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#3**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 We identified 79 opinions issued between June 1, 2018, and May 31, 2019, where taxpayers litigated the negligence or substantial understatement components of the accuracy-related penalty, which is a notable decrease over recent years.

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 or her return, plus (B) amounts not shown on the return but previously assessed (or collected without assessment), over the amount of rebates made.⁴ For this computation, Congress changed the law in 2015 to provide that the excess of refundable credits over the tax is taken into account as a negative amount.⁵ Therefore, for

1 IRC § 6662(b)(3) authorizes a penalty for any substantial valuation misstatement under chapter 1 (IRC §§ 1-1400Z-2); 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 also codified in the IRC. See 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).

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).

returns filed after December 18, 2015, or 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 (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. The negligence component of the penalty applies only to the portion of the underpayment attributable to negligence. 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 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 negligence.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 An understatement of tax may be reduced by any portion of the understatement attributable to an item for which there is either (1) substantial authority for the tax treatment of the item or (2) the tax treatment is adequately disclosed and supported by a reasonable basis.¹⁵ This substantial authority 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).¹⁶

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).

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 20.1.5.3.2, Common Features of Accuracy-Related and Civil Fraud Penalties (Apr. 22, 2019).

14 IRC § 6662(d)(2)(A)(i) - (ii).

15 IRC § 6662(d)(2)(B)(i) - (ii).

16 Treas. Reg. § 1.6662-3(b)(3). Applicable authority could include information such as sections of the IRC; proposed, temporary, or final regulations; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; and congressional intent as reflected in committee reports. Treas. Reg. § 1.6662-4(d)(3)(iii).

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.¹⁷ 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 \$10,000,000.¹⁸

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.¹⁹ A reasonable cause determination considers all the pertinent facts and circumstances.²⁰ Generally, the most important factor is the extent to which the taxpayer made an effort to determine the proper tax liability.²¹ Reliance on a return preparer may constitute reasonable cause and good faith if the reliance was reasonable and the taxpayer acted in good faith.²² *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.²³

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process²⁴ and through its Automated Underreporter (AUR) computer system.²⁵ 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.²⁶ Once the IRS concludes an accuracy-related penalty is warranted, it must follow deficiency procedures (*i.e.*, IRC §§ 6211-6213).²⁷ 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 U.S. Tax Court to challenge the

17 IRC § 6662(d)(1)(A)(i) - (ii). Note, however, that in the case of a taxpayer who claims a deduction allowed under IRC § 199A, the understatement of income tax is substantial if it exceeds the greater of five percent of the tax required to be shown on the return or \$5,000.

18 IRC § 6662(d)(1)(B)(i) - (ii). 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).

19 IRC § 6664(c)(1).

20 Treas. Reg. § 1.6664-4(b)(1).

21 *Id.*

22 Treas. Reg. § 1.6664-4(b).

23 115 T.C. 43, 99 (2000) (citations omitted), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

24 IRM 4.10.6.2(1), Recognizing Noncompliance (May 14, 1999) ("assessment of penalties should be considered throughout the audit"). See also IRM 20.1.5.4, Examination Penalty Assertion (Apr. 22, 2019).

25 The 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 4.19.3.2, Overview of IMF Automated Underreporter (Dec. 15, 2017); IRM 4.19.3.18.6, Accuracy-Related Penalty Due to Negligence or Disregard of Rules or Regulations (Negligence Disregard Penalty) (May 19, 2017).

26 For example, when the IRS proposes to adjust a taxpayer's liability, it typically sends a notice ("30-day letter"), which gives the taxpayer 30 days to contest the proposed adjustments to the Office of Appeals and raise issues related to the deficiency, including any reasonable cause defense to a proposed penalty. If not resolved after the 30-day letter, the IRS sends a statutory notice of deficiency ("90-day letter"). 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).

27 IRC § 6665(a)(1).

assessment.²⁸ Alternatively, taxpayers may seek judicial review through refund litigation.²⁹ Under certain circumstances, a taxpayer can request an administrative review of IRS collection procedures (and the underlying liability) through a Collection Due Process (CDP) hearing.³⁰

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 substantial understatement and negligence components of the accuracy-related penalty without supervisor review.³¹

