Written Supervisory Approval of IRS Penalties

When Must It Be Given, and Who May Give It?

By Henry Stow Lovejoy

The Internal Revenue Code (IRC) imposes penalties on understatements of tax as a way to encourage voluntary compliance and deter noncompliant behavior. Generally, the revenue agent examining a return will be one who proposes a penalty. Revenue agents are instructed to consider penalties as part of the examination of any return, and they must determine whether and which penalties apply only after the facts and circumstances of the taxpayer's return have been developed.

Once a penalty has been proposed, taxpayers and their representatives have the opportunity to contest the penalty in discussions with the agent, in an appeal within the IRS, or in court. In the past, some taxpayers and representatives believed that agents used the threat of a penalty to persuade taxpayers to compromise or abandon tax return positions that were appropriate, if aggressive. For this reason, Congress required in 1998 that all penalties be approved in writing by the agent's immediate supervisor.

The operative statute, IRC section 6751(b)(1), provides that "no 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." The rule requires that a penalty be approved by a supervisor, whether in a revenue agent's report, a notice of deficiency, or in an answer to a Tax Court petition. Section 6751(b)(1) does not, however, specify when the supervisor's approval must be given. Two recent cases, *Graev v. Comm'r* and *Chai v. Comm'r,* considered this timing issue and provided some answers. There remain unanswered questions, such that a taxpayer may be able to challenge a penalty that has not been promptly approved.

Graev v. Comm'r

Graev had donated a historical preservation easement to a charitable organization and taken a charitable deduction for the value of the easement; the IRS challenged the deduction on various grounds. The examining agent proposed a 40% gross valuation misstatement penalty under IRC section 6662(h), but not a 20% negligence or substantial understatement penalty under sections 6662(c) and (d) (an accuracy-related penalty). The agent's supervisor approved the 40% penalty, in writing, and the agent prepared a notice of deficiency including the 40% penalty. Before mailing the notice of deficiency, the agent forwarded it to IRS Office of Chief Counsel for review, pursuant to the relevant portions of the Internal Revenue Manual. The reviewing attorney recommended that the agent include a 20% accuracy-related penalty in the alternative; his recommendation was approved by his immediate supervisor, and the draft notice of deficiency was returned to the agent with the recommendation. The agent revised the notice of deficiency to add the 20% accuracy-related penalty in the alternative and mailed it to the taxpayer without obtaining the written approval of his immediate supervisor.

The taxpayer petitioned the Tax Court to reverse the disallowance of the charitable deduction but lost [*Graev v. Comm'r,* 140 T.C. 377 (2013), *Graev I*]. The IRS then conceded that the 40% gross valuation misstatement penalty was inapplicable, but maintained that the 20% accuracy-related penalty applied. The taxpayer responded that the IRS had not complied with IRC section 6751(b)(1) and moved for summary judgment.

In *Graev v. Comm'r* [147 T.C. No. 16 (2016), *Graev II*], the court held that it was premature to determine whether the IRS had complied with IRC section 6751(b), because the penalty had not yet been assessed. Assessment is the formal recording of the taxpayer's tax liability on the IRS's records, and that can only occur after the Tax Court proceeding. While section 6751(b) requires that there be a written approval of the initial determination of a penalty before the penalty is assessed, in the court's view it did not require that the approval occur at any particular time before the assessment of the penalty. In effect, the Tax Court held that a revenue agent's immediate supervisor could give her written approval of a penalty at any time before the assessment of the penalty and the tax with which it is associated.

Graev II was a regular decision of the Tax Court, reviewed by all the Tax Court judges; five judges dissented from the holding. The minority found that the question was not premature, because once the IRS has issued a notice of deficiency, the Tax Court decides whether the deficiency should be assessed. If a supervisor's failure to approve a penalty is a bar to assessment, the Tax Court can determine

whether the supervisor timely approved the penalty in writing. According to the minority, the approval must be given when the supervisor has the ability to approve or disapprove the penalty, so that it must be given before the Tax Court petition is filed.

