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Federal Income Taxation

Andrew Todd*

In 2022, the United States Court of Appeals for the Eleventh Circuit issued two published opinions involving U.S. federal income tax issues.[1] The first opinion, *Sarma v. Commissioner*,[2] addressed procedural issues arising under the unified partnership audit procedures that were added to the Internal Revenue Code[3] by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[4] The second opinion, *Kroner v. Commissioner*,[5] addressed an issue of first impression in this circuit concerning supervisory review of tax penalties.[6] This Article surveys both of those opinions.

I. SARMA V. COMMISSIONER

Different procedures govern how the Internal Revenue Service (IRS) conducts audits of partnership tax returns based on the taxable year involved.[7] In *Sarma v. Commissioner*, the Court of Appeals for the Eleventh Circuit considered procedural issues under the TEFRA's

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1. For an analysis of the Court's cases involving U.S. federal income taxation during the prior survey period, see Andrew Todd, *Federal Income Taxation*, *Eleventh Circuit Survey*, 73 MERCER L. REV. 1253 (2022).

2. 45 F.4th 1312 (11th Cir. 2022).

3. All references to "Section," "section," or "§" in this Article are to sections of the Internal Revenue Code of 1986, as amended (the Code), unless indicated otherwise.

4. Pub. L. No. 97-248, 96 Stat. 324 (1982).

5. 48 F.4th 1272 (11th Cir. 2022).

6. *Id.* at 1274.

7. Bipartisan Budget Act of 2015, Pub. L. No. 114-74, §§ 1101(a), (g)(1), 129 Stat. 584, 625, 638 (2015). The Bipartisan Budget Act of 2015 (hereinafter BBA) enacted new partnership audit procedures applicable to audits of partnership tax returns for taxable years beginning on or after January 1, 2018. *Id.* §§ 1101(c) (codified at I.R.C. §§ 6221–6241), (g)(1).

unified partnership audit procedures.[8] Agreeing with the United States Tax Court, the court of appeals found for the IRS on all issues presented on appeal.[9]

A. Overview of TEFRA Partnership Audit Procedures

Prior to the enactment of the TEFRA, the Internal Revenue Code did not provide a mechanism for the IRS to conduct audits of items attributable to partnerships in a single, unified proceeding.[10] Instead, the IRS was required to audit each partner individually under normal deficiency proceedings.[11] This led to inconsistent results among partners due to duplicative proceedings involving the same items.[12] By the late 1970s, the partnership had emerged as the vehicle of choice for financing and investment vehicles—in addition to syndicated tax shelters—with many unrelated partners.[13] Conducting partner-by-partner audits imposed significant administrative burdens on the IRS, which Congress sought to alleviate by enacting new partnership audit provisions in the TEFRA.[14]

The TEFRA regime features a two-tiered structure for resolving partnership tax matters.[15] First, a single partnership-level proceeding is used to adjust or determine "partnership items."[16] "[P]artnership-related item[s]" are items that are required to be taken into account for the partnership's taxable year[17] and are more appropriately determined at the partnership level (rather than at the partner level).[18] When challenging a partnership item, the IRS will commence an administrative proceeding against the partnership and provide notice to the partnership (and possibly certain partners) of the commencement of such proceeding.[19] At the conclusion of the partnership-level proceeding, the IRS notifies the partners of adjustments to partnership items by

8. 45 F.4th at 1315.
9. *Id.* at 1325.
10. United States v. Woods, 571 U.S. 31, 38 (2013). *See also* MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 10.01 (4th ed. 2007).
11. *Woods*, 571 U.S. at 38.
12. *Id.*
13. MCKEE ET AL., *supra* note 10, at ¶ 10.01.
14. *Woods*, 571 U.S. at 38.
15. I.R.C. §§ 6221(a), 6231(a)(3) (2012).
16. *Id.*
17. *Id.* at § 6231(a)(3).
18. *See* MCKEE ET AL., *supra* note 10, at ¶ 10.02[4].
19. I.R.C. § 6223(a) (2012).

issuing a notice of final partnership administrative adjustment (FPAA).[20] Adjustments made to partnership items are subject to judicial review in a partnership-level proceeding.[21]

Once partnership-level adjustments become final, the IRS determines whether any partner-level adjustments are required.[22] If an adjustment does not require partner-level factual determinations, the IRS can directly assess the adjustment against the partner without going through the normal deficiency procedures, leaving the partner without a prepayment right to judicial review.[23] However, if an adjustment to an affected item[24] requires partner-level factual determinations, the IRS must issue the partner an affected item notice of deficiency (AIND) and follow the normal deficiency procedures.[25] Partners have a prepayment right to judicial review of an AIND.[26]

The TEFRA regime applied to all partnerships that filed partnership returns.[27] However, for purposes of the TEFRA regime, the term "partnership" does not include "small partnerships."[28] A "small partnership" is a partnership with ten or fewer partners consisting only of individuals, C corporations, or the estate of a deceased partner.[29] A partnership cannot be a small partnership if it has a partner that is classified as a partnership for U.S. federal income tax purposes.[30] The determination of whether a partnership is a small partnership is made each taxable year.[31] If a partnership is a small partnership, then the TEFRA regime does not apply absent an election to the contrary, and such partnership's tax items are challenged through partner-level deficiency proceedings.[32]

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20. *Id.* at § 6223(a)(2).

