Supervisory Approval of Penalties: The Opening of a *Graev* Pandora's Box

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Abstract

Section 6751(b) of the Internal Revenue Code requires supervisory approval in writing prior to assessment of certain penalties. Enacted in 1998 as part of the Internal Revenue Service (the "Service") Restructuring and Reform Act, the statute's purpose was to prevent Service agents from using penalties as bargaining chips. The section remained essentially dormant for over 20 years, with both the Service and taxpayers accepting the position that approval needed to be obtained only prior to assessment. The trilogy of *Graev* cases and the Second Circuit Court of Appeals' decision in *Chai v. Commissioner* changed the section 6751(b) landscape completely, opening a Pandora's box of taxpayers using section 6751(b) to avoid penalties on the technicality of no-written-supervisory approval. Hundreds of court cases have followed, resulting in cases inconsistently interpreting section 6751(b) and well-counseled taxpayers avoiding tax penalties.

This article examines the enactment of section 6751(b) and explores the *Graev* and *Chai* decisions in detail. Tax Court cases decided since those decisions were issued are analyzed to determine the present state of the law. Without a change of course, the current situation of conflicting court decisions that have allowed well-deserved penalties not to be imposed will continue. Although there is more certainty as to the meaning of section 6751(b) than there was prior to these cases, different results for taxpayers may occur depending on which circuit has venue over any ensuing appeal.

Solutions to the section 6751(b) problem are analyzed—issuance of Treasury and Service guidance, amendment of the statute, and outright repeal of the statute. The article concludes by recommending that the statute be repealed. Internal Service procedures can address issues with the conduct of Service employees while not opening the door to taxpayers using a technicality to avoid penalties and Service employees overbroadly imposing penalties.

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I. Introduction

For over 20 years, the Internal Revenue Service (the "Service") gave little importance to section 6751(b) of the Internal Revenue Code (the "Code"),[1] which requires supervisory approval in writing prior to the assessment of certain penalties.[2] A poorly worded statute, section 6751(b) was never clarified by regulations. Through the trilogy of *Graev* cases and a decision of the Second Circuit Court of Appeals in *Chai v. Commissioner*, the section rose from the dead, opening a Pandora's box of taxpayers using section 6751(b) as a sword to avoid penalties on the technicality of no-written-supervisory approval. The result has been numerous cases inconsistently interpreting section 6751(b) and well-counseled taxpayers avoiding tax penalties.

[1] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

[2] In an examination of 98 cases with respect to the section 6694 tax-return-preparer penalty, eight of the cases, totaling $19,000 in penalties, were improperly assessed due to lack of written supervisory approval. Projections showed that 191 preparer penalties closed during fiscal years 2009 through 2011 may have improperly assessed $454,643 in penalties. TREASURY INSPECTOR GEN. FOR TAX ADMIN., IMPROVEMENTS ARE NEEDED IN ASSESSING AND ENFORCING INTERNAL REVENUE CODE SECTION 6694 PAID PREPARER PENALTIES (2013) Appendix IV.

Part I of this article discusses the background of the enactment of section 6751(b). The *Graev* and *Chai* decisions are examined in Part II, followed by a discussion of post-*Graev* cases in Part III. Part IV analyzes possible solutions to the section 6751(b) problem. The article concludes by recommending that the statute be repealed, with the impetus behind the enactment of the statute addressed through the Service's internal procedures.

II. Statutory Background

As part of the Internal Revenue Service Restructuring and Reform Act of 1998 (the "Act"), Congress enacted section 6751.[3] Section 6751(a) mandates the Service include with each penalty notice "information with respect to the name of the penalty, the section of this title under which the penalty is imposed, and a computation of the penalty." Prior to enactment, the law did not require the Service to describe how penalties were computed, and Congress believed "that taxpayers are entitled to an explanation of the penalties imposed upon them."[4]

Section 6751(b)(1) requires written supervisory approval prior to the assessment of certain penalties:

> 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.

Section 6751(b)(2)(A) carves out certain penalties from this approval requirement: section 6651 for a failure to file a return,[5] section 6654 for an individual's failure to pay estimated taxes, section 6655 for a corporation's failure to pay estimated taxes, and section 6662(b)(9) for overstated section 170(p) cash charitable contributions.[6] Supervisory approval is also not required for "any other penalty automatically calculated through electronic means."[7] A "penalty," for purposes of this section, "includes any addition to tax or any additional amount."[8] A companion provision enacted by the Act, section 7491(c), sets the burden of production "in any court proceedings"

[3] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3306(a), 112 Stat. 685 (effective for notices issued, and penalties assessed, after December 31, 2000).

[4] S. REP. NO. 105-174, at 65 (1998).

[5] The Internal Revenue Manual states that the penalty for fraudulent failure to file under section 6651(f) "should not be treated as included in this exception." I.R.M. 20.1.2.3.7.5.1(8) (July. 2, 2013).

[6] Section 6662(b)(9) was added by the Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, § 212(b)(3), 134 Stat. 1182 (2020) (effective for tax years beginning after December 31, 2020).

[7] I.R.C. § 6751(b)(2)(B).

[8] I.R.C. § 6751(c).

on the Service for the liability of an individual "for any penalty, addition to tax, or additional amount imposed by this title."[9]

The Act was enacted to modernize and improve the Service's efficiency and taxpayer services,[10] implementing recommendations of the National Commission on Restructuring the Internal Revenue Service (the "Commission") embodied in a 1997 report (the "Commission Report").[11] The Commission's goal was "to restore the public trust in the IRS" and "recommend how the IRS might better serve the American taxpayer and the federal government in the twenty-first Century."[12] As one part of its mission, the Commission Report identified the need to ensure "that taxpayers are treated fairly and impartially by the IRS, are able to seek redress or review of IRS actions by the courts, and are able to resolve conflicts creatively and expeditiously with IRS cooperation."[13] The Commission recognized improvement in the Service's culture since enactment of the Omnibus Taxpayer Bill of Rights and the Taxpayer Bill of Rights 2 in 1988 and 1996, respectively.[14] Even though the Commission "found very few examples of IRS personnel abusing power," it nevertheless projected that "there likely will continue to be the few unfortunate examples of abuse."[15] The Commission further found that examinations and collection actions could be "intrusive, burdensome, and lengthy" despite Service employees "generally striv[ing] to do a good job," laying the blame on "weak performance measurements, insufficient training, and a lack of proper managerial review and control."[16]

The legislative history of section 6751(b), a minor part of the Act's efforts to "restore public trust in the IRS,"[17] provides little information as to the motivation for including it in the Act's revamping of the Service. The report of the Senate's Committee on Finance states that supervisory approval should be required because "the Committee believes that penalties should only be imposed where appropriate and not as a bargaining chip."[18]

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[9] 112 Stat. 685 § 3001(a) (effective for court proceedings arising in connection with examinations commencing after July 22, 1998).

[10] S. REP. NO. 105-174, at 7.

[11] NAT'L COMM. ON RESTRUCTURING THE INTERNAL REVENUE SERVICE, 105TH CONG., A VISION FOR A NEW IRS, 105-30 (1997) [hereinafter the "COMMISSION REPORT"].

[12] COMMISSION REPORT, *supra* note 11, at 8.

[13] COMMISSION REPORT, *supra* note 11, at 48.

[14] COMMISSION REPORT, *supra* note 11. *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6226, 102 Stat. 3342; Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996).

[15] COMMISSION REPORT, *supra* note 11, at 48.

[16] COMMISSION REPORT, *supra* note 11, at 50.

[17] COMMISSION REPORT, *supra* note 11, at 5.

[18] S. Rep. No. 105-174, at 65; *see also* STAFF OF THE JOINT COMM. ON TAX'N, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1998 (1998). The House

Further, the provision "requires the specific approval of IRS management to assess all non-computer generated penalties unless excepted."[19] In Senate hearings on the Act, Michael I. Saltzman stated that the substantial understatement penalty of section 6662(a) "can easily be abused by IRS agents and be frustrating to taxpayers."[20] And, "many practitioners also believe that the penalty is asserted at the district level solely to gain some bargaining advantage at the Appeals level."[21] Stefan F. Tucker testified that penalties are an "IRS negotiating tool": "If you don't settle, we are going to assert the penalties."[22]

Additional insights as to the impetus behind including section 6751(b) in the Act can be gleaned from the report of the Joint Committee on Taxation that was mandated by the Act.[23] "The Joint Committee on Taxation and the Secretary of the Treasury were each directed to conduct a study (1) reviewing the administration and implementation by the IRS of the penalty and interest provisions of the Code and (2) making any legislative or administrative recommendations the Joint Committee or the Secretary deems appropriate to simplify penalty or interest administration and to reduce taxpayer burden."[24] The Joint Committee prepared a comprehensive, two-volume report and made extensive recommendations ("JCT Report").[25] The report of the Department of the Treasury offers no particular insights to the section 6751(b) supervisory approval requirement.[26]

One recommendation in the JCT Report was for the Service to "improve the supervisory review of the imposition of penalties" to make penalty administration more uniform and "reflect individual circumstances without unduly hindering the rapid resolution of disputes."[27] These improvements "could improve the fairness of the penalty system" and

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Conference Report does not address the reasons for the enactment of section 6751(b). See H.R. REP. NO. 105-599, at 260-61 (1998).

[19] S. REP. NO. 105-174, at 65.

[20] *IRS Restructuring Hearings on H.R. 2676 before the Finance Committee*, 105th Cong. 372 (1998) (statement of Michael I. Saltzman, White & Case).

[21] *Id.*

[22] *Id.* at 92 (statement of Stefan F. Tucker, chair-elect, Section of Taxation, American Bar Association).

[23] Pub. L. No. 105-26, § 3801, (1998).

[24] STAFF OF JOINT COMM. ON TAX'N, 105TH CONG., STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY SECTION 3801 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998 (INCLUDING PROVISIONS RELATING TO CORPORATE TAX SHELTERS), at 11 (1999) [hereinafter "JCT REPORT"].

[25] *Id.*

[26] DEP'T OF THE TREASURY, PENALTY AND INTEREST PROVISIONS OF THE INTERNAL REVENUE CODE (1999).

