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11th Circuit Decision - Penalty Approval by Supervisor Allowed at Any Time Prior to Assessment

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Proper procedure under Internal Revenue Code § 6751(b) has been hotly debated in the courts over the past few years. Of recent, the Eleventh Circuit Court of Appeals dealt taxpayers a blow in *Kroner v. Commissioner* by reversing the Tax Court to determine the taxpayer at issue could be assessed a penalty, despite the IRS agent's failure to obtain managerial approval of such penalty prior to communicating the penalty determination to the taxpayer. No. 20-12902, 2022 WL 4140340 (11th Cir. Sept. 13, 2022).

INTERNAL REVENUE CODE § 6751(B)(1) STATES THAT:

> 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.

While the plain language of the statute seems clear enough, the Second Circuit now disagrees with both the Ninth and Eleventh Circuits as to the meaning of the statute, furthering a split in the circuit courts of appeal, and increasing the likelihood of potential Supreme Court review of the issue.

Prior to *Kroner*, the Second Circuit, in *Chai v. Commissioner*, determined that the phrase "initial determination of such assessment" was ambiguous. 851 F.3d 190, 219 (2d Cir. 2017). Because of this ambiguity, the Second Circuit sought to discern Congress's intent by looking to the statute's legislative history and determined that the statutory purpose was to prevent "IRS agents from threatening unjustified penalties to encourage taxpayers to settle." *Id.* Accordingly, the *Chai* court determined that allowing penalty approval by a supervisor to occur any time before the actual assessment of the tax—which does not occur until after the audit, the appeal, and any court case is finalized—would not prevent the very abuses that the

statute was intended to remedy. *Id.* at 220. *Chai* notes that permitting written approval of a penalty determination up until, and even contemporaneously with, the IRS's final determination, would cause the statute to make little sense. *Id.* at 221. *Kroner* decidedly took a different approach, going even farther than the Ninth Circuit went in *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*. 29 F.4d 1066 (9th Cir. 2022). The Ninth Circuit, also looking only to the plain text of the statute, held that supervisory approval could occur after the "initial determination" or the "first formal communication by the IRS of the conclusion." *Id.* at 1070–71. However, it recognized that that penalty has to be approved while the supervisor still has discretion to approve such a penalty. *Id.*

Beyond the Ninth Circuit's holding, the Eleventh Circuit holding in *Kroner* allows for supervisory approval of a penalty determination to occur at any point up and until the IRS has *assessed* the penalty—an administrative act that can happen long after the agent is no longer involved in the process. This will allow agents to use penalties as bargaining chips because an agent's supervisors will not have to approve the penalty prior to the agent presenting the penalty determination to the taxpayer.

In deepening this circuit split, the Eleventh Circuit focused on what the word "initial" modifies. The court stated that "'initial' modifies the phrase 'determination of such assessment'" and not "the phrase 'no penalty under this title shall be assessed.'" *Kroner*, 2022 WL 4140340, at *5. The court determined that initial "describes *what* must be approved, not when." *Id.* Therefore, according to the court, the initial determination of the penalty must be approved, but that can occur at any point prior to the IRS putting the penalty on the government's books (assessment), which occurs just prior to collection.

The Eleventh Circuit discounted the Second Circuit's focus on pre-assessment penalties and instead stated that "negotiations do not end after a penalty is assessed." *Id.* at *7. The court noted that after a penalty is assessed, the taxpayer is provided with access to administrative and judicial remedies that may encourage parties to continue negotiating long after assessment. *Id.* Because of this access, the court held that the statute works to prevent penalties being used as bargaining chips, "without a pre-assessment deadline for securing that approval." *Id.* The court added that because of I.R.C. § 6751(b), supervisors and agents know approval will ultimately be needed, and will thus work together at an early stage of the process, disincentivizing agents from proposing improper penalties solely for the sake of negotiations. *Id.*

This IRS-favorable decision will have a significant impact on numerous ongoing cases. Taxpayers can expect penalties to be communicated to a taxpayer early and often. The Ninth Circuit recognized that some taxpayers may be "more inclined to settle" after receiving the initial determination because they are "misled about the probability of the assessment of the penalty." *Laidlaw's Harley Davidson Sales*, 29 F.4th at 1072. The Eleventh Circuit does not address how the decision may impact unrepresented or unsophisticated taxpayers. The Ninth Circuit recognized that requiring supervisory approval prior to the initial determination being communicated "would probably reduce the likelihood of a revenue agent threatening an unjustified penalty to secure a settlement." *Id.* In the Eleventh Circuit though, taxpayers no longer have this safeguard. Although the decision is arguably supported by a textualist reading of the statute, it undermines the apparent purpose of the statute as clarified by the statute's legislative history.

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