21. *Id.* § 6226(a), (b)(1) (2012). Partners in a partnership no longer have participation rights under the partnership audit rules currently in effect. *See id.* at § 6234(a) (2018).

22. *Id.* at § 6225 (2012).

23. *Id.* at §§ 6230(a)(1), (c) (2012); *Id.* at § 6231(a)(6) (2012); 26 C.F.R. § 301.6231(a)(1)-1(a)(2) (2001).

24. An "affected item" is "any item . . . [that] is affected by a partnership item." I.R.C. § 6231(a)(5) (2o12).

25. *Id.* at § 6230(a)(2)(A)(i); 26 C.F.R. § 301.6231(a)(1)-1(a)(3).

26. I.R.C. § 6230(a)(2)(A)(i) (2012).

27. *Id.* at § 6231(a)(1)(A).

28. *Id.* at § 6231(a)(1)(B)(i).

29. *Id.*

30. *Id.* at § 6231(a)(9); 26 C.F.R. § 301.6231(a)(1)-1(a)(2).

31. 26 C.F.R. § 6231(a)(1)-1(a)(3).

32. I.R.C. § 6231(a)(1)(A)–(B) (2012); *see* Arenjay Corp. v. Comm'r, 920 F. 2d 269, 270 (5th Cir. 1991).

B. Facts of the Case

Raghunathan Sarma,[33] a business owner, realized an $80.9 million capital gain in 2001 when he sold a division of his company.[34] In an attempt to avoid paying tax on that gain, Sarma participated in a tax avoidance scheme called "Family Office Customized Partnership," or "FOCus."[35] FOCus was marketed by Bricolage Capital, LLC (Bricolage) and the accounting firm KPMG to wealthy individuals with recent large liquidity events. At a high level, FOCus involves using multiple partnership tiers to generate artificial gains and losses.[36]

Sarma's FOCus vehicle consisted of three partnerships: Nebraska Partners Fund, LLC (Nebraska), Lincoln Partners Fund, LLC (Lincoln), and Kearney Partners Fund, LLC (Kearney) (referred to collectively as the Partnerships).[37] Nebraska owned a 99% interest in Lincoln, which owned a 99% interest in Kearney. A Bricolage-affiliated C corporation owned the remaining 1% interest in each Partnership.[38]

Kearney executed a series of offsetting foreign currency exchange forward contracts (the Straddles).[39] Kearney closed the gain legs of its Straddles, generating a gain of $79.1 million. The proceeds were placed in certificates of deposit. The loss legs of the Straddles were not closed out, but the unrealized losses in those legs were effectively locked in.[40]

Mr. Sarma purchased a 99% interest in Nebraska on December 4, 2001.[41] This triggered a technical termination of the Partnerships, resulting in each partnership having a short taxable year that ended on December 4, 2001.[42]

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33. During the years at issue, Mr. Sarma and his wife, Gaile Sarma (collectively, the Taxpayers), filed joint U.S. federal income tax returns. Sarma v. Comm'r, T.C. Memo. 2018-201, at *2 (2018). The Taxpayers divorced in 2005. *Id.*

34. *Sarma*, 45 F.4th at 1317.

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.*

41. *Sarma*, T.C. Memo. 2018-201, at *5.

42. *Id.* For partnership taxable years beginning on or before December 31, 2017, Section 708(b)(1)(B) provides that a partnership is deemed to terminate for U.S. federal income tax purposes (and a new partnership is deemed to be formed) if 50% or more of the total capital and profits interest in such partnership are transferred during a twelve-month period. This is commonly referred to as a "technical termination." 26 C.F.R. § 1.708-1(b)(2) (2014). A technical termination of an upper-tier partnership would cause a technical termination of a lower-tier partnership. *Id.* Section 708(b)(1)(B) was repealed for partnership taxable years beginning after December 31, 2017, by the legislation commonly

On December 14, 2001, Nebraska sold its 99% interest in Lincoln to Sarma, triggering a technical termination of Lincoln and Kearney.[43] Lincoln and Kearney each reported short tax periods from December 5–14, 2001. Application of the technical termination rule resulted in the deemed formation of two new partnerships for U.S. federal income tax purposes: (1) Lincoln, with Sarma as 99% partner and the Bricolage-affiliated C corporation as 1% partner; and (2) Kearney, with the new Lincoln as 99% partner and the Bricolage-affiliated C corporation as 1% partner. Lincoln filed a partnership tax return with Sarma as a partner for the short tax period of December 15–31, 2001 (the Dec. 31, 2001 tax period), as well as for the years 2002 through 2004.[44]

