

## Accuracy-Related Penalty Under IRC § 6662(b)(1) and (b)(2)

### TAXPAYER RIGHTS IMPACTED<sup>1</sup>

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

### OVERVIEW

The accuracy-related penalty is frequently one of the most litigated tax issues. This penalty may be imposed if the taxpayer's negligence or disregard of rules or regulations causes an underpayment of tax required to be shown on the taxpayer's return,<sup>2</sup> or if an underpayment exceeds a computational threshold called a substantial understatement.<sup>3</sup> The accuracy-related penalty does not apply to any portion of an underpayment where the taxpayer acted with reasonable cause and in good faith.<sup>4</sup> Additionally, the supervisor of the employee making the penalty determination generally must provide written approval of the accuracy-related penalty before the "initial determination of such assessment."<sup>5</sup> There is an exception to the written supervisory approval requirement if the penalty was automatically calculated through electronic means.<sup>6</sup>

Much of the accuracy-related penalty litigation this year and in previous years has focused on either whether the taxpayer met the reasonable cause exception or whether the IRS failed to secure timely supervisory approval. Still, the overall number of accuracy-related penalty cases has been declining, as shown in Figure 2.3.1.<sup>7</sup> We identified only 64 opinions issued between June 1, 2019, and May 31, 2020, where taxpayers litigated the negligence or substantial understatement components of the accuracy-related penalty. During this same period, taxpayers petitioned Tax Court in 569 cases where the accuracy-related penalty for negligence or substantial understatement of tax was an issue during the examination.<sup>8</sup>

1 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the IRC. See IRC § 7803(a)(3).

2 IRC § 6662(b)(1).

3 IRC § 6662(b)(2).

4 IRC § 6664(c)(1).

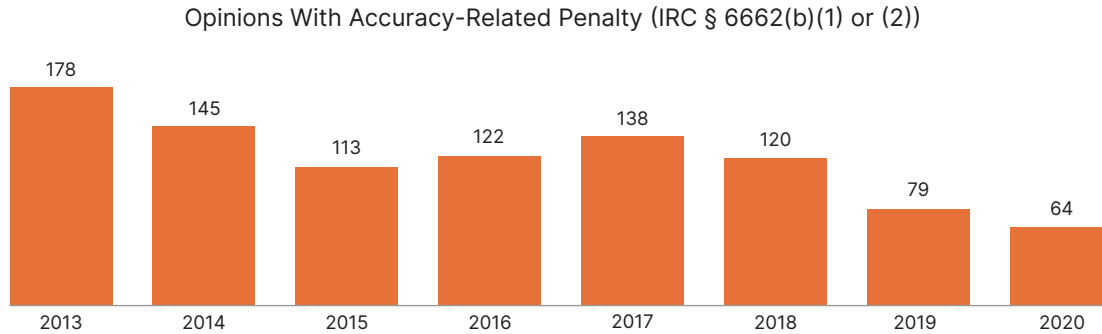
5 IRC § 6751(b)(1).

6 IRC § 6751(b)(2).

7 The periods in the figure refer to a one-year period ending on May 31 of each year.

8 IRS Appeals response to TAS information request (Dec. 3, 2020) showing cases petitioned to Tax Court between June 1, 2019 and May 31, 2020. TAS matched this data to the cases identified by examination where the accuracy penalty was recommended as recorded in the Examination Operational Automation Database on the IRS, Compliance Data Warehouse (Dec. 2020).

