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

Internal Revenue Code (IRC) § 6662(b)(1) and (2) authorizes the IRS to impose a penalty if a taxpayer's negligence or disregard of rules or regulations causes an underpayment of tax required to be shown on a return, or if an underpayment exceeds a computational threshold called a substantial understatement, respectively. IRC § 6662(b) also authorizes the IRS to impose the accuracy-related penalty on an underpayment of tax in six other circumstances.¹

TAXPAYER RIGHTS IMPACTED²

- *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*

PRESENT LAW

The amount of an accuracy-related penalty equals 20 percent of the portion of the underpayment attributable to the taxpayer's negligence or disregard of rules or regulations, or to a substantial understatement.³ An underpayment is the amount by which any tax imposed by the IRC exceeds the excess of:

The sum of (A) the amount shown as the tax by the taxpayer on his return, plus (B) amounts not shown on the return but previously assessed (or collected without assessment), over the amount of rebates made.⁴

In computing the amount of underpayment for accuracy-related penalty purposes, Congress changed the law in 2015 to provide that the excess of refundable credits over the tax is taken into account as a negative

1 Internal Revenue Code (IRC) § 6662(b)(3) authorizes a penalty for any substantial valuation misstatement under chapter 1 (IRC §§ 1-1400U-3); IRC § 6662(b)(4) authorizes a penalty for any substantial overstatement of pension liabilities; IRC § 6662(b)(5) authorizes a penalty for any substantial estate or gift tax valuation understatement; IRC § 6662(b)(6) authorizes a penalty when the IRS disallows the tax benefits claimed by the taxpayer when the transaction lacks economic substance; IRC § 6662(b)(7) authorizes a penalty for any undisclosed foreign financial asset understatement; and IRC § 6662(b)(8) authorizes a penalty for any inconsistent estate basis. IRC § 6662(b)(8) was added by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, § 2004(c)(1), 129 Stat. 443, 456 (2015). We have chosen not to cover the IRC § 6662(b)(3)-(8) penalties in this report, as these penalties were not litigated nearly as often as IRC § 6662(b)(1) and 6662(b)(2) during the period we reviewed.

2 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the IRC. See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

3 IRC § 6662(b)(1) (negligence/disregard of rules or regulations); IRC § 6662(b)(2) (substantial understatement of income tax).

4 IRC § 6664(a).

amount.⁵ Therefore, for returns filed after December 18, 2015, or for returns filed on or before that date for which the period of limitations on assessment under IRC § 6501 has not expired, a taxpayer can be subject to an IRC § 6662 underpayment penalty based on a refundable credit that reduces tax below zero.

The IRS may assess penalties under IRC § 6662(b)(1) and 6662(b)(2), but the total penalty rate generally cannot exceed 20 percent (*i.e.*, the penalties are not “stackable”).⁶ Generally, taxpayers are not subject to the accuracy-related penalty if they establish that they had reasonable cause for the underpayment and acted in good faith.⁷

Negligence

The IRS may impose the IRC § 6662(b)(1) negligence penalty if it concludes that a taxpayer’s negligence or disregard of the rules or regulations caused the underpayment. A taxpayer will be subject to the negligence component of the penalty only on the portion of the underpayment attributable to negligence. If a taxpayer wrongly reports multiple sources of income, for example, some errors may be justifiable mistakes, while others might be the result of negligence; the penalty applies only to the latter.

Negligence is defined to include “any failure to make a reasonable attempt to comply with the provisions of this title, and the term ‘disregard’ includes any careless, reckless, or intentional disregard.”⁸ Negligence includes a failure to keep adequate books and records or to substantiate items that give rise to the underpayment.⁹ Strong indicators of negligence include instances where a taxpayer failed to report income on a tax return that a payor reported on an information return,¹⁰ as defined in IRC § 6724(d)(1),¹¹ or failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion.¹² The IRS can also consider various other factors in determining whether the taxpayer’s actions were negligent.¹³

Substantial Understatement

Generally, an “understatement” is the difference between (1) the correct amount of tax and (2) the tax reported on the return, reduced by any rebate.¹⁴ Understatements are further reduced by the portion

5 IRC § 6664(a). Prior to December 18, 2015, refundable credits could not reduce below zero the amount shown as tax by the taxpayer on a return. See *Rand v. Comm’r*, 141 T.C. 376 (2013). On December 18, 2015, Congress enacted a law that reversed the Tax Court’s decision in *Rand* and amended IRC § 6664(a) to be consistent with the rule of IRC § 6211(b)(4). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title II, § 209, 129 Stat. 2242, 3084 (2015).

6 Treas. Reg. § 1.6662-2(c). The penalty rises to 40 percent if any portion of the underpayment is due to a gross valuation misstatement (IRC § 6662(h)(1); Treas. Reg. § 1.6662-5(a)), a nondisclosed noneconomic substance transaction (IRC § 6662(i)(1)), or an undisclosed foreign financial asset understatement (IRC § 6662(j)(3)).

7 IRC § 6664(c)(1).

8 IRC § 6662(c).

9 Treas. Reg. § 1.6662-3(b)(1).

10 Treas. Reg. § 1.6662-3(b)(1)(i). But see *Portillo v. Comm’r*, 928 F.2d 1128 (5th Cir. 1991), *rev’g in part, aff’g in part, remanding* T.C. Memo. 1990-68, which involved an assessment based solely on an information return submitted by a third party and held that the presumption of correctness does not apply to the IRS’s deficiency assessment in a case involving unreported income if the IRS cannot present any evidence supporting the determination.