[27] JCT REPORT, *supra* note 24, at 177.

reduce the perception "that penalties are on occasion asserted as a way of improving the IRS's bargaining position with the taxpayer, rather than strictly because the taxpayer's behavior justified the penalty."[28] The report, however, noted the difficulty of reducing this perception, because "the imposition of a penalty in many instances requires the exercising of sound judgment regarding complicated facts and motivations concerning which there may be disputes."[29] The report cautioned that legislative changes "should not be undertaken without careful and deliberative review by the Congress and the opportunity for public input," as well as "careful consideration … given to the views of the Administration, and particularly the IRS."[30]

The legislative history of section 7491(c) also sheds some light on the penalty approval requirement by its initial allocation of the burden of production in penalty cases to the Service:

> [I]n any court proceeding, the Secretary must initially come forward with evidence that it is appropriate to apply a particular penalty to the taxpayer before the court can impose the penalty. This provision is not intended to require the Secretary to introduce evidence of elements such as reasonable cause or substantial authority. Rather, the Secretary must come forward initially with evidence regarding the appropriateness of applying a particular penalty to the taxpayer; if the taxpayer believes that, because of reasonable cause, substantial authority, or a similar provision, it is inappropriate to impose the penalty, it is the taxpayer's responsibility (and not the Secretary's obligation) to raise those issues.[31]

Although sections 6751(b) and 7491(c) were just two of the many provisions enacted by the Act, they fall neatly within one of the Act's themes of the Service treating taxpayers fairly and impartially. This theme is further reflected in an uncodified provision of the Act that requires the discharge of any Service employee who has done any of 10 specified acts as part of the employee's official duties; these acts are commonly referred to as the "10 Deadly Sins."[32] Among the sins are the falsification or destruction of documents to conceal the employee's mistakes and violating a provision of the Code, Treasury Regulations, or a Service policy to retaliate against or harass a taxpayer, the taxpayer's representative, or another Service

[28] *Id.*
[29] *Id.*
[30] *Id.* at 2.
[31] H.R. REP. NO. 105-599, at 241.
[32] Pub. L. No. 105-206, § 1203(a), 112 Stat. 685 (1998).

employee.[33] The Act also required the Service to prioritize employee training by implementing an employee training program.[34]

III. The *Graev* and *Chai* Cases

Section 6751(b) was an uncontroversial provision for over 20 years. The *Graev* trilogy of cases, however, opened a Pandora's box of litigation and uncertainty as to the meaning and reach of the statute. *Graev* began with a Tax Court decision in 2013 ("*Graev I*"), in which the court upheld the Service's disallowance of charitable contribution deductions for cash and the noncash contribution of a façade easement made by Lawrence and Loran Graev to the National Architectural Trust.[35] The Service had imposed accuracy-related penalties under section 6662, which were the subject of subsequent proceedings in *Graev II*.[36]

In *Graev II*, the revenue agent ("RA") determined that the Graevs were liable for the 40% gross-valuation-misstatement penalty of section 6662(h) for noncash contributions.[37] The penalty was approved in writing by the RA's immediate supervisor, and the RA prepared a notice of deficiency ("NOD") reflecting the penalty.[38] A Chief Counsel attorney reviewed the NOD and advised by memorandum, approved in writing by the attorney's supervisor, that the NOD should include an alternative 20% penalty under section 6662(a) for noncash contributions.[39] The NOD was issued with both sections 6662(a) and 6662(h) penalties for the noncash contributions but without the written approval of the 20% penalty by the RA's supervisor.[40] The taxpayers filed a Tax Court petition and moved for partial

[33] *See* Pub. L. No. 105-206, §§ 1203(b)(4), 1203(b)(6), 112 Stat. 685 (1998). The other "sins" are willful failure to obtain required approvals on documents authorizing seizure of a taxpayer's home, personal belongings, or business assets; providing a false statement under oath regarding a material matter; violating rights under the Constitution or civil rights under six specific statutes; assault or battery of a taxpayer, his representative, or a Service employee; willful misuse of section 6103 to conceal information from a congressional inquiry; willful failure to file a tax return or willful understatement of federal tax liability; and threatening to audit a taxpayer for personal gain.

[34] *Id.* at § 1205. The Act also mandated the Service to submit a training plan to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives, which was required to address customer service training, provide a training schedule, furnish details of funding that "demonstrate[s] the priority and commitment of resources to the plan," review organizational design of customer service, and provide conflict management training for IRS collection employees." *Id.*

[35] Graev v. Commissioner, 140 T.C. 377 (2013) ("*Graev I*").

[36] Graev v. Commissioner, 147 T.C. 460 (2016) ("*Graev II*"). *Graev I*, 140 T.C. at 378, 379 n.2 (deferring taxpayers' liabilities for penalties to a subsequent proceeding).

[37] *Graev II*, 147 T.C. at 470.

[38] *Id.* at 470–71.

[39] *Id.* at 471.

[40] *Id.* at 472.

summary judgment, raising the issue of section 6751(b) non-compliance.[41] The Service then filed an amended answer, affirmatively alleging liability for the section 6662(a) penalty for cash contributions.[42] The taxpayers argued that the "initial determination" was to impose the 40% penalty and that the 20% penalty was neither "determined" by the RA nor approved by his immediate supervisor.[43]

The court sustained the imposition of the section 6662(a) penalty, rejecting the taxpayer's claim that the Service had not complied with section 6751(b).[44] The court addressed the timing requirement for section 6751(b) approval and found the challenge under section 6751(b) to be "premature."[45] The Service had not yet assessed the section 6662(a) penalty, and section 6751(b) "imposes no particular deadline for the IRS to secure the required written approval before a penalty is assessed."[46] Section 6203 provides that an assessment is made "by recording the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the Secretary." The section 6662(a) penalty cannot occur until the court's decision is final and unappealable, and therefore the section 6751(b) issue was "not ripe for review."[47]

The position of the Service and the Tax Court in *Graev II* reflected the state of the law in 2016 with respect to section 6751(b), which had been uniformly applied since 1998: Written supervisory approval could be obtained any time prior to assessment. Before the *Graev II* decision, few cases had interpreted the section. In fact, the Tax Court had issued just one regular decision and three memorandum decisions prior to *Graev II*. In *Legg v. Commissioner*, the Tax Court addressed the "timing aspects" of section 6751(b), holding that the initial determination was the Service's examination report.[48] Tax Court memorandum decisions held that a section 6652(c) delinquency penalty for an exempt organization's failure to file a return[49] and the section 6702 frivolous return penalties[50] were within the

[41] *Id.* at 472–73.
[42] *Id.* at 473.
[43] *Id.* at 475.
[44] *Id.* at 501.
[45] *Id.* at 476, 485.
[46] *Id.* at 481.
[47] *Id.* at 478. The court noted in a footnote, however, that a taxpayer may be able to raise section 6751(b)(1) in a post-assessment collection-due-process proceeding. *Id.* at 484 n.22.
[48] Legg v. Commissioner, 145 T.C. 344, 349 (2015). The court did not resolve the issue of whether the approval requirement applies to the first notice sent to the taxpayer or only before the assessment of penalties, thus leaving open the issue of whether approval must be obtained before issuance of a NOD. *Id.* at 348-49.
[49] Grace Found. v. Commissioner, 108 T.C.M. (CCH) 513, 2014 T.C.M (RIA) ¶ 2014-229.
[50] Lindberg v. Commissioner, 99 T.C.M. (CCH) 1273, 2010 T.C.M. (RIA) ¶ 2010-067.

electronic-means exception. The other memorandum decision granted summary judgment after verifying that the Service had validly assessed section 6702 penalties.[51]

Although the *Graev II* decision reflected the then-accepted interpretation of section 6751(b), the views of the Tax Court judges were split: nine judges supported the majority opinion, three judges concurred, and five judges adopted the dissenting opinion.[52] The dissent disagreed with the majority's view that section 6751(b) could not then be considered at the Tax Court level and opined that the supervisory approval requirement had not been met for the section 6662(a) penalty.[53] Regarding whether consideration of the issue was premature, the dissent stated that section 6751(b) does not "preclude pre-assessment consideration of compliance with that rule."[54] Section 7491(c) assigns the burden of production to the Service "in any court proceeding" with respect to penalties, and therefore "compliance with section 6751(b) is properly a part of the burden-of-production inquiry in our deficiency cases involving penalties."[55] If a Service agent "cynically raises an unwarranted penalty as a bargaining chip" and includes it in a NOD without supervisory approval, under the majority view, the Service could not "come forward with evidence that it is appropriate to apply a particular penalty to the taxpayer"[56] as required by section 7491(c). Further, supervisory approval must be obtained at a time when the supervisor has that authority.[57] Because the Code requires that a deficiency determined by the Tax Court be assessed when the court's decision is final,[58] approval must be obtained before such time or it would "thereafter be meaningless."[59] The dissent recognized that the phrase in the statute—"initial determination of such assessment"—is ambiguous, because an "assessment" is not "determined" and instead is only an administrative act to formally record a tax liability.[60] The dissent found this meaning to be "unworkable" in the context of section 6751(b): "One can determine *whether to make* an assessment, but one cannot 'determine' an 'assessment.'"[61]

After the *Graev II* opinion was issued, the Second Circuit Court of Appeals reversed the Tax Court memorandum decision in *Chai v.*

[51] Pohl v. Commissioner, 106 T.C.M. (CCH) 704, 2013 T.C.M. (RIA) ¶ 2013-291.
[52] *Graev II*, 147 T.C. at 502, 525.
[53] *Id.* at 503.
[54] *Id.*
[55] *Id.* at 507.
[56] *Id.* at 507–08 (citing H. REP. NO. 105-599, at 129).
[57] *Id.* at 508.
[58] I.R.C. § 6215(a).
[59] *Graev II*, 147 T.C. at 508.
[60] *Id.* at 512.
[61] *Id.*

Commissioner.[62] Jason Chai had underreported his income in 2003 due to a $2 million payment received in connection with a tax shelter scheme on which he failed to pay self-employment tax.[63] In a post-trial brief, Mr. Chai challenged the Service's deficiency and the imposition of a section 6662(a) penalty, alleging the Service did not meet its burden of production under section 7491(c), because it did not provide evidence of compliance with section 6751(b).[64] The Tax Court considered this argument untimely since the taxpayer had not previously raised the issue.[65] The court thus did not "rule on the issue of whether the section 6751(b) requirement is part of respondent's burden of production and express[ed] no opinion as to the merits of petitioner's argument."[66]

Mr. Chai appealed, and the Second Circuit reversed the Tax Court's decision and upheld imposition of the penalty.[67] Instead of arguing that the section 6751(b) claim was untimely as it did at the Tax Court level, the Service asked the court to follow *Graev II*'s holding that it was premature to consider the issue.[68] The court considered the *Graev II* majority and dissenting opinions and adopted the dissent's analysis, disagreeing with the majority that the statute was clear and finding that the meaning of "an initial determination of [an] assessment" is ambiguous.[69] Because of the ambiguity, the Court of Appeals looked to legislative history to determine the purpose of section 6751(b),[70] which was to "prevent IRS agents from threatening unjustified penalties to encourage taxpayers to settle."[71] Allowing a penalty to be unapproved until just before assessment "would do nothing to stem the abuses § 6751(b)(1) was meant to prevent."[72] The court examined at what point supervisory approval had to be given and decided such time was before a Tax Court proceeding was initiated.[73] Based on the "truly consequential moment" for approval, the court held that the written approval of "the initial penalty determination" had to be obtained no later than the date the NOD is issued, or the filing of an answer or amended answer asserting penalties.[74] The court further held that