**FIGURE 2.3.1**



Taxpayers were more successful in challenging the accuracy-related penalty in smaller dollar cases. Where taxpayers prevailed in full or in part (30 percent of all cases), the average amount of the penalty in controversy was about \$61,000; whereas in cases where the IRS prevailed, the average amount was about \$317,000.<sup>9</sup> Almost two-thirds of the accuracy-related penalty cases involved business taxpayers, including 27 sole proprietorships, eight C corporations, six partnerships, and one S corporation. In 17 cases, the penalty was asserted based on negligence, in 23 cases it was asserted due to a substantial understatement, and in 15 cases on both grounds.<sup>10</sup>

## ANALYSIS OF LITIGATED CASES

In past reports, we have discussed the significant controversy over the IRS’s compliance with the IRC § 6751(b) supervisory approval requirement.<sup>11</sup> Of the 19 opinions this year where taxpayers prevailed in full or in part, only five (26 percent) were due to the IRS’s failure to obtain written supervisory approval as required. This is a significant decrease from last year, where 19 of the 27 opinions where taxpayers prevailed in full or in part (70 percent) were due to the IRS’s failure to comply with the requirement. This decrease could be due to prior court opinions and the increased attention by the IRS to documenting supervisory approval prior to communicating the penalties to the taxpayer in writing,<sup>12</sup> or the IRS Office of Chief Counsel guidance advising its attorneys to concede cases where the IRS does not have sufficient evidence to show compliance with IRC § 6751(b).<sup>13</sup>

TAS recommended that the IRS and the Department of Treasury add a guidance project concerning the supervisory approval requirement in IRC § 6751(b) to the list of priority guidance for 2020-2021. Although guidance on IRC § 6751(b) was not included in the joint IRS and Department of Treasury Priority Guidance Plan for 2019-2020, the Office of Management and Budget (OMB) included in its unified agenda a proposal for guidance. OMB’s proposal would require the supervisory approval to occur before the IRS sends a written

<sup>9</sup> The amounts in controversy ranged from \$618 to \$8,313,303. Of the 64 cases, only 50 of the cases stated the amount of the accuracy-related penalty that was in controversy and the averages in the text reflect only those 50 cases.

<sup>10</sup> In nine opinions, the basis for the accuracy-related penalty was not stated.

<sup>11</sup> See *Chai v. Comm’r*, 851 F.3d 190 (2d Cir. 2017); *Graev v. Comm’r*, 149 T.C. 485 (2017), *supplementing and overruling in part* 147 T.C. 460 (2016).

<sup>12</sup> See Internal Revenue Manual (IRM) 20.1.5.2.3.1, Documenting Supervisory Approval of Penalties (Apr. 22, 2019).

<sup>13</sup> See IRS Chief Counsel Notice, Section 6751(b) Compliance Issues for Penalties in Litigation, CC-2018-006 (June 6, 2018).

communication that includes the penalty and offers appeal rights.<sup>14</sup> In 2020, the IRS updated the Internal Revenue Manual (IRM) to instruct employees to obtain written supervisory approval before sending a written communication that offers the taxpayer an opportunity to sign an agreement or consent to an assessment of the penalty, or request a conference with the IRS Independent Office of Appeals.<sup>15</sup> The IRM specifies that prior to obtaining supervisory approval, employees can share written communications with the taxpayer reflecting proposed adjustments as long as they do not offer the opportunity to sign an agreement or consent, or request an Appeals conference.

This year, we noted only one case where the court found the IRS did not have to obtain supervisory approval because the penalty was automatically calculated through electronic means.<sup>16</sup> However, the concern remains that the IRS continues to use electronic means to calculate negligence for the accuracy-related penalty and assert it with no human review of the computer's negligence determination.<sup>17</sup>

## Key Decisions

The vast majority of the cases we reviewed this year mentioned the IRC § 6751(b) requirement, whether to document compliance, discuss whether the record should be reopened for the IRS to demonstrate compliance, or explain why the IRS did not have the burden to demonstrate such compliance. The key decisions we discuss below are all significant because they address novel issues related to IRC § 6751(b).

### *Belair Woods, LLC v. Commissioner*<sup>18</sup>

This case is significant because the court declined to require supervisory approval before the first time the IRS communicated the penalties to the taxpayer in writing. The case draws a new line between what is deemed a mere proposal and what is a final decision to assert the penalties.