11 IRC § 6724(d)(1) defines an information return by cross-referencing various other sections of the IRC that require information returns (*e.g.*, IRC § 6724(d)(1)(A)(ii) cross-references IRC § 6042(a)(1) for reporting of dividend payments).

12 Treas. Reg. § 1.6662-3(b)(1)(ii).

13 These factors include the taxpayer’s history of noncompliance; the taxpayer’s failure to maintain adequate books and records; actions taken by the taxpayer to ensure the tax was correct; and whether the taxpayer had an adequate explanation for underreported income. Internal Revenue Manual (IRM) 4.10.6.2.1, *Negligence* (May 14, 1999). See also IRM 20.1.5.2.2, *Common Features of Accuracy-Related and Civil Fraud Penalties* (Dec. 13, 2016).

14 IRC § 6662(d)(2)(A)(i)-(ii).

attributable to (1) an item for which the taxpayer had substantial authority or (2) any item for which the taxpayer, in the return or an attached statement, adequately disclosed the relevant facts affecting the item's tax treatment and the taxpayer had a reasonable basis for the tax treatment.¹⁵ For individuals, the understatement of tax is substantial if it exceeds the greater of \$5,000 or ten percent of the tax that must be shown on the return for the taxable year.¹⁶ For corporations (other than S corporations or personal holding companies), an understatement is substantial if it exceeds the lesser of ten percent of the tax required to be shown on the return for the taxable year (or, if greater, \$10,000), or \$10,000,000.¹⁷

For example, if the correct amount of tax is \$10,000 and an individual taxpayer reported \$6,000, the substantial underpayment penalty under IRC § 6662(b)(2) would not apply because although the \$4,000 shortfall is more than ten percent of the correct tax, it is less than the fixed \$5,000 threshold. Conversely, if the same individual reported a tax of \$4,000, the substantial understatement penalty would apply because the \$6,000 shortfall is more than \$5,000, which is the greater of the two thresholds.

Reasonable Cause and Good Faith

The accuracy-related penalty does not apply to any portion of an underpayment where the taxpayer acted with reasonable cause and in good faith.¹⁸ A reasonable cause determination takes into account all of the pertinent facts and circumstances.¹⁹ Generally, the most important factor is the extent to which the taxpayer made an effort to determine the proper tax liability.²⁰ Reliance on a return preparer may constitute reasonable cause and good faith if the reliance was reasonable and the taxpayer acted in good faith.²¹ *Neonatology Associates v. Commissioner* establishes the three-part test for reasonable reliance on a tax professional in accuracy-related penalty cases:

- (1) The adviser was a competent professional who had sufficient expertise to justify reliance;
- (2) The taxpayer provided necessary and accurate information to the adviser; and
- (3) The taxpayer actually relied in good faith on the adviser's judgment.²²

Reasonable Basis

An understatement of tax may be reduced by any portion of the understatement attributable to an item for which the tax treatment is adequately disclosed and supported by a reasonable basis.²³ This standard is met if the taxpayer's position reasonably relies on one or more authorities listed in Treas. Reg. § 1.6662-4(d)(3)(iii).²⁴ Applicable authority could include information such as sections of the IRC; proposed, temporary, or final regulations; revenue rulings and revenue procedures; tax treaties and

15 IRC § 6662(d)(2)(A)(i) - (ii). No reduction is permitted, however, for any item attributable to a tax shelter. See IRC § 6662(d)(2)(C)(i). If a return position is reasonably based on one or more of the authorities set forth in Treas. Reg. § 1.6662-4(d)(3)(iii), the return position will generally satisfy the reasonable basis standard. This may be true even if the return position does not satisfy the substantial authority standard found in Treas. Reg. § 1.6662-4(d)(2). See Treas. Reg. § 1.6662-3(b)(3).

16 IRC § 6662(d)(1)(A)(i)-(ii).

17 *Id.* S corporations and personal holding companies are subject to the same thresholds as individuals and all other non-C corporation taxpayers, found in IRC § 6662(d)(1)(A)(i)-(ii).

18 IRC § 6664(c)(1).

19 Treas. Reg. § 1.6664-4(b)(1).

20 *Id.*

21 Treas. Reg. § 1.6664-4(b).

22 115 T.C. 43, 99 (2000) (citations omitted), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

23 IRC § 6662(d)(2)(B)(ii)(I), (II).

24 Treas. Reg. § 1.6662-3(b)(3).

regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; and congressional intent as reflected in committee reports.²⁵

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process²⁶ and through its Automated Underreporter (AUR) computer system.²⁷ Before a taxpayer receives a notice of deficiency, he or she generally has an opportunity to engage the IRS on the merits of the penalty.²⁸ Once the IRS concludes an accuracy-related penalty is warranted, it must follow deficiency procedures (*i.e.*, IRC §§ 6211-6213).²⁹ Thus, the IRS must send a notice of deficiency with the proposed adjustments and inform the taxpayer that he or she has 90 days to petition the United States Tax Court to challenge the assessment.³⁰ Alternatively, taxpayers may seek judicial review through refund litigation.³¹ Under certain circumstances, a taxpayer can request an administrative review of IRS collection procedures (and the underlying liability) through a Collection Due Process hearing.³²

IRC § 6751(b)(1) provides the general rule that no penalties may 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.” However, IRC § 6751(b)(2)(B) provides an exception for penalties calculated automatically “through electronic means.” The IRS interprets this exception as allowing it to use its AUR system to propose the

25 Treas. Reg. § 1.6662-4(d)(3)(iii).

26 IRM 4.10.6.2(1), *Recognizing Noncompliance* (May 14, 1999) (“assessment of penalties should be considered throughout the audit”). See also IRM 20.1.5.3, *Examination Penalty Assertion* (Dec. 13, 2016).

