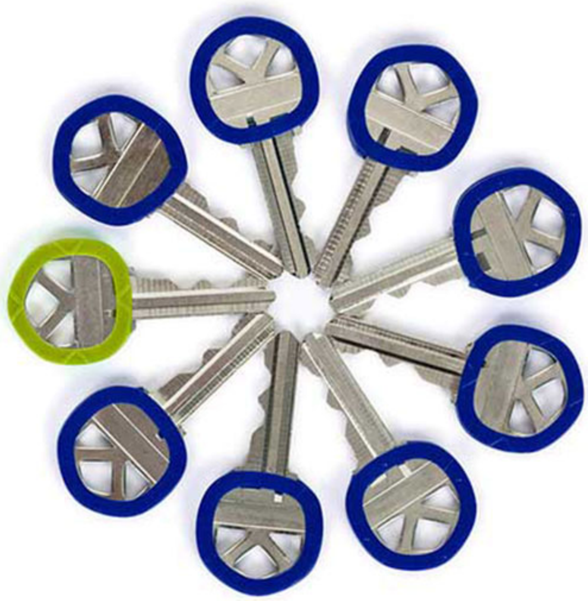

In this issue:

The Ninth Circuit Reverses the Tax Court in Altera

On June 7, 2019, the United States Court of Appeals for the Ninth Circuit reversed the Tax Court decision in *Altera Corporation & Subsidiaries v. Commissioner*, 145 T.C. No. 3 (2015).[1] At issue was the validity of 26 C.F.R. §1.482-

[1] 145 T.C. No. 3 (2015). This is the second opinion issued by the Ninth Circuit on *Altera*. The initial opinion was withdrawn because one of the judges on the original three-judge panel died before the initial opinion was issued. That judge was then replaced by another judge from the Ninth Circuit drawn by lot.

7A(d)(2),[2] which mandates that stock-based compensation ("SBC") costs related to the intangible development activity of a qualified cost sharing arrangement ("QCSA") must be included in the joint cost pool of the QCSA (the "all costs rule"). A three-judge panel ruled 2 – 1 that the all costs rule is consistent with section 482 and that, therefore, such costs must be included in the cost pool.

This is the second case in which the Ninth Circuit has considered this issue, and the first case in which the issue has been considered since the regulations were amended in 2003 to specifically include SBC costs in the all costs rule. The Ninth Circuit invalidated a prior version of the all costs rule that did not specifically mention SBC costs.

Background

The taxpayer-petitioner in this case, Altera Corporation, develops, manufactures, and sells programmable logic devices ("PLDs") and related hardware, software, and predefined design building blocks for use in programming the PLDs. On May 23, 1997, Altera US, the parent corporation incorporated in Delaware, and Altera International, a subsidiary of Altera US incorporated in the Cayman Islands, entered into a technology license agreement and a technology research and development ("R&D") cost sharing agreement that met the requirements of a QCSA under the 2003 cost sharing regulations.

During Altera's 2004 – 2007 tax years, Altera US granted stock options and other SBC costs to some of its employees, including employees who performed R&D activities subject to the QCSA. Those employees' cash compensation was included in the cost pool under the QCSA, but the SBC costs were not. The IRS sent Altera notices of deficiency for those tax years, making allocations of $24,549,315 in 2004, $23,015,453 in 2005, $17,365,388 in 2006, and $15,463,565 in 2007, all pursuant to the all costs rule requiring that such SBC costs be included in the joint cost pool for the QCSA.

Tax Court Decision

Altera challenged the adjustments and contested the validity of the all costs rule. Altera argued that, in adopting this rule, the IRS had violated the Administrative Procedure Act ("APA"). The Tax Court agreed with Altera in a 15-0 decision on July 27, 2015, and concluded that the regulation was invalid because the IRS and Treasury had failed to satisfy the requirements of the APA.[3] Specifically, when the IRS and Treasury issued the final rule, the files they maintained did not contain any expert opinions, empirical data, published or unpublished articles, papers, surveys, or reports supporting a determination that the amounts attributable to SBC costs must be included in the cost pool of the QCSA to achieve an arm's length result consistent with section 482 and the other regulations adopted under the statute. Additionally, when the IRS and Treasury issued the final rule, they were not aware of any written contracts between unrelated parties, whether in a cost sharing arrangement or not, that required one party to pay or reimburse the other for amounts attributable to SBC costs. Moreover, the Tax Court found that the IRS had not sufficiently rebutted the taxpayer's assertions that inclusion of such costs was not consistent with the arm's length standard adopted in the section 482 regulations.

