

# Questioning IRS Approval of Penalties Under Code Sec. 6751

By Joshua D. Smeltzer\*

*Joshua D. Smeltzer examines taxpayer options to challenge tax penalties under Code Sec. 6751.*

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**W**hen the IRS informs a taxpayer that they are assessing additional taxes it is bad news. However, when the IRS adds penalties to the amount it makes bad news even worse. Taxpayers have a variety of options to challenge tax penalties and attempt to get them reduced or eliminated. The IRS will sometimes forgive a first-time penalty. Other penalties are sometimes forgiven if the taxpayer can show reasonable cause for the tax position. Although the government bears the burden of production for penalties,<sup>1</sup> this often involves nothing more than showing that the penalties were properly assessed. Penalty relief is usually only given when the taxpayer can marshal their best facts and make a persuasive argument for leniency. This is because the focus is usually on the actions of the taxpayer in properly reporting amounts on the tax return and not the procedures followed by the IRS. However, recent litigation surrounding Code Sec. 6751 has turned added focus onto the IRS procedures for assessing penalties. This focus has resulted in numerous taxpayers having the opportunity to challenge penalties on technical grounds without delving into the actions of the taxpayer's tax reporting. In some cases, the IRS has even conceded penalties when faced with their own lack of evidence regarding the proper approval procedures.

Section 6751 is not a new provision of the Internal Revenue Code, it was adopted in 1998 and became law in 2001.<sup>2</sup> This provision requires the IRS to follow two procedural requirements when imposing penalties on taxpayers. First, a taxpayer must receive notice of the penalty, the Section of the Internal Revenue Code that imposes the penalty, and how the penalty is computed.<sup>3</sup> This requirement is usually easily satisfied. Second, the "initial determination" to assess the penalty must be approved "in writing" by the "immediate supervisor" or an approved higher official.<sup>4</sup> It is this second requirement that has resulted in the flurry of litigation over penalties. For years the IRS enjoyed a flexibility with these procedures that largely went unchallenged. However, when the approval provisions came under closer scrutiny by the Second Circuit Court of Appeals, in 2017, the longtime interpretation of when such approvals must occur changed.<sup>5</sup>

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The Tax Court then followed the Second Circuit's holding and taxpayers took advantage of the opportunity to challenge the approval of their own penalties.<sup>6</sup> The result was further guidance, mostly from the Tax Court, on the scope and definition of the terms in the statute. Although the courts are still drawing lines, and probably will for several years, taxpayers and their advocates should continue to examine their own facts and determine if their penalties are subject to challenge under Code Sec. 6751(b). Listed below are questions taxpayers and their advisors should be asking about the penalties assessed in their cases.

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## What Penalties Are Subject to Code Sec. 6751?

According to Code Sec. 6751(b), all penalties must comply with the procedural requirements unless they meet the specific exceptions listed.<sup>7</sup> Those specific exceptions include failure to file and failure to pay penalties as well as failure to make required estimated tax payments.<sup>8</sup> They also include "any other penalty automatically calculated through electronic means."<sup>9</sup> According to the IRS, this means "no Service human employee makes an independent judgment with respect to the applicability of the penalty."<sup>10</sup> Essentially, if a computer makes the determination, then the supervisory approval probably isn't required. The courts, interpreting the legislative history, have indicated that the purpose of Code Sec. 6751(b) was to prevent the IRS from threatening unjustified penalties without the proper supervisory determination and consideration. This exception to supervisory approval follows this statutory purpose and if a taxpayer can't point to a person making a determination then they likely can't challenge the penalty under Code Sec. 6751(b).

Otherwise, where any judgment regarding the applicability of the penalty exists, Code Sec. 6751(b)(1) must be satisfied. This appears to be the case even for penalties the government has long argued are not actually penalties. The

government has long argued that, despite the designation as penalties in the statute, liabilities under Section 6672 of the Internal Revenue Code are actually taxes. Under Code Sec. 6672, money deducted from the employee's wages is held in trust and paid to the Internal Revenue Service in quarterly payments on the employee's behalf. This arrangement shifts liability for the failure to remit these taxes from the employee to the employer to protect the Government from revenue losses.<sup>11</sup> Because the liability is reimbursing the government for lost withholding tax revenues, and not more, the government has argued that it is "essentially" a tax. The courts have accepted this argument in several cases<sup>12</sup>; however, the Tax Court disagreed for purposes of Code Sec. 6751. In *Chadwick*, the court found that "from the person sanctioned" these are "penalties" as stated in the Code and "in the ordinary sense of the word."<sup>13</sup> The Tax Court decided that, as a penalty, it was subject to the requirements of Code Sec. 6751(b) requiring written approval of the immediate supervisor at the time of the initial determination. Therefore, this broad interpretation of penalties appears to indicate that, unless the exception clearly applies, all penalties will need to meet the requirements of Code Sec. 6751.