27 The Automated Underreporter (AUR) is an automated program that identifies discrepancies between the amounts that taxpayers reported on their returns and what payors reported via Form W-2, Form 1099, and other information returns. IRM 4.19.3.1, *Overview of IMF Automated Underreporter* (Aug. 26, 2016); IRM 4.19.3.16.6, *Accuracy-Related Penalty Due to Negligence or Disregard of Rules or Regulations (Negligence Disregard Penalty)* (May 19, 2017).

28 For example, when the IRS proposes to adjust a taxpayer’s liability, including additions to tax such as the accuracy-related penalty, it typically sends a notice (“30-day letter”) of proposed adjustments to the taxpayer. A taxpayer has 30 days to contest the proposed adjustments to the IRS Office of Appeals, during which time he or she may raise issues related to the deficiency, including any reasonable cause defense to a proposed penalty. If the issue is not resolved after the 30-day letter, the IRS sends a statutory notice of deficiency (“90-day letter”) to the taxpayer. See IRS Pub. 5, *Your Appeal Rights and How to Prepare a Protest if You Don’t Agree* (Jan. 1999); IRS Pub. 3498, *The Examination Process* (Nov. 2004). However, for some taxpayers, the IRS sends a “combo” letter that combines the initial contact letter and the 30-day letter, which confuses taxpayers who do not know whether they should continue working with exam, file an appeal, or both. See National Taxpayer Advocate 2011 Annual Report to Congress, vol. 2, 85-86.

29 IRC § 6665(a)(1).

30 IRC § 6213(a). A taxpayer has 150 days instead of 90 to petition the Tax Court if the notice of deficiency is addressed to a taxpayer outside of the United States.

31 Taxpayers may litigate an accuracy-related penalty by paying the tax liability (including the penalty) in full, filing a timely claim for refund, and then timely instituting a refund suit in the appropriate United States District Court or the Court of Federal Claims. 28 U.S.C. § 1346(a)(1); 28 U.S.C. § 1491; IRC §§ 7422(a); 6532(a)(1); *Flora v. United States*, 362 U.S. 145 (1960) (requiring full payment of tax liabilities as a prerequisite for jurisdiction over refund litigation).

32 IRC §§ 6320 and 6330 provide for due process hearings in which a taxpayer may raise a variety of issues, including the underlying liability, provided the taxpayer did not actually receive a statutory notice of deficiency or did not otherwise have an opportunity to dispute such liability. IRC §§ 6320(c), 6330(c)(2)(B).

substantial understatement and negligence components of the accuracy-related penalty without supervisor review.³³

Burden of Proof

In court proceedings involving individual taxpayers, the IRS bears the initial burden of production regarding the accuracy-related penalty.³⁴ The IRS must first present sufficient evidence to establish that the penalty was warranted.³⁵ The burden of proof then shifts to the taxpayer to establish any exception to the penalty, such as reasonable cause.³⁶ Because the reasonable basis standard is a higher standard to meet than reasonable cause, it is possible that a taxpayer may obtain relief from a penalty assessment by successfully arguing a reasonable cause defense, even if that defense does not satisfy the reasonable basis standard.³⁷

ANALYSIS OF LITIGATED CASES

We identified 138 opinions issued between June 1, 2016 and May 31, 2017, where taxpayers litigated the negligence or disregard of rules or regulations or the substantial understatement components of the accuracy-related penalty. The IRS prevailed in full in 111 cases (80 percent), taxpayers prevailed in full in 22 cases (16 percent), and five cases (four percent) were split decisions. Table 1 in Appendix 3 provides a detailed list of these cases. In last year's Annual Report to Congress, we reported an uptick in the number of split decisions; however, during the period covered by this report, split decisions declined to below recent years' levels.³⁸

Taxpayers appeared *pro se* (without representation) in 84 of the 138 cases (61 percent). *Pro se* taxpayers convinced the court to dismiss or reduce the penalty in only 17 percent of those 84 cases, which is slightly below the overall success rate for taxpayers challenging these penalties. In some cases, the court found taxpayers liable for the accuracy-related penalty but failed to clarify whether it was for negligence under IRC § 6662(b)(1) or a substantial understatement of tax under IRC § 6662(b)(2), or both. Regardless of the subsection at issue, the analysis of reasonable cause is generally the same. As such, we have combined our analyses of reasonable cause for the negligence and substantial understatement cases.