Ninth Circuit Majority Opinion

The IRS appealed the unanimous US Tax Court opinion described above. On appeal, the Ninth Circuit considered all legal arguments and was not bound by any of the Tax Court's legal determinations in the case. The panel of three judges reversed the Tax Court, with one judge dissenting.[4]

In its majority opinion, the Ninth Circuit held that the all costs rule complied with the APA and was therefore entitled to deference.

In particular, the majority opinion stated that:

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[2] The regulations at issue were original designated as Treas. Reg. § 1.482-7 but were then redesignated as Treas. Reg. 1.482-7A by T.D. 9441. To minimize confusion, the citations in this alert are to the current version of the regulation unless otherwise specified.
[3] *See Altera*, 145 T.C. 91.
[4] *See Altera Corp. & Subs. v. Comm'r*, Nos. 16-70496, 16-70497 (9th Cir. June 7, 2019).

- The legislative history of section 482 supported the Treasury Department's decision to apply the commensurate with income ("CWI") principle as the basis for promulgating the all costs rule. In addition, given such legislative history, it was reasonable for Treasury to decide that uncontrolled cost-sharing arrangements do not provide helpful guidance regarding allocations of employee stock compensation between controlled parties.
- The second sentence of section 482 (for CWI) applies to QCSAs, and thus could be used as the basis for the SBC rule, because cost sharing transactions in QCSAs involve a transfer of rights to intangible property that has not yet come into existence.
- The Treasury Department provided adequate notice of its intent to promulgate the all costs rule by citing to the legislative history pertaining to the promulgation of the CWI principle in the notice for the 2003 SBC rule, and again in the preamble for the 2003 SBC regulation.
- The Treasury Department adequately considered the objections raised by commentators, including the objections that unrelated parties would not share SBC costs. Such comments, the majority held, were irrelevant, because Treasury had provided adequate notice that it was moving away from an analysis of comparable transactions as the exclusive means of achieving an arm's length result.
- Treasury's conclusion that stock-based compensation should be treated as a cost was adequately supported by "tax and other accounting principles."
- The decision in a prior similar case[5] was not controlling, because it did not speak directly to this issue but instead dealt with a conflict between two rules under the section 482 regulations.

Dissenting opinion

Judge Kathleen M. O'Malley filed a dissent against the majority opinion. The dissent maintained that Treasury did not satisfy the reasoned decision-making standard and that the all costs rule was invalid as arbitrary and capricious.

In particular, the dissent argued that, until the promulgation of the regulation in question, the Treasury Department consistently asserted that the only way to determine the arm's length standard was to conduct a comparability analysis. The dissent continued by saying that "[in this regulation] Treasury stated for the first time and with no explanation, that it may, *instead*, employ the 'commensurate with income standard' to reach the required arm's length result." (Emphasis in original). The dissent argued that this kind of switching of position by a federal agency is precisely the kind of activity that the APA, and the case law interpreting it, has indicated is unacceptable. Additionally, the dissent argued that taxpayers were not on notice of the change in position based on "cryptic" citations to legislative history because the APA, and the case law interpreting it, has indicated that the federal agencies must explain their changes in position, and the "cryptic" references to CWI legislative history were not sufficient to do so.

The dissent further argued that QCSAs are not subject to the second sentence of section 482 (for CWI) because it does not make sense to say that something that has not yet come into existence (and may never come into existence) can be transferred. In addition, the dissent maintained that the Treasury Department did not adequately consider the objections raised by commentators, particularly the objections that there was no evidence showing unrelated parties would share SBC costs. Finally, the dissent would have held that a prior similar case[6] did control and that this would therefore require the Tax Court's decision to be affirmed.

What comes next?

In a civil case involving a United States agency like the IRS, such as this case, the parties may file a motion for rehearing *en banc* within 45 days after entry of judgment.[7]

Alternatively, the parties can bypass the *en banc* panel and seek relief at the United States Supreme Court (they can also seek Supreme Court relief if they are turned down for an *en banc* hearing or lose at the *en banc* panel). In that case, the parties have 90 days to file a request to the clerk of the Supreme Court after the entry of the judgment.[8]

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[5] *See Xilinx, Inc. v. Comm'r*, 598 F.3d 1191 (9th Cir. 2010).
[6] *See id.*
[7] FRAP 40(a)(1).
[8] US Supreme Court Rule 13.

