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Montana Federal Court Strikes Down EO Donor Rule Change

by Kristen A. Parillo

The IRS violated the Administrative Procedure Act (APA) when it repealed the donor disclosure rules for some nonprofits without seeking input from affected parties, according to a Montana federal judge.

The July 30 order from the U.S. District Court for the District of Montana is a significant political victory for advocates of campaign finance transparency, but some observers say it also raises questions about Treasury's authority to issue regulations allowing the IRS to expand or contract rules through informal guidance

The IRS declined to comment, telling *Tax Notes* that it doesn't discuss litigation.

At issue in the case was whether the IRS followed APA rulemaking procedures when it promulgated Rev. Proc. 2018-38, 2018-31 IRB 280.

The agency announced in the July 2018 revenue procedure that exempt organizations other than section 501(c)(3) entities and section 527 political groups will no longer be required under the section 6033 reporting regulations to disclose the names, addresses, or donation amounts of substantial contributors on Schedule B of their Form 990 or 990-EZ.

EOs must still collect and maintain the information in their records and make it available to the IRS if the agency asks for it, however.

Eight days after it was issued, Montana Gov. Steve Bullock (D) and his state's revenue department filed a lawsuit against the IRS, contending that the revenue procedure violated the APA because it was issued without notice and comment.

> ***'The IRS must follow the proper notice-and-comment procedures pursuant to the APA if it seeks to adopt a similar rule,' the order says.***

New Jersey Attorney General Gurbir Grewal joined the lawsuit in March.

Judge Brian Morris heard arguments June 5 on the Justice Department's motion to dismiss and the states' motion for summary judgment that Rev. Proc. 2018-38 violated the APA.

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Granting the states' motion, Morris's July 30 order held that the revenue procedure is unlawful and will be set aside. "The IRS must follow the proper notice-and-comment procedures pursuant to the APA if it seeks to adopt a similar rule," the order says.

Bullock and Grewal praised the court's decision in separate statements July 31.

"We're holding the federal government accountable to following its own rules and making sure that people, not dark money groups, decide our elections," Bullock said, while Grewal called the decision a "big win for democracy and for the rule of law."

Senate Finance Committee ranking member Ron Wyden, D-Ore., also weighed in, saying Treasury "broke every rule in the book to repeal donor reporting requirements and open the floodgates to illegal dark and foreign money flowing through organizations like the [National Rifle Association] and [U.S.] Chamber of Commerce to influence U.S. elections."

Informational Injury

The states argued in their amended complaint that the IRS's action caused them "informational injury" because they had relied on substantial-contributor details to administer their own laws.

The Justice Department contended that the states lacked standing because they have no legally protected interest in receiving donor information from the IRS and suffered no actual harm from the agency's decision to no longer require annual reporting of substantial-contributor information.

Morris found that New Jersey's efforts to create new regulatory processes to access information that it previously obtained from the IRS "rise to the level of an injury sufficient to meet the standard set by" a 2015 D.C. Circuit decision on what constitutes an informational injury.

Morris found that Montana's grievance was a closer call because, unlike New Jersey's diversion of state resources, it would incur only future economic injury as a result of Rev. Proc. 2018-38. Nevertheless, Morris concluded that Montana still had standing because its injury would arise from an IRS action that significantly restricts the flow of information on which the state relies.

Alexander L. Reid of Morgan, Lewis & Bockius LLP questioned the conclusion in the court's order that the states' "information harm" is sufficient to support a claim that the federal government can't unilaterally allow EOs to submit redacted donor information without following the notice and comment procedure.

"The problem is that the party in interest was not at the table for this decision — namely, the donors," Reid told *Tax Notes*.

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Reid added that the case isn't so much about whether the government should make it easier for states to piggyback on information it collects. "It's about whether donors can trust the government to protect their privacy," he said. "When viewed as a balancing of the donor's informational harm against that of the government, the burden should be on the government to demonstrate why it needs the information."

Gaining a political advantage over opponents or encouraging retaliation against donors to unpopular causes aren't acceptable government reasons to collect donor information, Reid said.

APA Violation

On the APA claims, the Justice Department argued that the issuance of Rev. Proc. 2018-38 is unreviewable under the APA because of 5 U.S.C. section 701(a)(2), which bars judicial review when "agency action is committed to agency discretion by law."

Morris rejected the Justice Department's argument that the revenue procedure merely constituted a rule of IRS practice and procedure and thus fell outside the scope of APA rulemaking requirements.

The order found that Rev. Proc. 2018-38 rose to the level of a legislative rule requiring notice and comment because the underlying reporting regulation didn't retain its substantive meaning after the IRS's amendment.

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The revenue procedure "explicitly upended" the 50-year practice that had been set out under reg. section 1.6033-2(a)(ii)(f) requiring EOs to provide substantial-contributor information on their tax returns, Morris said.

While section 6033(a)(1) gives the IRS the authority to determine what information it wants from EOs, the agency "cannot escape . . . the procedural demands of the APA," Morris wrote.

The scope of the IRS's responsibility to enforce the tax code with integrity and fairness "provides sufficient reason for the IRS to seek external information and opposing opinions before it promulgates an amendment to a legislative rule," the order says.

The states' reasons for needing donor information — including that it helps them enforce limits on political activity and determine if an EO has violated the prohibition on private inurement — "support the need for the IRS to comply with the APA's notice-and-comment provision when it amends a long-standing regulation that implicates the collection and sharing of this information," Morris added.

The judge stressed that he wasn't assessing the merits of Rev. Proc. 2018-38, but was only concluding that the states should have an opportunity to submit data and opposing views or arguments to the IRS.

Guidance Impact

Patrick J. Smith of Ivins, Phillips & Barker Chtd. said that while the court's discussion on the states' standing "is unquestionably interesting," he found that the holding on the APA violation is "clearly the overwhelmingly important aspect of this decision."

Smith noted that the substantive issue is similar to that of the taxpayer's claim in *CIC Services LLC v. IRS*, No. 18-5019 (6th Cir. 2019), in which a captive insurance advisory firm contended that the IRS's microcaptive notice violated the APA because it was issued without notice and comment. The firm has appealed the Sixth Circuit's May decision that its lawsuit is barred by the Anti-Injunction Act.

"The question is whether the IRS and Treasury have the legal authority to expand or contract the scope of regulations by issuing documents in the Internal Revenue Bulletin without following the APA notice and comment requirements," Smith said.

The Montana district court's decision "says resoundingly that these tax agencies do not have that authority," Smith said.

While the case is getting a lot of political attention because of the donor disclosure issue, it also has considerable legal significance because Treasury has issued regulations with provisions allowing the IRS to later expand or contract a rule via informal guidance, Smith said.

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"This decision calls that practice into question," Smith added.

University of Iowa law professor Andy Grewal said the court's approach, if upheld, "could have significant implications for how we think about 'legislative rules' in the tax code."

"Subregulatory guidance, like IRS notices, rev. procs, and so on, have often escaped procedural scrutiny," Grewal continued. "But this decision, if upheld on appeal, will encourage the IRS to more carefully consider how it measures public input when it issues subregulatory guidance."

The case is *Bullock v. IRS*, No. 4:18-cv-00103 (D. Mont. 2019). ■

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