[62] *See* Chai v. Commissioner, 851 F.3d 190 (2d Cir. 2017), *aff'g in part, rev'g in part* 109 T.C.M. (CCH) 1206, 2015 T.C.M. (RIA) ¶ 2015-042.
[63] *Id.* at 194.
[64] *Id.*
[65] *Id.*
[66] *Chai*, 109 T.C.M. (CCH) 1206 at *26, 2015 T.C.M. (RIA) ¶ 2015-042 at 300.
[67] *Chai*, 851 F.3d at 195.
[68] *Id.* at 216.
[69] *Id.* at 218.
[70] *See* discussion of legislative history at text accompanying notes 17–31, *supra*.
[71] *Chai*, 851 F.3d at 219.
[72] *Id.*
[73] *Id.* at 220.
[74] *Id.* at 221.

compliance with section 6751(b) is part of the Service's burden of production *and proof* in a deficiency case, although the statute only states the Service has the burden of production.[75]

As a result of the *Chai* decision, the Tax Court reversed in part *Graev II*, which was appealable to the Second Circuit Court of Appeals. The court issued a supplemental opinion written by Judge Thornton in *Graev III*,[76] adopting the holding in *Chai*. Because the section 6751(b) issue was no longer premature, and, in the "interest of repose and uniformity that touches many cases," the court considered the merits of taxpayers' section 6751(b) argument.[77] The court then held that compliance with section 6751(b) was "properly a part of respondent's burden of production" under section 7491(c).[78] With the Service having conceded the section 6662(h) penalty, the court examined whether the Chief Counsel attorney's recommendation of section 6662(a) penalties for noncash contributions was an initial determination to assess the penalty.[79] The court found compliance with the approval requirement, because the attorney recommending the penalty was the "first person to recommend" the penalty,[80] and this determination was approved by the attorney's immediate supervisor in writing.[81] In addition, the amended answer to taxpayer's Tax Court petition filed by the Service counsel alleging section 6662(a) penalties for cash contributions was also approved by counsel's supervisor and met the requirements of section 6751(b).[82] The court thus set the rule that the initial determination refers to "the action of the IRS official who first proposes that a penalty be asserted."[83]

Judge Buch, joined by five other judges, concurred with the majority opinion in following *Chai* but dissented regarding the holding that a recommendation of a Chief Counsel attorney can constitute an "initial determination."[84] Eight judges concurred with the opinion of Judge Thornton.[85] Judge Holmes concurred with the result but disagreed with extending *Chai* to other circuits.[86] He advised that adopting *Chai* would have "unintended and irrational consequences" and "even end up harming

[75] *Id.*

[76] Graev v. Commissioner, 149 T.C. 485 (2017) ("*Graev III*").

[77] *Id.* at 493.

[78] *Id.* The Tax Court did not adopt *Chai's* holding that the Service has the burden of proof. *See also* Chief Counsel Notice CC-2018-006 (June 6, 2018) ¶ A.

[79] *Graev III*, 149 T.C. at 492–93.

[80] *Id.* at 494.

[81] *Id.* at 494–98.

[82] *Id.* at 498.

[83] *Id.* at 500 (Lauber, J., concurring).

[84] *Id.* at 527–35 (Buch, J., dissenting).

[85] *Id.* at 499.

[86] *Id.* at 502–27 (Holmes, J., concurring).

taxpayers unintentionally."[87] Disagreeing with *Chai's* extension of the burden of production to the burden of proof, Judge Holmes cautioned that this could "have a more powerful effect on penalty cases than anyone realizes."[88] He criticized *Chai's* rewriting the text of the Code, warning this could become "[l]ike some ghoul in a late-night horror movie that repeatedly sits up in its grave and shuffles abroad."[89] *Graev III* overruled *Graev II* "in the interest of repose," yet Judge Holmes determined "there will be no repose," because of the "confusion caused by this reconstruction."[90] He predicted the Pandora's box that would follow, noting that some taxpayers who should be penalized would be let off "their well-deserved hook," while others would be penalized in marginal cases.[91]

IV. Post-*Graev* Cases

As Judge Holmes predicted, the *Graev III* case opened the floodgates of section 6751(b) litigation. During the period 2017 (post-*Graev III*) through the end of 2021, there have been 23 regular Tax Court decisions[92] and over 200 Tax Court memorandum decisions addressing section 6751(b). Claiming noncompliance with section 6751(b) has become standard operating procedure for petitioning taxpayers. Taxpayers have even raised the issue where approval had been obtained at every stage of the proceeding—examination, appeals, and litigation.[93] Taxpayers saw an opening to avoid penalties on the technicality of lack of written supervisory approval, arguing variously that approval was required for specific types of penalties, approval procedures were not followed, approval was not of the initial determination of an assessment, or the Service did not meet its burden of production.

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[87] *Id.* at 503.

[88] *Id.* at 511.

[89] *Id.* at 512 (citing Lamb's Chapel v. Center Moriches Union Free Sch. Dist., 508 U.S. 384, 393 (1993) (Scalia, J., concurring)).

[90] *Id.* at 515.

[91] *Id.* at 524.

[92] All regular Tax Court decisions on section 6751(b), issued as of September 30, 2022, are discussed in this paper except for the following, which were not decisions of major importance: Perkins v. Commissioner, 150 T.C. 119 (2018); Alternative Health Care Advocs. v. Commissioner, 151 T.C. 225 (2018); Simonsen v. Commissioner, 150 T.C. 201 (2018); Mazzei v. Commissioner, 150 T.C. 138 (2018); Melasky v. Commissioner, 151 T.C. 93 (2018).

[93] *See, e.g.,* Roth v. Commissioner, 922 F.3d 1126 (10th Cir. 2019), *aff'g* 114 T.C.M. (CCH) 649, 2017 T.C.M. (RIA) ¶ 2017-248. Although the examiners' and the Appeals Office's determinations had been properly approved for both the section 6662(a) and 6662(h) penalties, the NOD only included the section 6662(a) penalty. The court did not find that this negated the fact that the section 6662(h) penalty had been approved: "Nothing in the broader statutory scheme requires the IRS to include its 'initial determination' in a notice of deficiency." *Id.* at 1133.

A. *Specific Penalties*

The statute excludes from the supervisory approval requirement the penalties of section 6651 for failure to file a return, section 6654 and section 6655 for failure to pay estimated taxes, and section 6662(b)(9) for an overstated cash charitable contribution under section 170(p).[94] Post-*Graev*, taxpayers challenged the lack of supervisory approval of penalties in other Code sections not within the statutory carve-outs. Courts held that the section 6751(b) requirement applies to the section 6663 civil fraud penalty,[95] the section 6672 trust fund recovery penalty,[96] section 6701 penalty for aiding and abetting an understatement of tax,[97] section 6702 frivolous return penalty,[98] and the section 6707A penalty for failure to disclose a reportable transaction.[99] The requirement does not, however, apply to the section 72(t) exaction of 10% on early distributions from retirement plans, which was determined to be a tax and not a penalty.[100] There is also no approval requirement for the penalty under section 6673 for frivolous claims, because the penalty is imposed by the Tax Court, and not by the Service, for misbehavior before the court.[101]

Section 6751(b) additionally excepts from the supervisory approval requirement "any other penalty automatically calculated through electronic means."[102] A post-*Graev* case determined that the section 6699 penalty for failure to file an S corporation return was within this exception, even though a reasonable-cause defense is available.[103] The Service had recognized pre-*Graev* that the section 6702 frivolous return penalty is within the electronic-means exception if the penalty is calculated automatically under the Electronic Fraud Detection System ("EFDS") but

[94] I.R.C. § 6751(b)(2)(A).

[95] Guess v. Commissioner, 115 T.C.M. (CCH) 1555, 2018 T.C.M. (RIA) ¶ 2018-097; Becker v. Commissioner, 115 T.C.M. (CCH) 1364, 2018 T.C.M. (RIA) ¶ 2018-069; Minemyer v. Commissioner, 120 T.C.M. (CCH) 4, 2020 T.C.M (RIA) ¶ 2020-099.

[96] Chadwick v. Commissioner, 154 T.C. 84 (2020). In a pre-*Graev* case, a district court held that a section 6672 recovery was not subject to section 6751(b). United States v. Rozbruch, 28 F. Supp. 3d 256 (S.D.N.Y. 2014), *aff'd on other grounds*, 621 F. App'x 77 (2d Cir. 2015). Service guidance also provided it was a tax and not a penalty. Chief Counsel Notice CC-2018-006 (June 6, 2018) ¶ E.2.

[97] Kapp v. Commissioner, 118 T.C.M. (CCH) 20, 2019 T.C.M. (RIA) ¶ 2019-084.

[98] Kestin v. Commissioner, 153 T.C. 14 (2019).

[99] Laidlaw's Harley Davidson Sales, Inc. v. Commissioner, 154 T.C. 68 (2020), *rev'd on other grounds,* 29 F.4th 1066 (9th Cir. 2022).

[100] Grajales v. Commissioner, 156 T.C. 55 (2021), *aff'd*, 47 F.4th 58 (2d Cir. 2022)).

[101] Williams v. Commissioner, 151 T.C. 1 (2018). *But see* Chief Counsel Notice CC-2018-006 (June 8, 2018) ¶ E.3, which advises Service attorneys to have their immediate supervisors approve the section 6673 penalty.

[102] I.R.C. § 6751(b)(2)(B).

[103] ATL & Sons Holdings, Inc. v. Commissioner, 152 T.C. 138 (2019).

not if the Service employee makes an "independent determination that the penalty should apply."[104] Post-*Graev*, the Service continued this interpretation, advising that penalties computed under the Automated Underreporter ("AUR") or Combined Annual Wage Reporting Automated programs were within the electronic-means exception but only if the taxpayer did not submit a response to the Service's notification of the penalty.[105] The Tax Court extended this distinction to the section 6662(d) substantial understatement penalty imposed automatically by the Automated Correspondence Exam ("ACE") software.[106] In sum, if the penalty is determined by a Service computer without any involvement of the Service examiner, it is not subject to supervisory approval.

