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Beyond Reasonable Cause: How to Successfully Argue Against the Assessment of Penalties Before the IRS

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8:30 a.m. – 9:30 a.m.

Speakers:

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Hon. Patrick J. Urda

Conference Reference Materials

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Beyond Reasonable Cause: An In-Depth Discussion of the Assessment, Abatement and Litigation of Penalties

Panelists:

- Honorable Patrick J. Urda, United States Tax Court
- Brian Beddingfield, IRS Office of Chief Counsel
- Matthew D. Carlson, Boutin Jones Inc.

*Note: The written presentation materials were prepared by Matthew D. Carlson of Boutin Jones, Inc. Any views expressed in the written presentation materials do not necessarily represent the views of the U.S. Tax Court, the Internal Revenue Service, or the Office of Chief Counsel.

I.R.C. § 6751(b) – Supervisory Approval

1. Part of IRS “burden of production” under I.R.C. § 7491(c). *Frost v. Commissioner*, 154 T.C. 23 (2020); *but see Dynamo Holdings Limited Partnership v. Commissioner*, 150 T.C. 224 (2018) (burden inapplicable in the case of corporations or partnership level proceedings).
2. Text of I.R.C. § 6751(b) “approval of assessment”:
 - (1) In general.--No 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.
 - (2) Exceptions.--Paragraph (1) shall not apply to--
 - (A) any addition to tax under section 6651, 6654, 6655, or 6662 (but only with respect to an addition to tax by reason of subsection (b)(9) thereof); or
 - (B) any other penalty automatically calculated through electronic means.
3. No Treasury Regulations under I.R.C. § 6751(b).
4. Internal Revenue Manual (IRM) Part 20.1 (Penalty Handbook) and other IRM provisions.

I.R.C. § 6751(b) – Seminal Case Law

1. *Graev v. Commissioner*, 147 T.C. 460 (2016) (*Graev II*): Held that the taxpayer's argument about 6751(b)(1) was premature.
2. *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017): Found that I.R.C. § 6751(b)(1) was an element of the IRS penalty claim and part of burden of production.
3. *Graev v. Commissioner*, 149 T.C. 485 (2017) (*Graev III*): Overruled *Graev II*, holding that I.R.C. § 6751(b)(1) was appropriately considered in the deficiency proceeding as part of respondent's burden of production, but finding that respondent showed compliance with the written approval requirement, citing *Chai*.

I.R.C. § 6751(b) – Timing of Supervisory Approval

1. *Clay v. Commissioner*, 152 T.C. 223 (2019): IRS must show that written supervisory approval for accuracy-related penalty was obtained before the first formal communication to the taxpayer of the initial determination to assess substantial understatement penalties under I.R.C. § 6662.
 - a. Revenue Agent Report (RAR) sent with 30-day letter with appeal rights was the “initial determination.”
2. *Belair Woods, LLC v. Commissioner*, 154 T.C. 1, 15 (2020): The “initial determination” of a penalty assessment “is embodied in the document by which the [IRS] Examination Division formally notifies the taxpayer, in writing, that it has completed its work and made an unequivocal decision to assert penalties.”
 - a. Approval of 6662(h) penalty for gross overvaluation penalty under 6662(h) and penalties for negligence and substantial understatement was timely. Letter 1807 inviting taxpayer to a closing conference to discuss adjustments was not an “initial determination,” 60-day letter issued after conferences with taxpayer was the initial determination.
3. *Beland v. Commissioner*, 156 T.C. No. 5 (2021): Providing the opportunity to consent to an assessment of tax and penalty is a “consequential moment” of IRS action.
 - a. RAR presented in-person asserting fraud penalty under I.R.C. § 6663 was initial determination despite no appeal rights.

