

Fallout from Backdated Documents Lands IRS in Hot Seat

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Recent revelations involving documents found to be backdated by the IRS in the case of *Lakepoint Land II, LLC v. Commissioner* resulted in the Tax Court imposing sanctions on the IRS. Further inquiries ensued as to whether the IRS also proffered backdated penalty documents in other similar cases, hinting at a troubling picture of potentially systemic issues within the IRS.

Lakepoint Land II, LLC v. Commissioner

On August 29, 2023, the Tax Court served a Memorandum Opinion in the case of *Lakepoint Land II, LLC v. Commissioner*, T.C. Memo. 2023-111, concluding that IRS counsel in the case knew or should have known no later than November 2, 2022, that his representations to the Court as to when a revenue agent signed a penalty lead sheet were less than accurate, and that IRS counsel failed to timely advise the Court of the revenue agent's erroneous declaration.

The issue of when the penalty lead sheet was signed involves Internal Revenue Code section 6751(b)(1), which prohibits the IRS from assessing a penalty unless the initial determination to apply the penalty is first approved in writing by the intermediate supervisor of the IRS employee who made such determination. Section 6751(b)(1) has been the subject of much debate over the last few years, with different courts adopting different interpretations of the phrase "initial determination of [the] assessment." *Compare Kroner v. Commissioner*, 48 F.4th 1272, 1276 (11th Cir. 2022), *rev'g in part* T.C. Memo. 2020-73, with *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, 29 F.4th 1066, 1074 (9th Cir. 2022), *rev'g and remanding* 154 T.C. 68 (2020), and *Chai v. Commissioner*, 851 F.3d 190, 220 (2d Cir. 2017), *aff'g in part, rev'g in part* T.C. Memo. 2015-42.

During the examination of the taxpayer in *Lakepoint*, IRS revenue agents failed to include the maximum penalty on certain documents, which were digitally timestamped as signed by the manager in July 2016 and November 2016. On February 10, 2017, the revenue agent indicated that she had failed to get her manager's signature on the penalty lead sheet that specified that the IRS was seeking the maximum penalty on top of disallowing the deduction for the conservation easement. The manager then added the penalty to the July 2016 lead sheet but did not sign her name with the digital timestamp to acknowledge that the document was signed on February 10, 2017; instead, she typed in her signature with the following notation: "penalties were discussed and approved by me – CCB" and the date of July 16, 2016. The taxpayer in *Lakepoint* was officially notified of the maximum penalty on March 27, 2017.

While the IRS may have informed the taxpayer of the penalties after they were approved, the fact that a managing IRS revenue agent had intentionally backdated a document and then IRS counsel subsequently refused to provide a clear answer to both the taxpayer and the Court as to when IRS personnel became aware of the backdated document is concerning.

On April 18, 2023, the taxpayer in *Lakepoint* filed a motion for sanctions against the IRS, requesting the Court to void the penalty and order the IRS to pay attorneys' fees and other expenses incurred as a result of the IRS's misconduct. The Court subsequently issued an Order directing the IRS to identify when IRS personnel became aware of the misstatements to the Court regarding the backdated penalty lead sheet, signaling that the Court is taking this situation seriously.

The IRS has maintained that its failure to immediately alert the Court that the penalty approval form was backdated should not give rise to sanctions, and that the IRS should not be deprived of an opportunity to pursue a penalty against a taxpayer that was nevertheless timely approved under case law. If this same behavior had been exhibited by the taxpayer, by contrast, it is unfathomable that the taxpayer would emerge unscathed. Thankfully, incidents like these have been rare. At some point, however, deceptive behavior of this nature by either litigant overshadows the Court's normal operations.

In its Memorandum Opinion, the Court in *Lakepoint* held that IRS counsel acted in bad faith and, as a result, multiplied the proceedings in the case unreasonably and vexatiously. The Court granted, in part, the taxpayer's Motion to Impose Sanctions under section 6673(a)(2). However, the Court reserved ruling on the IRS's liability for excess costs until after trial, finding it premature to determine the amount of an award prior to the introduction of evidence of the amount of excess costs and fees incurred.