Burden of Proof

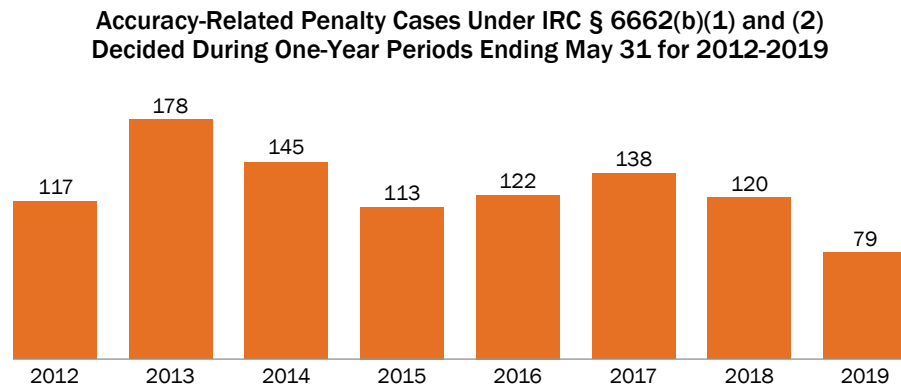
In court proceedings involving individual taxpayers, the IRS bears the initial burden of production regarding the accuracy-related penalty.³² The IRS must first present sufficient evidence to establish that the penalty was warranted.³³ The burden of proof then shifts to the taxpayer to establish a penalty exception, such as reasonable cause.³⁴

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- 28 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.
- 29 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) (generally requiring full payment of tax liabilities as a prerequisite for jurisdiction over refund litigation).
- 30 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).
- 31 If the taxpayer does not respond timely to an AUR notice proposing an assessment, the computers automatically convert the proposed penalty to an assessment without managerial review. IRM 4.19.3.21.1.4, Accuracy-Related Penalties (Sept. 30, 2018).
- 32 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.”
- 33 *Higbee v. Comm’r*, 116 T.C. 438, 446 (2001); IRC § 7491(c). See *Portillo v. Comm’r*, 932 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.
- 34 IRC § 7491(a). See also Tax Ct. R. 142(a).

ANALYSIS OF LITIGATED CASES

We identified 79 opinions issued between June 1, 2018, and May 31, 2019, where taxpayers litigated the negligence or substantial understatement components of the accuracy-related penalty. This is the lowest number of accuracy-related penalty cases in the last eight years, as shown in Figure 2.3.1.

FIGURE 2.3.1



The IRS prevailed in full in 52 cases (66 percent), taxpayers prevailed in full in 25 cases (32 percent), and two cases (three percent) were split decisions. Table 3 in Appendix 5 provides a detailed list of these cases.

Taxpayers appeared *pro se* (without representation) in 37 of the 79 cases (47 percent). *Pro se* taxpayers convinced the court to dismiss or reduce the penalties in 32 percent of these 37 cases, which is the same as the overall success rate for all 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.

Requirement for Managerial Approval Prior to Assessment of Penalties

In several past reports, we reported on significant decisions regarding the IRC § 6751(b)(1) requirement to have a supervisor approve the penalties in writing prior to the initial determination of assessment.³⁵ Of the 27 decisions we reviewed this year where taxpayers prevailed in full or in part, 19 were due to the IRS's failure to obtain written supervisory approval prior to the initial determination of assessment. This is a significant increase over last year, where only eight out of 34 decisions where taxpayers prevailed in full or in part were due to the IRS's lack of compliance with the IRC § 6751(b) supervisory approval requirement. Additionally, we noted many opinions this year that verified compliance with the supervisory approval requirement — courts verified compliance in 32 of the 54 cases where the

³⁵ See *Chai v. Comm'r*, 851 F.3d 190 (2d Cir. 2017); *Graev v. Comm'r*, 147 T.C. 460 (2016), *vacated*, Docket No. 30638-08 (T.C. Mar. 30, 2017). In late 2017, the Tax Court overruled in part its 2016 *Graev* decision and held that it was appropriate in the deficiency proceeding to consider the taxpayers' argument that the IRS failed to comply with the IRC § 6751(b)(1) supervisory approval requirement. *Graev III*, 149 T.C. 485 (2017) (This decision was the third in a series of Tax Court decisions related to the Graevs' liability for tax years 2004 and 2005).