I.R.C. § 6751(b) – Exemptions from Supervisory Approval Requirement

1. I.R.C. § 6751(b)(2)(A) specifically exempts I.R.C. §§ 6651, 6654, 6655, and 6662(b)(9) (overstatement of the deduction provided in section 170(p)).
2. I.R.C. § 6751(b)(2)(B) exempts “any other penalty automatically calculated through electronic means.”
 - a. *Walquist v. Commissioner*, 152 T.C. 61 (2019): Penalties determined under I.R.C. § 6662(a) and (b)(2) by an IRS computer program without human review are “automatically calculated through electronic means” within the meaning of I.R.C. § 6751(b)(2)(B) and thus are exempt from the written supervisory approval requirement of I.R.C. § 6751(b)(1).
 - b. Other exempted penalties:
 - i. I.R.C. § 6669 (late-filed Form 1121S): *ATL & Sons Holdings, Inc. v. Commissioner*, 152 T.C. 138, 154 (2019).
 - ii. Non-Title 26 Penalties (e.g., FBAR/Title 31 penalties).

I.R.C. § 6751(b) – Assorted Issues

1. Collection Due Process: Where supervisory approval requirement of I.R.C. § 6751(b)(1) applies, Appeals should obtain verification that such approval was obtained. *ATL & Sons Holdings, Inc. v. Commissioner*, 152 T.C. 138 , 144 (2019); *Rosendale v. Commissioner*, T.C. Memo. 2018-99.
2. Penalty Raised in Tax Court: Penalty can be raised for first time in Tax Court proceedings. *Roth v. Commissioner*, 922 F.3d 1126 (10th Cir. 2019).
3. Form of Approval: Actual signature is not required; the approval form need only show that the penalties were approved by the supervisor. *Blackburn v. Commissioner*, 150 T.C. 218, 223 (2018); *Rosendale v. Commissioner*, T.C. Memo. 2018-99.

I.R.C. § 6751(b) – Litigation of Penalties in Tax Court

1. I.R.C. § 6751 applies to all Title 26 penalties unless excepted in 6751(b)(2).
2. Deficiency Cases: I.R.C. §§ 6662, 6662A, 6663
3. Assessable Penalties: I.R.C. §§ 6672-6725
 - i. Not subject to deficiency procedures.
 - ii. May only be litigated in Tax Court in CDP cases (where possible, not all penalties have been litigated). *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, 154 T.C. 68, 79 (2020) (I.R.C. § 6707A); *Kapp v. Commissioner*, T.C. Memo. 2019-84 (I.R.C. § 6701).
 - iii. If CDP not available, must litigate in refund litigation or bankruptcy.

Exceptions For Adequate Disclosure – Treas. Reg. §§ 1.6662-3(c), -4(e), -4(f)

1. The penalties for disregard of rules or regulations and for a substantial understatement of income tax may be avoided by adequately disclosing certain information as provided in § 1.6662-3(c) and §§ 1.6662-4(e) and (f), respectively. Treas. Reg. § 1.6662-1 (flush language).
2. The penalties for negligence and for a substantial (or gross) valuation misstatement under chapter 1 may not be avoided by disclosure. Treas. Reg. § 1.6662-1 (flush language).

Adequate Disclosure Exception to Disregard of Rules or Regulations – Treas. Reg. § 1.6662-3(c)

1. Two Requirements:
 - i. Position must have a reasonable basis; and
 - ii. Taxpayer must keep adequate books and records and substantiate items properly.
2. Positions Contrary to a Rule or Regulation: No penalty under section 6662(b)(1) may be imposed for a position contrary to a rule or regulation if the position is properly disclosed and, in case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation.
3. Method of Disclosure: In the case of an item or position other than one that is contrary to a regulation, disclosure must be made on Form 8275 (Disclosure Statement); in the case of a position contrary to a regulation, disclosure must be made on Form 8275-R (Regulation Disclosure Statement).
4. Reasonable Basis: Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. Treas. Reg. § 1.6662-3(b)(3).

Adequate Disclosure Exception to Substantial Understatement – Treas. Reg. § 1.6662-4

1. Generally: Items for which there is adequate disclosure are treated as if such items were shown properly on the return for the taxable year in computing the amount of the tax shown on the return. Treas. Reg. § 1.6662-4(e).
2. Requirements: Position must:
 - i. Have a reasonable basis;
 - ii. Not be attributable to a tax shelter;
 - iii. Be properly substantiated/ adequate books and records.
3. Same method of disclosure requirements as disregard of rules or regulations (Form 8275, 8275-R).