33 If a taxpayer responds to an AUR-proposed assessment, the IRS first involves its employees at that point to determine whether the penalty is appropriate. If the taxpayer does not respond timely to the notice, the computers automatically convert the proposed penalty to an assessment without managerial review. See National Taxpayer Advocate 2014 Annual Report to Congress 404-10 (Legislative Recommendation: *Managerial Approval: Amend IRC § 6751(b) to Require IRS Employees to Seek Managerial Approval Before Assessing the Accuracy-Related Penalty Attributable to Negligence under IRC § 6662(b)(1)*); National Taxpayer Advocate 2007 Annual Report to Congress 259 (“Although automation has allowed the IRS to more efficiently identify and determine when such underreporting occurs, the IRS’s over-reliance on automated systems rather than personal contact has led to insufficient levels of customer service for taxpayers subject to AUR. It has also resulted in audit reconsideration and tax abatement rates that are significantly higher than those of all other IRS examination programs.”).

34 IRC § 7491(c) provides that “the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title.”

35 *Higbee v. Comm’r*, 116 T.C. 438, 446 (2001); IRC § 7491(c).

36 IRC § 7491(a). See also Tax Ct. R. 142(a).

37 Treas. Reg. § 1.6662-3(b)(3).

38 During the 2016 reporting period, 16 out of the 122 total cases (13 percent) were split decisions. National Taxpayer Advocate 2016 Annual Report to Congress 432. During the 2015 period, six cases (five percent of the total) were split and during the 2014 period, ten cases (seven percent of the total) were split. National Taxpayer Advocate 2015 Annual Report to Congress 450; National Taxpayer Advocate 2014 Annual Report to Congress 446.

Requirement for Managerial Approval Prior to Assessment of Penalties

There were two significant decisions during our reporting period regarding the IRC § 6751(b)(1) requirement to have a supervisor approve the penalties in writing prior to assessment.

*Graev v. Commissioner*³⁹

The Graevs claimed a charitable deduction for the donation of a facade easement. A revenue agent disallowed the deduction and proposed penalties. The agent's manager approved a 40 percent gross valuation misstatement penalty under IRC § 6662(h). IRS Counsel subsequently recommended the IRS assert, in the alternative, the 20 percent accuracy-related penalty under IRC § 6662(a). The revenue agent revised the notice of deficiency to include both penalties, as recommended, but did not resubmit it for written supervisory approval. In litigation, the IRS conceded the 40 percent penalty, but continued to assert the 20 percent penalty.

In a motion for partial summary judgment, the Graevs argued that the IRS could not assess the 20 percent penalty because, among other things, it failed to comply with the IRC § 6751(b)(1) requirement for supervisory approval of the initial determination of assessment. The Graevs argued that the 20 percent penalty was not “determined” by the revenue agent and approved by his immediate supervisor, and the IRS Counsel's later “determination” was insufficient.⁴⁰

The IRS made four counterarguments:

1. Because the IRS had not yet assessed the penalty, it is premature to consider whether it satisfied IRC § 6751(b).
2. The IRS Counsel attorney made the initial determination, was authorized to do so, and received approval in writing from his immediate supervisor.
3. Any perceived noncompliance with IRC § 6751(b) is harmless error because the Court's redetermination of the penalty will prevent improper penalty assessment.
4. Even if the penalty could not be assessed based on the notice of deficiency, it could still be assessed based on its being raised in the IRS's amendment to its answer, pursuant to IRC § 6214(a).

Focusing on the plain language of the statute, a majority of the U.S. Tax Court held that it was premature to conclude that the IRS had failed to comply with the supervisory approval requirement because the penalty had not yet been assessed. The written approval of the initial determination of the assessment could occur at any time before the assessment is made. In this case, the assessment could not happen until the Tax Court's decision became final and unappealable. The majority discounted the IRS's administrative procedures, which require supervisory approval to be documented in an examiner's workpapers, as non-binding. Further, the majority argued that the effective date provision of the statute, as well as the title of the section, focussed on assessment rather than an initial determination.

Three judges concurred with the result. They said the failure to obtain managerial approval did not prejudice the taxpayers because the penalties were appropriate and not used as a threat or bargaining chip. They also noted that the IRS's failure to follow its existing procedures could be challenged as an abuse of discretion in a collection action.

³⁹ *Graev v. Comm'r*, 147 T.C. No. 16 (2016), *vacated*, No. 30638-08 (T.C. Mar. 30, 2017).

⁴⁰ *Id.*

Five judges dissented. According to the dissent, “[t]he fact that a rule is cast as a bar on ‘assessment’ does not preclude pre-assessment consideration of compliance with that rule.”⁴¹ The dissent compared the situation where a taxpayer challenges a deficiency on the grounds that assessment is barred due to the statute of limitations. In that situation, the Tax Court does not treat such a challenge as premature, even though an assessment has not occurred. The dissent held that part of the IRS’s burden of production under IRC § 7491(c) in penalty deficiency cases is showing compliance with IRC § 6751(b). Moreover, the statute requires approval by a revenue agent’s supervisor at a time when the supervisor still has the ability to approve or disapprove the penalty. Such approval would be meaningless once the taxpayer petitions the Tax Court because IRC § 6215(a) provides that the liability, as determined by the Tax Court, “shall be assessed,” and IRC § 7803(b)(2)(D) provides that the Office of Chief Counsel, not examination, represents the IRS before the court. The dissent further argued that the majority’s interpretation would fail to accomplish the purpose of the statute, which is to prevent penalties from being imposed inappropriately and being used as bargaining chips.