The revenue agent sent the taxpayer a summary report of proposed adjustments along with Letter 1807, TEFRA Partnership Cover Letter for Summary Report, and invited the taxpayer to a closing conference to discuss the proposed adjustments, including accuracy-related penalties. After two conferences with no agreement, the revenue agent obtained supervisory approval of the penalties and issued a 60-day letter offering appeal rights. The court found the Letter 1807 and summary report with the tentative proposed adjustments did not trigger the supervisory approval requirement, but the subsequent 60-day letter did. The court reasoned that the 60-day letter was akin to a 30-day letter in *Clay v. Commissioner*<sup>19</sup> in that it formally communicated the IRS's definite decision to assert the penalties and gave appeal rights.<sup>20</sup> In rejecting the taxpayer's argument, the court noted: "The statute requires approval for the initial determination of a penalty assessment, not for a tentative proposal or hypothesis."<sup>21</sup>

<sup>14</sup> Office of Information and Regulatory Affairs, Office of Management and Budget, Rules for Supervisory Approval of Proposed Penalties, RIN 1545-BP63 (Spring 2020).

<sup>15</sup> Memorandum from Director, Examination Field and Campus Policy, to Area Directors, Field Examination, SBSE-04-0920-0054 (Sept. 24, 2020).

<sup>16</sup> *Purdie v. Comm'r*, T.C. Summ. Op. 2020-6.

<sup>17</sup> See IRM 4.19.3.22.1.4, Accuracy-Related Penalties (Sept. 21, 2020).

<sup>18</sup> 154 T.C. No. 1, 2020 WL 58313 (Jan. 6, 2020). Although we reviewed this case, it was not included in the count of 64 opinions we reported because it was not a final decision on the merits of the accuracy-related penalty. However, because of the significance of this summary judgment opinion on the IRC § 6751(b) issue, it warrants a discussion here.

<sup>19</sup> 152 T.C. 223 (2019).

<sup>20</sup> 154 T.C. No. 1, 2020 WL 58313, at \*5 (Jan. 6, 2020) (citing IRM 8.19.1.6.8.4(3) (Oct. 1, 2013)).

<sup>21</sup> 154 T.C. No. 1, 2020 WL 58313, at \*5 (Jan. 6, 2020).

***Frost v. Commissioner***<sup>22</sup>

In an issue of first impression, the Tax Court established that once the IRS proves supervisory approval before a formal written communication (here the notice of deficiency), the IRS has met its initial burden of production and does not need to show there were no prior formal communications about the penalty. This holding could create difficulty for taxpayers who have misplaced or did not retain all IRS written communications and cannot prove a prior communication.<sup>23</sup>

The IRS disallowed the taxpayer's business expense deductions and asserted the accuracy-related penalty during an examination. The IRS provided a Civil Penalty Approval Form, which was signed over a year before the IRS issued the notice of deficiency. The court found the IRS only had to show it had supervisory approval before issuing the notice of deficiency, and it would not require the IRS to prove a negative (*i.e.*, the absence of any prior formal communications). It noted that evidence of prior formal communication would be available to the taxpayer since the taxpayer would have received it.

***Wells Fargo & Company v. Commissioner***<sup>24</sup>

The Eighth Circuit's opinion included two significant holdings: (1) taxpayers must show actual reliance on a relevant authority to show reasonable basis, and (2) written supervisory approval is not required for penalties that merely reduce a taxpayer's refund. The first holding has broad implications for attorney-client privilege as attorneys could be forced to disclose opinions given to taxpayers to show the taxpayer knew about the relevant authority. The second holding exposes a loophole in the IRC § 6751(b) supervisory approval requirement because the IRS can assert penalties without supervisory approval as long as the penalties only reduce a refund and do not result in an assessment.