IRS prevailed in whole or in part. The courts also discussed the supervisory approval requirement in an additional nine cases.³⁶

We reviewed a number of memorandum decisions that teased out some of the intricacies of the IRC § 6751(b) requirement.³⁷ Two decisions highlighted timing issues. In one case, the court refused to accept an undated written supervisory approval,³⁸ and in another case the IRS did not prevail when it tried to satisfy IRC § 6751(b) by reasserting the accuracy-related penalties in an amended answer and then securing supervisory approval for the amendments.³⁹ In two cases, the taxpayer sought to question the IRS about the supervisory approval. In *Raifman v. Commissioner*, in response to the IRS's motion to reopen the record to demonstrate supervisory approval, the taxpayers requested the opportunity to cross examine the revenue agent and his supervisor.⁴⁰ However, the court did not allow it, noting that the penalty approval form itself would indicate compliance with IRC § 6751(b). In *Archer v. Commissioner*, the IRS's motion to reopen the record to demonstrate IRC § 6751(b) compliance was accompanied by a declaration of the examiner, and the court permitted the taxpayer to serve on the IRS interrogatories comprised of single, definite questions directed towards the examiner's declaration.⁴¹

In some cases, the Tax Court took a strict stance with the supervisory approval requirement. In one case, the Tax Court disallowed the accuracy-related penalty because the statutory notice of deficiency only listed the IRC § 6662(b)(2) penalty based on substantial understatement, but the supervisory approval was for the negligence component of the penalty under IRC § 6662(b)(1).⁴²

Although no CDP hearing cases were included in our count of reviewed decisions because none decided the accuracy-related penalty based on the merits, we did note CDP opinions are increasingly referencing the IRC § 6751(b) requirement. In two of these CDP cases, the IRS conceded the penalty based on the settlement officer's failure to verify that the supervisory approval requirement had been met, even though the taxpayer could not challenge the liability in either of these cases.⁴³

Discussed in detail below, all four of the full Tax Court decisions issued during our reporting period include analyses of the IRS's compliance with IRC § 6751(b).

*Palmolive Building Investors, LLC v. Commissioner*⁴⁴

The taxpayer filed a Form 1065, U.S. Return of Partnership Income, claiming a \$33 million deduction for the charitable contribution of a façade easement. The IRS disallowed the deduction and asserted

36 In some of these cases, analysis of whether the IRS met its burden was unnecessary because the taxpayer established reasonable cause. In others, there was simply no analysis of how the IRS met the requirement.

37 Generally, the Tax Court issues memorandum opinions in cases that do not involve a novel legal issue. These opinions can be cited as legal authority and appealed. United States Tax Court, Taxpayer Information: After Trial, https://www.ustaxcourt.gov/taxpayer_info_after.htm (last visited Aug. 12, 2019).

38 *Shuman v. Comm'r*, T.C. Memo. 2018-135, *aff'd*, 774 F. App'x 813 (4th Cir. Aug. 15, 2019).

39 *Endeavor Partners Fund, LLC v. Comm'r*, T.C. Memo. 2018-96, *appeal docketed*, Nos. 18-1275, 18-1276, 18-1277, 18-1278 (D.C. Cir. Oct. 3, 2019).

40 *Raifman v. Comm'r*, T.C. Memo. 2018-101.

41 *Archer v. Comm'r*, T.C. Memo. 2018-111, *appeal docketed*, Nos. 19-70304, 19-70305 (9th Cir. Feb. 4, 2019). In this case, the court found that the taxpayer submitted interrogatories outside the scope of what was permitted and thus squandered the opportunity to provide a valid objection to the IRS's motion to reopen the record.

42 *Estate of Ronning v. Comm'r*, T.C. Memo. 2019-38.

43 *Ansley v. Comm'r*, T.C. Memo. 2019-46; *Ransom v. Comm'r*, T.C. Memo. 2018-211. Taxpayers can only raise the underlying liability at a collection due process hearing if taxpayer did not receive a statutory notice of deficiency for the liability or did not otherwise have an opportunity to dispute the liability. IRC § 6330(c)(2)(B).

44 152 T.C. No. 4 (2019).

multiple penalties under IRC § 6662. The Tax Court previously granted the IRS's motion for summary judgment with respect to the deduction,⁴⁵ and the taxpayer and the IRS subsequently filed competing motions, asking the court to address whether the IRS obtained supervisory approval for the penalties, required under IRC § 6751(b).

During the examination, the examiner initially asserted two penalties related to the disallowed deduction — a 40 percent gross valuation misstatement penalty under IRC § 6662(h) and a 20 percent accuracy-related penalty for negligence under IRC § 6662(b)(1). The examiner's supervisor signed the Form 5701, Notice of Proposed Adjustment, which included only the IRC § 6662(h) penalty, but was accompanied by two Forms 866A, Explanation of Items, which included both penalties. Following an Appeals conference, the Appeals Officer proposed issuing a final partnership administrative adjustment (FPAA) by issuing a Form 5402-c, Appeals Transmittal and Case Memo. Attached to the appeals case memo was a Form 866A, Explanation of Items, which included the initial two penalties proposed by the examiner, and penalties for substantial understatement of tax under IRC § 6662(b)(2) and substantial valuation misstatement under IRC § 6662(b)(3). Subsequently, the IRS issued the FPAA to the taxpayer disallowing the deduction and determining all four penalties.