The IRS requested, and the Tax Court agreed, to vacate the *Graev* decision after the Second Circuit’s decision in *Chai* (discussed immediately below) as *Graev* was appealable to the Second Circuit.⁴²

*Chai v. Commissioner*⁴³

In *Chai*, the United States Tax Court had previously found Mr. Chai owed self-employment tax and an accuracy-related penalty in connection with income he earned for his role in a tax shelter scheme.⁴⁴ After the Tax Court proceeding, Chai argued for the first time in a post-trial brief that the accuracy-related penalty did not apply because the IRS had not met its burden of production. IRC § 7491(c) provides that “the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title.” The taxpayer argued that the IRS did not introduce evidence that a supervisor approved the revenue agent’s initial determination to assert the penalty, as required by IRC § 6751(b)(1). The Tax Court declined to address this new argument because doing so after the trial would prejudice the IRS, as it could no longer introduce evidence that it had complied with IRC § 6751(b)(1).

On appeal before the United States Court of Appeals for the Second Circuit, the IRS first argued that the substantial understatement penalty was “a type” of penalty “automatically calculated through electronic means,” and thus exempt from the supervisory approval requirement.⁴⁵ The Second Circuit observed that an IRS employee had actually determined (1) to assess the penalty, and (2) that the taxpayer did not have reasonable cause.⁴⁶ The Second Circuit found no evidence that the determination was or could have been made electronically through the AUR program, noting this was particularly the case for an IRC § 6662(b)(1) penalty, which is based on a taxpayer’s negligence.⁴⁷

41 *Graev v. Comm’r*, 147 T.C. No. 16 (2016) (Gustafson, J., dissenting), *vacated*, No. 30638-08 (T.C. Mar. 30, 2017).

42 *Id.* *Chai v. Comm’r*, 851 F.3d 190 (2d Cir. 2017).

43 *Chai v. Comm’r*, 851 F.3d 190 (2d Cir. 2017).

44 *Chai v. Comm’r*, T.C. Memo. 2015-42.

45 IRC § 6751(b)(2)(B). The National Taxpayer Advocate has long opposed the IRS’s expansive view of this exception. See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress 275 (Most Serious Problem: *The Accuracy-Related Penalty in the Automated Underreporter Units*); National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, 16-18 (A Framework for Reforming the Penalty Regime).

46 *Chai*, 851 F.3d at 217.

47 *Id.*

While this appeal was pending, the Tax Court decided *Graev*, discussed above, and the IRS then adopted the argument that the issue was not ripe since no assessment had occurred.⁴⁸ The Second Circuit held that (1) IRC § 6751(b)(1) requires a supervisor to approve an IRS employee's penalty determination before the IRS first asserts penalties by issuing a notice of deficiency (or filing an answer or amended answer), and (2) the IRS has the burden to establish that it complied with IRC § 6751(b)(1) in deficiency cases under IRC § 7491(c).

First, the Second Circuit concluded that IRC § 6751(b)(1) was ambiguous because, quoting the dissent in *Graev*, “one cannot ‘determine’ an ‘assessment.’”⁴⁹ Next, the Second Circuit considered the legislative history, which indicated the statute was intended to discourage IRS agents from threatening unjustified penalties in an effort to encourage taxpayers to settle. It found the Tax Court's review of penalty determinations does not prevent this problem because taxpayers can be pressured to settle before the Tax Court renders a decision. Further, once the Tax Court issues an opinion, the supervisor no longer has discretion to give or withhold approval of the penalty because it is final. For IRC § 6751(b)(1) to have any effect, supervisory approval must be obtained before the IRS issues a notice of deficiency (or asserts penalties in court).

The Second Circuit held the taxpayer's post-trial argument was timely. Because the supervisory approval requirement is an element of a penalty claim for which the IRS bears the burden of production, the IRS cannot establish a prima facie case for imposing a penalty unless it has established compliance with the approval requirement. The IRS could not have failed to meet its burden of production until it concluded with its presentation of evidence. Thus, the Tax Court should have considered the taxpayer's argument, even after the trial. It was not the taxpayer's obligation to alert the IRS to the elements of its claim. To hold otherwise would require taxpayers to move to dismiss each element of a claim before trial, just in case the IRS failed to make its case.⁵⁰

Together, the *Graev* and *Chai* cases signal a split between a majority of the Tax Court's judges and the Second Circuit over: (1) when IRS employees must obtain supervisory approval of penalties, and (2) whether taxpayers may challenge noncompliance with this requirement in a deficiency proceeding before the Tax Court.⁵¹

48 *Graev v. Comm'r*, 147 T.C. No. 16 (2016), vacated No. 30638-08 (T.C. Mar. 30, 2017). After the Second Circuit's decision in *Chai*, the IRS requested, and the Tax Court agreed, to vacate *Graev*, as it was appealable to the Second Circuit. *Chai*, 851 F.3d at 217.

49 *Chai*, 851 F.3d at 218-19.