TIGTA Releases Report Finding Few Accuracy-Related Penalties Proposed by LB&I and Most Not Sustained by Appeals

TIGTA issued a report dated May 31, 2019 that examined the imposition of accuracy-related penalties by the Large Business and International Division ("LB&I") and the percentage of such penalties that are sustained by the IRS Appeals Office ("Appeals").

The report noted that LB&I examiners assess proportionally fewer accuracy-related penalties than Small Business/Self Employed Division ("SB/SE") examiners. From fiscal year ("FY") 2015 to FY 2017, only 6% of closed LB&I examinations proposed accuracy-related penalties. By contrast, 25% of closed SB/SE examinations proposed accuracy-related penalties.

In addition, many of the penalties proposed by LB&I examiners are not sustained by Appeals. For FY 2015 through FY 2017, TIGTA identified 519 examinations in which LB&I proposed accuracy-related penalties totaling $1.8 billion. During the same period, Appeals closed 195 cases, and in 183 of those cases, Appeals reduced or eliminated a total of $765 million of the penalties.

The report recommends that the IRS should:

1. Conduct a study to determine why accuracy-related penalties proposed by LB&I examiners are not being sustained by appeals and whether LB&I examiners are considering all relevant facts and circumstances before proposing penalties;
2. Ensure that LB&I examiners and supervisors are properly trained to consider accuracy-related penalties, to follow penalty development procedures, and to obtain supervisory approval of all penalty decisions;
3. Update Internal Revenue Manual guidelines to clarify which LB&I examiners are responsible for penalty development and to clarify the requirement to obtain supervisory approval for all penalty decisions;
4. Ensure that its quality review systems can accurately determine whether examiners are properly considering civil penalties, adequately supporting penalty decisions, involving management in penalty decisions, and obtaining required supervisory approvals; and
5. Evaluate its system for closing, shipping, and storing paper examination records.

The IRS partially agreed to the first recommendation and fully agreed with the four remaining recommendations. The IRS's response to the first recommendation noted that the missions of the examination function and Appeals are not the same. Appeals, unlike LB&I, has authority to settle cases based on the hazards of litigation, and many penalties may therefore be conceded as part of a hazards settlement.

The Ninth Circuit Holds That Common-Law Mailbox Rule No Longer Available to Establish Presumption of Actual Delivery

In *Baldwin v. Commissioner*,[9] the Ninth Circuit reversed the decision of the district court and upheld the validity of a Treasury regulation that precludes taxpayers from relying on the common-law mailbox rule to establish the presumption of actual delivery of a document to the Internal Revenue Service ("IRS"). The Ninth Circuit held that, absent direct proof of actual delivery, the proper use of registered mail, certified mail, or a designated private delivery service are the only ways to establish a presumption of actual delivery.

Background

The taxpayers in *Baldwin* were required to file their amended 2005 return by October 15, 2011 for them to obtain a refund of their 2007 overpayment of tax.[10] Employees of the taxpayers testified, and the district court found, that the

[9] Nos. 17-55115, 17-55354 (9th Cir. Apr. 16, 2019).
[10] See id., Slip Op. at 4.

taxpayers mailed their amended 2005 return in June 2011 (the "original refund claim").[11] The IRS never received the original refund claim.

In July 2013, the IRS received a new copy of the taxpayers' 2005 amended return, but the new amended return was postmarked after October 15, 2011.[12] The IRS denied the taxpayers' refund claim for 2007 on the grounds that the refund claim was not timely filed.[13] The taxpayers then brought a refund action in the district court.[14] Relying on the common-law mailbox rule, the district court allowed the taxpayers' refund suit to proceed.[15]

Proving Actual Delivery of a Document to the IRS

Common-law mailbox rule: Before 1954, a tax return or other document submitted to the IRS was generally considered as timely filed only when the return was physically delivered to the IRS.[16] Courts, however, generally allowed taxpayers to prove delivery of the return or other document under the, so called, "common-law mailbox rule."[17] Under the common-law mailbox rule, proof of proper mailing creates a rebuttable presumption that the document was physically delivered to the addressee in the time that such a mailing would ordinarily take to arrive.[18]

