

CLIENT ALERT

## Proposed Penalty Must Satisfy Approval Requirement of Section 6751

FEBRUARY 27, 2018

In 2016, in *Graev v. Commissioner (Graev I)*, the Tax Court sustained a 20% penalty under Section 6662 against the Graevs and dismissed the taxpayers' Section 6751 argument, holding, in part, that their Section 6751 claim was premature in a pre-assessment deficiency proceeding. Subsequently, the Second Circuit held in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), that the written-approval requirement of Section 6751(b)(1) is an element of a penalty claim and that Section 6751(b)(1) requires written approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency. Because *Graev* was appealable to the Court of Appeals for the Second Circuit, the Tax Court vacated its decision in

*Graev I*. In light of *Chai*, the Tax Court reconsidered the Graevs' arguments but ultimately held that the IRS ("Service") satisfied the approval requirements under Section 6751(b).

### Facts

In the notice of deficiency issued to the Graevs, the Service determined that for 2004 and 2005 Petitioners were liable for Section 6662 accuracy-related penalties on the underpayment attributable to disallowed claimed charitable-contribution deductions of \$99,000 for a cash contribution and \$990,000 for a façade easement in 2004 and a \$445,551 carryover charitable-contribution deduction in 2005. The agent determined that a 40% gross valuation misstatement penalty should apply and completed a "Penalty Approval Form" consistent with the Internal Revenue Manual ("IRM"), which was approved by the agent's immediate supervisor. The supervisor checked the "approved" box and initialed the form. The agent then prepared a proposed notice of deficiency regarding the 40% penalty, which was reviewed by a Technical Services employee and forwarded to the Manhattan Area Counsel for review. General Attorney Mackey ("Mackey") and the IRS Area Counsel docket attorney approved the 40% penalty in the notice of deficiency but suggested an alternative noncash contribution-accuracy-related penalty position of 20% be applied to the underpayments, which was approved by Mackey's immediate supervisor and Manhattan Technical Services. Technical Services made the penalty changes to the notice of deficiency, consistent with the IRM, and mailed it to Petitioners. In summary, the 40% penalty was first suggested by the agent and the 20% penalty was first suggested by Mackey.

Prior to the Tax Court's first review, the Service conceded that Petitioners are not liable for the 40% penalty but maintained that the 20% accuracy-related penalties stand. Petitioners asserted that the 20% penalties were barred because Respondent failed to comply with the supervisory approval requirements of Section 6751(b), which requires that penalties must be "approved, in writing, by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate."

In *Graev I*, Petitioners argued that because there was no separate computation for the 20% penalty, it could not be imposed. The Tax Court dismissed Petitioners' Section 6751(b) arguments as premature, finding that the penalty assessment was a proposed assessment and not an actual one. The Tax Court interpreted the statute to require written approval any time prior to the Tax Court's decision on the penalty becomes final and the IRS assessed the penalty.

## Discussion in Light of *Chai*

Subsequently, the Second Circuit in *Chai* clarified that the IRS must have written approval of the initial penalty determination and it must be provided no later than the date the IRS issues the notice of deficiency asserting the penalty. The Tax Court, in its reconsideration of *Graev* (*Graev II*), reversed the portions of its earlier decision that held that it was premature to consider the Section 6751(b) deficiency issues. Accordingly, the court considered the merits of Petitioners' Section 6751(b) arguments.

## Alternative Noncash Contribution Penalties

In *Graev II*, the Tax Court held that it agreed with Respondents—that Mackey made the initial determination of the 20% penalty and it was approved, in writing, by his immediate supervisor. The Court discussed that not only was Mackey the first one to make the determination, but he had the authority to do so. Consistent with the IRM procedures, the penalty was reviewed, approved, and forwarded to Technical Services, who then added the recommendation to the notice of deficiency. The Court noted that neither party argued that anyone other than Mackey made the initial determination of the 20% penalty. Thus, Mackey's determination was the initial determination and it was properly approved by his immediate supervisor. Therefore, the requirements of Section 6751(b) were satisfied with respect to the 20% alternative noncash contribution penalties for 2004 and 2005.

The Tax Court rejected Petitioners' arguments that Mackey lacked authority to make an initial determination. They argued that attorneys in the Office of Chief Counsel never have authority to make an initial determination of a penalty if it is included in a notice of deficiency. The Court disagreed, stating that nothing in the text or legislative history of Section 6751(b) suggests that the identification of who made the initial determination should determine the penalty's inclusion or exclusion.

Further, the Tax Court disagreed with Petitioners' argument that the Office of the Chief Counsel is only an advisory role. Section 7803(b)(2) specifies the Chief Counsel's duties, which extend beyond an advisory role. Regardless, the Tax Court noted that even if the Chief Counsel's statements are merely advisory, an initial determination can take the form of advice—noting that there is no textual distinction between "advice" and an "initial determination" in the statute. The Court further noted that "any initial determination; governed by section 6751(b), whether made by an examining agent or a chief counsel attorney, is mere advice until it receives the requisite supervisory approval and is finalized by the Commissioner or one of his agents." The Tax Court highlighted that this agent could be Technical Services as it was here for both Mackey and the agent's determinations.

## Cash Contribution Penalties

Although the 40% gross valuation misstatement penalty was removed, the Court still analyzed the legitimacy of the penalty under the approval requirements of Section 6751(b). The Court noted, and the parties agreed, that the penalties were determined by an agent and were approved, in writing, by her immediate supervisor. Accordingly, the service met the burden of Section 6751(b).

# Conclusion

In *Graev II*, the Tax Court concluded that the Service met its burden and complied with the requirements of Section 6751(b) for both the 20% accuracy-related penalties as asserted in the notice of deficiency and the 40% gross valuation misstatement penalty. Accordingly, Petitioners were liable for the accuracy-related penalties equal to 20% of the underpayments attributable to disallowance of both the cash and noncash charitable contribution deductions.

This decision, paired with *Chai*, affords taxpayers with another avenue with which to procedurally challenge any penalties imposed by the IRS by requiring the Service to prove that it satisfied the written approval requirements of Section 6751(b).

5 Min Read

---

## Related Locations

New York

## Related Topics

Tax

## Related Capabilities

Tax

## Related Regions

North America