B. *Approval Procedures*

Taxpayers challenged the Service procedures used to obtain supervisory approval, often unsuccessfully. The Tax Court rejected taxpayers' argument that they had to be allowed time to present a reasonable-cause defense prior to supervisory approval, noting that section 6751(b) requires no particular procedure for penalty approval.[107] Taxpayer's argument that proof of approval could only be obtained through cross-examination of the RA and his supervisor was likewise rebuffed.[108] Similarly, although a supervisor must review the penalty approval form, there is no requirement that her "thought process" be analyzed or that her review was "meaningful."[109] Consideration of the merits of the penalty determination is not required.[110] The Tax Court

[104] Chief Counsel Notice CC-2014-004 (May 20, 2014). *See, e.g., Kestin*, 153 T.C. at 28 (the Service acknowledged section 6702 penalties at issue were not automatically calculated by electronic means).

[105] Chief Counsel Notice CC-2018-006 (June 6, 2018) ¶ E.1. The penalty is "no longer automated once a Service employee makes an independent determination to pursue a penalty." *Id. See also* I.R.M. 20.1.2.3.2 (Oct. 19, 2020) (automatic penalty includes those issued under the Correspondence Examination Automation Support ("CEAS") Program); I.R.M. 20.1.5.2.3.1(4) (Aug. 31, 2021) (on CEAS cases, "the supervisor will indicate their approval by leaving a CEAS non-action note specifically stating which penalty is approved. In a deficiency case, the CEAS non-action note must be input prior to issuing any written communication of penalties that offers the taxpayer an opportunity to sign an agreement, or consent to assessment or proposal of the penalty").

[106] Walquist v. Commissioner, 152 T.C. 61 (2019); Walton v. Commissioner, 121 T.C.M. (CCH) 1279, 2021 T.C.M. (RIA) ¶ 2021-040. *See* I.R.M. 20.1.5.2.3(7) (Aug. 31, 2021) ("The IRS also requires supervisory approval of the non-assertion of penalties when there is a substantial understatement of tax under IRC 6662(d), Substantial Understatement of Income Tax").

[107] Alterman v. Commissioner, 115 T.C.M. (CCH) 1452, 2018 T.C.M. (RIA) ¶ 2018-083.

[108] Raifman v. Commissioner, 116 T.C.M. (CCH) 13, 2018 T.C.M. (RIA) ¶ 2018-101.

[109] Blackburn v. Commissioner, 150 T.C. 218, 221 (2018).

[110] Larkin v. Commissioner, 119 T.C.M. (CCH) 1485, 2020 T.C.M. (RIA) ¶ 2020-070. *See also* Thompson v. Commissioner, 124 T.C.M. (CCH) 51, 2022 T.C.M. (RIA) ¶ 2022-080 (IRS attorney and supervisor did not have to have real estate expertise to satisfy section 6751(b)

made its position clear: "The written supervisory approval requirement of section 6751(b)(1) requires just that: written supervisory approval."[111]

Although written approval is required, an actual signature of the supervisor is not.[112] An electronic signature is sufficient,[113] and approval may be shown by e-mail.[114] The Tax Court did find that the approval requirement was not met where the date of approval was not included on the penalty approval form,[115] where the reason for the penalty in the approval form was not the same as that stated in the NOD, [116] and where the approval form did not show that the approver was the immediate supervisor.[117] Further, a general statement that penalties are approved, without specifying the specific penalty, is not sufficient.[118]

Section 6751(b) requires that the taxpayer's "immediate supervisor" approve the penalty. In a challenge as to whether the proper person approved the penalty, the Tax Court determined that such supervisor "is most logically viewed as the person who supervises the agent's substantive work on an examination, even if the examiner's direct supervisor is someone

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for penalties related to valuation); Sparta Pink Prop., LLC v. Commissioner, 124 T.C.M. (CCH) 121, 2022 T.C.M. (RIA) 2022-088 (supervisory approval of section 6662 penalties met section 6751(b) requirements even though supervisor received appraisal two weeks after approval).

[111] Raifman v. Commissioner, 116 T.C.M. (CCH) 13 at *61, 2018 T.C.M. (RIA) ¶ 2018-101 at 861.

[112] Gallagher v. Commissioner, 115 T.C.M. (CCH) 1433, 2018 T.C.M. (RIA) ¶ 2018-077. *See also* the pre-*Graev* case of Deyo v. United States, 2008-2 U.S.T.C. ¶ 50,606, 102 A.F.T.R.2d 2008-6664 (2d Cir. 2008); C.C.N. CC-2018-006 (June 6, 2018) ¶ C (a note or email may be sufficient, as well as evidence "to infer that the written approval existed at the relevant time"). "Supervisory approval may be documented on a penalty approval form, in the form of an email, memo to file or electronically." I.R.M. 20.1.1.2.3(6) (Oct. 16, 2020) Penalty approval forms include Lead Sheet 300, Civil Penalty Approval Form, SAIN 011 Lead Sheet, Form 4700, signed comment on Form 5464, Form 8278, Form 5701. I.R.M. 20.1.5.2.3.1(3) (Aug. 31, 2021).

[113] Chadwick v. Commissioner, 154 T.C. 84 (2020).

[114] Estate of Morissette v. Commissioner, 121 T.C.M. (CCH) 1447, 2021 T.C.M. (RIA) ¶ 2021-060; Rogers v. Commissioner, 117 T.C.M. (CCH) 1306, 2019 T.C.M. (RIA) ¶ 2019-061; C.C.A. 2022-04-008 (Sept. 13, 2021).

[115] Shuman v. Commissioner, 116 T.C.M. (CCH) 210, 2018 T.C.M. (RIA) ¶ 2018-135, *aff'd*, 124 A.F.T.R.2d 2019-5534 (4th Cir.), *cert. denied*, 140 S. Ct. 1268 (2020). *See also* Colbert v. Commissioner, 124 T.C.M. (CCH) 31, 2022 T.C.M. (RIA) ¶ 2022-074 (approval requirement not met where date illegible).

[116] Estate of Ronning v. Commissioner, 117 T.C.M. (CCH) 1206, 2019 T.C.M. (RIA) ¶ 2019-038.

[117] Duffy v. Commissioner, 120 T.C.M. (CCH) 39, 2020 T.C.M. (RIA) ¶ 2020-108.

[118] Campbell v. Commissioner, 119 T.C.M. (CCH) 1266, 2020 T.C.M. (RIA) ¶ 2020-041. *See also* McCarthy v. Commissioner, 119 T.C.M. (CCH) 1514, 2020 T.C.M. (RIA) ¶ 2020-074 (for a section 6662 penalty, the specific penalty must be identified).

else."[119] When there is an acting supervisor, the Service considers that person to be the immediate supervisor if she has an approved Designation to Act or a Notification of Personnel Action on file.[120]

For court proceedings, a taxpayer cannot raise the section 6751(b) issue for the first time on appeal when the issue could have been raised in the Tax Court.[121] Further, a claim of noncompliance cannot be raised at the district court level if it was not raised in administrative proceedings.[122] If a taxpayer, instead of disputing this issue in court, enters into a closing agreement with the Service, he waives the section 6751(b) requirement.[123]

C. *Initial Determination*

Although *Chai* held that supervisory approval must be obtained by the time of the issuance of the NOD,[124] taxpayers attempted to push this moment back to a point when there had been no supervisory approval. *Graev III* examined the timeline more closely, concluding that the initial determination is the time of the action of the first Service official to propose a penalty.[125] In a post-*Graev* case, *Clay v. Commissioner*, the Tax Court held the initial determination occurs at the time of the Service's first "formal communication" to the taxpayer advising that penalties will be imposed and the taxpayer has the right to request an Appeals conference.[126] In *Clay*, the first formal communication, and thus the initial determination, was the 30-day letter and Form 4549, Income Tax Examination Changes, commonly referred to as a Revenue Agent Report ("RAR"), proposing penalties.[127] The

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[119] Sand Inv. Co. v. Commissioner, 157 T.C. 11, 80 (2021). Although the RA had changed teams, his former supervisor continued to supervise the examination. *Id.* at 79. *See also* Long Branch Land, LLC v. Commissioner, 123 T.C.M. (CCH) 1008, 2022 T.C.M. (RIA) ¶ 2022-002.

[120] I.R.M. 20.1.1.2.3(7) (Oct. 19, 2020).

[121] Blau v. Commissioner, 924 F.3d 1261 (D.C. Cir. 2019); Curtis Investment Co., LLC v. Commissioner, 909 F.3d 1339 (11th Cir. 2018); Mellow Partners v. Commissioner, 890 F.3d 1070 (D.C. Cir. 2018).

[122] Ginsburg v. United States, 2019-1 U.S.T.C. ¶ 50,199, 123 A.F.T.R.2d 2019-1218 (M.D. Fla.), *aff'd*, 17 F.4th 78 (11th Cir. 2021).

[123] McAvey v. Commissioner, 116 T.C.M. (CCH) 245, 2018 T.C.M. (RIA) ¶ 2018-142. For closing agreements, *see* I.R.C. § 7121.

[124] *See* discussion of *Chai* at text accompanying notes 62–75, *supra*.

[125] *See* discussion of *Graev III* at text accompanying notes 76–91, *supra*.

[126] Clay v. Commissioner, 152 T.C. 223 (2019), *aff'd on other grounds*, 990 F.3d 1296 (11th Cir. 2021), *cert. denied*, 142 S. Ct. 342 (2021). *See also* Berry v. Commissioner, 121 T.C.M. (CCH) 1292, 2021 T.C.M. (RIA) ¶ 2021-042; Belanger v. Commissioner, 120 T.C.M. (CCH) 198, 2020 T.C.M. (RIA) ¶ 2020-130; Sarkin v. Commissioner, 118 T.C.M. (CCH) 307, 2019 T.C.M. (RIA) ¶ 2019-131.