50 The Second Circuit distinguished *Kaufman v. Comm'r*, 784 F.3d 56 (1st Cir. 2015), in which the First Circuit refused to consider the IRS's compliance with IRC § 6751(b) because the taxpayer raised the issue for the first time on appeal. *Chai*, 851 F.3d at 223. The Second Circuit observed that the taxpayer in *Chai* had raised the issue before the Tax Court. *Id.*

51 Under the *Golsen* rule, the Tax Court will generally follow a circuit court's precedent for cases appealable to that circuit court, but will follow its own precedent for cases appealable to other courts that have not addressed the issue. See *Golsen v. Comm'r*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). Because *Graev* was vacated, it is not precedential. But see the Tax Court's Order in *Zolghadr v. Comm'r*, T.C. Memo. 2017-49, No. 19241-14 (T.C. June 12, 2017) (recharacterizing and denying the taxpayer's motion requesting the court order the IRS to demonstrate compliance with IRC § 6751(b) because it was not timely and because the case was not appealable to the Second Circuit) (“For cases in which the appellate venue is a court of appeals other than the Second Circuit, the applicable Tax Court rule is that enunciated in *Graev v. Commissioner*, 147 T.C. No. 16 (2016) (slip. op. at *42 n. 25). Under that case, respondent has no burden of production to demonstrate compliance with section 6751(b).”). See also Keith Fogg, *Chai not Gaining Traction with Tax Court or IRS*, PROCEDURALLY TAXING, <http://procedurallytaxing.com/chai-not-gaining-traction-with-tax-court-or-irs/> (June 22, 2017).

Reasonable and Good Faith Reliance on a Competent Tax Professional

In approximately a third of the IRC § 6662(b)(1) and (2) cases which TAS reviewed this year, the court discussed whether or not the taxpayer established reasonable cause based on reasonable reliance on a tax professional. The taxpayer prevailed in whole or in part in approximately 32 percent of these cases, which is noticeably higher than the 20 percent overall success rate for challenging section 6662(b)(1) and (2) penalties in the cases which TAS reviewed. This success rate for litigating reasonable reliance on a tax professional is inconsistent with an Internal Revenue Manual (IRM) instruction, which stated reliance on a tax professional generally did not qualify taxpayers for penalty relief because it did not demonstrate ordinary business care and prudence.⁵² As a result of TAS's advocacy, the language was removed from the IRM in late 2016.⁵³

Exelon v. Commissioner

In *Exelon*, the corporate taxpayer, Unicom Corporation, sought to defer recognition of gain on the sale of its fossil fuel power plants by engaging in an alleged like-kind exchange under IRC § 1031.⁵⁴ Unicom participated in six transactions that the IRS labeled as sale-in/lease-out (SILO), where tax-exempt governmental entities leased power stations to the taxpayer for a period longer than their useful life (qualifying the transaction as a sale), and the taxpayer then leased these stations back to the tax-exempt entities with an end-of-term fixed purchase option.⁵⁵ The taxpayer engaged numerous advisors in connection with these transactions to provide engineering and environmental analysis, appraisal of the replacement properties, financial and economic analysis, and legal and tax analysis. Winston & Strawn, LLP, the firm providing the legal and tax analysis, provided two opinion packages to the taxpayer totaling over 700 pages, stating that the transactions should be treated as valid like-kind exchanges under IRC § 1031. However, Winston & Strawn separately warned the taxpayer that the IRS had recently released guidance on lease-in/lease-out (LILO) transactions, and there was a risk the proposed transaction could be classified as a corporate tax shelter.

The U.S. Tax Court concluded that the transactions did not transfer the benefits and burdens of ownership to the taxpayers, leading to them being characterized as loans and not leases. As a result, Unicom exchanged power plants for interests in financial instruments, which does not meet the requirements for a like-kind exchange under IRC § 1031.

To determine whether Unicom was liable for the IRC § 6662(b)(1) penalty for negligence, the court applied the three-prong test from *Neonatology v. Commissioner*.⁵⁶ Unicom satisfied the first prong, requiring the advisor to be a competent professional with sufficient expertise, with the court noting there was no evidence of conflict of interest. The taxpayer also satisfied the second prong, requiring the

52 IRM 4.19.3.16.6, *Accuracy-Related Penalty Due to Negligence or Disregard of Rules or Regulations (Negligence Disregard Penalty)* (Dec. 12, 2014) ("Generally, reasons such as forgetfulness, ignorance of the law, mistakes (e.g., the taxpayer preparer forgot to include the income or thought the income was nontaxable) or reliance on Professional Tax Advice/Tax Preparation Software do not qualify for penalty relief because these actions do not demonstrate ordinary business care and prudence."). In contrast, IRM 20.1.5.6.4, *Reliance on Advice* (Dec. 13, 2016), provides a thorough explanation of what constitutes reasonable reliance on a return preparer. IRM chapter 4 pertains to IRS examination employees, and chapter 20 pertains to all employees who work with penalties.

53 IRM 4.19.3.16.6, *Accuracy-Related Penalty Due to Negligence or Disregard of Rules or Regulations (Negligence Disregard Penalty)* (Aug. 26, 2016). See TAS Internal Management Document (IMD) 2224 (Jan. 6, 2016).

54 147 T.C. No. 9 (2016), *appeal docketed*, No. 17-2964 (9th Cir. Sept. 22, 2017). *Exelon Corp.*, the petitioner in this case, was the successor by merger to Unicom and its consolidated subsidiaries.

