

CLIENT ALERT

Tax Court Rules That It Has Jurisdiction to Review Whether Penalties Have Been Authorized

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In light of recent decisions, taxpayers should demand proof from the IRS that it has the requisite authority for asserting a penalty. In *Graev v. Commissioner (Graev III)*, 149 T.C. No. 23 (December 20, 2017), the Tax Court held that (1) penalties cannot be imposed without the requisite supervisory approval and (2) the court had authority to determine whether the IRS had obtained such approval. The Tax Court's conclusion was unsurprising—the case was appealable to the Second Circuit which recently held the same. What is surprising is that the Tax Court did not limit its decision to only those cases appealable to the Second Circuit.

Applicable statute

Section 6751 of the Internal Revenue Code imposes procedural requirements on the IRS when it assesses a penalty. Section 6751(b) provides that “[n]o 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) applies to all penalties, except computer-generated penalties, including failure to file and failure to pay penalties and estimated tax penalties.

The issue in *Graev III* focuses on the ambiguous phrase the “initial determination of such assessment.” The phrase is confusing because of its use of *assessment*—a term defined by and frequently used in the Internal Revenue Code. *Assessment* is defined as the formal recording of a tax liability on the IRS's books. Section 6751(b) is unclear in the context of that definition—there cannot be an “initial determination of such assessment” because assessments are not determined. Tax liabilities, not assessments, are determined; assessments merely record those determinations.

The assertion of penalties in *Graev III*

The case arose from the IRS's disallowance of a married couple's deductions for cash and noncash charitable contributions. The IRS asserted three different penalties, at different times, against the taxpayers. In the proposed notice of deficiency, the revenue agent proposed a 40 percent gross valuation misstatement penalty for the noncash charitable contribution. The revenue agent's immediate supervisor approved.

When the notice of proposed deficiency was reviewed by a Chief Counsel attorney, the attorney recommended, as an alternative position, that a 20 percent accuracy-related penalty be included with respect to the disallowed noncash contribution. The Chief Counsel attorney's immediate supervisor approved.

When the case was in Tax Court, the IRS conceded the 40 percent penalty with respect to the noncash contribution and amended its answer to assert for the first time a 20 percent accuracy-related penalty with respect to the disallowed cash contribution.

The taxpayers' attempt to challenge the penalties

In *Graev v. Commissioner (Graev I)*, 140 T.C. 377 (2013), the Tax Court disallowed the charitable contribution deductions. The taxpayer argued the penalties were barred because the IRS did not obtain the proper approval for the penalties as required by § 6751(b). In *Graev v. Commissioner (Graev II)*, 147 T.C. No. 16 (Nov. 30, 2016), a split Tax Court concluded because the penalty had not yet been assessed, the issue was not ripe. The Tax Court stated the issue would not be ripe until the penalty was assessed in alleged violation of the supervisory-approval requirement.

Within months of *Graev II*, the Second Circuit reached the opposite conclusion. In *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), the Second Circuit found the phrase “initial determination of such assessment” ambiguous. The court looked the legislative history, which provided that Congress enacted § 6751(b) to prevent IRS agents from threatening unjustified penalties. Based on that intent, the Second Circuit held that the written approval requirement of § 6751(b) is an element of the penalty claim and is properly before the Tax Court in a deficiency proceeding. The Second Circuit held the IRS has the burden of proving it complied with § 6751(b) as part of its *prime facie* penalty case.

Following *Chai*, the Tax Court vacated *Graev II* and ordered additional briefing.

Tax Court's reversal on its authority to review

On December 20, 2017, a split Tax Court reversed its position in *Graev II* and followed the Second Circuit in *Chai*. Given that the case was appealable to the Second Circuit, this was expected. However, in a surprising decision, the Tax Court reversed its position in *Graev II* for all taxpayers, not just those in the Second Circuit.

The majority's opinion lacks substantial analysis. The majority simply announced that, “[h]aving considered the opinion of the Court of Appeals for the Second Circuit in *Chai*, and in the interest of repose and uniformity on an issue that touches many cases before us,” it vacates *Graev II* and holds it has authority to consider § 6751(b) issues in deficiency proceedings.

Judge Holmes agreed that the Tax Court had to follow *Chai* in this particular case because it is appealable to the Second Circuit. But he disagreed that *Chai* is the proper result. In his concurrence in result only opinion, he warned against “[a]dopting this reading as our own, and rolling it out nationwide” as it will have unintended and irrational consequences.

The merits

As can happen with jurisdictional fights, the taxpayers won the battle, but lost the war. After deciding it could hear the taxpayers' argument, the majority of the Tax Court concluded the IRS followed proper approval procedures and upheld the penalties.

Six judges dissented from the majority on this issue. The dissent maintained that the Chief Counsel attorney reviewing the proposed notice of deficiency had only the authority to advise or recommend and, therefore, “the attorney's recommendation to assert a penalty is not the initial determination that must be approved in writing.”

Bottom line

When the IRS asserts a non-computer-generated penalty, taxpayers should demand proof from the IRS that a proper initial determination was made and that the requisite supervisory approval was obtained. If the IRS fails to present evidence that it complied with § 6751(b), the Second Circuit and the Tax Court will not sustain the penalty.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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