The court held that the initial determinations of the penalties were those by the examiner when he issued the Form 5701, which was approved in writing by his supervisor, and by the Appeals Officer when he issued the Form 5402-c, which was also approved in writing by his supervisor. The court was not persuaded by the taxpayer's observance that the examiner only asserted and received supervisory approval for two of the penalties because it held there is no requirement under IRC § 6751(b) for all the penalties to be asserted and approved at the same time. The taxpayer also argued that the penalty determinations were invalid because the IRS failed to comply with the IRM instruction for the penalty approval to be documented in the examination work papers. The court noted that the IRM is not binding and held that using a form other than what is prescribed by administrative rules does not preclude a finding of compliance with IRC § 6751(b) and the statute does not require approval on any particular form. Thus, the court granted the IRS's motion for summary judgment.

*Alternative Health Care Advocates v. Commissioner*⁴⁶

The Tax Court held the taxpayer, a C corporation operating a medical dispensary, was not entitled to business expense deductions because its sole trade or business was trafficking in a controlled substance. The Tax Court also held that the C corporation had substantially understated its income tax and did not establish reasonable cause. The court rejected the taxpayer's arguments that it would be unfair to impose the accuracy-related penalty given the unsettled case law and confusion over IRC § 280E at the time the returns were filed. The court drew a clear distinction between the present case and the only relevant case involving medical marijuana during the years at issue, where the facts allowed the court to allocate expenses between the taxpayer's businesses. The court stated that the only directly relevant authority was directly against the taxpayer's tax treatment.⁴⁷ In a footnote, the court explained that because IRC § 7491(c) does not apply to corporations, the IRS did not have the burden of production with respect to the accuracy-related penalty and since the taxpayer did not raise IRC § 6751(b), it was unnecessary to reopen the record for the IRS to demonstrate compliance with the supervisory approval requirement.⁴⁸

45 *Palmolive Bldg. Inv'rs, LLC v. Comm'r*, 149 T.C. 380 (2017).

46 151 T.C. 225 (2018).

47 *Alt. Health Care Advocates*, 151 T.C. at 247.

48 *Id.* at 246 n.15.

*Walquist v. Commissioner*⁴⁹

In this case, the IRS examined the taxpayers via correspondence and issued a 30-day letter to them via its Correspondence Examination Automated Support (CEAS) software program, which processes a case with little to no examiner involvement unless the taxpayer responds. The software automatically calculated a substantial understatement penalty under IRC § 6662(b)(2), which was included in the 30-day letter. When the taxpayers failed to respond to the 30-day letter, the CEAS software generated a statutory notice of deficiency (SNOD), which included the IRC § 6662(b)(2) penalty. The penalty was not reviewed by an employee prior to the issuance of the SNOD. The court held that because the penalty was determined mathematically by a computer software program with no involvement by a human IRS employee, the penalty was “automatically calculated through electronic means.” The court explained how it would be difficult for the IRS demonstrate compliance with IRC § 6751(b)(1) for a penalty calculated by a computer program because there would be no individual making the determination; if the computer itself were the individual, then the question would arise as to who the immediate supervisor of the computer program was. Thus, the court held the IRS had met its burden with respect to the accuracy-related penalty.

*Clay v. Commissioner*⁵⁰

The taxpayers, members of a Native American tribe, challenged the IRS’s determination of unreported income from tribal casino revenue and related penalties. Although the Tax Court found the members were liable for the unreported income, it found the taxpayers not liable for the accuracy-related penalty due to the IRS’s failure to obtain supervisory approval. The trial was held before the Tax Court issued its third *Graev* ruling, so the court accepted the IRS’s motion to reopen the record to demonstrate compliance, as well as motions by the taxpayers to conduct additional discovery around the new documents. The taxpayers argued the IRS did not meet its burden because the supervisory approval did not occur before the IRS sent the taxpayers written notice of the proposed penalties in the form of the revenue agent report, which contained the first suggestion of the penalties. The court agreed that the revenue agent report transmitted with the 30-day letter constituted the initial determination of the penalties. The court cited the *Palmolive* decision discussed above, stating “when those proposed adjustments are communicated to the taxpayer formally as part of a communication that advises the taxpayer that penalties will be proposed and giving the taxpayer the right to appeal them with Appeals (via a 30-day letter), the issue of penalties is officially on the table.”⁵¹

