

# Court Vacates IRS Microcaptive Notice

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By Kristen A. Parillo

A Tennessee district court has invalidated and vacated the IRS's microcaptive notice, rejecting the Justice Department's suggestion that it send the notice back to the agency to fix its procedural deficiencies.

Because the IRS didn't comply with notice and comment procedures and acted arbitrarily and capriciously when it promulgated [Notice 2016-66](#), 2016-47 IRB 745, "vacating the Notice in its entirety is appropriate," Judge Travis R. McDonough of the U.S. District Court for the Eastern District of Tennessee wrote in a [March 21 opinion](#) in *CIC Services LLC v. IRS*.

The decision is the first to adopt the reasoning of the Sixth Circuit's [March 3 opinion](#) in *Mann Construction Inc. v. United States*, No. 21-1500 (6th Cir. 2022), which held that a separate listing notice on cash value life insurance trusts ([Notice 2007-83](#), 2007-45 IRB 960) is invalid because the IRS issued it without notice or comment as required by the Administrative Procedure Act (APA). The panel rejected the Justice Department's argument that Congress authorized the IRS to proceed without notice and comment when it enacted the reportable transaction regime in 2004.

Because Tennessee is within the Sixth Circuit's jurisdiction, McDonough issued an order March 4 in *CIC* inviting the parties to submit supplemental briefings on the *Mann* opinion's effect on the lawsuit brought by CIC Services LLC, a microcaptive adviser based in Knoxville, Tennessee.

Like the taxpayers in *Mann*, CIC argued that Notice 2016-66 is invalid under the APA because the IRS issued it without notice or comment. That notice designated microcaptive insurance transactions as transactions of interest requiring disclosure by taxpayers and their advisers. CIC asserted in its [March 8 supplemental brief](#) that *Mann* is fully dispositive of the arguments in its November 2021 summary judgment motion that Notice 2016-66 is invalid and that the court [must vacate](#) the notice nationwide.

In its own [March 11 supplemental brief](#), the Justice Department urged McDonough to hold off on relying on *Mann* until the government has weighed its appeal options. The department argued that if the court were to hold that Notice 2016-66 is invalid, it shouldn't interpret *Mann* as requiring that the notice be vacated. The court should instead either limit a *vacatur* to CIC or permit the notice to remain in place upon remand to the IRS to correct flaws identified by the court, according to the government.

That remedy, known as a remand without *vacatur*, was created by the D.C. Circuit in *Allied-Signal Inc. v. U.S. Nuclear Regulatory Commission*, 988 F.2d 146 (D.C. Cir. 1993). Under the *Allied-Signal* approach, which [is controversial](#) among academics and has been criticized by some circuits, a decision on whether to vacate depends on the seriousness of the rule's deficiencies and the disruptive consequences that may result from a *vacatur*.

## Invalid and Arbitrary

Dismissing the Justice Department's claim that Congress excused the IRS from following APA rulemaking when issuing notices under the reportable transaction regime, McDonough concluded that Notice 2016-66 is a legislative rule that is invalid because the IRS failed to comply with notice and comment procedures.

"The Sixth Circuit's analysis in *Mann Construction* is binding on this Court and applies equally to the arguments advanced by the IRS regarding Notice 2016-66 in this case," McDonough wrote.

Regarding CIC's claim that the IRS acted arbitrarily and capriciously in issuing the notice, McDonough noted that the administrative record must show that the agency "examined the relevant data" and "articulated a satisfactory explanation" for its decision to designate microcaptive transactions as transactions of interest based on the potential for tax avoidance or evasion.

Finding that the IRS didn't meet that standard, McDonough wrote that the notice "simply states that the IRS is aware of microcaptive transactions and 'believes' these transactions have the potential for tax avoidance or evasion."

"While the Notice goes on to describe these transactions, it does not identify any facts or data supporting its belief," McDonough continued. "The IRS's executive summary regarding the Notice similarly fails to provide underlying facts and data."

## Remedy

Rejecting the Justice Department's suggestion that the court limit a remedy to CIC or remand without *vacatur*, McDonough noted that the APA states that the reviewing court "shall . . . hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, and abuse of discretion, or otherwise not in accordance with law" or "without observance of procedure required by law."

Given that the IRS didn't comply with notice and comment procedures and acted arbitrarily and capriciously, vacating Notice 2016-66 in its entirety is appropriate, McDonough said.

While the IRS may be able to rectify those deficiencies if it decides to promulgate a new rule, "nothing about its actions supports leaving the Notice in place while it takes the actions necessary to comply with the APA or vacating the Notice as to CIC only, especially given the Sixth Circuit's prior observations that the IRS 'does not have a great history of complying with APA procedures,' and that it does not follow the basic rules of administrative law," McDonough wrote.

McDonough also agreed with CIC that the IRS must return to taxpayers and material advisers information and documents it collected under Notice 2016-66. However, he refused to enter an injunction that would bar agencies from offering any documents produced by individuals or entities in response to the notice in judicial or administrative proceedings.

“The Notice is merely one source of information for the IRS, and granting such relief risks depriving the IRS of the use of such documents for the public’s benefit even if it acquires them lawfully in the future,” McDonough wrote.

## Fallout

The district court “clearly reached the only reasonable result regarding the IRS’s failure to use notice and comment rulemaking procedures, given the Sixth Circuit’s reasoning in *Mann Construction*,” Kristin Hickman of the University of Minnesota Law School told *Tax Notes*.

The court’s additional conclusion that Notice 2016-66 was arbitrary and capricious is interesting because it provides an independent rationale for invalidating the notice, Hickman said.

“This part of the opinion suggests that, even if another circuit or the Supreme Court were to agree with the government and conclude that notices like Notice 2016-66 do not require notice and comment rulemaking procedures, the government could still lose,” Hickman said.

According to Mary E. Wood of Meadows, Collier, Reed, Cousins, Crouch & Ungerman LLP, the *CIC* decision reflects the far-reaching implications of *Mann*.

“While *Mann Construction* stemmed from a taxpayer’s challenge to a listed transaction notice, the *CIC Services* case was initiated by a material adviser subject to the Notice 2016-66 disclosure requirements,” Wood said. “These victories will likely embolden other taxpayers and advisers to challenge penalties related to listed transactions under the APA, as well as other types of non-regulatory IRS guidance.”

The plaintiff in *CIC Services LLC v. IRS*, No. 3:17-cv-00110 (E.D. Tenn. 2022), is represented by Adam R. Webber; Kenneth A. Lazarus of Lazarus & Associates; and John Kizer of Gentry, Tipton & McLemore PC.