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Pre-Enforcement Challenges and the Anti-Injunction Act

by Patrick J. Smith

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In this article, Smith discusses four arguments in support of the district court holding in *Chamber of Commerce* that the Anti-Injunction Act does not bar the pre-enforcement challenge to the serial acquisition regulation under section 7874.

I. Background

The decision by the U.S. District Court for the Western District of Texas in *Chamber of Commerce*[1] has received a substantial amount of attention in the tax world, both for the court's holding that the issuance as a temporary regulation of the serial acquisition rule under section 7874 violated the notice-and-comment rulemaking requirements[2] of the Administrative Procedure Act (APA) and for the court's holding that the Anti-Injunction Act (AIA) did not bar the pre-enforcement challenge to the validity of the regulation.[3] The government is appealing the case to the Fifth Circuit Court of Appeals.[4]

Although the court's holding that temporary tax regulations are not exempt from the APA's notice-and-comment requirements has probably received the most attention, in my view the court's holding regarding the AIA is far more significant.

The principal reason the AIA issue in *Chamber of Commerce* is so significant is that the district court is the first that has given proper effect to the Supreme Court's 2015 *Direct Marketing* decision[5] in interpreting the AIA, after several other courts, including the D.C. Circuit Court of Appeals,[6] failed to do so. The significance of the AIA issue concerns the type of court proceeding in which the validity of tax regulations can be challenged. The implications of the *Direct Marketing* decision regarding the interpretation of the AIA would have a radical effect on how challenges to the validity of tax regulations are litigated.

The types of court proceedings in which tax regulations have traditionally been challenged are significantly different from those in which regulations issued by all other federal agencies are ordinarily challenged. For regulations issued by all federal agencies other than tax regulations issued by the IRS and Treasury, regulated parties who would be adversely affected by the regulations and wish to challenge their validity typically file suit in federal district court soon after the regulations are issued, under the APA's judicial review provisions,[7] without any requirement that the regulations first be applied to the plaintiffs bringing the suit. These are referred to as pre-enforcement challenges. In 1967 the Supreme Court held in *Abbott Laboratories*[8] that the APA authorizes these pre-enforcement challenges to the validity of regulations issued by federal agencies.

However, for challenges to the validity of IRS and Treasury tax regulations, pre-enforcement challenges have not been the traditional avenue. Instead, those challenges have been brought in the same types of litigation in which all other challenges to IRS action have traditionally been brought: tax refund litigation or petitions for redetermination of a tax deficiency brought in the Tax Court. In those traditional types of tax

[1] *Chamber of Commerce v. IRS*, No. 1:16-cv-944-LY (W.D. Tex. 2017).

[2] 5 U.S.C. section 553.

[3] Section 7421(a).

[4] No. 17-51063 (5th Cir.). This article was written before the plaintiffs submitted their brief in the Fifth Circuit.

[5] *Direct Marketing Association v. Brohl*, 135 S. Ct. 1124 (2015).

[6] *Florida Bankers Association v. Treasury*, 799 F.3d 1065 (D.C. Cir. 2015).

[7] 5 U.S.C. sections 701-706.

[8] *Abbott Laboratories v. Gardner*, 387 U.S. 136 (1967).

litigation, the taxpayer can challenge the validity of a regulation as part of the determination of the taxpayer's correct tax liability for a specific tax year if the challenged regulation affects the amount of the taxpayer's tax liability.

However, pre-enforcement challenges to tax regulations, if they were available, would provide two significant advantages for taxpayers in comparison with challenges using a traditional route. First, it would be possible to obtain a judicial resolution of the challenge much sooner, in comparison with the traditional situation in which a potential challenger must first engage in a transaction that would be subject to the regulation, file a tax return, and then either go through the IRS audit process based on the taxpayer's failure to apply the regulation or file a refund claim and then a refund suit for the year based on first applying, but then challenging, the regulation.

A second and even more significant advantage of pre-enforcement challenges is that a taxpayer could challenge a regulation without entering into a transaction to which the regulation would apply and therefore would not risk having the regulation applied to the transaction if the challenge to the validity of the regulation fails on the merits.[9] Many tax regulations are effectively immune from challenge under the traditional methods because the adverse tax consequences of engaging in a transaction subject to the regulation are so significant. This consideration applies to the regulation in *Chamber of Commerce*.

Considering the substantial advantages of pre-enforcement challenges, why haven't they been used for tax regulations? This is because of the traditional view of the scope of the AIA, which provides that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person."

Before *Direct Marketing*, the general view was that the AIA barred any litigation in federal district court relating in any way to federal taxes, other than tax refund litigation, if success by the plaintiffs could have any adverse effect on the amount of tax revenue collected by the federal government. I briefly describe the *Direct Marketing* decision later in this article.