Reasonable Cause

*Losantiville Country Club v. Commissioner*⁵²

The taxpayer, a private country club operating as an IRC § 501(c)(7) tax exempt organization, deducted expenses for nonmember events from its investment income. The IRS disallowed these deductions because it stated that the club did not intend to profit from its nonmember sales, meaning it could not deduct these losses under IRC § 162. The IRS also asserted accuracy-related penalties for negligence. The Tax Court ruled in favor of the IRS on both issues, finding that the taxpayer did not prepare the returns in good faith and did not have reasonable cause.⁵³ The Court of Appeals for the Sixth Circuit likewise ruled that the taxpayer did not have reasonable cause and could not demonstrate reasonable

49 152 T.C. No. 3 (2019).

50 152 T.C. No. 13 (2019).

51 *Clay*, 152 T.C. No. 13, 2019 U.S. Tax Ct. LEXIS 14, at *40 (T.C. Apr. 24, 2019).

52 906 F.3d 468 (6th Cir. 2018), *aff’g* T.C. Memo. 2017-158.

53 *Losantiville Country Club v. Comm’r*, T.C. Memo. 2017-158.

reliance on the advice of a tax professional.⁵⁴ The taxpayer did not submit any opinion letters or correspondence from its accountants explaining their advice, and the evidence shows that the taxpayer itself communicated its own opinions about its tax obligations to its accountants. The taxpayer argued that because it was advocating for a novel application of existing law, it met the reasonable cause exception. The court rejected this argument, noting that the tax treatment had to be buttressed by substantial authority to meet reasonable cause and the taxpayer did not provide any evidence supporting its arguments for underpayment.⁵⁵

CONCLUSION

This year marked a significant decrease in cases deciding the accuracy-related penalty under IRC § 6662(b)(1) and (2). Despite this decrease in overall cases, more courts are grappling with the issue of whether the IRS obtained the required supervisory approval for the accuracy-related penalty. Notably, the majority of cases where taxpayers prevailed this year were due to the IRS's failure to meet the supervisory approval provision. Based on the decisions this year, it appears that the timing of the supervisory approval is something that will continue to be contested. The following administrative recommendations to update the IRM and further specify when the approval must occur could mitigate future litigation.

RECOMMENDATIONS TO MITIGATE DISPUTES

The National Taxpayer Advocate recommends that Congress:

- Amend IRC § 6751(b)(2)(B) to clarify that written managerial approval is required prior to the assessment of the accuracy-related penalty imposed on the portion of an underpayment attributable to negligence or disregard of rules or regulations under IRC § 6662(b)(1) and consider clarifying which penalties or facts-and-circumstances result in penalties “automatically calculated through electronic means” that are exempt from the managerial-approval requirement.⁵⁶

The National Taxpayer Advocate recommends that the IRS:

- Issue regulations clarifying that written supervisory approval required under IRC § 6751(b) must occur prior to the first time the IRS formally communicates the proposed penalties to the taxpayer in writing.
- Update the IRM to require written supervisory approval not just “prior to the issuance of the Statutory Notice of Deficiency (SNOD)”⁵⁷ but instead “prior to the first time the penalties are communicated to the taxpayer formally as part of a written communication that advises the taxpayer the penalties will be proposed.”⁵⁸

54 *Losantiville Country Club*, 906 F.3d at 476, *aff'g* T.C. Memo. 2017-158.

55 *Id.*

56 National Taxpayer Advocate 2020 Purple Book: *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration*, 62-63 (*Clarify the Parameters for Written Managerial Approval Required for Penalty Assessments under IRC § 6751(B)*). See also National Taxpayer Advocate 2014 Annual Report to Congress 404 (*Legislative Recommendation: Managerial Approval: Amend § 6751(b) to Require IRS Employees to Seek Managerial Approval Before Assessing the Accuracy-Related Penalty Attributable to Negligence under IRC § 6662(b)(1)*).

57 IRM 20.1.5.2.3, *Supervisory Approval of Penalties - IRC 6751 Procedural Requirements* (Apr. 22, 2019).

58 This language is based on the Tax Court's holding in *Clay v. Comm'r*, 152 T.C. No. 13 (2019).