Statutory mailbox rule: In 1954, Congress enacted a statutory mailbox rule. Section 7502(a)(1) provides that, if a document or payment is postmarked before, and is received by the IRS after, the due date of the required filing or payment, then the date of the postmark is treated as the date that the document was filed with the IRS. Section 7502(c)(1) and the regulations thereunder provide that, if a document is sent by registered mail, certified mail, or with a designated private delivery service, then the document will be presumed to have been delivered on the registration date.[19]

Circuit split: In the years that followed, a circuit split developed regarding whether the common-law mailbox rule survived the enactment of the statutory mailbox rule. Some circuit courts of appeals, such as the Ninth Circuit in *Anderson v. United States*,[20] have held that the statutory mailbox rule supplements the common-law mailbox rule and does not supplant it.[21] By contrast, other circuit courts of appeals have held that, after the enactment of section 7502(c)(1), the statutory mailbox rule is the exclusive means of establishing a presumption of delivery.[22]

Treas. Reg. § 301.7502-1(e)(2)(i): In August 2011, Treasury and the IRS promulgated an amended version of Treas. Reg. § 301.7502-1(e)(i). The amended regulation provides that, absent direct proof of actual delivery, the exclusive means to establish prima facie evidence of delivery of a document to the IRS is through the proper use of registered or certified mail or designated private delivery service.[23] The amended regulation, thus, interprets section 7502(c)(1) like the circuit courts of appeals that held that the statutory mailbox rule supplants the common-law mailbox rule.

Is Treas. Reg. § 301.7502-1(e)(2)(i) valid?

The primary question before the district court and the Ninth Circuit was whether amended Treas. Reg. § 301.7502-1(e)(2)(i) reflects a valid interpretation of section 7502(c)(1). Under *Chevron USA. Inc. v. National Resources Defense*

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[11] *See id.*
[12] *See id.*
[13] *See id.*
[14] *See id.*
[15] *See id.*, Slip Op. at 10.
[16] *See id.*, Slip Op. at 5.
[17] *See id.*
[18] *See id.*, Slip Op. at 5 – 6.
[19] *See* Treas. Reg. §§ 301.7502-1(c)(2) and (3), (e)(2). The IRS has issued a list of designated delivery services. The list of designated delivery services is provided in Notice 2015-38.
[20] 966 F.2d 487 (9th Cir. 1992).
[21] *See, e.g.*, *Sorrentino v. IRS*, 383 F.3d 1187, 1193 (10th Cir. 2004); *Estate of Wood v. Comm'r*, 909 F.2d 1155, 1161 (8th Cir. 1990).
[22] *See, e.g.*, *Miller v. United States*, 784 F.2d 728, 730 – 31 (6th Cir. 1986); *Deutsch v. Comm'r*, 599 F.2d 44, 46 (2d Cir. 1979).
[23] *See* Treas. Reg. § 301.7502-1(e)(2)(i).

Council, Inc.,[24] courts must defer to an agency's reasonable interpretation of an ambiguous statute. The district court, following *Anderson*, held that the regulation was invalid because section 7502(c)(1) unambiguously supplements, and does not supplant, the common-law mailbox rule.[25]

The Ninth Circuit disagreed with, and reversed, the district court. It reasoned that section 7502 is silent as to whether the statutory mailbox rule supplants or, instead, supplements the common-law mailbox rule.[26] The Ninth Circuit held that, as reflected by the circuit split on this issue, amended Treas. Reg. § 301.7502-1(e)(2)(i) reflects a reasonable interpretation of section 7502. The court noted that this interpretation is consistent with the principle that, "where Congress explicitly enumerates certain exceptions to a general prohibition, additional exceptions are not to be implied, in the absence of evidence of a contrary legislative intent."[27]

The taxpayers argued that a contrary principle supports the position that the statutory mailbox rule supplements, and does not supplant, the common-law mailbox rule. That principle provides that "the common law…ought not to be deemed repealed, unless the language of a statute be clear and explicit for this purpose."[28] The Ninth Circuit acknowledged that dueling principles of statutory interpretation applied but concluded that, therefore, either interpretation is reasonable.[29]

Finally, the Ninth Circuit explained that its prior decision in *Anderson* did not bar it from upholding amended Treas. Reg. § 301.7502-1(e)(2)(i) because *Anderson* did not conclude that its interpretation of section 7502 was the only permissible interpretation of that statute.[30] The court noted that, under *National Cable & Telecommunications Association v. Brand X Internet Services*, "[a] court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion."[31] Thus, the court concluded that Treasury was free to fill the statutory gap by adopting its own reasonable interpretation of section 7502.

