Biden Reporting Scheme Could Be on *CIC Services* Collision Course

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The Biden administration's vision for increased information reporting, depending on implementation specifics, may have a new obstacle to contend with: the Supreme Court's recent decision shortening the reach of the Anti-Injunction Act (AIA).

In *CIC Services LLC v. IRS*, No. 19-930 (S. Ct. 2021), the Supreme Court held on May 17 that the AIA does not bar a pre-enforcement challenge of IRS reporting rules backed by tax penalties. At issue was a notice that designated microcaptive insurance transactions as transactions of interest requiring disclosure by taxpayers and their advisers.

Under the AIA, suits that would restrain the assessment or collection of tax are disallowed.

In the same week that the decision was released, Treasury announced new details of the administration's plan to ramp up enforcement and increase collections, which includes increased information reporting that is predicted to raise $460 billion over 10 years. The Treasury report released May 20 advocates for using the Form 1099-INT, "Interest Income" series, as a framework for a much broader information reporting regime to catch new or overlooked taxable income and transactions. Starting in tax year 2023, domestic and foreign financial institutions, third-party payment settlement organizations, and crypto asset exchanges and custodians would be required to report gross income inflows and outflows, including loans and investments, on existing IRS information returns.

Former Treasury Secretary Lawrence H. Summers and former IRS Commissioner Charles O. Rossotti have made similar recommendations. In a November 2020 *Tax Notes* article, they recommended that the IRS receive statutory authority to require new Form 1099 reports from banks reporting summary deposits and withdrawals from accounts held by individual taxpayers and passthrough business entities. High-income taxpayers would be required to reconcile these summary reports with their tax returns on a new schedule. Some have expressed concern that such an increase in bank account reporting could turn local banks into an extension of the IRS and that smaller banks would vehemently protest any increased compliance costs they incur.

Patrick J. Smith of Ivins, Phillips & Barker Chtd. said the administration's information reporting proposal on inflows and outflows is like the information reporting at issue in *Florida Bankers Association v. Treasury*, 799 F.3d 1065 (D.C. Cir. 2015).

"Obviously, someone would have to come up with a substantive challenge, but in terms of coming within the scope of *CIC Services . . .* I think it would," Smith said.

The majority held in *Florida Bankers* that the AIA barred two banking associations from seeking pre-enforcement review of a Treasury regulation that imposed penalties on U.S. banks that fail to report interest paid to nonresident alien individuals.

Although *CIC Services* does not explicitly reference *Florida Bankers*, Smith sees the Supreme Court's decision as effectively overruling the latter.

A Formal Test?

While some observers have argued that *CIC Services* is narrowly targeted, it could be interpreted as establishing a three-part test to determine the applicability of the AIA that might be applied to future reg challenges. Justice Elena Kagan even lists the factors in consecutive paragraphs in the Court's unanimous opinion. The AIA was found inapplicable to the notice because 1) it imposed affirmative reporting obligations that resulted in costs separate from the tax penalty; 2) the reporting and the penalty were "several steps removed from each other," requiring CIC to withhold the information, the IRS to find a violation, and the agency to decide to impose the discretionary penalty; and 3) it carried separate criminal penalties.

Smith said he is not sure that the majority opinion was meant to establish a three-part test, but he added that there is a good chance that it will be viewed as such going forward by lower courts.

"Certainly, there's a tendency on the part of lower courts to take whatever the Supreme Court says and turn it into a formal test," Smith said.

The first prong of the test would almost certainly be met by any new third-party reporting requirement. Even if the new reporting regime does not come close to touching the compliance costs of FATCA, which by some early estimates run smaller FFIs $1 million and larger banks several hundred million each, it is hard to see how new information reporting requirements won't lead to significant compliance costs.

Regarding the second prong's emphasis that the reporting rule and the tax penalty are not directly connected, Smith argued that the connection is even more attenuated for the administration's information reporting proposal.

"Proposed reporting of inflows and outflows . . . what does that mean?" Smith asked. "The IRS would have to do quite a bit beyond just having that information. Who knows what they're going to do with that?"

Robert Horwitz of Hochman Salkin Toscher Perez PC also noted that if the IRS received a Form 1099 with an interest or dividend income reporting discrepancy, it would not automatically make an assessment on the taxpayer, but rather would inform the taxpayer and ask for an explanation. He also noted that the taxpayer would have a right to appeal if it disagreed with the IRS's position.

"You could say anytime the IRS is going to assess a tax, there are multiple steps," Horwitz said.

Although the Treasury report states that the administration will look to reduce the burden imposed on financial institutions by the new reporting requirement, it asserts that the proposal "preserves significant flexibility for the Secretary and the IRS to design the new reporting requirements in the way that will be most effective for tax compliance efforts."

If the administration or Congress wishes to avoid any pre-enforcement challenge headaches down the road, it may want to avoid attaching criminal penalties to the new reporting regime.

Smith argued that the applicability of the third prong from *CIC Services* about criminality is the most in doubt for any new third-party information reporting regime.

"It seemed very clear from the questions the justices had at the oral arguments that they were very offended by that aspect of the case," Smith said.