[127] *Clay*, 152 T.C. at 249. For unagreed issues in an audit, the Service issues a "30-day letter" that includes the RAR and advises the taxpayer of his right to protest to Appeals within 30 days. Reg. § 601.105(c)(2). The 30-day letter must "describe the basis for, and identify the amounts (if

Tax Court moved the date back even earlier in *Carter v. Commissioner*, where a Letter 5153 (Examination Report Transmittal – Statute less than 240 Days)[128] sent with the RAR was held to be the initial determination, because the letter "clearly reflected" the examiner's conclusion as to the imposition of penalties.[129] In *Kroner v. Commissioner*, a different report transmittal, Letter 915 (Examination Report Transmittal),[130] accompanied by the RAR, was held to be the initial determination, because it notified the taxpayer that penalties were being proposed and the taxpayer had the right to appeal.[131] Although penalty approval had been obtained prior to sending the 30-day letter and RAR, the court held that the Letter 915 was the initial determination; "the content of a document and not its label is controlling."[132] The Eleventh Circuit Court of Appeals reversed both the *Carter* and *Kroner* decisions, holding that the statute requires approval only before the assessment of penalties and not before an RA's first communication with the taxpayer about penalties.[133]

The RAR can be delivered in person at a closing conference and constitute an initial determination; there is no requirement that it be sent by mail.[134] However, a telephone call between the Service and the taxpayer, where the Service mentioned the possibility of penalties but had not reached an unequivocal decision, was not an initial determination.[135] The taxpayer

any) of, the tax due, interest, additional amounts, additions to the tax, and assessable penalties." I.R.C. § 7522. If the case is not resolved at Appeals or if the taxpayer does not contact Appeals within 30 days, the Service will issue a NOD. I.R.C. § 6212(a).

[128] Letter 5153 is not a 30-day letter. I.R.M. 4.10.8.12.1(4) (Mar. 25, 2021). If, after receiving Letter 5153, the taxpayer signs an extension of the statute of limitations, a 30-day letter is issued. *Id.* If the statute is not extended, a NOD is issued. *Id.*

[129] Carter v. Commissioner, 119 T.C.M. (CCH) 1128 at *30, 2020 T.C.M. (RIA) ¶ 2020-021 at 200. The Service appears to have sent Letter 5153 instead of a 30-day letter because of the taxpayers' "unwillingness to provide Appeals sufficient time to consider their cases." *Id. See also* Patel v. Commissioner, 120 T.C.M. (CCH) 211, 2020 T.C.M. (RIA) ¶ 2020-133.

[130] Letter 915 is the letter generally used to transmit an examination report if there are 240 or more days remaining in the statute of limitations. I.R.M. 4.10.8.4.1.1 (Mar. 25, 2021).

[131] Kroner v. Commissioner, 119 T.C.M. (CCH) 1507, 2020 T.C.M. (RIA) ¶ 2020-073. *See also* Battat v. Commissioner, 121 T.C.M. (CCH) 1438, 2021 T.C.M. (RIA) ¶ 2021-057 (RAR with a Letter 4121, Agreed Examination Report Transmittal, is an initial determination).

[132] *Kroner*, 119 T.C.M. (CCH) 1507 at *30, 2020 T.C.M. (RIA) ¶ 2020-073 at 743.

[133] Carter v. Commissioner, 2022-2 U.S.T.C. ¶ 50,232, 130 A.F.T.R.2d 5958 (11th Cir. 2022); Kroner v. Commissioner, 48 F.4th 1272 (4th Cir. 2022).

[134] Beland v. Commissioner, 156 T.C. 80 (2021). The Service had issued a summons in *Beland*, which added "a degree of formality not present in most IRS meetings. Under these circumstances, the closing conference at the end of petitioners' examination process was, like an IRS letter, a formal means of communicating respondent's initial determination that petitioners should be subject to the fraud penalty." *Id.* at 50.

[135] Excelsior Aggregates, LLC v. Commissioner, 122 T.C.M. (CCH) 292, 2021 T.C.M. (RIA) ¶ 2021-125. This case also held that the taxpayer's initial determination does not include notification to the appraiser involved in the case that section 6695A appraiser penalties would be

also did not succeed in the distressed asset trust transaction in *Thompson v. Commissioner*, where the examiner sent several letters containing a settlement offer with reduced penalty amounts, because the correspondence did not indicate that the Service had completed its work and made an unequivocal decision to assert penalties.[136] Similarly, Service Letter 3176C[137] sent to a taxpayer warning that his position was frivolous under section 6702 was held not to be an initial determination, because it was a "contingent" communication and not an "unequivocal" communication.[138] A taxpayer even went so far as to claim the Service's public notice advising the penalty risk to participants in syndicated easement transactions[139] was an initial determination.[140] The court held that a public notice was not an initial determination, because it did not constitute the "first communication *to the taxpayer*."[141]

The Tax Court followed *Clay* in *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, holding that the first formal communication to the taxpayer in which penalties were proposed (*i.e.*, the 30-day letter) was an initial determination in a non-deficiency case for a penalty under section 6707A for failure to report a reportable transaction.[142] The RA's supervisor had approved the penalty before a requested Appeals conference but after sending the 30-day letter, thus failing to timely obtain approval.[143] On appeal, the Ninth Circuit reversed the Tax Court decision and put some limitation on the expansive interpretations of the Tax Court.[144] The court held that section 6751(b) requires supervisory approval at the earlier of the assessment of the penalty or before the supervisor "loses discretion whether to approve the penalty assessment."[145] Because section 6707A is not subject to deficiency rules, the supervisor had such discretion at the time he

assessed. *Id.* at *15. *See also* Oxbow Bend, LLC v. Commissioner, 123 T.C.M. (CCH) 1124, 2022 T.C.M. (RIA) ¶ 2022-023.

[136] Thompson v. Commissioner, 155 T.C. 87 (2020).

[137] "The Letter 3176C informs taxpayers that their return is frivolous and subject to a $5000 civil penalty under section 6702. The letter outlines frivolous behavior and gives the taxpayer the opportunity to provide corrected information within 30 days of the date of the letter to avoid assessment of the penalty." I.R.M. 25.25.10.6 (5) (Sept. 28, 2020).

[138] *Kestin*, 153 T.C. at 30. *See also* Belair Woods, LLC v. Commissioner, 154 T.C. 1 (2020) (Letter 1807 in TEFRA partnership audit was not initial determination).

[139] Notice 2017-10, 2017-4 I.R.B 544.

[140] Pickens Decorative Stone, LLC v. Commissioner, 123 T.C.M. (CCH) 1127, 2022 T.C.M. (RIA) ¶ 2022-022.

[141] *Id.* (emphasis added).

[142] Laidlaw's Harley Davidson Sales, Inc. v. Commissioner, 154 T.C. 68 (2020), *rev'd*, 29 F.4th 1066 (9th Cir. 2022).

[143] *Id.* at 72-73, 83.

[144] *Laidlaw's Harley Davidson Sales*, 29 F.4th 1066.

[145] *Id.* at 1074.

approved the penalty.[146] Commenting on the lower court decision, the court said: "The problem with Taxpayer's and the Tax Court's interpretation is that it has no basis in the text of the statute. … The statute does not make any reference to the communication of a proposed penalty to the taxpayer, much less a 'formal' communication."[147]

The Tax Court addressed when an initial determination occurs for TEFRA partnerships.[148] In a 2018 memorandum decision, the court held that supervisory approval must be obtained prior to issuance of a Final Partnership Audit Adjustment ("FPAA");[149] amending an answer and reasserting the penalties after approval is not sufficient.[150] In a 2020 regular Tax Court case, *Belair Woods, LLC v. Commissioner*, [151] the Service sent the taxpayer Letter 1807 and the Summary Report,[152] setting out tentative proposed adjustments and penalties and inviting taxpayer to a closing conference. After the conference, the Service issued a 60-day letter, which formally stated the Service's decision to assert penalties and offer the taxpayer the opportunity to appeal.[153] The penalties had not been approved by the time Letter 1807 was sent to the taxpayer, but they had been approved by the time of the 60-day letter.[154] The taxpayer's appeal was unsuccessful, at which point the Service issued a FPAA.[155] The court determined the 60-day letter, and not the Letter 1807, was the initial determination.[156] "The statute requires approval for the

[146] *Id.* at 1071. The court notes that a NOD could "limit a supervisor's discretion to prevent the assessment of a penalty." *Id.* at 1072.

[147] *Id.* at 1072.

[148] "TEFRA partnerships" are partnerships subject to the audit procedures enacted by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 648.

[149] For FPAAs, *see* I.R.C. § 6223(a)(2) (before amendment in 2015).

[150] Endeavor Partners Fund, LLC v. Commissioner, 115 T.C.M. (CCH) 1540, 2018 T.C.M. (RIA) ¶ 2018-096, *aff'd on other grounds*, 943 F.3d 464 (D.C. Cir. 2019). *See also* Sugarloaf Fund, LLC v. Commissioner, 116 T.C.M. (CCH) 451, 2018 T.C.M. (RIA) ¶ 2018-181, *aff'd*, 953 F.3d 439 (7th Cir. 2020) (section 6751(b) requirement not met where approval obtained four days after FPAA was issued even though amended answer was approved). *But see* C.C.N. CC-2018-006 (June 6, 2018) ¶ B.3 ("If the penalty is not included in the FPAA, the penalty may be raised upon answer (or amended answer)"); Koh v. Commissioner, 119 T.C.M. (CCH) 1529, 2020 T.C.M. (RIA) ¶ 2020-077 (same).

[151] *Belair Woods*, 154 T.C. at 5 (2020).

[152] Letter 1807 is a cover letter for TEFRA partnership audits that transmits examination changes in the Summary Report. I.R.M. 4.31.2.3.9.4. (Apr. 20, 2017) The Summary Report contains proposed examination changes and explanations of adjustments. *Id.*

[153] *Belair Woods,* 154 T.C. at 6.

[154] *Id.* at 5–6.

[155] *Id.* at 6.

[156] *Id.* at 14–15. A penalty under section 6662(e) was asserted for the first time in the FPAA; the court determined that section 6751(b) had not been met for that penalty because supervisory

initial *determination* of a penalty assessment, not for a tentative proposal or hypothesis";[157] a "mere suggestion or indication of a possibility" is not a "determination."[158]

Following the same logic, the Tax Court held in another TEFRA case, *Tribune Media Co. v. Commissioner*, that Form 5071, Notice of Proposed Adjustment (NOPA), was not an initial determination.[159] The NOPA contained no notification of the opportunity to administratively appeal and conveyed no "sense of finality."[160] Instead, the NOD, along with the FPAA, was the first formal communication that the Service had determined to assert penalties and thus was the initial determination.[161] If a partner brings a partner-level proceeding following the partnership-level proceeding, proof of supervisory approval is not again required.[162] The issue must, however, have been raised during the partnership-level proceedings; it is not a partner-level defense.[163]

Several cases addressed penalties under section 6662, which imposes a penalty for accuracy-related understatements, generally 20% under section 6662(a), for nine categories listed in section 6662(b). The penalty is increased to 40% in the case of a "gross valuation misstatement" under section 6662(h), a "nondisclosed noneconomic substance transaction" under section 6662(i) for a transaction lacking economic substance described in section 6662(b)(6), and an "undisclosed foreign financial asset understatement" under section 6662(j). With this myriad of penalties in one Code section, the courts addressed whether approval is required for each section 6662 penalty.