Accordingly, the Ninth Circuit held that the taxpayers' refund claim was not timely filed because the IRS never received the taxpayers' original refund claim and the original refund claim was not sent by registered mail, certified mail, or a designated private delivery service.

Conclusion

The Ninth Circuit's decision in *Baldwin* signals that courts that previously followed the common-law mailbox rule may not to do so following the amendment of Treas. Reg. § 301.7502-1(e)(2)(i) in August 2011. It also illustrates the potential consequences of not using registered mail, certified mail, or a designated private delivery service to mail time-sensitive documents to the IRS.

The Second Circuit Reverses a Tax Court Decision that Created a Black Hole in the Tax Court's Jurisdiction to Resolve Certain Refund Claims

In *Borenstein v. Commissioner*,[32] the Court of Appeals for the Second Circuit reversed a Tax Court decision and held that the 3-year lookback rule of the flush language of section 6512(b)(3) applies where a notice of deficiency is mailed during the third year after the original due date for filing a delinquent return. As such, the Second Circuit held that the

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[24] 467 US 837 (1984).
[25] *Baldwin*, Nos. 17-55115, 17-55354, Slip Op. at 10.
[26] *Id.*, Slip Op. at 11.
[27] *Id.*, Slip Op. at 12 (quoting *Hillman v. Maretta*, 569 US 483, 496 (2013)).
[28] *Id.* (quoting *Norfolk Redevelopment & Housing Authority v. Chesapeake & Potomac Tel. Co.*, 464 US 30, 35 (1983)).
[29] *See id.*
[30] See id., Slip Op. at 13.
[31] 545 US 967, 982 (2005).
[32] 919 F.3d 746 (2d Cir. 2019).

Tax Court had jurisdiction to determine a claim for refund where the notice of deficiency was issued 26 months after the original, but 20 months after the extended, due date.

Background

The Facts: In *Borenstein v. Commissioner*,[33] the taxpayer's 2012 federal income tax return was due on April 15, 2013 (the "original due date"). Under section 6513, the original due date is also the deemed payment date for amounts withheld to satisfy the taxpayer's 2012 tax liability.

The taxpayer requested and received a 6-month extension of time for filling her return. The taxpayer, however, failed to file her return by the October 15, 2013 extended due date. On June 19, 2015, approximately 26-months after the original due date, the IRS sent a notice of deficiency to the taxpayer that determined a 2012 income tax liability of $1,666,463 and penalties of $572,757.[34] On August 29, 2015, the taxpayer filed her original 2012 federal income tax return reporting an income tax liability of $79,559 and an overpayment of $32,441.[35] The parties stipulated that the income tax liability and overpayment reported on the taxpayer's original 2012 federal income tax return are correct.[36]

Section 6512(b)(3): The Tax Court has jurisdiction to resolve claims for refund or credit for a tax year that is at issue in a notice of deficiency if the tax was paid within the applicable lookback period (or after the mailing of the notice of deficiency).[37] If a taxpayer did not file a return on or before the day of the mailing of the notice of deficiency, the default lookback period is the 2-year period before the mailing of the notice of deficiency.[38]

In 1997, Congress added the flush language of section 6512(b)(3) to provide a 3-year lookback period if the notice of deficiency was mailed "during the third year after the due date (with extensions) for filing the return."[39] The issue before the Tax Court and the Second Circuit in Borenstein was whether June 19, 2015, the date of the mailing of the notice of deficiency, was "during the third year after the due date (with extensions) for filing the return." The resolution of this issue, in turn, depends on whether the parenthetical term "with extensions" in section 6512(b)(3) modifies the term "due date" or the term "third year."[40]

The Parties' Arguments: The IRS argued that the term "with extensions" modifies the term "due date." That is, the 3-year lookback period of section 6512(b)(3) applies where the notice of deficiency was mailed during the third year after the extended due date of the delinquent return. In this case, the 3-year lookback period would apply if the notice of deficiency was mailed during the period that began on October 16, 2015 (24 months after the extended due date of the return) and ended on October 15, 2016 (36 months after the extended due date of the return). However, because the notice of deficiency was issued on June 19, 2015 (*i.e.*, 20 months after the extended due date of the return), the 3-year lookback period of section 6512(b)(3) is inapplicable.

