaw Journal of Insurance Coverage, Issue 41 (July 2015). See also Joseph Isenberg, "Musings on Form and Substance in Taxation," 49 Univ. Chi. Law Rev. 859 (1982) and Allen D. Madison, "The Tension Between Textualism and Substance Over Form Doctrine in Tax Law," 43 Santa Clara Law. Rev. 693, 717(2003).

[59] Todd Kohout, TC Memo 2022-37 (April 18, 2022).

[60] Bittker and Lokken, Federal Taxation of Income, Estate, and Gifts, 4:33 (2nd Ed. 1998), quoted in

The doctrine, frequently cited by the Supreme Court,[61] has been described by one Court as "the cornerstone of sound taxation,"[62] and one commentator has stated that "the doctrine s not only enshrined in the text of the Code, but it also serves as a canon of construction overarching the tax system in its entirety."[63]

In a series of related Circuit Court cases, the IRS was unable to persuade any Circuit Court that the substance over form doctrine should be applied expansively. For example, in *Mazzei v. Commissioner*, the taxpayers had established a foreign sales corporation under the now repealed provisions of Code Sections 921–927. The Mazzeis then made their Roth IRAs the formal shareholders of their foreign sales corporation. The taxpayers export corporation paid commissions into the foreign sales corporation, upon which the foreign sales corporation paid a modest amount of tax pursuant to the specific foreign sales corporation tax rules. The foreign sales corporation's after tax income was then paid into a Roth IRA, rather than to their export corporation. As a result, no tax was paid when the money was received into the Roth IRAs, and no tax would be paid upon qualified withdrawals from the Roth IRAs. As a result, the Roth IRAs could receive these dividends in effect as annual contributions without the usual limits imposed on contributions to Roth IRAs. The IRS did not dispute that all of the actions taken by the taxpayers were in compliance with the Code, but nevertheless took the position that the court should use the substance over form doctrine to treat the Mazzeis as the real owners of the financial services corporation, rather than the IRAs. Under this recharacterization, the taxpayers would be deemed to have received the dividends, in which case their contributions to the Roth IRAs would have exceeded the statutory limit on contributions to Roth IRAs, subjecting them to a 6 percent excise tax. The Court of Appeals for the Ninth Circuit reversed, concluding that the Tax Court had erred by invoking substance-over-form principles to effectively reverse congressional judgment.

Three Circuit Court cases also held for the taxpayers in three cases involving domestic international service corporations, or DISCs. These cases involved a series of

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Robert Thornton Smith, "A Taxpayer's Right to Assert the Priority of Substance," 44 Tax Lawyer 1, p.137 (Fall 1990).

[61] *United States v. Phellis*, 257 US 156, 168 (1921) (A long established principle in the interpretation of the Tax Code is "the importance of regarding matters of substance and disregarding form"); *Helvering v. Gregory*; *Commissioner v. Ct. Holding*, 324 US 331, 334 (1945) ("To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."); and *Frank Lyon Co. v. United States*, 435 US 561, 573 (1978). (When the form of a transaction has not altered any cognizable relationship, the substance of a transaction, rather than its form, will be given effect.)

[62] *Estate of Weinert v. Commissioner*, 294 F2d 750, 755 (5th Cir 1961).

[63] Summer Desloge, "Clarity or Confusion? The Common Law Economic Substance Doctrine and Its Statutory Counterpart," 46 Journal of Legislation 326, 336 (2019).

transactions the sole purpose of which was to transfer monies into the son's Roth IRAs, so that income on assets in the Roth IRAs could be accumulated and distributed on a tax free basis. Taxpayers devised a clever tax strategy which allowed them to establish IRAs in 2002 with a $3,500 contribution and by 2008 hold $3.1 million in assets. The initial step was the purchase for $1,500 of 1,500 shares of a newly created DISC, JC Export. The same day the parents of the IRA owners established a new corporation, JC Holding, which purchased all of the IRA's shares in JC Export for an equal number of shares in JC Holdings. That is, JC Holdings, which was owned 50 percent by each Roth IRA, was the sole shareholder of JC Export. By owning JC Export indirectly through JC Holdings, the Roth IRAs avoided tax reporting and shareholder obligations for the DISC. From 2002 to 2008, Summa Holdings paid millions of dollars of export income to JC Holdings as tax deductible commissions, even though no services were performed. JC Export distributed these funds as dividends to JC Holdings, which paid the required 33% corporate income tax on them, then distributed the balance to its own shareholders, the Roth IRAs, on a tax-free basis as investment income. The IRS sought to recharacterize what Summa had treated as tax deductible DISC contributions as nondeductible dividends to its shareholders. Under that recharacterization, the IRS determined that JC Export did not receive any DISC commissions, and therefore could not have paid DISC dividends to JC Holdings, which could claim a refund of the corporate income taxes that it had paid. Finally, the dividends paid from JC Holdings to the Roth IRAs were characterized as excess contributions. That is, the IRS's position was that the substance-over-form doctrine was necessary to avoid the circumvention of the Code limitations on Roth IRA contributions. However, the First,[64] Second,[65] and Sixth[66] circuits held application of the substance-over-form doctrine unwarranted in this instance, concluding that the recharacterized transactions have the economic substance in the Code provisions authorizing their tax-minimizing form.

§ 8.08 CONCLUSION

With respect to both the notice and comment period requirements of the Administrative Procedure Act and its expansive reading of the substance-over-form doctrine, the IRS has suffered appellate court losses with respect to employee benefit plans in recent years. Situations in which these types of challenges can be made are not a staple feature of the employee benefits practice of most practitioners, but in a situation in which it appears IRS may have exceeded its authority, it is important to know the types of procedural and substantive challenges to IRS actions that can be successfully advanced.

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[64] *Benenson v. Commissioner*, 887 F3d 511 (1st Cir 2018).

[65] *Benenson, Jr., v., Commr.*, 910 F3d 690 (2nd Cir 2018).

[66] *Summa Holdings, Inc. v. Commissioner*, 848 F3d 779 (6th Cir 2018).