In a 2019 TEFRA partnership audit, the RA proposed a section 6662(h) penalty in a letter that invited the taxpayer to attend a conference to discuss proposed adjustments within 30 days.[164] After the conference, the RA issued a 60-day letter with approval attached for both the section 6662(h) penalty and section 6662(b)(1) penalty for negligence, advising that the Service had determined to assess the penalties and that the taxpayer had 60 days to request an Appeals conference.[165] On appeal, the Appeals Officer added

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approval had not been timely obtained. *Id.* at 1. *See also Clay*, 152 T.C. 223 (30-day letter in deficiency proceeding was an initial determination).

[157] *Belair Woods*, 154 T.C. at 9.

[158] *Id.* at 11. *See also Kestin*, 153 T.C. 14.

[159] Tribune Media Co. v. Commissioner, 119 T.C.M. (CCH) 1006, 2020 T.C.M. (RIA) ¶ 2020-002.

[160] *Id.* at *17.

[161] *Id.* at *17, *24.

[162] Nix v. United States, 339 F. Supp. 3d 580 (E.D. Tex. 2018).

[163] *Mellow Partners*, 890 F.3d 1070; *Ginsburg*, 2019-1 U.S.T.C. ¶ 50,199, 123 A.F.T.R.2d 2019-1218.

[164] Palmolive Bldg. Invs. v. Commissioner, 152 T.C. 75, 80 (2019).

[165] *Id.*

penalties under section 6662(b)(2) for substantial understatement and section 6662(b)(3) for substantial valuation misstatement; the FPAA proposed all four penalties.[166] The Tax Court treated each as a separate penalty, and because each had been appropriately approved, the requirements of section 6751(b) had been met.[167] "Section 6751(b)(1) includes no requirement that all potential penalties be initially determined by the same individual nor at the same time."[168]

The Tax Court followed this approach in a memorandum decision that considered penalties in a micro-captive insurance tax shelter case, *Oropeza v. Commissioner* ("*Oropeza I*").[169] The Service sent Letter 5153 and the RAR to the taxpayers, which included a 40% penalty under either section 6662(h), section 6662(i), or section 6662(j).[170] The letter stated that the Examination Division had concluded its work and gave the taxpayers the option to agree to the adjustments in the RAR or consent to an extension of the statute of limitations if they wished to go to Appeals.[171] If the taxpayer declined both options, a NOD would be issued asserting the penalties listed in the RAR.[172] The Service subsequently issued a NOD that listed a section 6662(i) penalty and a penalty under sections 6662(b)(1) and 6662(b)(2).[173] The 40% penalties included in the RAR had not been timely approved, but the 20% penalties in the NOD had been.[174] The court held that the lack of supervisory approval for the penalties in the RAR did not taint the section 6662(b) penalties asserted in the NOD, but the section 6662(i) penalty could not be imposed because of lack of compliance with section 6751(b).[175]

Oropeza v. Commissioner ("*Oropeza II*") addressed this same issue in a regular Tax Court decision involving a different year for the same taxpayer in *Oropeza I*.[176] In *Oropeza II*, the examiner had sent Letter 5153 and an RAR proposing a section 6662(a) penalty that had not been approved for the categories of sections 6662(b)(1), 6662(b)(2), 6662(b)(3), and 6662(b)(6).[177] Several months later, the RA changed his recommendation to

[166] *Id.* at 81.
[167] *Id.* at 84.
[168] *Id.* at 85.
[169] Oropeza v. Commissioner, 120 T.C.M. (CCH) 71, 2020 T.C.M. (RIA) ¶ 2020-110 ("*Oropeza I*").
[170] *Id.* at *3.
[171] *Id.* at *3, *7.
[172] *Id.* at *4.
[173] *Id.* at *5.
[174] *Id.* at *4-5.
[175] *Id.* at *8.
[176] Oropeza v. Commissioner, 155 T.C. 132 (2020) ("*Oropeza II*"). *See also* Sells v. Commissioner, 121 T.C.M. (CCH) 1072, 2021 T.C.M. (RIA) ¶ 2021-012.
[177] *Oropeza II,* 155 T.C. at 132.

the section 6662(i) penalty, for which approval was obtained.[178] The Tax Court determined that section 6662(i) does not impose a separate penalty but merely "enhances" the penalty rate.[179] Thus, since the penalties in the initial determination (Letter 5153) were not approved, no penalty under section 6662 could be imposed.[180]

D. Burden of Production

Section 7491(c), which places the burden of production on the Service with respect to the liability for penalties, applies by its express language only to individuals. Prior to *Graev*, the Tax Court specifically held that section 7491(c) does not apply to corporations.[181] Post-*Graev*, the Tax Court held that section 7491(c) does not apply to a partnership-level proceeding under TEFRA audit rules.[182] If the partnership is within the small partnership exception from TEFRA procedures, however, section 7491(c) applies.[183] A TEFRA partnership is not precluded from raising the penalty approval issue but must do so as a defense, in which case the Service must then prove compliance with section 6751(b).[184] The Service must also prove compliance if it amends its answer in a Tax Court case to include a new penalty.[185]

The Service issued guidance in 2018 to Chief Counsel attorneys on addressing compliance with section 6751(b) in litigation.[186] The Chief Counsel Notice affirms the burden of production requirement and advises attorneys to concede the penalty if evidence would not meet this burden.[187] For a Tax Court deficiency case, evidence of compliance with section 6751(b) must be submitted if it is sufficient, even if the taxpayer does not

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[178] *Id.*

[179] *Id.* at 144.

[180] The Service cautions its examiners to obtain approval for alternative penalties. I.R.M. 20.1.5.2.3.1(2) (Aug. 31, 2021)

[181] NT, Inc. v. Commissioner, 126 T.C. 191 (2006).

[182] Dynamo Holdings Ltd. P'ship v. Commissioner, 150 T.C. 224 (2018).

[183] *Carter*, 119 T.C.M. (CCH) 1128, 2020 T.C.M. (RIA) ¶ 2020-021. *See* I.R.C. § 6231(a)(1)(B)(i) (before amendment in 2015) for the small partnership exception.

[184] *Id.* at 236-37. *See also Endeavor Partners Fund*, 115 T.C.M. (CCH) 1540, 2018 T.C.M. (RIA) ¶ 2018-096. The Service considers the best practice in such a case to be to submit evidence of compliance to avoid litigation of the burden issue. C.C.N. CC-2018-006 (June 6, 2018) at ¶¶ A, B.3.

[185] *Dynamo Holdings,* 150 T.C. at 237-38. *See* Mancini v. Commissioner, 117 T.C.M. (CCH) 1062, 2019 T.C.M. (RIA) ¶ 2019-016, *aff'd on other grounds*, 2021-2 U.S.T.C ¶ 50,177, 127 A.F.T.R.2d 2021-2509 (9th Cir. 2021) (case where no evidence of compliance with I.R.C. § 6751(b) was introduced); Hommel v. Commissioner, 119 T.C.M. (CCH) 1017, 2020 T.C.M. (RIA) ¶ 2020-004 (the Service could not reopen the record to introduce evidence of supervisory approval where it failed to produce any evidence at trial).

[186] C.C.N. CC-2018-006 (June 6, 2018).

[187] *Id.* ¶¶ A, D.

raise the issue.[188] An attorney can raise a penalty in the answer or amended answer if not included in the NOD; the penalty must be approved by the attorney's immediate supervisor.[189] The Notice also provides guidance on Collection Due Process and TEFRA cases.[190]

The Tax Court weighed in on the burden of production in several post-*Graev* cases. A 2020 memorandum decision provides guidance as to what type of evidence meets the Service's burden of production: the date of supervisory approval, the identity of the supervisor, which penalties were approved, and evidence that the supervisor approved.[191] Where there was a dispute as to whether the RAR or a 30-day letter was the initial determination and the Service did not introduce evidence of the RAR, the Service did not meet its burden of production.[192] Another case clarified that once the Service has introduced evidence of compliance with section 6751(b) in court, the taxpayer has the burden to rebut the evidence.[193]

V. Potential Solutions for the Section 6751(b) Problem

A poorly drafted statute[194] and creative tax lawyers opened the Pandora's box of challenges to the imposition of penalties based on the Service's failure to properly and timely obtain written supervisory approval. The Tax Court has taken an expansive view of section 6751(b) and, in some cases, prevented penalties from being imposed by a technicality and not because the Service used the threat of penalties inappropriately. Other taxpayers may have had penalties imposed out of an abundance of caution by the RA and her supervisor. As Judge Holmes stated in his concurring opinion in *Graev III*, "the cost of scrawling initials or checking the box is close to nil," while litigation can be costly, thus incentivizing RAs and their supervisors to "recommend and approve penalties in marginal cases."[195] Thus, "a provision meant to protect taxpayers from unjustified penalties will lead to more taxpayers being penalized in more marginal cases."[196]

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[188] *Id.* ¶ B.1.

[189] *Id.*

[190] *Id.* ¶¶ B.2, B.3, C.

[191] Purvis v. Commissioner, 119 T.C.M. (CCH) 1081, 2020 T.C.M. (RIA) ¶ 2020-013. *See also Duffy*, 120 T.C.M. 39, 2020 T.C.M. (RIA) ¶ 2020-108 (evidence as to the identity of the immediate supervisor).

[192] *Minemyer*, 120 T.C.M. (CCH) 4, 2020 T.C.M. (RIA) ¶ 2020-099.

[193] Frost v. Commissioner, 154 T.C. 23 (2020).

[194] Professor T. Keith Fogg, Clinical Professor of Law, Harvard Law School, maintains section 6751(b) is "among the top few provisions as the worst ever drafted in the tax procedure realm." Keith Fogg, *Congress to Consign IRC 6751(b) to the* Graev?, PROCEDURALLY TAXING, Sept. 20, 2021, https://proceduralltaxing.com/congress-to-consign-irc-6751b-to-the-graev/ [https://perma.cc/2GED-4QNG].

[195] *Graev III*, 149 T.C. at 524–25.

[196] *Id.* at 525.

