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## **Penalties invalid if IRS does not get proper approvals - by Michael Duffy**

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When the IRS discovers that a taxpayer failed to report income on their tax returns, or adjusts the amount of tax they owe in an audit, there is a chance that something known as the Section 6662 accuracy-related penalty will be assessed. The penalty, which is equal to 20% of the amount of additional tax the taxpayer failed to report and pay on their originally filed return, can make large audit adjustments even more painful.

What is less commonly known is that prior to imposing a Section 6662 penalty, in many cases IRS field agents need to obtain written approval from an immediate supervisor. As has recently been discovered in a series of court cases, however, the IRS has not always followed the law in getting the requisite approvals before the penalty communications are sent to taxpayers. The IRS errors create potential refund opportunities for certain taxpayers.

**Basis for Section 6662 Penalty:** The Section 6662 penalty may be imposed when there is an underpayment of tax and the IRS determines some or all of the underpayment was due to negligence or a disregard of the tax rules and regulations. The Section 6662 penalty may alternatively be asserted when there is an understatement of tax that exceeds 10% of the amount of tax required to be shown on the taxpayer's return for a given year, provided this 10% amount exceeds \$5,000. IRS agents can use one or both arguments as a basis to impose a Section 6662 penalty on a taxpayer.

Taxpayers are eligible to have Section 6662 penalties reversed if they can show there was "reasonable cause" for the underpayment. Essentially, to qualify for the abatement, the taxpayer needs to show they reasonably relied on incorrect professional advice or incorrect information in computing their tax liability. Although this rule is conceptually fair, it can be practically very difficult for taxpayers to convince the IRS that they acted in good faith in making the mistake if a professional was not involved in preparing the tax returns or if there is little contemporaneous

documentation concerning the taxpayer's decision-making process when the return was prepared. The IRS also applies heightened scrutiny to determining whether there is reasonable cause in situations where the underpayment of tax is large.

Supervisory Approvals Are Required: Congress became concerned in the late 1990s that the threat of imposing a Section 6662 penalty could be used by the IRS to exert unfair leverage over taxpayers. The primary concern was that agents could tell taxpayers the IRS would impose a penalty unless they conceded to particular audit issues. Congress found this practice to be abusive and passed Section 6751 to combat the problem.

Section 6751 requires a lower-level employee to obtain the approval of an immediate supervisor prior to making an "initial determination of [a penalty assessment]." Section 6751 applies whenever or not the IRS proposes a Section 6662 adjustment that is not based on an uncontested automated-underreporter adjustment.

Although Section 6751 was added to the Internal Revenue Code in 1998, it did not receive a lot of attention among tax practitioners until the past five years or so. An issue has been when exactly field agents need to obtain approval to assess a Section 6662 penalty.

Technically, a penalty is not legally "assessed" until it is due and owing. If the penalty requires supervisory approval at any point prior to final assessment, then the IRS could conceivably assert a penalty against a taxpayer and obtain the supervisory approval at any point before a final decision is reached in a subsequent court proceeding. Subsequent developments have revealed that supervisory approval at such a late stage in an audit or judicial case does not comport with the intent of Congress when Section 6751 was initially passed.

Recent cases have confirmed that the Section 6751 supervisory approval is an element to the imposition of a Section 6662 penalty. As such, if the IRS does not properly obtain authorization to threaten the imposition of this penalty prior to sending certain communications to the taxpayer, the penalty is invalid.

Many recent cases have explored exactly when supervisory approval is required in a myriad of different situations. The cases have also revealed failures at the IRS to obtain appropriate approvals and created significant taxpayer victories.

### IRS Mistakes Create Refund Opportunities

The recent Section 6751 cases present refund opportunities for some taxpayers. Although IRS field agents may not have been intentionally circumventing the supervisory approval process by including Section 6662 penalties in certain communications, this does not change the fact that many accuracy-related penalties may not have been properly assessed and are therefore invalid. Taxpayers who have been hit with significant audit adjustments and Section 6662 penalties in the past several years should review their administrative files and confirm that the proper procedures were followed.

We have also identified opportunities where Section 6662 penalties have been assessed pursuant to contested automated-underreporter reviews. An automated-underreporter review occurs when the IRS receives a W-2 or 1099 from a third party that does not appear to be on the taxpayer's return. Rather than conducting a full audit, the IRS simply sends a notice proposing to add the missing item to the taxpayer's income and computes the additional tax due. If the discrepancy is large enough, an automatic Section 6662 will be added. Because the Section 6662 penalty in these cases is being automatically computed by "electronic means," the IRS does not need to obtain Section 6751 approval. If the taxpayer contests the automated-underreporter notice, however, the IRS must then actually look at the file and obtain a Section 6751 approval to impose any sort of accuracy-related penalty.

Due to COVID-19-related disruptions, the IRS is frequently not timely processing taxpayer responses to automatic-underreporter notices. Instead, the IRS is ignoring taxpayers and issuing Notices of Deficiency as if no response was submitted. When this occurs, per se the government should lose its ability to impose a Section 6662 penalty because the deadline for supervisory approval has passed by the time the Notice of Deficiency has been issued.

If you have recently been threatened with or paid a large Section 6662 penalty, please reach out to us. Taxpayers are under no obligation to pay more tax to the government than is required under the law, and recent court cases have confirmed that not all penalties asserted are necessarily valid.

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