Qualified Amended Return

1. I.R.C. § 6662(a) “applies to any portion of an underpayment of tax required to be shown on a return.”
2. The amount shown as the tax by the taxpayer on the return includes an amount shown as additional tax on a qualified amended return. Treas. Reg. § 1.6664-2(c)(2).
3. A “qualified amended return” is an amended return filed before:
 - i. The date the taxpayer is first contacted by the IRS concerning any examination/ criminal investigation with respect to the return;
 - ii. The date any person is first contacted by the IRS concerning an examination of that person under section 6700 (relating to the penalty for promoting abusive tax shelters);
 - iii. In the case of a pass-through item, the date the pass-through entity is first contacted by the IRS in connection with an examination of the return to which the pass-through item relates;
 - iv. The date on which the IRS serves a summons described in section 7609(f) relating to the tax liability of a person, group, or class that includes the taxpayer with respect to an activity for which the taxpayer claimed any tax benefit on the return directly or indirectly.
 - v. The date on which the Commissioner announces a settlement initiative to compromise or waive penalties, in whole or in part, with respect to a listed transaction.

Reasonable Cause – I.R.C. § 6664(c)

1. No penalty under I.R.C. §§ 6662 or 6663 for any portion of an underpayment if there was reasonable cause for such portion and the taxpayer acted in good faith.
2. Made on a case-by-case basis taking into account all pertinent facts and circumstances. Treas. Reg. § 1.6664-4(b).
3. Reasonable reliance in good faith on opinion or advice. Treas. Reg. § 1.6664-4(c).
4. Special rules for reportable transactions, substantial understatement attributable to tax shelter items of corporations, and valuation misstatements of charitable deduction property. Treas. Reg. § 1.6664-4(d), (f), and (h).

Reliance on Professional Advice

1. All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. Treas. Reg. § 1.6664-4(c).
2. *Neonatology Assocs., P.A. v. Commissioner*, 115 T.C. 43, 99 (2000): Courts apply a three-prong test which asks whether:
 - a. the adviser was a competent professional who had sufficient experience to justify the reliance;
 - b. the taxpayer provided necessary and accurate information to the adviser; and
 - c. the taxpayer actually relied in good faith on the adviser's judgment.

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Thank you!

Bio: The Honorable Patrick J. Urda

Judge Urda was born in South Bend, Indiana, where he grew up with four siblings. He graduated from the University of Notre Dame and Harvard Law School. After a stint in private practice in Chicago, Judge Urda clerked for Judge Daniel A. Manion of the U.S. Court of Appeals for the Seventh Circuit and then moved to Washington, D.C. to work for the Tax Division of the Department of Justice (DOJ). During his 12 years at DOJ, he litigated tax appeals in each of the federal circuit courts, presenting 50 appellate arguments. In addition to his work as a line attorney, he served as Counsel to the Deputy Assistant Attorney General for Appellate and Review, as well as details to the Office of Legal Policy and to the Criminal Division's Office of Overseas Prosecutorial Development Assistance and Training. Judge Urda has previously served as an Adjunct Professor of Law at American University Washington College of Law. He joined the United States Tax Court on September 27, 2018.

Brian is a Senior Attorney with the IRS Office of Chief Counsel, Small Business/Self Employment Division in Laguna Niguel, California. Brian earned his J.D. and LL.M. in Taxation from the University of San Diego, School of Law. While in law school, Brian served as an intern for two years with the IRS's Office of Chief Counsel in San Diego, CA. Prior to joining the IRS Office of Chief Counsel, Brian worked as an Attorney with the Department of Homeland Security, Customs and Border Protection (CBP), in San Francisco, CA. While at CBP Brian primarily focused on cases involving international trade. Brian's current practice focus is on partnership audits and litigation. In 2020, Brian received the Office of Chief Counsel's Bronze Medallion for Litigation Excellence. Brian is an avid professional basketball fan and enjoys long distance running.