Arden Row Assets, LLC v. Commissioner, Basswood Aggregates, LLC v. Commissioner, and Delwood Resources, LLC v. Commissioner

The attorney representing the taxpayer in *Lakepoint* also represents taxpayers before the Tax Court in the cases of *Arden Row Assets, LLC v. Commissioner, Basswood Aggregates, LLC v. Commissioner, and Delwood Resources, LLC v. Commissioner*. Based on the alleged backdating in *Lakepoint*, the taxpayers in *Arden Row Assets, Basswood Aggregates, and Delwood Resources* filed First Request for Admissions on August 16, 2023, seeking admissions from the IRS as to whether certain penalty approval forms were backdated.

The examinations of all three partnerships in *Arden Row Assets, Basswood Aggregates, and Delwood Resources* were handled by the same revenue agent and manager. On July 12, 2021, the revenue agent separately emailed his manager with respect to each partnership, informing him that it was likely that penalties would be asserted against each partnership, but did not specify which penalties or the basis for those penalties. On July 14, 2021, the manager responded to the revenue agent's emails with the subject lines for each email: "I approve penalties." In the body of each response, the manager simply wrote the name of the partnership, without indicating which penalty he was approving or confirming the basis for asserting the penalties. In an email dated March 11, 2022, the revenue agent asked his manager to sign a penalty approval lead sheet for the three partnerships. The revenue agent wrote: "Ideally (?) the date you use to sign should be either the date you 'approved' penalties against Taxpayer (7/14/21) . . . or a little thereafter?"

The taxpayers' First Request for Admissions seeks to ascertain whether a penalty approval lead sheet (or its equivalent) had been signed by the team manager and whether the revenue agent was asking his manager to backdate his signature on the lead sheet to July 14, 2021, or a date shortly thereafter.

Even more troubling, the First Request for Admissions seeks to ascertain whether the revenue agent also attached to the email dated March 11, 2022, workpapers and a signed penalty lead sheet from an unrelated audit to provide the manager with "backup" examples. In seeking this information, the First Request for Admissions notes that the manager responded by writing: "All 3 are signed with the date of July 14, 2021. Thanks for giving me all the 'backup' too!"

TAKEAWAYS

While the IRS has historically been given substantial deference by the Tax Court, these recent events are deeply problematic and might reveal broader and systemic issues within the IRS. These incidents also have come to light at a time when recent IRS funding provided by the Inflation Reduction Act is being targeted, and the IRS is at risk of losing additional funding that it has so desperately needed.

The Court, however, seems to be taking note of these missteps by the IRS, as evidenced by the recent Memorandum Opinion in *Lakepoint*. In an Opinion served on August 28, 2023, the Court also admonished the IRS in the case of *R. J. Channels, Inc. v. Commissioner*, T.C. Memo. 2023-109, for its “common practice” of reconstructing a statutory notice of deficiency from electronic databases when the IRS was unable to produce a copy of the original notice, stating that such practice was “disconcerting” and “created doubt” as to whether the accuracy-related penalty asserted in the notice was, in fact, ever determined by the IRS.

We will continue to monitor these developments. For more information or to discuss further, please contact the authors or your Winston relationship attorney.

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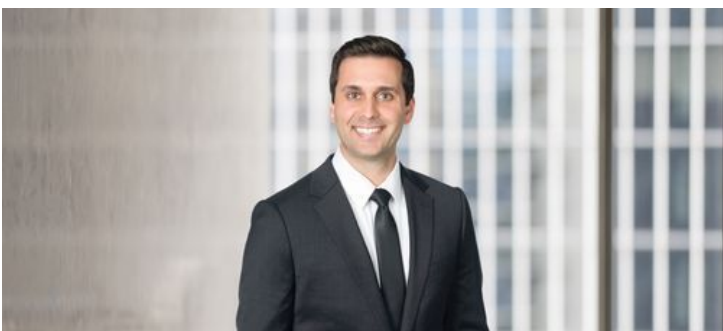
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