55 For a detailed discussion of sale-in/lease out (SILO) transactions, see Robert W. Wood, Steven E. Hollingsworth, *SILOs and LILOs Demystified*, 129 TAX NOTES 195 (Oct. 11, 2010).

56 115 T.C. 43 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

taxpayer to provide necessary and accurate information, because the parties did not dispute the advisor was closely involved in the transactions and knew all relevant facts.

However, the court concluded Unicom failed the third prong by not showing that it relied in good faith on the advisor's judgment. The court found that Unicom should have known that the tax-exempt entities were reasonably likely to exercise their cancellation/purchase options because they would not be able to return the power plants to Unicom under the return requirements without significant expense. It noted Winston & Strawn "interfered with the integrity and independence of the appraisal process by providing Deloitte [the firm providing the appraisal] with a list of conclusions it expected to see in the appraisals to be able to issue tax opinions at the 'will' and 'should' level."⁵⁷ Winston & Strawn's positive tax opinion ignored an obvious inconsistency between the power plant capacity requirements for returning the power plants to the taxpayer and the power plant capacity factor used in the appraisal. Because the taxpayer was a sophisticated power plant operator, it should have understood that the tax opinions, based on the appraisals, were flawed. Finally, the Tax Court noted that the taxpayer was apprised of the risk that the transactions would be classified as a corporate tax shelter, yet registered them with the IRS close to the time it entered into the transactions. Although Unicom paid significant due diligence and consulting fees, the court likened this to paying for an insurance policy against penalties.

*Boree v. Commissioner*⁵⁸

In *Boree*, a former logger, Mr. Boree, established Glen Forest, LLC with a partner (who was later replaced by Mrs. Boree) to acquire and develop real property. Glen Forest acquired 1,892 acres, which it planned to develop into approximately 100 lots. However, beginning approximately two years after Glen Forest purchased the land, the County Board of Commissioners adopted some land-use restrictions that would require Glen Forest to pay approximately \$11.4 million to pave internal and connecting roads to the development.⁵⁹ Glen Forest revised its development strategy to justify these costs by pursuing higher density development. Between 2002 and 2006, Glen Forest sold approximately 600 of the acres, and upon learning a successful developer was developing an adjacent property, Glen Forest sold the remainder of the property in 2007.

The United States Court of Appeals for the Eleventh Circuit upheld the Tax Court's determination of the taxpayers' liability, agreeing with the IRS that the taxpayers' income was ordinary income and not capital gains. However, the Eleventh Circuit reversed the Tax Court's determination that the Borees were liable for the IRC § 6662(b)(2) accuracy-related penalty. The Eleventh Circuit noted that the Tax Court did not elaborate on its finding that the taxpayers did not establish reasonable cause and good faith. The Eleventh Circuit found the taxpayers reasonably relied on professional tax advice because Mr. Boree was a former logger with no accounting experience, the return was prepared by a reputable accounting firm that the taxpayers had used since 1998, and Mrs. Boree personally provided the accountant with information and records she kept relating to all of the land transactions. Because the Borees were untrained in tax matters, it was reasonable for them to rely on their accountant, even though the accountant made the seemingly obvious error of claiming business expense deductions for the same activity for which she claimed capital gains.

57 *Exelon v. Comm'r*, 147 T.C. No. 9 (2016), *appeal docketed*, No. 17-2964 (9th Cir. Sept. 22, 2017).

58 837 F.3d 1093 (11th Cir. 2016), *rev'g* T.C. Memo. 2014-85.

59 *Boree*, 837 F.3d at 1096-97.

*Tsehay v. Commissioner*⁶⁰

In *Tsehay*, the taxpayer was a custodian at a community college and did not speak English as his first language. During tax year 2013, the taxpayer and his wife were married and living together with their five children in a public housing apartment, and separated at some point in 2014. The taxpayer's 2013 return claimed dependency exemptions, the Earned Income Tax Credit (EITC), and the Child Tax Credit (CTC). Because the taxpayer was separated at the time he filed his 2013 return, he asked his preparer to file his return married filing separately, but the preparer erroneously filed the return as head of household.

The Tax Court found the taxpayer was eligible for dependency exemptions for the children, EITC, and CTC, but not head of household status because he was married during the 2013 tax year. However, the accuracy-related penalty was not appropriate because the taxpayer qualified for the reasonable cause and good faith exception to the accuracy-related penalty based on reasonable reliance on a return preparer. The court relied on the facts that “the [taxpayer] had a language barrier, sought and relied on professional advice, and was separated from his wife when he actually filed his return.”⁶¹

Access to Tax Law Help

*Larkin v. Commissioner*⁶²

The taxpayers (Mr. and Mrs. Larkin) challenged the IRS's statutory notices of deficiency for tax years 2003 through 2006. Mr. Larkin worked as a partner at a multinational law firm in the United Kingdom (U.K.) and operated a real estate business as a sole proprietor on the side. The U.S. Tax Court held, among other holdings, that the taxpayers were not entitled to various deductions related to Mr. Larkin's self-employment as a consultant and real estate developer; the taxpayers were liable for self-employment taxes related to the husband's partnership interest in the law firm; and the taxpayers were not entitled to the foreign tax credit to offset tax reported due for the four taxable years.

