

Tax Court Places Burden of Production in Penalty Challenges on Partnerships

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On May 7, 2018, the United States Tax Court issued a decision in *Dynamo Holdings v. Commissioner*,¹ holding for the first time that in a partnership-level proceeding, the Internal Revenue Service does not bear the burden of production with respect to penalties under the Internal Revenue Code sec. 7491(c). The Tax Court further noted that Dynamo Holdings failed to raise the lack of supervisory approval of penalties as a defense at trial, although it would have been a valid evidentiary claim against the Commissioner. The opinion is significant not only because it expressly ruled on the burden of production issue with respect to penalties asserted against partnerships for the first time, but also because it demonstrates the importance of timely challenging the Commissioner's compliance under section 6751(b).

Overview – Partnership Challenges Penalties

Dynamo is a property development company that specializes in developing property in southern Florida. It is a partnership formed in Delaware with its principal place of business in Florida. Dynamo shares at least one direct owner and other indirect beneficial owners with a Delaware corporation, Beekman Vista (co-petitioner), which is also in the business of property development in southern Florida.

During 2005, 2006, and 2007, there were transfers of property among Beekman Vista, Dynamo, and entities owned by each of them. The Commissioner determined that taxes were not properly withheld during these transfers and issued a notice of final partnership administrative adjustment (FPAA) to Dynamo for 2005, 2006, and 2007 on December 28, 2010. Dynamo filed a timely petition challenging the deficiencies, but failed to raise the issue of whether the Commissioner complied with the supervisory approval requirement of section 6751(b). The cases were consolidated, and a two-week trial was held in early 2017.

On December 20, 2017, the Tax Court issued an Opinion in *Graev v. Commissioner (Graev III)*,² holding that in cases in which the Commissioner bears the burden of production with respect to penalties under section 7491(c), evidence of written supervisory approval of penalties should be provided as required by section 6751(b). The next day, the Court issued an order in these consolidated cases directing the parties' attention to *Graev III*. On February 2, 2018, two motions were filed. The Commissioner filed a motion to reopen the record so that additional testimony from the supervisors and revenue agents will be allowed to reinforce the evidence of supervisory approval. Dynamo filed a

motion to dismiss as to the tax penalties, arguing that the Commissioner bears the burden of production under section 7491(c) and must meet the supervisory approval requirement under section 6751(b) as a part of that burden.

Tax Court Opinion

The Tax Court denied the Commissioner's motion to reopen the record because it ruled that the Commissioner does not bear the burden of production with respect to penalties in a partnership-level proceeding. It denied Dynamo Holdings' motion to dismiss as to penalties for the same reason. The Court also noted that Dynamo could have raised the lack of penalty approval as a defense to penalties in its petition, at trial, or on brief. However, Dynamo did not seek to reopen the record to dispute whether penalty approval occurred and the defense was considered by the Court to "have been waived."³

In *Dynamo*, the Tax Court expressly ruled that the Commissioner does not bear the burden of production under section 7491(c) based on the statutes' plain language, inferred Congressional intent, and practical implications of its decision.

First, section 7491(c) applies only to the liability of an "*individual* for any penalty, addition to tax, or additional amount imposed by this title,"⁴ and the court decided that partnership-level proceedings are not about the liabilities of *individuals* under "a plain reading of the statutes governing partnership-level proceedings."⁵ Partnerships are not individuals. Section 7701(a)(1) defines a person as "an individual, a trust, estate, partnership, association, company or corporation," making clear that an individual is distinct from a partnership.⁶ Moreover, "[a] partnership-level proceeding determines the treatment of partnership items and the applicability of a penalty at the partnership level, but not the liability of any partner for either tax or penalties."⁷ The Court's rationale is similar to its decision in *NT, Inc. v. Commissioner*,⁸ in which the Court held that the Commissioner does not bear the burden of production under section 7491(c) with respect to penalties asserted against a corporation because the "[p]etitioner is not an individual; it is a corporation."⁹

Second, there is evidence within section 7491 itself that Congress intended to narrowly define the scope of section 7491(c). Whereas section 7491(c) refers to the "liability of any *individual* for any penalty," section 7491(a) speaks of the "liability of the *taxpayer* for any tax" and clarifies that subsection (a) applies to "*partnership[s]*." The court believes that by using the different terms "individual" and "taxpayer," Congress intended to distinguish the two terms and not to apply section 7491(c) to partnerships.¹⁰

Third, the practical effect of applying section 7491(c) in a partnership-level proceeding prevents the Commissioner from bearing the burden of production because the added workload will be substantial. If section 7491(c) applies to partnership-level proceedings, the Commissioner and the Court will be "require[d] to identify the ultimate taxpaying partners of a partnership to determine who bears the burden of production as to penalties."¹¹ In cases with tiered partnership structures, countless time and resources will be spent on identifying these ultimate taxpaying partners. To avoid the additional burden on the Commissioner and the Court, section 7491(c) should not be applied in a partnership-level proceeding.

Although most of the Court's opinion in *Dynamo* addressed why the Commissioner does not bear the burden of production under section 7491(c), the Court raised an important issue in the conclusion on the importance of challenging the Commissioner's compliance with section 6751(b) in a timely manner. The Court held that because Dynamo did not challenge the sufficiency of the written penalty approval in the record until the record was closed and the case was fully submitted, they considered this defense to penalties to have been waived. Had Dynamo challenged the supervisory approval in its petition, at trial, or on brief, the Court would have considered the claim and the result of the case may have been different. In the future, petitioners who hope to challenge their tax penalties by raising an issue on the Commissioner's compliance with section 6751(b) must do so in a timely manner.

Grace Zhu¹²

1 150 T.C. No. 10 (2018).
2 149 T.C. No. 23 (December 20, 2017).
3 150 T.C. No. 10 at 22.
4 I.R.C. sec. 7491(c).
5 150 T.C. No. 10 at 15.
6 *Id.* at 17.
7 *Id.* at 16.
8 126 T.C. 191 (2006).
9 126 T.C. at 195.
10 150 T.C. No. 10 at 19.
11 *Id.* at 20.

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Grace Zhu was a 2018 summer associate at Winston & Strawn LLP.