Under the broad view of the AIA's scope that was prevalent before the *Direct Marketing* decision, pre-enforcement challenges to tax regulations would be prohibited because a plaintiff's success would prevent the IRS from applying the regulations to any taxpayer and from collecting any tax based on the application of the regulations. That broad view was based primarily on two 1974 Supreme Court decisions, *Bob Jones*[10] and *"Americans United."*[11]

I focus on four arguments relevant to sustaining the district court's position in *Chamber of Commerce* that the Supreme Court's *Direct Marketing* decision supports a relatively narrow view of the AIA's scope:

- the argument that the AIA applies only to suits regarding taxes that are alleged to be due based on the factual situation that exists when the suit is being litigated;
- the argument that the rationale for a broad view of the scope of the AIA that has been expressed in several court decisions, based on the need to assure a steady flow of tax revenue to the federal government by limiting court contests relating to federal taxes to refund suits brought after the contested tax has been paid, is substantially undercut by the availability of the Tax Court as a forum for taxpayers to litigate the correctness of an assertion by the IRS that the taxpayers owe additional taxes for a particular tax year, without any requirement that the taxpayers must first pay the tax before being able to challenge their liability in a tax refund suit;
- the argument that it would not be necessary for *Bob Jones* to be overturned to give effect to *Direct Marketing* in interpreting the AIA, but that instead the situation in *Bob Jones* is distinguishable from the situation in many pre-enforcement challenges to tax regulations, including the challenge in *Chamber of Commerce*; and

[9] For previous discussions of these points, see Patrick J. Smith, "Challenges to Tax Regulations: The APA and the Anti-Injunction Act," *Tax Notes*, May 25, 2015, p. 915; and Smith, "D.C. Circuit in *Florida Bankers* Misapplies Anti-Injunction Act," *Tax Notes*, Dec. 21, 2015, p. 1493.

[10] *Bob Jones University v. Simon*, 416 U.S. 725 (1974).

[11] *Alexander v. "Americans United" Inc.*, 416 U.S. 752 (1974).

- a response to the government's argument that because the word "restrain" in the AIA is not accompanied by the words "enjoin" and "suspend," in contrast with the statutory provision directly at issue in *Direct Marketing*, *Direct Marketing* is inapplicable to the AIA.

II. *Williams Packing*

For purposes of explaining those four arguments, it is relevant to discuss *Williams Packing*,[12] a Supreme Court case on the AIA that preceded the two 1974 Supreme Court cases that have been the basis for a broad view of the scope of the AIA.

Williams Packing was a 1962 decision that involved the liability of the plaintiff for employment taxes for tax years preceding the year the case was filed. The taxpayer filed suit in federal district court for an injunction to prevent collection of the taxes. That seems like the type of suit that the AIA clearly bars under even the narrowest view of its scope.

However, the plaintiff argued the AIA should not apply because if the taxpayer were required to pay the taxes to challenge its tax liability for the taxes, it would bankrupt the taxpayer, and thus the taxpayer would be unable to pursue the remedy of filing suit for a refund to challenge its tax liability. The Supreme Court rejected that argument based on a comparison of the text of the 1867 AIA with the text of the 1937 Tax Injunction Act (TIA),[13] which imposes similar limitations on the ability to obtain injunctions in federal district court relating to state taxes, and which the Court noted was modeled on the AIA. It was the TIA that was at issue in *Direct Marketing*.

The Court in *Williams Packing* noted that the TIA specifically provides that the TIA's limitations on suits in federal district court relating to state taxes apply only "where a plain, speedy, and efficient remedy may be had at law or in equity in the courts of such State." The Court noted that the plaintiff in *Williams Packing* was essentially asking it to apply a similar limitation on the application of the AIA: that the AIA limitations apply only when an adequate alternative judicial remedy is available. However, the Court concluded that the lack of any similar limitation in the text of the AIA meant that no such limitation was intended to apply to the AIA.

III. *Direct Marketing*

Before turning to the aspect of *Williams Packing* that concerns the first two of the four arguments identified above, it is appropriate to describe the Supreme Court's 2015 *Direct Marketing* decision because it concerns the relationship between the AIA and the TIA. *Direct Marketing* involved a constitutional challenge to Colorado state statutory provisions requiring retailers located outside of Colorado but making sales to customers within Colorado to submit information reports to the state of Colorado providing details about those sales as well as to notify the customers of their obligation to pay Colorado tax on the purchases.