## When Does the "Initial Determination" Occur?

The timing of the supervisory approval is where the confusion over Code Sec. 6751 all started. In *Chai*,<sup>14</sup> the Second Circuit rejected the government's argument that supervisory approval could be obtained at any time before actual assessment. Which was the longstanding opinion and practice of the IRS. According to *Chai*, supervisory approval must occur at the time of the "initial determination" of the penalty and no later than the date of the notice of deficiency or an answer or amended answer asserting such penalties.<sup>15</sup>

Several courts have held that the notice of deficiency (*i.e.*, 90-day letter) itself can satisfy the written supervisory approval requirement. The 90-day letter may, in fact, be the first time the taxpayer learns the IRS intends to assert a penalty. However, what if the IRS actually communicates its intention to assert a penalty much earlier. Does this earlier communication of a proposed penalty require prior supervisory approval? That was the question in *Clay*,<sup>16</sup> and the Tax Court's answer was *yes*. In *Clay*, the Tax Court held that the "initial determination" occurred when the IRS sent a Revenue Agent Report and Appeals Letter (*i.e.*, 30-day letter) to the taxpayer. Subsequent decisions have confirmed that the "initial determination" occurs when the

communication “advises the taxpayer that penalties will be proposed and giving the taxpayer the right to appeal them.”<sup>17</sup> Tax practitioners would be wise to review all correspondence to determine exactly when the penalties, and appeal rights, are communicated to their clients. Such statements fix the initial determination date and allow the opportunity to challenge supervisory approval if it occurs after that date.

If there is no penalty listed in a 30-day letter or 90-day letter, and the case proceeds to court, the government can still comply with Code Sec. 6751(b) and then assert the penalty in its answer or amended answer.<sup>18</sup> Therefore, the mere absence of a penalty in the documents received, by the IRS administratively, doesn’t mean that a penalty will not be assessed in litigation. Although the penalty may be a surprise at this point, the late assertion alone, does not provide a defense under Code Sec. 6751(b). Perhaps there will be an occasional misstep by the government in failing to get proper approvals before asserting penalties in its answer or amended answer. However, this seems unlikely given the amount of attention currently surrounding Code Sec. 6751.

## What Qualifies as Approval “In Writing?”

The IRS uses several forms when determining and imposing penalties, however, the courts have indicated that a particular form of “written” approval is not necessary to satisfy Code Sec. 6751(b).<sup>19</sup> Therefore, approval of the “initial determination” must be “personally approved (in writing)” but this does not mean that it requires a signature or particular form.<sup>20</sup> When verifying approval, the evidence the IRS may rely on could be a note, email, or any other written form so long as it shows written approval of the penalty at issue. The Internal Revenue Manual instructs that the approval must be “dated, and retained in the case file ... on a penalty approval form, in the form of an email, memo to the file, or electronically.”<sup>21</sup> Even if a signature is used, it doesn’t need to be a specific type or placed in a specific place to qualify. For example, in *PBBM-Rose Hill, Ltd.*,<sup>22</sup> the court found supervisory approval sufficient even though the signature was on the cover page and not the report outlining the penalty.

Therefore, if a tax practitioner doesn’t see an official form signed by the IRS supervisor it doesn’t mean the required “written” supervisory approval is lacking. Perhaps the IRS is relying on a less traditional approval. Therefore, it could be in the case file in one of the many penalty forms used by the IRS and in multiple formats.

This raises the question of how a taxpayer might obtain the information and evidence of approval after receiving notice of the assessment of a penalty to which Code Sec. 6751 applies. The taxpayer could request that the IRS voluntarily produce proof of compliance with Code Sec. 6751. Given the current prominence of this issue the IRS may provide proof voluntarily and, if it can’t, it might even concede the issue. However, taxpayers have other options to obtain administrative case file information that might prove useful in disputing the penalties at issue. A taxpayer can file a request for these documents under the Freedom of Information Act (FOIA). Also, the recently enacted Taxpayer First Act, specifically requires that IRS Appeals provide non-privileged portions of the case file to the taxpayer no later than 10 days before the appeals conference.<sup>23</sup> Although there are some limitations to the access of these files by certain taxpayers, it provides an alternative to the sometimes expensive and time-consuming FOIA process.