Other Information Reporting

New pre-enforcement challenges to Treasury rules may not be confined to whatever new rules on inflows and outflows reporting the IRS drafts for Biden's or congressional Democrats' endorsement.

According to Leslie Book of Villanova University Charles Widger School of Law, *CIC Services* could cause courts to sustain challenges to published guidance that could be characterized as regulatory mandates backed by tax penalties instead of tax challenges.

"Post-*CIC Services*, information reporting and disclosure requirements, even when directly imposed on taxpayers, seem like the most likely types of actions that courts will deem as surviving an AIA challenge," Book said.

Smith argued that the scope of the holding in *CIC Services* may not extend to information reporting that does not involve third parties. He pointed to Justice Sonia Sotomayor's concurring opinion, in which she noted that the answer "might be different if *CIC Services* were a taxpayer instead of a tax advisor."

That concurrence is also like that of the late Justice Ruth Bader Ginsburg's concurring opinion in *Direct Marketing Association v. Brohl*, 135 S. Ct. 1124 (2015). That case held that a federal lawsuit challenging a Colorado law requiring out-of-state retailers to notify Colorado customers of their sales and use tax liabilities and report those customers' purchases to the state wasn't barred by the Tax Injunction Act.

But Book cautioned against reading too much into Sotomayor's concurrence.

"None of the other justices joined her concurrence," Book said. "Arguably, the distance between the reporting rule and the statutory tax penalty is less when the challenge (and requirement) itself is brought by taxpayers, but the rationale of the opinion strongly supports sustaining all forms of information reporting and disclosure challenges outside of traditional tax enforcement proceedings."

One relevant factor to consider in determining the future applicability of *CIC Services* is whether a tax must be owed before a penalty is imposed, according to Smith. If the information reported could quickly inform the IRS of the tax liability owed, it would be less likely to fall within the ambit of *CIC Services*, he argued. Conversely, if the information could be used during an examination but did not directly lead to a tax, it would be more likely for the case to apply, he added.

Chapter 61 of the code lays out reporting requirements, which include numerous foreign information reporting standards. One of the more well-known code sections there — section 6038 — requires taxpayers to provide information on controlled foreign corporations and partnerships. Like other reporting requirements, it is backed up by penalties for failures, which can become quite substantial.

The national taxpayer advocate's 2020 annual report to Congress called out the IRS's systemic assessment of international penalties under sections 6038 and 6038A for its burden imposed on taxpayers and the agency and argued that it did not find support in the code.

"To systemically impose a $10,000 penalty per missing or incomplete Form 5471 ($25,000 for Form 5472) when the taxpayer may be missing tens or evens hundreds of forms can cause a highly disproportionate penalty, particularly when failure to file may not affect the underlying tax liability," the report states.

Horwitz asserted that nothing in the code refers to the chapter 61 penalties as taxes.

Horwitz has previously argued that the Supreme Court's rationale in *National Federation of Independent Business (NFIB) v. Sebelius*, 567 U.S. 519 (2012) could be read as extending the inapplicability of the AIA to chapter 61 penalties.

In *NFIB*, the Supreme Court upheld the Affordable Care Act and held that the AIA did not apply to the ACA penalty under section 5000A.

In *Department of Health and Human Services et al. v. Florida*, No. 11-398, an ACA challenge on certiorari before the same Court, Ginsburg asked whether section 5000A was "just out there all by itself" as an exaction under the code that did not qualify as a tax under the AIA. In response, the solicitor general asserted that there were several other provisions that fell outside the AIA, including reporting requirements for foreign corporations under section 6038.

Muddied Waters and Cans of Worms

Despite *NFIB*, Horwitz said he is unaware of any published decision that addresses the applicability of the AIA to the information reporting penalties. He surmised, however, that the issue would ultimately be addressed, potentially regarding penalties for a failure on Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts." He also noted that for any information reporting requirement, a person who willfully fails to file a report could face criminal penalties.

"The *CIC* decision, and *Direct Marketing* to a certain extent, have muddied the water [regarding] when a court would have jurisdiction over an injunction action in a tax case," Horwitz

said. “Would it be any type of notice issued by the IRS that doesn’t have a comment period? Could someone who is affected by that notice bring an action attacking it on the grounds that it violated the [Administrative Procedure Act]? The case is broadly worded enough that it could be read as doing that.”

Horwitz also wondered about the reach of the decision to information reporting guidance, including as related to the administration’s proposal for increased third-party reporting. He noted that normally when Congress requires information reporting, the IRS will issue regs, subject to notice and comment rulemaking, that outline the forms needed. The IRS will also issue pre-draft proposed forms, but he questioned whether an accounting firm might bring an injunction action if the IRS does not give an opportunity for comment and suggestions on the form itself. The same question could also be asked about revenue procedures issued without notice and comment, he added.

“It opens up a can of worms, especially since in most cases involving procedural matters . . . they do impose certain burdens on return preparers and attorneys who are advising taxpayers,” Horwitz said. “Is this for only cases where a failure to comply with a notice or the ruling or the revenue procedure imposes potential criminal sanctions? Is it . . . in those instances where it would impose civil penalties regardless of whether there are criminal sanctions? It is sort of all in the air.”