The state of Colorado argued that the TIA barred the suit from being litigated in federal court, and the Tenth Circuit Court of Appeals agreed. However, the Supreme Court disagreed.

The Court began by noting that in interpreting the TIA, it had previously looked to the AIA and federal tax law more generally because the TIA was modeled on the AIA. The Court noted that in interpreting the TIA, it assumed that terms used in both acts have the same meaning, and that the meaning of the terms in the AIA is determined by reference to the other provisions of the IRC.

The Court noted that the TIA provides that "the district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under state law," while, as noted earlier, the AIA provides that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person." The Court noted that for purposes of deciding the case, "the question becomes whether the enforcement of the notice and reporting requirements is an act of 'assessment, levy or collection.'"[14] The Court concluded that based on the meaning these terms have in the IRC, "they do

[12] *Enochs v. Williams Packing & Navigation Co.*, 370 U.S. 1 (1962).

[13] 28 U.S.C. section 1341.

[14] *Direct Marketing*, 135 S. Ct. at 1129.

not encompass enforcement of the notice and reporting requirements at issue."

The Court concluded that based on the meaning the terms "assessment," "levy," and "collection" have in the IRC, "these three terms refer to discrete phases of the taxation process that do not include informational notices or private reports of information relevant to tax liability." Instead, "the Federal Tax Code has long treated information gathering as a phase of tax administration procedure that occurs before assessment, levy, or collection." The information gathering "step includes private reporting of information used to determine tax liability, including reports by third parties who do not owe the tax." The Court concluded that the Colorado "notice and reporting requirements precede the steps of 'assessment' and 'collection'":

> Enforcement of the notice and reporting requirements may improve Colorado's ability to assess and ultimately collect its sales and use taxes from consumers, but the TIA is not keyed to all activities that may improve a State's ability to assess and collect taxes. . . . The TIA is keyed to the acts of assessment, levy, and collection themselves, and enforcement of the notice and reporting requirements is none of these.

The Court then addressed the reasoning in the Tenth Circuit's opinion, noting that this court had not relied on the terms "assessment, levy or collection" in holding that the TIA barred the suit. The Court noted that instead, the Tenth Circuit relied on giving a broad meaning to the word "restrain" in the TIA, holding that this term meant that the TIA barred any suit that would "limit, restrict, or hold back" the assessment, levy, or collection of state taxes.

The Court noted that the term "restrain" can have two meanings, a broad meaning under which the term means "inhibit" and a narrow meaning under which the term means "prohibit" or "stop." The Court gave several reasons for its conclusion that the narrow meaning was more appropriate in the context of the TIA. First, the Court noted "that the words 'enjoin' and 'suspend' are terms of art in equity" that "refer to different equitable remedies that restrict or stop official action to varying degrees, strongly suggesting that 'restrain' does the same."

Second, the Court interpreted the term "restrain" by reference to the actions to which the term applies in the TIA:

> Additionally, as used in the TIA, "restrain" acts on a carefully selected list of technical terms — "assessment, levy, collection" — not on an all-encompassing term, like "taxation." To give "restrain" the broad meaning selected by the Court of Appeals would be to defeat the precision of that list, as virtually any court action related to any phase of taxation might be said to "hold back" "collection." Such a broad construction would thus render "assessment [and] levy" — not to mention "enjoin [and] suspend" — mere surplusage, a result we try to avoid.

Finally, the Court identified two additional considerations that supported giving the term "restrain" in the TIA a narrow meaning rather than a broad one. Noting that the TIA "has its roots in equity practice," the Court said that courts of equity "did not refuse to hear every suit that would have a negative impact on States' revenues," but that "the Court of Appeals' definition of 'restrain,' however, leads the TIA to bar every suit with such a negative impact."

Moreover, the Court stated that "adopting a narrower definition is consistent with the rule that 'jurisdictional rules should be clear.'" In contrast, "the Court of Appeals' definition of 'restrain' . . . produces a 'vague and obscure' boundary that would result in both needless litigation and uncalled-for dismissal."

IV. Four Arguments

With that background provided by the Supreme Court's analysis in *Direct Marketing*, I turn to a discussion of the four arguments identified above to the district court's conclusion in *Chamber of Commerce* that *Direct Marketing* supports the holding that the AIA does not bar the pre-enforcement challenge to the validity of the serial acquisition regulation.

A. Taxes 'Alleged to Be Due'

The first two arguments are based on a *Williams Packing* passage describing the purpose of the AIA:

> The manifest purpose of section 7421(a) is to permit the United States to assess and collect taxes *alleged to be due* without judicial intervention, and to require that the legal right to the disputed sums be determined in a suit for refund. In this manner the United States is assured of prompt collection of its lawful revenue.[15] [Emphasis added.]