Chai v. Comm'r

The Tax Court decided *Chai v. Comm'r* (TC Memo 2015-42) before *Graev II*, and the taxpayer in *Chai* did not raise whether the question of whether IRC section 6751(b)(1) had been satisfied until after the Tax Court trial. The Tax Court found that the taxpayer had raised the question too late, and therefore it did not consider it, because the delay was prejudicial to the IRS. The taxpayer appealed to the Second Circuit Court of Appeals.

Between the Tax Court's decision and briefing of the appeal, the Tax Court announced its decision in *Graev II.* As a result, the IRS argued that, instead of the question being raised too late, deciding whether the IRS complied with section 6751(b)(1) was premature, as it could not be decided until the Tax Court decision became final. The Second Circuit thus had to decide when the IRS was required to comply with the written supervisory approval requirement of IRC section 6751(b). If written approval of the penalty is required before a notice of deficiency is sent to the taxpayer, Chai could not be assessed the penalty, because the IRS had not established written supervisory approval as part of bearing the burden of production on the penalty in Tax Court.

In *Chai v. Comm'r* [851 F.3d 190 (2nd Cir. March 20, 2017)], the Second Circuit Court of Appeals sided with the taxpayer. Following the minority in *Graev II*, the court found that the meaning of "initial determination of [an] assessment" was ambiguous, because the IRS determines a deficiency, but not an assessment. In considering what the statute intended, the Second Circuit examined the legislative history of IRC section 6751 and concluded that the statute was meant to deter agents from asserting unjustified penalties in order to obtain a settlement. This perceived abuse would not be prevented by allowing the written approval to wait until the moment before the assessment of the penalty, as the Tax Court held in *Graev II;* therefore, penalty approval must be obtained while the supervisor still has discretion to give approval or to withhold it. According to the Second Circuit, written approval of the initial penalty determination must be received no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer in Tax Court) asserting such penalty.

Graev III

Once the Second Circuit decided Chai, the Tax Court vacated its earlier decision on section 6751(b) and allowed the parties to brief and argue whether written supervisory approval had been timely received. In *Graev v. Comm'r* [149 T.C. No. 23 (December 20, 2017), *Graev III*], the Court decided that the "initial determination" of the 20% accuracy-related penalty had been approved, in writing, when the supervising attorney approved the IRS Office of Chief Counsel attorney's recommendation that the notice of deficiency be revised to include the 20% penalty. The taxpayer argued that the IRS Office of Chief Counsel attorney did not have authority to make an "initial determination" of a penalty, because his role prior to a petition being filed in Tax Court is advisory only, and that his recommendation did not amount to an initial determination. The Tax Court, over a dissent joined by six judges, decided that IRS Office of Chief Counsel has the authority to make the initial determination of a penalty before a petition is filed in Tax Court and that in this case the suggestion that a 20% penalty be added in the alternative was such an "initial determination."

Ramifications

The decisions in *Chai* and *Graev II* clear up some of the uncertainty with respect to the written supervisory approval rule in IRC section 6751(b). The penalty must be approved by a supervisor, in writing, before a notice of deficiency is issued, or, if the penalty is asserted for the first time in Tax Court, before the answer or amended answer asserting the penalty is filed. In addition, the IRS must establish the written supervisory approval as an element of its case in Tax Court. Many questions remain, however; despite the Tax Court's decision in *Graev III,* it is not clear that IRS Office of Chief Counsel has the authority to make an "initial determination," and have that determination approved, before a Tax Court proceeding is begun. Also, if a taxpayer receives a 30-day letter and protests the adjustments, must any penalty included in the adjustments be approved before the Office of Appeals considers the case, or may an appeals officer, and her manager, remedy the lack of written approval? If the Office of Appeals can remedy the absence of written supervisory approval, will more taxpayers bypass the appeals process and file in Tax Court?

Taxpayers, and taxpayers' representatives, should be alert for situations in which a penalty has been added to determine whether the penalty has been approved in writing by the agent's supervisor, when the approval was given, and who gave the approval. It may be the quickest way to remove the penalty. ❑

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