The Ninth Circuit Court of Appeals in *Laidlaw's Harley Davidson v. Commissioner* put a limit on the Tax Court's broad interpretation in a case involving a non-deficiency penalty.[197] The Eleventh Circuit followed suit, reversing both the *Kroner* and *Carter* Tax Court decisions in holding that the statute requires approval only before the assessment of penalties and not before an RA's first communication with the taxpayer about penalties.[198] Other circuit courts could take a more restrictive approach, or they could stay with the rules that have developed from *Chai* and subsequent Tax Court decisions. If the status quo is maintained and no specific action is taken to change course, courts will continue having section 6751(b) cases before them, which can result in inconsistent interpretations and different results to taxpayers depending on the applicable circuit. Judge Holmes' warning that there would be no repose proved to be prescient.[199]

The Biden administration's 2022 Greenbook discusses the current unsettled and imperfect state of penalty approval under section 6751(b), bemoaning the fact that courts have barred penalties without considering whether the "penalties were appropriate under the facts of the particular case":[200]

> These barred penalties have included accuracy-related penalties where the taxpayers did not show they acted with reasonable care for underpayments on their returns. Barred penalties have also included those arising from understatements attributable to reportable transactions that the IRS identified as tax avoidance transactions or that taxpayers entered into with a significant purpose of income tax avoidance or evasion. In some cases, barred penalties have even included civil fraud penalties where the IRS has met its burden of showing by clear and convincing evidence that an underpayment of tax was attributable to fraud. These cases undercut the purpose of penalties to deter taxpayer non-compliance with tax laws, based on unclear, hard to apply rules that often apply retroactively.[201]

Various actions can be taken to rein in this judicial lawmaking that range from issuance of Treasury and Service guidance, to amendments to the statute, and even to repeal of the statute.

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[197] *See Laidlaw's Harley Davidson Sales*, 29 F.4th 1066, discussed at text accompanying notes 142–47, *supra*.

[198] *Kroner*, 48 F.4th at 1280-81, *rev'g* 119 T.C.M. (CCH) 1507, 2020 T.C.M. (RIA) ¶ 2020-073; *Carter*, 2022-2 U.S.T.C. at ¶ 50,232, *rev'g* 119 T.C.M. (CCH) 1128, 2020 T.C.M. (RIA) ¶ 2020-021.

[199] *See* discussion of Judge Holmes' concurring opinion in *Graev III*, at text accompanying notes 86–91, *supra*.

[200] DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2022 REVENUE PROPOSALS (MAY 2021) at 100 [hereinafter "2022 GREENBOOK"].

[201] *Id.*

A. *Issuance of Guidance*

The issuance of regulations under section 6751(b) soon after its enactment would have avoided the issues currently being dealt with in the courts. In the absence of regulations, the courts have been forced to interpret an ambiguous statute with little legislative history. Regulations could be issued now, but that would take time. They also could be challenged because of earlier contradictory judicial decisions, although the Supreme Court has held that an agency generally can issue regulations that do not conform to prior court decisions if the statute is ambiguous.[202] There is a "presumption that Congress, when it left ambiguity in a statute meant for implementation by an agency, understood that the ambiguity would be resolved, first and foremost, by the agency, and desired the agency (rather than the courts) to possess whatever degree of discretion the ambiguity allows."[203] The Supreme Court, on the other hand, has held a regulation invalid that prescribed an interpretation that was different from an earlier decision of the Court, because the Court had "already interpreted the statute, and there is no longer any different construction that is consistent with [the earlier decision] and available for adoption by the agency."[204] That case, however, involved unambiguous language, which was a "clear sign that Congress did not delegate gap-filling authority to an agency;...in ambiguous language [there is] at least a presumptive indication that Congress did delegate that gap-filling authority."[205]

Besides regulations, the Service internal guidance can assist with the proper implementation of section 6751(b). Following *Graev III*, the Service issued guidance in 2018 to Chief Counsel attorneys on addressing compliance with section 6751(b) in litigation.[206] The Service also updated its Internal Revenue Manual in October 2020 to set forth its procedures for written supervisory approval.[207] The procedures require supervisory approval before any written communication of penalties to the taxpayer that offers the taxpayer the opportunity to sign an agreement or consent to assessment or the penalty.[208] The manual distinguishes between the section

[202] Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 545 U.S. 967 (2005); Chevron U.S.A., Inc. v. Nat. Res. Defense Council, Inc., 467 U.S. 837 (1984). For application of *Brand X* to a tax case, *see* Swallows Holding, Ltd. v. Commissioner, 515 F.3d 162 (3d Cir. 2008).

[203] *Nat'l Cable*, 545 U.S. at 982 (citing Smiley v. Citibank (South Dakota), N.A., 517 U.S. 735, 740–41 (1996)).

[204] United States v. Home Concrete & Supply, LLC, 566 U.S. 478, 487 (2012).

[205] *Id.* at 488.

[206] C.C.N. CC-2018-006 (June 6, 2018). *See* discussion at text accompanying notes 1866–11900, *supra*.

[207] I.R.M. 20.1.1.2.3 (Oct. 19, 2020) *See also* SBSE-04-0920-0054 (Sept. 24, 2020) for interim Field Examination guidance for supervisory approval of penalties.

[208] I.R.M. 20.1.1.2.3.1 (Oct. 19, 2020).

6662 accuracy-related penalty when it is "systemically assessed" under the AUR or CEAS Programs, in which case approval is not required.[209] If a taxpayer challenges the penalty assessment, approval is required before any subsequent written communication regarding the penalty.[210] Internal Revenue Manual 20.1.5.2.3 sets out procedural requirements and explains how to document supervisory approval.

The Service's internal guidance is helpful, but given the constantly evolving and mutating case law of section 6751(b), the guidance would need to be regularly updated. More importantly, "the provisions of the [Internal Revenue Manual] are directory rather than mandatory, are not codified regulations, and clearly do not have the force and effect of law."[211] While the Service's efforts in putting order and structure to the supervisory approval requirement through written procedures are beneficial, without any legal effect their utility is limited.

B. *Legislative Changes to Statute*

The Biden administration proposed legislative changes to section 6751(b) to address the shortcomings of the statute in ensuring that penalties are imposed where appropriate.[212] Approval would be required "prior to the issuance of a notice from which the Tax Court can review the proposed penalty and, if the taxpayer petitions the court, the Service may raise a penalty in the court if there is supervisory approval before doing so."[213] If a penalty is not subject to Tax Court review before assessment, supervisory approval could occur at any time prior to assessment.[214] Approval authority would be expanded to any supervisor, "including those that are at higher levels in the management structure or others responsible for review of a potential penalty."[215] Finally, the statutory carve-outs would be extended to section 6662 for accuracy-related penalties, section 6662A for reportable transactions, and section 6663 for fraud penalties.[216] The 2023 Green Book does not contain a proposal for fixing section 6751(b).[217]

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[209] I.R.M. 20.1.1.2.3.2 (Oct. 19, 2020).

[210] *Id.*

[211] Marks v. Commissioner, 947 F.2d 983, 986 n.1 (D.C. Cir. 1991). *See also* Fargo v. Commissioner, 447 F.3d 706, 713 n.6 (9th Cir. 2006); Carlson v. United States, 126 F.3d 915, 922 (7th Cir. 1997).

[212] *See* 2022 GREENBOOK, *supra* note 200, at 100.

[213] *Id.*

[214] *Id.*

[215] *Id.*

[216] *Id.*

[217] DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2023 REVENUE PROPOSALS (MAR. 2022).

Nina Olson, Executive Director of the Center for Taxpayer Rights, and former National Taxpayer Advocate,[218] proposes that Congress amend section 6751(b) such that supervisory approval would be required before the issuance of a NOD.[219] For immediately assessable penalties or penalties not subject to deficiency procedures, approval would need to occur in accordance with the Internal Revenue Manual's current provision, *i.e.*, "prior to issuing any written communication of penalties to a taxpayer that offers the taxpayer an opportunity to sign an agreement, or consent to assessment or proposal of the penalty."[220]

Instead of allowing additional exceptions to the approval requirement as proposed in the 2022 Greenbook, another proposal would extend section 6751(b) to all accuracy penalties.[221] The statute currently provides an exception for "any other penalty automatically calculated through electronic means."[222] The courts and the Service have broadly applied this provision to mean any penalty imposed without the independent determination of a Service employee.[223] The *Walquist* decision[224] extended this exception to section 6662(d) penalties imposed by the Service's ACE software, which is an—

> IRS-developed, multifunctional software application that fully automates the initiation, Aging and Closing of certain Earned Income Tax Credit (EITC) and Non-EITC cases. Using ACE, Correspondence Exam can process specified cases with minimal to no tax examiner involvement until a taxpayer reply is received. Because the ACE system will automatically process the case through creation, statutory notice and closing, tax examiner (TE) involvement is eliminated entirely on no-reply cases.[225]

With ACE's emphasis on the EITC, accuracy-related penalties are automatically assessed against low-income taxpayers with no supervisory

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[218] *See* Nina Olson Profile, Harvard Kennedy School, https://www.hks.harvard.edu/about/nina-e-olson [https://perma.cc/RC6H-659B].

[219] Nina Olson, *Throwing the Baby Out with the Bath Water—the Proposed Repeal of IRC § 6751(b) Supervisor Approval of Penalties*, PROCEDURALLY TAXING (Dec. 1, 2021), https://proceduralltytaxing.com/throwing-the-baby-out-with-the-bathwater-the-proposed-repeal-of-irc-%C2%A7-6751b-supervisor-approval-of-penalties/ [https://perma.cc/LU62-GL3Y].

[220] *See* I.R.M. 20.1.1.2.3.1 (Oct. 19, 2020), discussed at text accompanying notes 208211, *supra*.

[221] Patrick Riley Murray, *Walquist Harms the Poor: Revisiting Supervisory Approval for Accuracy Penalties*, MINNESOTA LAW REVIEW BLOG (May 7, 2021), https://minnesotalawreview.org/2021/05/07/walquist-harms-the-poor-revisiting-supervisory-approval-for-accuracy-penalties/ [https://perma.cc/797M-GQ6V].

[222] I.R.C. § 6751(b)(2)(B).

[223] *See* discussion at text accompanying notes 104–106, *supra*.

[224] *Walquist*, 152 T.C. 61.

[225] I.R.M. 4.19.20.2(1) (Jan.1, 2021).

approval unless the taxpayer responds to the Service regarding the penalty.[226] For accuracy-related penalties assessed through non-automatic means, which generally would not be the type of penalties commonly imposed against low-income taxpayers, supervisory approval would have to be obtained in accordance with section 6751(b). This differing treatment results in unfair consequences to lower-income taxpayers. A taxpayer with the means to hire tax counsel to represent her could be advised to challenge whether the supervisory approval requirement was met.

Amending section 6751(b) to replace the ambiguous language requiring supervisory approval before the "initial determination of [the] assessment" would clarify with relative certainty the timing requirement for approval. This would allow the Service to issue procedures and train its employees on how to ensure compliance with supervisory approval so that penalties are properly imposed. Whether penalties would be required to have supervisory approval at the time set out in the 2022 Greenbook or at the time set forth in the Internal Revenue Manual (or at a different time), precisely defining that point would continue the section 6751(b) requirement as a defense against RAs using penalties as bargaining chips.