The first argument based on this statement of the purpose of the AIA involves the statement that the AIA applies to taxes that are "alleged to be due" — meaning taxes that are alleged to be currently due, based on facts existing when the suit is brought.

Limiting the scope of the AIA to taxes that are alleged to be due is supported by the reasoning in *Direct Marketing* with its focus on giving the terms "assessment" and "collection" the narrow, technical meaning they have in the IRC. Taxes can be assessed based only on a specific factual situation that exists at a specific time, and it makes the most sense that the most relevant factual situation is the one that exists when the suit in which the AIA is invoked is being litigated, rather than some hypothetical factual situation that might exist in the future.

This application of the AIA only to taxes that are alleged to be due would not extend to taxes that are potentially due in the future based on events that have not yet happened when the AIA is invoked in litigation. Thus, this statement of the purpose of the AIA would not extend the scope of the AIA to pre-enforcement challenges to tax regulations, at least if the plaintiffs in the pre-enforcement challenge have not yet engaged in the type of transaction to which the regulation would apply.

In that case, there is no possibility that taxes could be currently due from the plaintiffs from application of the regulation because the plaintiffs have not engaged in any transaction to which the regulation would apply. However, as discussed below, the two 1974 Supreme Court decisions removed this limitation of the scope of the AIA to taxes alleged to be due, without providing explanation or acknowledging that they did so.

B. The Availability of the Tax Court

The second argument is based on the rationale in *Williams Packing* that the AIA is necessary to ensure a steady flow of tax revenue to the federal government by limiting litigation concerning taxes to tax refund suits, a proposition frequently quoted in later cases as support for giving the AIA a broad scope. However, the notion that the AIA must be given a broad scope to protect the flow of tax revenue to the government, and that thus taxpayers may contest their tax liabilities only in tax refund suits after having paid the tax, is inconsistent with the existence of the Tax Court and its predecessors since 1924, long after the AIA was enacted.

The fundamental and indisputable purpose for the creation of the Tax Court was to permit taxpayers to contest in court tax liabilities that have been asserted against them by the IRS without first having to pay the tax, as would be necessary in a tax refund suit. The ability of taxpayers to avoid paying taxes alleged by the IRS to be due by filing a petition in Tax Court clearly undercuts the rationale expressed in *Williams Packing*. And yet case after case continues to invoke that rationale for giving a broad scope to the AIA, even though it doesn't hold up today.

C. Distinguishing *Bob Jones*

The third argument relates to the two 1974 Supreme Court cases, *Bob Jones* and "*Americans United*," that have provided the basis for the traditional view that the AIA has an extremely broad scope. While these two cases purported to be merely applying the principles from *Williams Packing*, they went significantly beyond that holding by completely departing from the concept that the AIA applies only to taxes alleged to be due.

Both cases involved organizations that were challenging revocation of tax-exempt status rulings from the IRS. The Supreme Court held that both challenges were barred by the AIA. To the extent the revocation of tax-exempt status

[15] *Williams Packing*, 370 U.S. at 7.

affected the current or prior tax liability of the organizations themselves, the conclusion that the AIA barred a challenge to the revocation by the organization did not represent a broad or surprising reading of the scope of the AIA and would have been completely consistent with *Williams Packing*.

However, the Supreme Court's reasoning in the two cases was not limited to the effect of the challenge on the tax liability of the organizations themselves but also relied on the effect of the challenge on the tax liability of contributors to the organizations. Moreover, the Court was not concerned about the effect on contributions that had already been made when the cases were being litigated, but rather about the effect on possible future contributions. In both cases, the Court concluded that one of the main purposes of the challenge was for the organizations to obtain "advance assurance" that any future contributions to the organizations would be tax deductible by the contributors, and concluded that this was an important additional reason why the AIA barred the suit.[16]

These references to advance assurance of deductibility is what makes these decisions represent an extremely broad view of the scope of the AIA; in this aspect of its reasoning, the Court was relying on the effect of the challenge on possible future contributions unrelated to any tax the IRS could possibly have assessed based on the facts that existed when the cases were being litigated.

It is in this way that *Bob Jones* and *"Americans United"* clearly go far beyond the holding in *Williams Packing* that the AIA relates only to taxes alleged to be due. This aspect of the two cases is what would make the AIA applicable to pre-enforcement challenges to regulations because under this view of the scope of the AIA, plaintiffs challenging a regulation cannot rely on the fact that they have not engaged in a transaction to which the regulation would apply as a basis for avoiding the application of the AIA.

