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CLIENT ALERT

Penalty Litigation Updates: IRS Guidance to its Attorneys and Tax Court's Decision re Frivolous Penalties

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In December 2017, the Tax Court held that the IRS must comply with certain procedural requirements in 26 U.S.C. § 6751(b)(1) before asserting a penalty. In response, the IRS Chief Counsel recently issued a notice advising its attorneys on how to litigate the § 6751(b)(1) compliance issue. Based on the notice, taxpayers should seek evidence of compliance with § 6751(b)(1) whenever a non-computer generated penalty is at issue and raise the § 6751(b)(1) compliance issue in administrative refund claims.

In another recent development, the Tax Court ruled that § 6751(b)(1) does not apply to penalties imposed by the Tax Court.

Background

Under the Internal Revenue Code, the IRS must follow certain procedures when assessing a penalty. Generally, the IRS cannot assess a penalty unless the "initial determination" to impose a penalty is approved in writing by the "immediate supervisor of the individual making such determination." Section 6751(b)(1). This rule applies to all penalties except computer-generated penalties, including failure to file, failure to pay, and estimated tax penalties.

In Graev v. Commissioner, a split Tax Court reversed its prior position and held that, in a deficiency case, a penalty subject to § 6751(b)(1) must be approved in writing before the IRS mails the notice of deficiency or files an answer or amended answer asserting penalties. 149 T.C. No. 23 (December 20, 2017). For more in-depth discussion of *Graev*, please see our prior alert *Tax Court Rules that It Has Jurisdiction to Review Whether Penalties Have Been Authorized*.

IRS instructions to its field attorneys

In June 2018, the IRS issued guidance advising Chief Counsel attorneys on how to address § 6751(b) issues in litigation (the "*Graev* Notice").

Tax Court deficiency cases

In the *Graev* Notice, the IRS instructs attorneys not to challenge the holding of *Graev*—it instructs Chief Counsel attorneys not to argue that a penalty in the statutory notice of deficiency could be approved after the notice is mailed.

The IRS also tells Chief Counsel attorneys to submit evidence of the IRS's compliance with § 6751 (e.g., proof of supervisory approval) in any deficiency case in which a penalty is at issue, even if the taxpayer has not raised the compliance issue.

If a Chief Counsel attorney raises a penalty for the first time in litigation, the *Graev* Notice requires that the answer or amended answer raising the penalty be signed by the attorney's supervisor and "identify the supervisor's signature as written supervisory approval of the [trial] attorney's initial determination pursuant to section 6751(b)(1)."

Chief Counsel review of draft notices of deficiencies

In addition to litigating Tax Court cases, Chief Counsel attorneys also review certain notices of deficiencies before they are issued. If a Chief Counsel attorney seeks to add a penalty to a notice of deficiency he is reviewing, the *Graev* Notice provides that the following should happen: (1) the Chief Counsel attorney prepares a memorandum for his supervisor's signature, (2) the signed memorandum goes to the examiner, (3) the examiner documents his acceptance of the penalty, and (4) the examiner's immediate supervisor approves the examiner's acceptance of the penalty in writing.

District court refund cases

When a taxpayer files a refund case in a U.S. district court or the Court of Federal Claims, Chief Counsel attorneys write defense letters to the Department of Justice setting forth the facts and legal grounds for defending the suits. Per the *Graev* Notice, the defense letters must address whether § 6751 applies and, if so, whether the IRS complied with it. In the defense letter, the attorney should identify the document with the supervisor's approval.

The *Graev* Notice provides that the defense letter should also address whether the taxpayer raised § 6751(b)(1) compliance in its administrative refund claim. Generally, under the variance doctrine, taxpayers cannot raise a claim in a refund case that it did not raise in its administrative refund claim if the statute of limitations on filing on administrative claim is closed. The *Graev* Notice suggests that the IRS will argue that the variance doctrine bars the raising § 6751(b) compliance issues for the first time in a refund suit.

The *Graev* Notice also provides that § 6751(b)(1) does not apply when DOJ attorneys seek to assert penalties to offset a refund claim. The IRS maintains that the United States does not need to prove compliance with § 6751(b)(1) when asserting an offset because "the United States can retain any amount that the Service could have assessed on audit."

Penalties in the alternative

The IRS suggests in the *Graev* Notice that penalties asserted in the alternative may not need to be approved in writing by a supervisor. The *Graev* Notice provides that when one penalty has proper approval but approval is missing for a penalty in the alternative, "it may be possible to argue that approval of one penalty might function as approval of an alternative." The *Graev* Notice instructs Chief Counsel attorneys to contact IRS Procedure and Administration if they have this situation.

Tax Court: § 6751(b) doesn't apply to frivolous penalties imposed by the Tax Court

On July 3, 2018, the Tax Court addressed one of the many questions *Graev* left unanswered—the role of *Graev* in the context of frivolous argument penalties. Under section 6673(a)(1)(B), the Tax Court may impose a penalty if the taxpayer makes frivolous or groundless arguments. In *Williams v. Commissioner*, the Tax Court found that the taxpayer raised frivolous tax-protester arguments. 151 T.C. No. 1. However, before imposing the penalty, the Tax Court had to determine whether, under *Graev*, a frivolous penalty has to have comply with the supervisory approval requirement in § 6751(b)(1).

After analyzing the legislative history behind § 6751 and § 6673, the court concluded that § 6751(b)(1) does not apply to the Tax Court when it imposes penalties under § 6673(a)(1). The court held that Congress enacted § 6673 to enable the Tax Court to "combat frivolous litigation and reduce its congested docket." Whereas Congress enacted § 6751 to "prevent the IRS from

improperly using penalties that are within its power to determine in order coerce settlements." Because 6751(b) was "clearly not intended as a mechanism to restrain the Tax Court," the Tax Court found it did not apply to penalties imposed by the Tax Court.

What these recent developments mean for taxpayers

Based on the *Graev* Notice, taxpayers litigating a case involving a non-computer generated penalty should: (1) seek evidence that the penalty's initial determination was approved in writing by a supervisor and (2) raise compliance with § 6751(b)(1) in administrative refund claims to avoid issues with the variance doctrine.

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