Legislative Recommendation #33

Clarify That Supervisory Approval Is Required Under IRC § 6751(b) Before Proposing Penalties

SUMMARY

- *Problem:* By law, some penalties require supervisory approval. However, the law leaves the timing of this approval unclear. This ambiguity has generated conflicting decisions among the courts, which leaves taxpayers lacking certainty about how they should be treated by the IRS.
- *Solution:* Clarify that supervisory approval is required before a proposed penalty is communicated in written form to a taxpayer.

PRESENT LAW

IRC § 6751(b)(1) provides: "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."

IRC § 6751(b)(2) carves out two categories of exceptions from this supervisory approval requirement: (i) the additions to tax for failure to file a tax return or pay the tax due (IRC § 6651) and the additions to tax for failure to pay sufficient estimated tax (IRC §§ 6654 and 6655) and (ii) any other penalty that is "automatically calculated through electronic means."

REASONS FOR CHANGE

IRC § 6751(b) protects taxpayers' *right to a fair and just tax system*[1] by ensuring that penalties are only imposed in appropriate circumstances and are not used as a bargaining chip to encourage settlement.[2] However, the phrase "initial determination of [an] assessment" is unclear. A "determination" is made based on the IRS's investigation of the taxpayer's liability and an application of the penalty statutes. An "assessment" is merely the entry of a decision on IRS records. Therefore, while a penalty can be determined and a penalty can be assessed, "one cannot 'determine' an 'assessment.'"[3] Due to this apparent drafting error and consequent ambiguity in the statute, an increasing number of courts have had to grapple with the question of when written supervisory approval must be provided.[4] In recent years, courts have come to various conclusions about when the supervisory approval must occur:

- In 2016, the Tax Court held in *Graev v. Commissioner* (which was later vacated) that supervisory approval for penalties subject to deficiency procedures could take place at any point before the assessment was made.[5]

1 *See* IRS, Pub. 5169, Taxpayer Bill of Rights (July 2014), https://www.irs.gov/pub/irs-pdf/p5169.pdf.
2 *See* S. Rep. No. 105-174, at 65 (1998).
3 *Chai v. Comm'r*, 851 F.3d 190, 218-19 (2d Cir. 2017) (quoting *Graev v. Comm'r*, 147 T.C. 460 (2016) (Gustafson, J., dissenting)).
4 *See* National Taxpayer Advocate 2019 Annual Report to Congress 149 (Most Litigated Issue: *Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/ARC19_Volume1_MLI_03_Accuracy.pdf; National Taxpayer Advocate 2018 Annual Report to Congress 447 (Most Litigated Issue: *Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/07/ARC18_Volume1_MLI_01_AccuracyRelatedPenalty.pdf.
5 147 T.C. at 460, *superseded by*, *in part*, *modified by*, *in part*, 149 T.C. 485 (2017).

- In 2017, the U.S. Court of Appeals for the Second Circuit held in *Chai v. Commissioner* that supervisory approval was required for penalties subject to deficiency procedures no later than the date on which the IRS issued the notice of deficiency or, if the penalty was asserted through an answer or amended answer, the time of that filing.[6]
- In 2019, the Tax Court held in *Clay v. Commissioner* that supervisory approval for penalties subject to deficiency procedures was required prior to sending the taxpayer a formal communication that included the right to go to the IRS Independent Office of Appeals.[7]
- In 2020, the Tax Court followed *Clay* and held in *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner* that the same timing rule applied to assessable penalties. That decision was overruled by the U.S. Court of Appeals for the Ninth Circuit in 2022.[8] There, the Ninth Circuit held that approval must be obtained before assessment of the penalty or, if earlier, before the relevant supervisor loses discretion to approve the penalty assessment.

In *Belair Woods, LLC v. Commissioner,* the Tax Court found the IRS did not have to obtain supervisory approval before sending the taxpayer a Letter 1807, TEFRA Partnership Cover Letter for Summary Report, which invited the taxpayer to a closing conference to discuss proposed adjustments.[9] Instead, the court found that Letter 1807 only advised the taxpayer of the possibility that penalties could be proposed, and the pivotal moment requiring supervisory approval was when the IRS sent the 60-day letter formally communicating its definite decision to assert the penalties.

In September 2020, the IRS issued interim guidance that instructs employees to obtain written supervisory approval before sending a written communication that offers the taxpayer an opportunity to sign an agreement or consent to assessment or proposal of a penalty.[10] The interim guidance specifies that prior to obtaining written supervisory approval, employees can share written communications with the taxpayer that reflect proposed adjustments as long as they do not offer the opportunity to sign an agreement or consent to assessment or proposal of the penalty.

In 2023, the Treasury Department issued proposed regulations under IRC § 6751.[11] For pre-assessment penalties subject to Tax Court review, the proposed regulations would allow supervisory approval to be obtained any time before issuance of the statutory notice of deficiency. Penalties not subject to pre-assessment Tax Court review could be approved up until the time of the assessment itself. Also in 2023, the Treasury Department asked Congress to amend IRC § 6751 to achieve the same result.[12] Thus, the proposed regulations and legislation would establish the broadest possible window and allow the requisite supervisory approval to occur at the latest possible moment. In this way, the proposed regulations and legislative proposal would bring relative certainty to this area, but they would do so by seriously eroding

6 851 F.3d 190 (2d Cir. 2017).

7 152 T.C. 223 (2019).

