New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

ALM.

NOVEMBER 16, 2022

Litigating IRS Penalty Approval

By Jeremy H. Temkin

Jeremy Temkin

Each year the Internal Revenue Service assesses billions of dollars in civil penalties against taxpayers. In 1998, Congress adopted §6751(b) of the Internal Revenue Code, which imposes a procedural restriction on the IRS's ability to assess penalties. That section provides that "[n]o penalty … 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."

For years the IRS's compliance with this statutory requirement went largely unquestioned by taxpayers. In *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), however, the U.S. Court of Appeals for the Second Circuit reversed the Tax Court and held that the IRS bears the burden of establishing that supervisory approval was given "no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty."

While Tax Court cases decided after *Chai* adopted and enlarged the Second Circuit's rule, the Ninth and Eleventh Circuits recently departed from *Chai*'s reasoning and allowed for the approval of penalties much later in the administrative process. Given that the Tax Court applies the law as interpreted by the Court of Appeals in the Circuit where the taxpayer lives, the varying interpretations of the supervisory approval requirement mean that liability for substantial penalties may turn on where the taxpayer resides.

Procedural Context

The Internal Revenue Code contains over 150 types of civil penalties. Certain penalties, including accuracy-related penalties imposed for negligent mistakes on income tax returns and civil fraud penalties, are subject to "deficiency procedures" that provide taxpayers with the opportunity to challenge penalties in Tax Court prior to payment being due. In the deficiency regime, if the IRS concludes a taxpayer owes funds and the taxpayer either does not appeal the proposed adjustment to the IRS Independent Office of Appeals or the taxpayer's appeal is unsuccessful, the IRS will issue a "notice of deficiency." The taxpayer then has 90 days to file a petition in Tax Court. If the taxpayer fails to file a Tax Court petition, or if the Tax Court rejects the taxpayer's petition, the IRS will "assess" the deficiency, at which point the IRS can take steps to collect the amount owed.

By contrast, other penalties, including penalties for failure to file information returns, are "assessable penalties" that are due upon notice and demand. See 26 U.S.C. §6671. Taxpayers generally are not entitled to pre-payment judicial review of assessable penalties except for limited review of IRS Collection Due Process (CDP) hearings. See id. §§6320, 6330.

'Chai'

Chai arose out of deficiency proceedings following an audit

JEREMY H. TEMKIN *is a partner of Morvillo Abramowitz Grand Iason & Anello, P.C. Emily Smit, an associate at the firm, assisted in the preparation of this article.*

Photo: Patrick Semansky/AP

A sign is displayed outside the Internal Revenue Service building May 4, 2021, in Washington.

of Jason Chai, a participant in a tax shelter transaction. The revenue agent conducting the audit concluded that Chai had failed to pay self-employment taxes on $2 million in unreported income. The IRS issued a notice of deficiency that included an accuracy-related penalty. In post-trial briefing before the Tax Court, Chai argued for the first time that the penalty should be vacated because the Commissioner had failed to satisfy his burden of production regarding the supervisory approval requirement. The Tax Court found that the argument was untimely and upheld the penalty.

Among the issues addressed on appeal, the Second Circuit considered Chai's supervisory approval argument. In doing so, the court analyzed the text of §6751(b) and found that, although the provision clearly requires supervisory approval of the "initial determination of [a penalty] assessment," the provision was rendered ambiguous by virtue of the statutory definition of an "assessment."

After finding an ambiguity in the statute, the Second Circuit proceeded to review the legislative history to determine what Congress had intended would constitute an "initial determination." Relying on a Senate Committee Report expressing the view "that penalties should only be imposed where appropriate and not as a bargaining chip[,]" *Chai*, 851 F.3d at 219 (quoting S. Rep. No. 105-174, at 65 (1998)), the court found that the approval requirement was designed to prevent revenue agents from threatening unjustified penalties to coerce taxpayers to agree to otherwise disputable audit adjustments. The court further reasoned that this salutary purpose would be lost if a supervisor could grant approval up until the moment a penalty was "assessed" since an unapproved penalty could be used as leverage "through administrative proceedings, settlement negotiations, and potential Tax Court proceedings," at which point a supervisor's consideration of the matter would be moot.

Ultimately, the Second Circuit concluded that in order to vindicate Congress's intent in adopting §6751(b), supervisory approval must be given before either the issuance of a notice of deficiency, which triggers a taxpayer's ability to file a petition in Tax Court, or the date on which the IRS asserts a penalty in an answer or amended answer in Tax Court. Based on this holding, the court went on to find that the Commissioner bears both the burden of production and the burden of proof with respect to procedural compliance, and that the Commissioner had failed to carry his burden in Chai's case. As a result, the court reversed the portion of the Tax Court's decision upholding the penalty.