The taxpayer argued that the term "with extensions" modifies the term "third year." That is, the 3-year lookback period under section 6512(b)(3) applies where the notice of deficiency was mailed during the third year after the original due date of the delinquent return and during the subsequent period that is equal to any filing extension received. In this case, the 3-year lookback period applies because the notice of deficiency was mailed during the period that began April 16, 2015 (24 months after the original due date of the return) and ended October 15, 2016 (42 months after the original due date of the return).

The Tax Court Opinion

The Tax Court held that that the term "with extensions" unambiguously refers to the term "due date" and not the term "third year."[41] The Tax Court principally relied on the canon of statutory interpretation known as the "rule of the last

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[33] *See id.* at 748.
[34] *See id.*
[35] *See id.* at 748 – 49.
[36] *See id.*
[37] See IRC § 6512(b)(1), (3)(A).
[38] *See* IRC §§ 6511(b)(2)(B), 6512(b)(3)(B).
[39] IRC § 6512(b)(3) (flush language).
[40] *See Borenstein v. Comm'r*, 149 T.C. 263 (2017).
[41] See *id.* at 272.

antecedent." The rule of the last antecedent "provides that 'a limiting clause or phrase…should ordinarily be read as modifying only the noun or phrase that it immediately follows.'"[42] Applying the rule of the last antecedent, the Tax Court reasoned that the term "with extensions" should be read as modifying the immediately preceding term "due date" rather than the earlier term "third year."[43]

Accordingly, the Tax Court held that (1) the 3-year lookback period under the flush language of section 6512(b)(3) did not apply because the notice of deficiency was issued 20 months after the extended due date of the return and (2) the 2-year lookback period under section 6512(b)(2) did not apply because the tax at issue was deemed paid 26 months before the mailing of the notice of deficiency.[44] The Tax Court acknowledged that its holding produced an oddresult but concluded that it was required to interpret the statute as enacted by Congress because the result is not "so gross as to shock the general moral or common sense."[45]

The Second Circuit Opinion

On Appeal, the Second Circuit disagreed with the Tax Court's conclusion that that the term "with extensions" in the flush language of section 6512(b)(3) unambiguously refers to the term "due date."[46] The Second Circuit reasoned that reading the term "with extensions" as modifying the phrase "third year after the due date" is at least as plausible as reading such term as modifying the term "due date."[47] Because it found the flush language of section 6512(b)(3) to be ambiguous, the Second Circuit consulted the legislative history of that section.

The Second Circuit noted that Congress enacted the flush language of section 6512(b)(3) after the Supreme Court, in *Commissioner v. Lundy*,[48] held that non-filers were only entitled to a 2-year lookback period for asserting a refund claim in the Tax Court.[49] Specifically, the conference committee report to the Taxpayer Relief Act of 1997 states that the purpose of the flush language is to eliminate the differential treatment between taxpayers who file a return on or before the day of the mailing of the notice of deficiency and taxpayers who fail to file a return until after the day of the mailing of the notice of deficiency.[50]

The Second Circuit noted that the Tax Court's interpretation of the flush language of section 6512(b)(3) results in the differential treatment of non-filing taxpayers who received a filing extension and non-filing taxpayers who did not receive a filing extension.[51] In effect, "the Tax Court's interpretation creates a six-month 'black hole' into which the [taxpayer's] refund disappears."[52] To avoid this differential treatment, the Second Circuit concluded that the term "with extensions" must be read as modifying the phrase "third year after the due date."[53]

Conclusion

The Second Circuit's opinion in *Borenstein* may provide limited relief to non-filing taxpayers who received an extension of time to file their tax returns. The extent of this relief, and whether other courts will agree with the Second Circuit's interpretation of the flush language of section 6512(b)(3), remain to be seen.

