

## Legislative Recommendation #36

## Clarify That Supervisory Approval Is Required Under IRC § 6751(b) Before Proposing Penalties

### PRESENT LAW

IRC § 6751(b)(1) states: “No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate.” IRC § 6751(b)(2) carves out two categories of exceptions from this supervisory approval requirement: (i) the penalties for failure to file a tax return (IRC § 6651(a)(1)), failure to pay the tax due (IRC § 6651(a)(2)), and failure to pay sufficient estimated tax (IRC §§ 6654 and 6655) and (ii) any other penalty that is “automatically calculated through electronic means.”

### REASONS FOR CHANGE

IRC § 6751(b) protects taxpayers’ *right to a fair and just tax system* by ensuring penalties are only imposed in appropriate circumstances and not used as a bargaining chip to encourage settlement.<sup>1</sup> However, the phrase “initial determination of [an] assessment” is unclear. A “determination” is made on the basis of calculation or research. An “assessment” is merely the entry of a decision on IRS records. Therefore, while a penalty can be determined and a penalty can be assessed, “one cannot ‘determine’ an ‘assessment.’”<sup>2</sup> Due to this ambiguity in the statute, an increasing number of court cases have had to grapple with when written supervisory approval must be provided.<sup>3</sup> In recent years, courts have found that the supervisory approval must occur at even earlier times than previously determined:

- In 2016, the Tax Court held in *Graev v. Commissioner* (which was later vacated) that supervisory approval could occur at any point before the assessment was made.<sup>4</sup>
- In 2017, the U.S. Court of Appeals for the Second Circuit held in *Chai v. Commissioner* that supervisory approval was required no later than the date on which the IRS issued the notice of deficiency, or if the penalty was asserted through an answer or amended answer, the time of that filing.<sup>5</sup>
- In 2019, the Tax Court held in *Clay v. Commissioner* that supervisory approval was required prior to sending the taxpayer a formal communication that included the right to go to the IRS Independent Office of Appeals.<sup>6</sup>

In late 2019, however, the Tax Court declined to require supervisory approval prior to that point. In *Belair Woods LLC v. Commissioner*, the Tax Court found the IRS did not have to obtain supervisory approval before sending the taxpayer a Letter 1807, TEFRA Partnership Cover Letter for Summary Report, which invited the taxpayer to a closing conference to discuss proposed adjustments.<sup>7</sup> Instead, the court found the Letter 1807 only advised the taxpayer of the possibility that the penalties could be proposed and the pivotal moment requiring supervisory approval was when the IRS sent the 60-day letter, formally communicating its definite decision to assert the penalties.

1 See S. REP. NO. 105-174, at 65 (1998).

2 *Chai v. Comm’r*, 851 F.3d 190, 218-219 (2d Cir. 2017) (quoting *Graev v. Comm’r*, 147 T.C. 460 (2016) (Gustafson, J., dissenting)).

3 See National Taxpayer Advocate 2019 Annual Report to Congress, 149-157 (Most Litigated Issue: *Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)*); National Taxpayer Advocate 2018 Annual Report to Congress 447-457 (Most Litigated Issue: *Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)*).

4 147 T.C. at 460, superseded by, in part, modified by, in part 149 T.C. 485 (2017).

5 851 F.3d 190 (2d Cir. 2017).

6 152 T.C. 223 (2019).

7 154 T.C. No. 1, Tax Ct. Rep. Dec. (RIA) 154.1 (Jan. 6, 2020).

The IRS issued interim guidance that instructs employees to obtain written supervisory approval before sending a written communication that offers the taxpayer an opportunity to sign an agreement or consent to assessment or proposal of a penalty.<sup>8</sup> The interim guidance specifies that prior to obtaining written supervisory approval, employees can share written communications with the taxpayer that reflect proposed adjustments as long as they do not offer the opportunity to sign an agreement or consent, or request an Appeals conference.

However, both *Belair Woods* and the IRS's interim guidance leave open the possibility that IRS employees could use penalties as a bargaining chip – precisely what Congress sought to prevent by enacting IRC § 6751(b). Under *Belair Woods*, IRS employees can propose penalties in order to induce a resolution without first obtaining written supervisory approval, as long as the communication is deemed a proposal and not a definite decision. This approach undermines the statutory intent because, as explained in the dissent in *Belair Woods*, “[e]very communication from the Commissioner proposing a deficiency and a related penalty – whether it is a preliminary report, a 30- or 60-day letter, or a notice of deficiency – sets forth proposed adjustments, which do not become final until a decision is entered or an assessment is properly recorded.”<sup>9</sup> The IRS's interim guidance seeks to resolve the question of what is merely a proposal versus a definite decision by drawing the line at written communications that offer a chance to agree to assessment or consent to proposal of a penalty. However, employees could still use penalties as a bargaining chip because some taxpayers may feel pressured to resolve their cases when penalties are first put on the table as proposed adjustments.

In addition to the timing issue, the statutory language of IRC § 6751(b)(1) is also problematic because of its focus on “assessment(s).” In *Wells Fargo & Company v. Commissioner*, the U.S. Court of Appeals for the Eighth Circuit found that supervisory approval under IRC § 6751(b) was not required because there was no assessment.<sup>10</sup> There, the IRS asserted the accuracy-related penalty in a refund suit to offset any refund granted to the taxpayer. Because the penalty, if upheld by the court, would only lead to a reduced refund and not a balance to be assessed, the court found there would be no assessment and thus no requirement for supervisory approval. Under this holding, the IRS can assert penalties in refund litigation to persuade taxpayers to settle without supervisory approval to ensure the penalties are appropriate. Thus, IRC § 6751(b)(1) should be revised to specify that supervisory approval is required in situations where the penalty is included as part of a final judicial decision.

In practice, the overwhelming majority of penalties imposed by the IRS are excluded from the supervisory approval requirement through one of the exceptions in IRC § 6751(b)(1).<sup>11</sup> But where written supervisory approval is required, it should be required early enough in the process to ensure it is meaningful and not merely an after-the-fact rubber-stamp applied in the limited number of cases in which a taxpayer challenges a proposed penalty.

## RECOMMENDATION

- Amend IRC § 6751(b)(1) to clarify that no penalty under Title 26 shall be assessed or entered in a final judicial decision unless the penalty is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate *prior to the first time the IRS sends a written communication to the taxpayer proposing the penalty as an adjustment.*

8 Memorandum from Director, Examination Field and Campus Policy, to Directors, Field Examination, SBSE-04-0920-0054 (Sept. 24, 2020).

9 154 T.C. No. 1, Tax Ct. Rep. Dec. (RIA) 154.1, 11 (Jan. 6, 2020) (Marvel, J., dissenting).

10 957 F.3d 840 (8th Cir. 2020), *aff'd* 260 F. Supp. 3d 1140 (D. Minn. 2017).

11 In FY 2020, the IRS imposed 40.5 million penalties on individuals, estates, and trusts in connection with income tax liabilities. The following penalties, generally imposed by electronic means, accounted for over 80 percent of the total: failure to pay (19.3 million), failure to pay estimated tax (10.7 million), failure to file (2.4 million) and bad checks (1.1 million). IRS, 2020 Data Book, Table 26, Civil Penalties Assessed and Abated, by Type of Tax and Type of Penalty, Fiscal Year 2020, at 60 (2021).