The 2022 Greenbook's extension of the supervisor definition aims to head off litigation as to who, exactly, constitutes the "immediate supervisor" under section 6751(b).[227] A definition of "supervisor" is a relatively minor point that would be more appropriately defined in Treasury Regulations. Removing the automatic approval exception for accuracy penalties in an attempt to level the playing field, however, would create a vast amount of work for the Service and hamper the Service's move to automation. The 2022 Greenbook proposal to carve out more penalties from the approval requirement is more controversial and seems to be leading in the direction of an outright repeal of section 6751(b).

C. *Repeal of Statute*

In 2021, the House of Representatives proposed repealing section 6751(b) retroactively to the date of its enactment.[228] In its place, new section 6751(b) would require that each "appropriate supervisor" certify quarterly to the Commissioner that section 6751(a) (*not* § 6751(b)) has been complied with for notices of penalties issued by the supervisor's employees.[229] The Joint Committee on Taxation estimates repeal would generate more than $200 million of additional revenue in 2022 and 2023

[226] For the EITC, *see* I.R.C. § 32.

[227] *See* discussion at text accompanying notes 119119–120, *supra*.

[228] H.R. 5376, 117th Cong. §§ 138404(a), 138404(c)(1). These proposed provisions were deleted from the Bill, which President Biden signed into Law as the Inflation Reduction Act of 2022, Pub. L No. 117-169, 136 Stat. 1818 on August 16, 2022.

[229] *Id.* § 138404(b).

and more than $1.4 billion from 2022 to 2031.[230] A retroactive repeal would render moot the set of rules that has developed from case law beginning with *Chai*.

The fundamental question as to whether section 6751(b) should be repealed is whether it has accomplished its purpose, which was to prevent penalties from being used as bargaining chips. No data is available to make this determination, and it is debatable whether requiring supervisory approval achieves this result. Penalties are not the only part of an audit that can be used as a bargaining chip. The deductibility of expenses, inclusion of income, availability of credits, and amounts of each can also be so used, yet section 6751(b) does not mandate supervisory approval of these items. And, although written supervisory approval of penalties is required, as interpreted by the courts, nothing more than the approval itself need be demonstrated.[231] The supervisor need not have engaged in any meaningful review or discussion of the penalty with the RA, including apparently whether penalties were used as bargaining chips.

Beyond the ostensible legislative purpose, there is the issue of whether the bargaining-chip purpose was even valid in 1998. The Commission found "very few" instances of the Service employees abusing their power.[232] The Joint Committee on Taxation, while recommending that supervisory review of penalties be improved, warned that legislative actions should be made only with "careful and deliberative review" by Congress.[233] Congress enacted an apparently hastily drafted and ambiguous section 6751(b) without careful thought as to the opportunities taxpayers would have to take advantage of a less-than-perfect approval process and avoid often well-deserved penalties.

The Commission pointed to "weak performance measurements, insufficient training, and a lack of proper managerial review and control" in the Commission Report as the reason for problems within the Service.[234] Whether mandating written supervisory approval of penalties through legislation is a better approach than addressing the issue internally in the

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[230] STAFF OF THE JOINT COMM. ON TAX'N, 117TH CONG., ESTIMATED BUDGETARY EFFECTS OF AN AMENDMENT IN THE NATURE OF A SUBSTITUTE TO THE REVENUE PROVISIONS OF SUBTITLES F, G, H, I, AND J, OF THE BUDGET RECONCILIATION LEGISLATIVE RECOMMENDATIONS RELATING TO INFRASTRUCTURE FINANCING AND COMMUNITY DEVELOPMENT, GREEN ENERGY, SOCIAL SAFETY NET, RESPONSIBLY FUNDING OUR PRIORITIES, AND DRUG PRICING, SCHEDULED FOR MARKUP BY THE COMMITTEE ON WAYS AND MEANS ON SEPTEMBER 14, 2021, FISCAL YEARS 2022 – 203 (Sept. 13, 2021.

[231] *See* discussion at text accompanying notes 107–111, *supra*.

[232] *See* discussion of the COMMISSION REPORT, *supra* note 11, at text accompanying notes 10–16, *supra*.

[233] *See* discussion of the JCT REPORT, *supra* note 24, at text accompanying notes 23–30, *supra*.

[234] *See* discussion of the COMMISSION REPORT, *supra* note 11, at text accompanying notes 10–16 *supra*.

Service as the Commission highlighted is far from a given. Ensuring proper imposition of penalties could instead be addressed through increased training and review of employees, as well as through clear and precise internal procedures and management structure. Congress recognized the importance of training when it required in the Act that the Service implement a training program and provide a plan to Congress.[235] Training remains as important now as it was in 1998 to ensure that employees perform their jobs in accordance with the Code, Treasury Regulations, and the Service's internal procedures.

Congress's concern in 1998 with inappropriate Service employee behavior extended beyond the imposition of penalties. As part of the Act, Congress legislated proper conduct of the Service employees in 10 specific instances when it enacted the "10 Deadly Sins" in section 1203, providing for the termination of an employee for committing any of the ten.[236] The concern, however, seems to have been misplaced based on subsequent studies that showed little evidence of Service employee misconduct toward taxpayers. A General Accounting Office review found that over a four-year period in 1998 through 2002, 3,970 allegations of section 1203 misconduct had resulted in only 71 firings.[237] Eighty-seven percent of the infractions were due to late filing of the employee's tax return or understatement of the employee's tax and not due to failings in their job performance.[238] In addition, "many frontline enforcement employees believe that other factors such as the Service's reorganization and tax law changes have had a greater impact on their ability to do their jobs than section 1203."[239] A 2004 Government Accountability Office report lists 36 substantiated allegations for taxpayer and employee rights and 667 for employee compliance with federal tax laws for the period July 1998 through April 2004.[240] The most recent Semiannual Report to Congress of the Treasury Inspector General for Tax Administration shows that all substantiated section 1203 inquiries related to willful untimely returns and willful understatements of tax for the period April through September 2021.[241] The vast majority of Service employee infractions thus have been related to the filing (or non-filing) of their tax returns and not to abuses of taxpayers. Further, many of the

[235] Pub. L. No. 105-206, § 1205, 112 Stat. 685 (1998).

[236] *See* discussion at text accompanying notes 32–33, *supra*.

[237] *See* GEN. ACCT. OFF., GAO-03-394, TAX ADMINISTRATION: IRS AND TIGTA SHOULD EVALUATE THEIR PROCESSING OF EMPLOYEE MISCONDUCT UNDER SECTION 1203 (2003) at 2.

[238] *Id.*

[239] *Id.* at 3.

[240] U.S. GOV'T ACCOUNTABILITY OFF., GAO-04-1039R, IRS' EFFORTS TO EVALUATE THE SECTION 1203 PROCESS FOR EMPLOYEE MISCONDUCT AND MEASURE ITS IMPACTS ON TAX ADMINISTRATION (2004), at Slide 16.

[241] TREASURY INSPECTOR GEN. FOR TAX ADMIN., SEMIANNUAL REPORT TO CONGRESS: APRIL 1, 2021 – SEPTEMBER 30, 2021, at 79.

accusations of improper Service's employee conduct made during the congressional testimony that inspired the Act were determined to be unfounded.[242]

The Service has a system in place to address employee discipline that is set forth in the Internal Revenue Manual.[243] Offenses include the "failure to observe written regulations, orders, rules of IRS procedures,"[244] which would cover procedures for supervisory approval of penalties. The IRS Manager's Guide to Penalty Determinations provides a list of offenses and suggested penalties, which range from a written reprimand to suspension to removal, for a failure to follow Service rules.[245] Although not always perfectly implemented,[246] procedures have been established that address the supervisory approval issue for penalties.

VI. Conclusion

The *Chai* and *Graev* decisions overturned years of Service procedures that permitted supervisory approval of penalties at any time prior to assessment. These cases opened the door for taxpayers in hundreds of cases to challenge the imposition of penalties on a technicality and not because a Service employee threatened penalties to get an audit resolved. Well-deserved penalty assessments were overturned, and some taxpayers may have had penalties assessed because of cautious RAs and their supervisors. In the current situation, although a set of rules has developed from case law, taxpayers will continue to challenge penalties based on section 6751(b). Depending on the arguments made and the circuit to which the case would be appealable, individual taxpayers may have different results.

The situation will not get better unless some action is taken. Issuing Treasury Regulations or other Service guidance would be helpful but would not go far enough. Amending the statute to replace the "initial determination" language would go a long way to creating certainty as to when supervisory approval must be obtained. It does not appear that employee conduct was so egregious, however, as to warrant statutory

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[242] *See* David Cay Johnston, *U.S. Disputes Accusations Of Abuses By the I.R.S.*, N.Y. TIMES, Apr. 26, 1998, at 23; David Cay Johnston, *Inquiries Find Little Abuse By Tax Agents.*, N.Y. TIMES, Aug. 15, 2000 (§ C), at 1; Ryan J. Donmoyer, *Judge May Dismiss Jewish Mother Lawsuit*, 1999 TAX NOTES TODAY 117-7 (June 18, 1999). *See also* GEN. ACCT. OFF, GAO/GGD-99-82, TAX ADMINISTRATION: ALLEGATIONS OF IRS EMPLOYEE MISCONDUCT (1999) (investigation of allegations made at congressional hearings that preceded enactment of the Act).

[243] *See* I.R.M. 6.751.1 (Nov. 4, 2008).

[244] I.R.M. 6.751.1.12 (Nov. 4, 2008).

[245] I.R.S., IRS Manager's Guide to Penalty Determinations, Doc. 11500 (Rev. Aug. 2021) at 11.

[246] *See* TREASURY INSPECTOR GEN. FOR TAX ADMIN., PROCEDURES TO ADDRESS EMPLOYEE MISCONDUCT WERE FOLLOWED, BUT RESOLUTION TIME AND QUALITY REVIEW NEED IMPROVEMENT (2020).

enforcement. Reviews of the 10 Deadly Sins have not shown significant Service employee misconduct; nor have there been subsequent findings of Service employees using penalties as bargaining chips. The Service's internal procedures to discipline employees seem to effectively deal with inappropriate conduct by Service employees. The best solution, therefore, would be to repeal the statute. This would allow the Service, as an employer, to deal with its employees internally, while preventing taxpayers from escaping penalties on a technicality or encouraging Service employees to broadly assess penalties.