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[42] *Lloyd v. J.P. Morgan Chase & Co.*, 791 F.3d 265, 271 (2d Cir. 2015) (quoting *Barnhart v. Thomas*, 540 US 20, 26 (2003)).
[43] *See Borenstein*, 149 T.C. at 272.
[44] *See id.*
[45] *See id.* at 276 – 77 (quoting *Crooks v. Harrelson*, 282 US 55, 60 (1930)).
[46] *See Borenstein*, 919 F.3d at 750.
[47] *See id.*
[48] 516 US 235 (1996).
[49] See Borenstein, 919 F.3d at 750 – 51.
[50] *See id.* at 751 (citing H.R. Rep. No. 105-220, at 701 (1997)).
[51] *See id.* at 751 – 52.
[52] *See id.* at 752.
[53] The Second Circuit did not address whether the period of any filing extension received is added to the 3-year lookback period under the flush language of section 6512(b)(3). If the period of any filing extension is not added to the 3-year lookback period under section 6512(b)(3), then the Tax Court will lack refund jurisdiction with respect to tax deemed paid on the return due date by non-filing taxpayers who receive a filing extension. The Tax Court, however, stated that, even if the term "with extensions" modifies the term "third year," the period of any filing extension received would not be added to the 3-year lookback period. *See Borenstein*, 149 T.C. at 273 – 74.

Tax Court holds that, where IRS asserted multiple penalties against a taxpayer, it is not required to make the "initial determination" and supervisory approval of the penalties at the same time or by the same individual and the supervisory approval of the penalties do not need to be made on a specific form

In *Palmolive Building Investors, LLC, DK Palmolive Building Investors Participants, LLC, Tax Matters Partner v. Commissioner of Internal Revenue*,[54] the IRS disallowed Palmolive's deduction for a conservation easement and imposed multiple penalties against it. In a TEFRA partnership-level action, the Tax Court held that, where the IRS asserts multiple penalties, the "initial determination" and supervisory approval requirements of section 6751(b)(1) of the Internal Revenue Code need not be made at the same time or by the same individual and the supervisory approval of the penalties do not need to be made on a specific form.

Facts

Palmolive owns the Palmolive Building in Chicago. It executed a conservation easement deed with a qualified organization under section 170(h)(3). The purpose of the deed was to ensure the preservation of the exterior perimeter walls of the buildings' façade. Palmolive filed a Form 1065, US Return of Partnership Income on which it claimed a $33.41 million charitable contribution deduction for the contribution of the easement.

The IRS examined Palmolive's 2004 return. The Internal Revenue Agent who conducted the examination concluded that the façade easement contribution deduction should be disallowed and that penalties should be imposed. The Revenue Agent prepared a Form 5701, Notice of Proposed Adjustment, and attached to it Forms 886A, Explanation of Items, that proposed a gross valuation misstatement penalty under section 6662(h)(1) and, in the alternative, a negligence penalty under section 6662(b)(1). The Revenue Agent did not sign the documents. Instead they were signed by the Revenue Agent's supervisor. The IRS sent Palmolive a 60-day letter offering it an opportunity to file a protest and request a conference before the IRS Office of Appeals ("Appeals"). In response to the 60-day letter, Palmolive timely submitted a Protest and requested a conference with IRS Appeals.

While under consideration in Appeals, the Appeals Officer concluded that additional alternative penalties should be imposed. The Appeals Officer prepared and signed a Form 5402-c, Appeals Transmittal and Case Memo, and attached a proposed Final Partnership Administrative Adjustment ("FPAA") that listed additional accuracy related penalties of either a 40 % penalty for a gross valuation misstatement under section 6662(a) and (h), a 20% penalty due to negligence or intentional disregard, or a substantial valuation misstatement .The Appeals Officer gave the documents to his immediate supervisor who signed both the Form 5402-c and the proposed FPAA.

The IRS issued an FPPA that determined that Palmolive did not adequately substantiate the value of the contribution and that the deed did not meet the requirements of section 170. Alternatively, the IRS determined that Palmolive did not establish the easement had a value of $33,410,000. The FPAA disallowed the deduction and imposed penalties. Palmolive brought a TEFRA partnership-level proceeding contesting both the IRS's determination to disallow its charitable deduction and to assert penalties against Palmolive. The parties filed cross-motions for summary judgement on the question of whether the IRS complied with section 6751(b) in proposing the penalties.[55]

Law and Analysis

Section 6751(b)(1) provides that no penalty shall be assessed unless the initial determination is personally approved in writing by the immediate supervisor.[56]

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[54] 152 T.C. No. 4 (Feb. 28, 2019).
[55] In a prior opinion the Tax Court granted partial summary judgment in favor of the IRS and held that Palmolive was not entitled to its claimed charitable contribution because of its failure to comply with certain requirements of section 170. *See Palmolive Bldg. Inv'rs, LLC v. Comm'r*, 149 T.C. 380 (2017).
[56] *See* §6751(b)(1).