However, a possible basis for distinguishing these two 1974 decisions is provided by a footnote in the *Bob Jones* decision in which the Court addressed the argument that if the challenge were allowed to proceed and the organization lost the challenge on the merits, potential contributors to the organization would refrain from making contributions to the organization because of the inability to claim a tax deduction for the contributions and that as a result, the suit would have no adverse effect on tax revenue.[17] The Court rejected that argument because it said that even if the organization lost its tax exemption, some portion of the organization's current donors would continue making contributions.

Based on the footnote, it could be argued that for pre-enforcement challenges to tax regulations, *Bob Jones* should be limited to situations in which at least some taxpayers who would suffer adverse consequences if the challenged regulation were upheld on the merits would nonetheless choose to suffer those adverse tax consequences rather than refraining from taking the action that would make the regulation applicable to them.

While this way of distinguishing *Bob Jones* would not, in my view, represent the most correct legal outcome, it represents a possible approach that would give partial effect to *Direct Marketing* for a judge who might be hesitant to disregard *Bob Jones* completely. A more realistic view of *Bob Jones* would view the result in that case as being the product of a distinctive combination of circumstances.

First, *Bob Jones* and *"Americans United"* were decided when the Supreme Court, in interpreting statutory provisions, gave far less attention to the actual text of the provision being interpreted than it does now. Second, it seems plausible that the outcome in *Bob Jones* was affected, at least in part, by a desire on the part of the Supreme Court justices to hand a resounding defeat to an organization that was engaged in open and undisguised racial discrimination, even if that outcome required some stretching to be applied to what they must have considered to be an obscure, highly technical provision of the IRC.

Those two 1974 Supreme Court decisions do not represent part of a larger pattern of Supreme Court decisions consistently holding that the AIA

[16] *Bob Jones*, 416 U.S. at 727, 739; "*Americans United*," 416 U.S. at 760-761.

[17] *Bob Jones*, 416 U.S. at 739 n.10.

is not limited to taxes that are alleged to be due. Instead, the cases stand essentially alone on this issue, in terms of Supreme Court decisions — and if it is necessary to overturn those decisions to maintain consistency in interpretation between the AIA and the TIA as interpreted in *Direct Marketing*, in my view that would represent the most appropriate result.

D. The Meaning of 'Restrain'

As noted in the earlier discussion of the *Direct Marketing* decision, in the Court's discussion of the meaning to give to the word "restrain" in the TIA, it identified four reasons for giving the word a narrower meaning rather than a broader meaning. Three of those four reasons equally apply in determining the meaning of the word "restrain" in the AIA. The fact that one reason is not applicable to the AIA should not be sufficient to reach a different conclusion about the meaning of "restrain" in the AIA than it has in the TIA.

Moreover, the *Direct Marketing* discussion of the meaning of "restrain" appears in the section of the opinion that discusses the Tenth Circuit decision. In the opinion's preceding section, the Supreme Court seemed to have already concluded that the TIA was inapplicable based on its analysis of the meaning of the words "assessment," "levy," and "collection" in the IRC. Thus, it is not at all clear that the section of the opinion discussing the meaning of "restrain" was necessary to the Court's holding in the case.

The government's argument was that because in the AIA the word "restrain" is not accompanied by the words "enjoin" and "suspend," in contrast with the TIA, the word "restrain" in the AIA should be given a broader meaning than it has in the TIA. That argument ignores the historical relationship between the AIA and the TIA. As the Supreme Court has repeatedly noted, the 1937 TIA was modeled on the 1867 AIA.

By adding the words "enjoin" and "suspend" in enacting the TIA, to the extent that Congress in 1937 intended any difference between the scope of the TIA and the scope of the AIA, the intended difference presumably would have been to make the scope of the TIA broader than the scope of the AIA because "enjoin" and "suspend" could have been viewed as being potentially applicable when "restrain" might not have applied. However, the government's argument that "restrain" has a different meaning in the TIA than it does in the AIA suggests that by adding those two words, the effect was to make the scope of the TIA narrower than the scope of the AIA. That argument seems counterintuitive and nonsensical. If Congress intended any difference in scope between the TIA and the AIA, it presumably would have been to broaden the scope of the TIA in comparison with the AIA by adding the words "enjoin" and "suspend" to the word "restrain," whereas, under the government's argument, the effect of adding these words was instead to narrow the scope of the TIA in comparison with the AIA.

V. Conclusion

Based on the four arguments discussed above, the Fifth Circuit should affirm the district court's holding that the AIA is inapplicable in *Chamber of Commerce*, and, assuming the Supreme Court grants the government's likely petition for certiorari based on the resulting circuit split with the D.C. Circuit, the Supreme Court should reach the same result. ■