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## Who Is the Immediate Supervisor?

Although Code Sec. 6751(b) uses the term “immediate supervisor” it isn’t specifically defined. The Internal Revenue Manual uses the term to mean “the person who writes an employee’s evaluation or approves the employee’s leave.”<sup>24</sup> Code Sec. 6751(b) allows written approval by “such higher level official” designated by the Secretary as well, but no designation currently exists. Although this may appear as easy requirement to fulfill there are situations when it could cause issues. For example, in large cases there are often multiple “managers” and “supervisors” at the IRS involved in overseeing the case. The cases have indicated that approval for different penalties do not require approval by the same person,<sup>25</sup> it is unclear whether an IRS employee can have multiple “immediate supervisors.” Also, Revenue Agents are sometimes placed on details within the IRS that take them away from their regular “immediate” supervisors. There are likely other

scenarios where, as a practical matter, the official “immediate supervisor” isn’t available when approval is requested. If the Revenue Agent seeks an alternative, for expediency purposes, that alternative may create an argument that the person was the improper person to approve the penalty. Regardless, while the focus is still on the IRS compliance, asking the right questions about every requirement under Code Sec. 6751 may provide an unexpected defense against the penalties involved.

## Conclusions

There are, of course, additional questions that a taxpayer might want to ask if the assertion of a penalty appears

questionable regarding supervisory approval. Perhaps documents obtained from a FOIA request or as part of a request under the Taxpayer First Act will raise questions about the approval process. In some cases, merely asking for proof of supervisory approval might alert the IRS to a failure to obtain the proper approvals and cause them to concede the issue. The IRS operated for years under the, now mistaken, presumption that approval could be made at any time before assessment and that the approval process was flexible. The recent case law imposes a stricter standard on the IRS. Both the IRS and the courts are adjusting and interpreting different factual circumstances and there will likely be additional guidance on Code Sec. 6751.

## ENDNOTES

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<sup>1</sup> Code Sec. 7491(c).

<sup>2</sup> See P.L. 105-206, §3306, 112 Stat. 685 (1998).

<sup>3</sup> Code Sec. 6751(a).

<sup>4</sup> Code Sec. 6751(b).

<sup>5</sup> See *J. Chai*, CA-2, 2017-1 USTC ¶50,180, 851 F3d 190.

<sup>6</sup> See *Graev*, 149 TC 23 (2017).

<sup>7</sup> See Code Sec. 6751(b)(2) (specifically listing penalties under Code Secs. 6651, 6654, or 6655 and others automatically calculated through electronic means).

<sup>8</sup> See Code Secs. 6651, 6654, and 6655.

<sup>9</sup> See Code Sec. 6751(b)(2)(B).

<sup>10</sup> IRM 20.1.1.2.3(5).

<sup>11</sup> See *D.J. Turnbull*, CA-5, 91-1 USTC ¶50,196, 929 F2d 173, 178 n.6.

<sup>12</sup> See e.g., *Rozbruch*, 28 FSupp3d 256 (S.D.N.Y. 2014).

<sup>13</sup> *Chadwick*, 154 TC 84 (2020).

<sup>14</sup> *J. Chai*, CA-7, 2017-1 USTC ¶50,180, 851 F3d 190.

<sup>15</sup> *J. Chai*, 851 F3d 221.

<sup>16</sup> *Clay*, 152 TC 223, 249–250 (2019).

<sup>17</sup> See e.g., *Belair Woods, LLC*, 154 TC 1 (2020).

<sup>18</sup> See *Roth*, 114 TCM 649, Dec. 61,096(M), TC Memo. 2017-248, *aff’d*, CA-10, 922 F3d 1126 (2019).

<sup>19</sup> See *PBBM-Rose Hill, Ltd.*, CA-5, 900 F3d 193, 213 (stating that the Code Sec. 6751(b) only mandates that approval be “in writing” but does not require a specific form).

<sup>20</sup> See *Deyo*, CA-2, 296 FedAppx 157, 159.

<sup>21</sup> IRM 20.1.1.2.3 (Oct. 19, 2020) (6).

<sup>22</sup> See *PBBM-Rose Hill, Ltd.*, 900 F3d 213.

<sup>23</sup> Taxpayer First Act §1001(a), codified as new Code Sec. 7803(e)(7)(A).

<sup>24</sup> IRM 20.1.1.2.3—Managerial Approval for Penalty Assessments (Aug. 5, 2014).

<sup>25</sup> See *Palmolive Bldg. Inv’rs, LLC*, 152 TC 75, 85 (2019).

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