In this case, the issue before the court was whether each of the penalties proposed by IRS officials met the requirements of section 6751(b)(1). Palmolive made a series of arguments against the validity of the penalties – all of which were rejected by the tax court.

Palmolive argued that the two penalties proposed by the Appeals Officer were not initially determined by the Internal Revenue Agent who proposed the first penalties and they were not initially approved by the Revenue Agent's supervisor. The court rejected this argument because, although the same employee and supervisor did not determine and approve all of the penalties, the court held that there is no requirement in section 6751(b)(1) that the same employee and supervisor must determine and approve all penalties.

Palmolive also argued that the IRS failed to comply with its internal procedures by omitting the signature of the Revenue Agent, thus rendering the determinations invalid. The court rejected this argument as well because the Internal Revenue Manual does not have the force of law and is not binding on the IRS.[57] The court held that section 6751(b)(1) only requires that the supervisory approval be in writing and the fact the Revenue Agent who proposed the penalties did not sign the Form 5701 is immaterial to the satisfaction of the supervisory approval requirement.

Palmolive also argued that section 6662(b) contains more than one penalty and that section 6751(b)(1) requires that each penalty must be separately approved. Section 6662(b) applies an accuracy related penalty to the proportion of the underpayment penalty that is due to: 1) negligence or disregard of rules or regulations and 2) any substantial understatement of income tax.[58] Palmolive contended that the IRS had not made an initial determination with respect to the penalty for disregard of rules or regulations. The court rejected this argument ruling that, even if Palmolive's division of section 6662(b) into two distinct penalty provisions were correct, it would not render the penalty invalid. The Agent's supervisor approved the negligence penalty and the Appeals Officer later approved the penalty for intentional disregard of rules or regulations.

Finally, Palmolive argued that because the initial determination for the substantial valuation misstatement penalty and substantial understatement penalty were omitted from the Form 5701 drafted by the Appeals officer, they could not be asserted in the July 2014 FPAA. Palmolive reasoned that the FPAA represents the IRS's final determination of penalties and not an initial determination and therefore those penalties failed to comply with section 6751(b)(1). The court rejected this argument because the penalties were first determined by the Internal Revenue Agent and the Appeals Officer and subsequently received supervisory approval before assessment.

Thus, the court found that the penalties complied with the requirements of section 6751(b)(1). This case, along with other recent decisions, is part of a trend where courts are narrowly interpreting the signature requirements of section 6751(b)(1). [59] In light of these recent cases, the Second Circuit's opinion in *Chai* and the Tax Court's opinion in *Graev*, holding that IRS has the burden of proof of satisfying the requirements of section 6751(b), may not offer taxpayers such an expansive refuge against the imposition of penalties by the IRS.[60]

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[57] *Thomson v. Comm'r*, 140 T.C. 173, 190 n.16 (2013).
[58] *See* § 6662(b).
[59] *See ATL & Sons Holdings, Inc. v. Comm'r*, 152 T.C. No. 8 (Mar. 13, 2019) (IRS may assess a penalty under section 6699 without the written approval of an immediate supervisor having been obtained); *Walquist v. Comm'r*, 152 T.C. No. 3 (Feb. 25, 2019) (Penalty determined by the IRS that was calculated through electronic means as set forth in section 6751(b)(2)(B) is exempt from written supervisory approval requirement of section 6751(b)(1); *Nix v. United States*, Nos. 2:17-CV-00434, 435 & 436, 2018 US Dist. LEXIS 152354 (E.D. Tex. Sept. 7, 2018) (Where a penalty was conclusively determined in a prior TEFRA partnership proceeding, section 6751(b)(1) does not require the section 6751(b)(1) "procedural safeguard" at the partner-level proceeding "which merely applies the penalty" to the partner). **URL:** http://taxcontroversyposts.postschell.com/wp-content/uploads/2018/09/Nix-v.-United-States.pdf
[60] *Chai v Comm'r*, 851 F.3d 190, 219 (2nd Cir. 2017); *Graev v. Comm'r*, 149 T.C. __, __ (slip op. at 13-14) (Dec. 20, 2017), supplementing and overruling in part 147 T.C. 460 (2016).