

#33 REQUIRE WRITTEN MANAGERIAL APPROVAL BEFORE ASSESSING THE ACCURACY-RELATED PENALTY FOR “NEGLIGENCE”

Present Law

A taxpayer who submits a return that is not accurate (*i.e.*, reflects an “underpayment”) may be subject to an accuracy-related penalty under IRC § 6662. In particular, a penalty for “negligence or disregard of rules or regulations” may be imposed under IRC § 6662(b)(1). IRC § 6662(c) defines “negligence” as “any failure to make a reasonable attempt to comply with the provisions of this title” and defines “disregard” to include “any careless, reckless, or intentional disregard.”

As a taxpayer protection, IRC § 6751(b)(1) requires that the immediate supervisor of an employee making the initial determination of a penalty assessment must personally approve the determination in writing.¹¹⁵ However, penalties “automatically calculated through electronic means” are not required to receive managerial approval.¹¹⁶

Reasons for Change

The purpose of penalties is to encourage voluntary compliance and deter noncompliance. Unlike penalties that can be assessed by answering a simple yes/no question (for example, the penalty for failing to file a return under IRC § 6651), the determination of whether to assess a negligence penalty requires knowledge of what actions the taxpayer took to comply with the tax laws, as well as his or her motivations for taking those actions. Negligence cannot reasonably be determined by a computer, because a computer cannot assess whether a taxpayer made a “reasonable attempt” to comply with the law.

Nevertheless, the IRS has programmed its computers to apply negligence penalties automatically as part of its Automated Underreporter (AUR) program. More specifically, the AUR program identifies discrepancies between the amounts taxpayers report on their returns and the amounts payors report via Forms W-2, Forms 1099, and other information returns, and it generally assesses penalties automatically based on the discrepancies it detects. If the negligence penalty is assessed through the AUR program without an employee independently determining its appropriateness, there is no requirement for managerial approval.

An IRS employee will review a penalty assessment to make a determination of “negligence” only if a taxpayer responds to initial notices issued by AUR. There are many reasons why a taxpayer may not respond to a notice. A taxpayer may not receive it if he or she has moved and does not receive the notice. A taxpayer may put the notice aside and not get back to it before the response deadline. Or a taxpayer may accept the proposed tax adjustment but not realize he or she must respond to avoid the penalty assessment. In these and other circumstances, taxpayers may be assessed a penalty for negligence without any analysis into their

115 This area of law has been the focus of recent litigation. In 2016, a majority of the U.S. Tax Court ruled that the written approval for an accuracy-related penalty could be given at any time prior to assessment, including while a case was in litigation before the Tax Court. As a result, the Tax Court held it was premature for it to consider an argument under IRC § 6751(b). *Graev v. Comm’r*, 147 T.C. No. 16 (2016), *vacated*, No. 30638-08 (T.C. Mar. 30, 2017). However, the decision in *Graev v. Comm’r* has since been vacated, because shortly after the decision was issued, the U.S. Court of Appeals for the Second Circuit (to which *Graev* would have been appealed) came to a different conclusion. In *Chai v. Commissioner*, the Second Circuit ruled that managerial approval for penalty assessments must be obtained before the IRS issues a notice of deficiency. *Chai v. Comm’r*, 851 F.3d 190 (2d Cir. 2017). These two rulings initially suggested a split between the majority of the Tax Court and the Second Circuit. Following the ruling in *Chai*, however, the Tax Court reversed course in a subsequent ruling in *Graev*. Taking *Chai* into account, the Tax Court ruled that it is not premature to consider an argument under IRC § 6751(b) in a deficiency proceeding, and the IRS bears the burden of production under IRC § 7491(c) to show the penalty received managerial approval. *Graev v. Comm’r*, 149 T.C. No. 23 (2017).

116 IRC § 6751(b)(2)(B).

reasonable attempts to comply with tax laws (or lack thereof). This result undermines the protections afforded in IRC § 6751(b).

The National Taxpayer Advocate believes strongly that a computer cannot determine “negligence”—*i.e.*, whether a taxpayer has failed to “make a reasonable attempt to comply with the provisions of this title.” Therefore, when Congress authorized the IRS to impose certain penalties “automatically calculated by electronic means” without managerial approval, we do not believe Congress intended that exception to apply to negligence penalties.

In response to several judicial decisions, the IRS Office of Chief Counsel recently issued a notice instructing IRS attorneys to submit evidence of compliance with IRC § 6751(b)(1) when addressing penalty disputes.¹¹⁷ If an attorney cannot find sufficient evidence of compliance, the notice says the attorney must concede the penalty. We commend the Office of Chief Counsel for taking this step, but a Counsel notice does not have the force of law and can be reversed at any time.

Recommendation

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.

¹¹⁷ IRS Office of Chief Counsel, Notice CC-2018-006, *Section 6751(b) Compliance Issues for Penalties in Litigation* (June 6, 2018).