

#35 REQUIRE WRITTEN MANAGERIAL APPROVAL BEFORE ASSESSING THE ACCURACY-RELATED PENALTY FOR “NEGLIGENCE”

Present Law

A taxpayer who submits a return that is not accurate (*i.e.*, reflects an “underpayment”) may be subject to an accuracy-related penalty under IRC § 6662. In particular, a penalty for “negligence or disregard of rules or regulations” may be imposed under IRC § 6662(b)(1). IRC § 6662(c) defines “negligence” as “any failure to make a reasonable attempt to comply with the provisions of this title” and defines “disregard” to include “any careless, reckless, or intentional disregard.”

As a taxpayer protection, IRC § 6751(b)(1) requires that the immediate supervisor of an employee making the initial determination of a penalty assessment must personally approve the determination, in writing.¹²⁸ However, penalties “automatically calculated through electronic means” are not required to receive managerial approval.¹²⁹

Reasons for Change

The purpose of penalties is to encourage voluntary compliance and deter noncompliance. Unlike penalties that can be assessed by answering a simple yes/no question (for example, the penalty for failing to file a return under IRC § 6651), the determination to assess a negligence penalty requires knowledge of what actions the taxpayer took to comply with the tax laws, as well as his or her motivations for taking those actions. Negligence cannot reasonably be determined by a computer, because a computer cannot assess whether a taxpayer made a “reasonable attempt” to comply with the law.

Nevertheless, the IRS has programmed its computers to apply negligence penalties automatically as part of its Automated Underreporter (AUR) program. AUR is an automated program that identifies discrepancies between the amounts that taxpayers report on their returns and what payors report via Forms W-2, Forms 1099, and other information returns. In general, penalties assessed under the AUR program are automatically computed pursuant to a computer program when a discrepancy is detected in the document matching program. If the negligence penalty is assessed through the AUR program, without an employee independently determining its appropriateness, there is no requirement for managerial approval.

An IRS employee will review a penalty assessment to make a determination of “negligence” only if a taxpayer responds to initial notices issued by AUR. There are many reasons why a taxpayer may not respond to a notice. The taxpayer may not receive it if he or she has moved. The taxpayer may put it aside and not get back to it. Or a taxpayer may accept the proposed adjustment but not realize he or she must respond to avoid the penalty assessment. In these and other circumstances, taxpayers may be assessed a penalty for negligence

128 This area of law has been the focus of recent litigation. In 2016, a majority of the U.S. Tax Court ruled that the written approval for an accuracy-related penalty could be given at any time prior to assessment, including while a case was in litigation before the Tax Court. As a result, the Tax Court held it was premature for it to consider an argument under IRC § 6751(b). *Graev v. Comm’r*, 147 T.C. No. 16 (2016), *vacated*, No. 30638-08 (T.C. Mar. 30, 2017). However, the decision in *Graev v. Comm’r* has since been vacated, because shortly after the decision was issued, the U.S. Court of Appeals for the Second Circuit (to which *Graev* would have been appealed) came to a different conclusion. In *Chai v. Commissioner*, the Second Circuit ruled that managerial approval for penalty assessments must be obtained before the IRS issues a notice of deficiency. *Chai v. Comm’r*, 851 F.3d 190 (2d Cir. 2017). These two rulings initially suggested a split between the majority of the Tax Court and the Second Circuit. Following the ruling in *Chai*, however, the Tax Court reversed course in a subsequent ruling in *Graev*. Taking *Chai* into account, the Tax Court ruled that it is not premature to consider an argument under IRC § 6751(b) in a deficiency proceeding, and the IRS bears the burden of production under IRC § 7491(c) to show the penalty received managerial approval. *Graev v. Comm’r*, 149 T.C. No. 23 (2017).

129 IRC § 6751(b)(2)(B).

without any analysis into their reasonable attempts to comply with tax laws (or lack thereof). This result runs contrary to the protections afforded in IRC § 6751(b).

Recommendation

Amend IRC § 6751(b)(2)(B) to require written managerial approval prior to assessment of the accuracy-related penalty imposed on the portion of an underpayment attributable to negligence or disregard of rules or regulations under IRC § 6662(b)(1) and specify which penalties and facts or circumstances result in penalties “automatically calculated through electronic means.”