8 *Laidlaw's Harley Davidson, Inc. v. Comm'r*, 29 F.4th 1066 (9th Cir. 2022), *rev'g* 154 T.C. 68 (2020). *See also Kroner v. Comm'r*, 48 F.4th 1272 (11th Cir. 2022), *rev'g* T.C. Memo. 2020-73, in which the Eleventh Circuit agreed with the Ninth Circuit's *Laidlaw's* decision. In *Carter v. Comm'r*, No. 20-12200 (11th Cir. Sept. 14, 2022), *rev'g* T.C. Memo. 2020-21, the Eleventh Circuit followed its decision in *Kroner*.

9 154 T.C. 1 (2020).

10 Interim Guidance Memorandum (IGM) SBSE-04-0920-0054, Timing of Supervisory Approval of Penalties Subject to IRC 6751(b) (Sept. 24, 2020), *reissued by* IGM SBSE-04-0922-0075, Reissue Interim Guidance (IG) for Timing of Supervisory Approval of Penalties Subject to IRC 6751(b) (Sept. 28, 2022), https://www.irs.gov/pub/foia/ig/sbse/sbse-04-0922-0075.pdf.

11 Prop. Treas. Reg. § 301.6751-1, 88 Fed. Reg. 21,564 (Apr. 11, 2023).

12 Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals* 161-162 (Mar. 2023), https://home.treasury.gov/policy-issues/tax-policy/revenue-proposals. Like the proposed regulations, this legislative proposal would also expand the definition of supervisors permitted to provide the required approval. We note it is extremely unusual for the Treasury Department to simultaneously propose legislation and regulations that are substantially identical. Presumably, the General Counsel's office is uncertain whether it has the legal authority to impose a timing rule by regulation, so it is asking for a legislative change in case the courts invalidate the regulation.

the taxpayer protections provided by IRC § 6751 and in opposition to the views expressed by a range of stakeholders and commentators, including the National Taxpayer Advocate.[13]

Both *Belair Woods* and the Treasury Department's position leave open the possibility that IRS employees could use penalties as a bargaining chip – precisely what Congress sought to prevent by enacting IRC § 6751(b). Under *Belair Woods*, IRS employees can propose penalties to induce a resolution without first obtaining written supervisory approval, so long as the communication is deemed a proposal and not a definite decision. This approach undermines the statutory intent because, as explained in the dissent in *Belair Woods*, "[e]very communication from the Commissioner proposing a deficiency and a related penalty – whether it is a preliminary report, a 30- or 60-day letter, or a notice of deficiency – sets forth proposed adjustments, which do not become final until a decision is entered, or an assessment is properly recorded."[14]

The IRS's interim guidance, the proposed regulations, and the Treasury Department's legislative proposal seek to resolve the question of what is merely a proposal as opposed to a definite decision by drawing the line at written communications that offer a chance to agree to assessment or consent to proposal of a penalty. However, employees could still use penalties as a bargaining chip because some taxpayers may feel pressured to resolve their cases when penalties are first put on the table as proposed adjustments.

In addition to the timing issue, the statutory language of IRC § 6751(b)(1) is also problematic because of its focus on "assessment(s)." In *Wells Fargo & Company v. Commissioner*, the U.S. Court of Appeals for the Eighth Circuit found that supervisory approval under IRC § 6751(b) was not required because there was no assessment.[15] There, the IRS asserted the accuracy-related penalty in a refund suit to offset any refund granted to the taxpayer. Because the penalty, if upheld by the court, would only lead to a reduced refund and not a balance to be assessed, the court found there would be no assessment and thus no requirement for supervisory approval.

In practice, the overwhelming majority of penalties imposed by the IRS are excluded from the supervisory approval requirement through one of the exceptions in IRC § 6751(b)(1).[16] But where written supervisory approval is required, the National Taxpayer Advocate believes it should be required early enough in the process to ensure it is meaningful and is not merely an after-the-fact rubber stamp applied in the cases in which a taxpayer challenges a proposed penalty.

RECOMMENDATION

- 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*.

---

13 For a more detailed discussion of the problems arising under the IRS's interpretation of IRC § 6751, see Erin M. Collins, *Reconsidering the IRS's Approach to Supervisory Review*, National Taxpayer Advocate Blog (Aug. 29, 2023), https://www.taxpayeradvocate.irs.gov/news/nta-blog-reconsidering-the-irs-approach-to-supervisory-review/. Stakeholder comments regarding the proposed regulations can be viewed at https://www.regulations.gov/document/IRS-2023-0016-0010/comment.

14 *Belair Woods, LLC v. Comm'r*, 154 T.C. 1, 11 (Jan. 6, 2020) (Marvel, J., dissenting).

15 957 F.3d 840 (8th Cir. 2020), *aff'g* 260 F. Supp. 3d 1140 (D. Minn. 2017).

16 In fiscal year 2022, the IRS imposed 33.5 million penalties on individuals, estates, and trusts in connection with income tax liabilities. The following penalties, generally imposed by electronic means, accounted for nearly 98 percent of the total: failure to pay (16.2 million), failure to pay estimated tax (12.2 million), failure to file (3.4 million) and bad checks (1.1 million). IRS, 2022 Data Book, Table 26, Civil Penalties Assessed and Abated, by Type of Tax and Type of Penalty, Fiscal Year 2022, at 60 (2023), https://www.irs.gov/pub/irs-pdf/p55b.pdf.