Alternative Approaches

In concluding that §6751(b) mandated supervisory approval before the issuance of a notice of deficiency, the Second Circuit disagreed with a majority of the Tax Court, which had previously held in a different case that written approval may be obtained at any time before the penalty is "assessed," and may be challenged in post-assessment proceedings. See *Graev v. Comm'r*, 147 T.C. 16 (2016) (*Graev II*). After *Chai*, however, the Tax Court reconsidered *Graev*, and opted to follow the Second Circuit's conclusion, with the concurrence explaining that requiring approval before a taxpayer is informed of a penalty is faithful to *Chai*'s reading of Congress's purpose because it reduces the likelihood of the IRS using the specter of penalties as leverage against taxpayers. See *Graev v. Comm'r*, 149 T.C. 485 (2017) (adopting holding in *Chai*). The Tax Court has since applied this reasoning to further move up the deadline for approval. See *Clay v. Comm'r*, 152 T.C. 223 (2019), aff'd on other grounds, 990 F.3d 1296 (3d Cir. 2021), cert. denied, 142 S. Ct. 342 (2021); *Carter v. Comm'r*, 119 T.C.M. (CCH) 1128, *30 (2020). Recently, however, the Ninth and Eleventh Circuits have cast doubt on *Chai*'s scope.

In *Laidlaw's Harley-Davidson Sales v. Comm'r*, 29 F.4th 1066 (9th Cir. March 25, 2022), a revenue agent sent the corporate taxpayer a "30-day letter" notifying the corporation of an intention to assess a penalty. The letter informed the corporation of its right to request a conference with the IRS Appeals Office or to pay the penalty, but also threatened to assess the penalty and initiate collection proceedings if it took no action. The revenue agent sent the letter before obtaining supervisory approval, which was only obtained after the taxpayer pursued an administrative appeal.

The administrative appeal was unsuccessful, and the IRS assessed the penalty and initiated collection activity. The taxpayer did not pay and requested a CDP hearing. After the IRS Appeals Office rejected the taxpayer's challenge, the taxpayer filed a petition in the Tax Court and concluded that the failure to obtain supervisory approval before communicating the penalty to the taxpayer violated §6751(b), precluding collection of the penalty.

On appeal, the Ninth Circuit acknowledged that "a supervisor cannot truly approve a penalty without also possessing discretion to withhold approval," and thus that the supervisory approval requirement cannot always be satisfied "by waiting to provide written approval until just before the moment of assessment." The court, however, distinguished the assessable penalty at issue in *Laidlaw's* from penalties that are subject to deficiency procedures, as in *Chai*. The court reconciled *Chai* by noting that the issuance of a notice of deficiency in that case ended the manger's discretion to approve an initial determination, and concluded that, notwithstanding the revenue agent's misleading letter, the supervisor retained discretion to reject the assessable penalty at the time they signed the approval form.

In *Kroner v. Comm'r*, 48 F.4th 1272 (11th Cir. Sept. 13, 2022), after an examination, a revenue agent issued an audit report asserting that Kroner owed back taxes and almost $2 million in penalties, together with a letter threatening that the IRS would issue a notice of deficiency if Kroner failed to take certain actions. After further discussions, the IRS issued an updated audit report with a 30-day letter that was signed by the revenue agent's supervisor. After a conference with the IRS Appeals Office failed to resolve the case, the IRS issued a notice of deficiency.

The Tax Court concluded that the IRS had failed to comply with the supervisory approval requirement, but the Eleventh Circuit reversed. Citing *Laidlaw's*, the court concluded that "the IRS satisfies Section 6751(b) so long as a supervisor approves an initial determination of a penalty assessment before it assesses those penalties." Like the Ninth Circuit, the court found that the Tax Court had erroneously equated an "initial determination of such assessment" with communications about that determination, and that approval can occur up until the moment of assessment. In reaching this holding, the Eleventh Circuit explicitly disagreed with *Chai*, finding that not only is the statutory language clear, but also that the Second Circuit's focus on the improper use of penalties as a "bargaining chip" ignores that the statute "is not just about bargaining, it is also a check on the imposition of erroneous penalties." This other purpose was especially important, the Eleventh Circuit reasoned, in the case of assessable penalties (like those at issue in *Laidlaw's*) that are not subject to "pre-assessment" review in Tax Court. Accordingly, in the Eleventh Circuit approval is not required at any particular time prior to assessment.

Conclusion

Despite this recent momentum in challenging *Chai*, the Second Circuit still offers the more sensible approach to interpreting the supervisory approval requirement of §6751(b). If approval is permitted up until assessment, as the Ninth and Eleventh Circuits have held, there is a risk that approval will end up being a mere formality. It remains to be seen in the coming years whether the growing circuit split gets the attention of the Supreme Court. In the meantime, practitioners need to be cognizant of the precedent in the Circuit in which their clients reside in asserting lack of supervisory approval as a defense to penalties.