The Tax Court agreed with the IRS that the taxpayers were liable for the accuracy-related penalty and rejected the taxpayers' arguments for reasonable cause. Specifically, the taxpayers argued that their returns were complicated due to Mr. Larkin's work as a law firm partner and his real estate business. Mr. Larkin testified that he sought guidance from the IRS regarding how to prepare his returns and could not find a qualified person to help him. He also testified that the revenue officer with whom he met had specifically directed him on how to report the items related to the law firm, the real estate business, and the exclusion from income. He testified that he filed his returns on that basis.

However, the court was not convinced that the revenue officer had directed Mr. Larkin regarding how to file the returns, finding no notes, records, or other tangible evidence. The court also did not accept Mr. Larkin's testimony that he tried but failed to find a qualified professional with knowledge of U.S. and U.K. tax regimes to advise him. The court noted that the taxpayers had been residing abroad since 1999 and explained that the understatements of tax arose largely from a simple failure to substantiate items on their returns and report income of which they were aware.⁶³ Interestingly, the court did not rebut the taxpayers' arguments for reasonable cause based on the arguments themselves, but instead rebutted them based on the specific facts of the taxpayers' case, leaving open the possibility that reliance on IRS advice,

60 T.C. Memo. 2016-200.

61 *Id.*

62 T.C. Memo. 2017-54.

63 *Id.*

inaccessibility of a knowledgeable IRS employee or qualified professional, complexity of the tax law, and difficulties for taxpayers residing abroad could be used to argue reasonable cause.⁶⁴

CONCLUSION

The accuracy-related penalty under IRC § 6662(b)(1) and (2) remains the number one most litigated tax issue, continuing a trend from the last four years. Two cases from this year have the potential for far-reaching effects in accuracy-related penalty cases, as well as in other penalty cases. *Chai* establishes for the first time that, at least in the Second Circuit, the IRS has the burden of producing evidence that it obtained supervisory approval of penalties in any case where the supervisory approval requirement applies. Although *Graev* was vacated, a Tax Court judge subsequently issued an order stating that for cases not appealable to the Second Circuit, *Graev* provided the rule for demonstrating compliance with IRC § 6751(b).⁶⁵ Thus, the split appears to remain between the majority of the Tax Court's judges and the Second Circuit over when IRS employees must obtain supervisory approval of penalties, and whether taxpayers may challenge noncompliance with this requirement in a deficiency proceeding before the Tax Court.

The potential for continuing controversy in this area highlights the need for Congress to clarify when an IRS manager should review and approve a penalty determination and the consequences of not obtaining such approval, as recommended by the National Taxpayer Advocate.⁶⁶ Although penalties calculated through electronic means are exempt from the requirement for supervisory approval, the *Chai* opinion casts doubt over whether the IRC § 6662(b)(1) penalty for negligence can be made electronically. This portion of the opinion supports the National Taxpayer Advocate's recommendation to require managerial approval for all accuracy-related penalties based on negligence. Requiring managerial approval in more cases could reduce the number of accuracy related penalties that are challenged and abated, which may have a positive effect on compliance. A 2013 TAS research study found that Schedule C filers receiving accuracy-related penalties by default assessment or who appealed the penalties actually had worse compliance for years thereafter.⁶⁷

Taxpayers' success in establishing reasonable cause based on reasonable reliance on a tax professional may suggest the IRS needs better guidance regarding when such reliance is reasonable. The National Taxpayer Advocate is optimistic that TAS's success in removing an IRM instruction,⁶⁸ which stated reliance on a tax professional generally would not qualify a taxpayer for penalty relief, will lead to proper reasonable cause determinations in more cases and further the taxpayer's *right to a fair and just tax system*.

Although not a precedential decision, the *Larkin* opinion raises interesting arguments for reasonable cause based on the taxpayer being confused about how to report items, seeking guidance from the IRS on how to report items, allegedly relying on incorrect guidance from an IRS employee, and not being able to find a qualified person to assist him. Ultimately, the Tax Court was not persuaded that the taxpayer

64 For a discussion of the taxpayer service problems for taxpayers residing abroad, see National Taxpayer Advocate 2015 Annual Report to Congress 72-81 (Most Serious Problem: *International Taxpayer Service: The IRS's Strategy for Service on Demand Fails to Compensate for the Closure of International Tax Attaché Offices and Does Not Sufficiently Address the Unique Needs of International Taxpayers*).

65 See footnote 51, *supra*.

66 See, e.g., National Taxpayer Advocate 2014 Annual Report to Congress 404-10 (Legislative Recommendation: *Amend IRC § 6751(b) to Require IRS Employees to Seek Managerial Approval Before Assessing the Accuracy-Related Penalty Attributable to Negligence under IRC § 6662(b)(1)*).

67 National Taxpayer Advocate 2013 Annual Report to Congress vol. 2, 1-14.

68 See notes 52 and 53, *supra*.

received guidance from an IRS employee and was unable to find a qualified professional, and that the understatements were the result of complex tax issues related to being employed abroad. However, this case raises the question whether declining taxpayer service for taxpayers abroad,⁶⁹ complexity of the tax code, and inability to find answers to tax law questions may give rise to a reasonable cause determination for some taxpayers challenging accuracy-related penalties.

69 See, e.g., footnote 64, *supra*.