The taxpayer entered into a "structured trust advantaged repackaged securities" (STARS) transaction. After the IRS disallowed the foreign tax credits and interest deduction, the taxpayer paid the deficiency and filed a refund suit. The IRS first asserted the accuracy-related penalty in litigation. The United States Court of Appeals for the Eighth Circuit affirmed the lower court's ruling that a portion of the STARS transaction was a sham. The taxpayer argued that it should not be liable for an accuracy-related penalty because it had a reasonable basis for the transaction since its return position was objectionably reasonable under the relevant authorities. However, the Eighth Circuit held that it was not enough to show the return position was reasonable when considering the authorities. The taxpayer must provide evidence that it actually knew about the relevant authorities and relied on them. Because the taxpayer could not provide such evidence, it did not establish that it had a reasonable basis for its position.

Concerning the supervisory approval requirement, the Eighth Circuit concluded that the supervisory approval requirement in IRC § 6751(b) did not apply because approval is only required if the penalties are eventually assessed. In this case, the penalty was never assessed by a revenue agent during an exam or proposed by the IRS in a notice of deficiency but was first raised by the government in litigation as an offset defense to the taxpayer's

<sup>22</sup> 154 T.C. No. 2, 2020 WL 70716 (Jan. 7, 2020).

<sup>23</sup> The burden on taxpayers who have misplaced IRS communications would be alleviated if the IRS were to make all notices and correspondence accessible in taxpayers' online accounts. See Most Serious Problem: *Online Records Access: Limited Electronic Access to Taxpayer Records Through an Online Account Makes Problem Resolution Difficult for Taxpayers and Results in Inefficient Tax Administration*, *supra*.

<sup>24</sup> 957 F.3d 840 (8th Cir. 2020), *aff'g* 260 F.Supp.3d 1140 (D. Minn. 2017).

claim for refund. As a result, the penalty would never be assessed or collected by the IRS. The court noted that procedural requirements are generally relaxed when a penalty is asserted as a refund offset defense.

## CONCLUSION

This year, we saw a continued decrease in accuracy-related penalty cases. Although the requirement for written supervisory approval continues to be a hotly-contested issue, there was a noticeable drop in the percentage of taxpayers who prevailed. Nonetheless, legislative changes and regulatory guidance could mitigate future disputes by clarifying exactly when the supervisory approval is required. Additionally, legislation could protect taxpayers' rights by requiring supervisory approval not only in cases where a penalty is assessed, but also where it is included in a final judicial decision. Legislation could also ensure that where the IRS proposes the accuracy-related penalty for negligence based on a computer calculation, a supervisor has reviewed to ensure the penalty is appropriate. The IRS could also accomplish this last objective administratively by ending its practice of relying solely on a computer program to determine negligence.

## Recommendations to Mitigate Disputes

The National Taxpayer Advocate recommends that Congress:<sup>25</sup>

1. Amend IRC § 6751(b)(1) to clarify that no penalty under Title 26 shall be assessed or entered in a final judicial decision unless the penalty 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 *prior to the first time the IRS sends a written communication to the taxpayer proposing the penalty as an adjustment.*
2. Amend IRC § 6751(b)(2)(B) to clarify that the exception for “other penalties automatically calculated through electronic means” does not apply to the negligence penalty under IRC § 6662(b)(1).

The National Taxpayer Advocate recommends that the IRS:

1. Issue regulatory guidance to clarify that the supervisory approval under IRC § 6751(b) must occur prior to the first time the IRS sends a written communication to the taxpayer proposing the penalty as an adjustment.
2. Update its IRM to clarify that where the IRS uses a computer program to determine the accuracy-related penalty based on negligence, an IRS employee must first contact the taxpayer and review the facts and circumstances prior to determining the applicability of the negligence penalty and the IRS must obtain supervisory approval to ensure the penalty is appropriate prior to assertion of the penalty, consistent with the Memorandum from Director, Examination Field and Campus Policy, to Area Directors, Field Examination, SBSE-04-0920-0054 (Sept. 24, 2020).

<sup>25</sup> The National Taxpayer Advocate has submitted these recommendations in her 2021 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 68-70 (*Clarify That Supervisory Approval Is Required Under IRC § 6751(b) Before Proposing Penalties*) and 71-72 (*Require an Employee to Determine and a Supervisor to Approve All Negligence Penalties Under IRC § 6662(b)(1)*).