On December 19, 2001, Lincoln sold its interest in Kearney to a Bricolage-related entity for $737,118 (the Kearney Sale).[45] At the time of the sale, Lincoln reported its outside basis[46] in Kearney as $79,110,062, resulting in a $78,392,194 short-term capital loss. Lincoln allocated $77,608,272 of this loss to Sarma as its 99% partner. Taxpayers deducted this loss on their 2001 joint U.S. federal income tax return and carried portions of the loss forward to 2002, 2003, and 2004.[47]

The IRS examined the Partnerships' tax returns for the short periods, as well as the Taxpayers' 2001 tax return.[48] It concluded that the transactions lacked economic substance and should be disregarded for U.S. federal income tax purposes. The IRS issued numerous FPAAs to the Partnerships for several of the short tax years. However, Lincoln was not issued an FPAA for the December 31, 2001 tax period because it was a small partnership during that time.[49]

The Partnerships challenged the FPAAs in the United States District Court for the Middle District of Florida.[50] The district court found that the transactions involving the Partnerships and the Straddles were completed only for tax avoidance purposes, lacked economic substance and a legitimate business purpose, were not entitled to respect for tax purposes, and that Kearney was a sham and should be disregarded for

known as the Tax Cuts and Jobs Act. Act of Dec. 22, 2017, Pub. L. No. 115-97, § 13504, 131 Stat. 2054 (2017).

43. *Sarma*, T.C. Memo. 2018-201, at *6.

44. *Id.*

45. *Id.*

46. *Id.* Outside basis is "a partner's tax basis in a partnership interest". *See*, *e.g.,* United States v. Woods, 571 U.S. 31, 35–36.

47. *Sarma*, T.C. Memo. 2018-201, at *6.

48. *Id.* at *12.

49. *Id.*

50. *Id.* at *14. *See also* Kearney Partners Fund, LLC v. United States, No. 10-cv-153-FtM-37CM, 2014 U.S. Dist. LEXIS 29652 (M.D. Fla. Mar. 7, 2014).

tax purposes.[51] Accordingly, the district court sustained the IRS's adjustments, reducing Kearney's gain and loss from the Straddles to zero.[52] Kearney unsuccessfully appealed the district court's decision,[53] and "[t]he partnership-level proceeding became final on January 11, 2016."[54]

The results of the Kearney partnership-level proceeding affected Lincoln's outside basis in Kearney.[55] Under TEFRA, courts lack authority to adjust a partner's outside basis during partnership-level proceedings, so a partner-level proceeding was required to adjust Lincoln's outside basis in Kearney.[56]

On September 9, 2016, the IRS issued an AIND to the Taxpayers (the 2016 Notice).[57] In that notice, the IRS disallowed the $77.6 million loss deduction that Lincoln allocated to Sarma following the Kearney Sale. Taxpayers challenged the notice of deficiency in the Tax Court. The Tax Court decided three main issues, finding for the IRS on all three.[58]

C. Issues Presented[59]

1. Was the Assessment Barred by the Statute of Limitations?

Generally, the statute of limitations for the assessment of U.S. federal taxes is three years from the date of payment of the tax or the date on which the associated tax return was filed, whichever is later.[60] However, a special statute of limitations applies with respect to "partnership items" and "affected items" under the TEFRA regime.[61]

With respect to "partnership items" and "affected items" of partnership returns subject to the TEFRA regime, the limitations period

51. *Kearney Partners Fund, LLC*, 2014 U.S. Dist. LEXIS 29652, at *38–39.

52. *Id.* at *40.

53. *See* Kearney Partners Fund, LLC v. United States, 803 F.3d 1280, 1281 (11th Cir. 2015) (per curiam).

54. Sarma v. Commissioner, 45 F.4th 1272, 1319.

55. *See* I.R.C. § 705(a)(1) (2018) (providing that a partner's basis in his partnership interest is increased by the partner's distributive share of income and gain from such partnership).

56. States v. Woods, 571 U.S. 31, 41.

57. *Sarma*, 45 F.4th at 1319.

58. *Id.*

59. The United States Court of Appeals for the Eleventh Circuit also quickly dispatched a due process concern that the Taxpayers first raised in a footnote in their brief. *Id.* at 1325. Because this issue was not critical to the Court's decision, it is not discussed in this Article.

60. I.R.C. § 6501(a) (2022).

61. *Id.* at § 6501(n)(2) (2022); *Id.* at § 6229(d) (2010).

is triggered upon the filing of a partnership return.[62] The timely mailing of an FPAA under the TEFRA regime suspends the running of the limitations period until one year following the final resolution of the proceedings.[63] However, for small partnerships, the limitations period is generally triggered by filing the partner's tax return (rather than the partnership's return).[64] The Tax Court found that Lincoln's outside basis in Kearney was an "affected item[]," subject to the special statute of limitations under the TEFRA.[65]

The Eleventh Circuit began its analysis by considering whether the Tax Court correctly determined that Lincoln's outside basis in Kearney was an affected item.[66] This question turned on whether Lincoln's outside basis in Kearney was "affected by" the district court's findings in the *Kearney* litigation.[67] The court noted that partners could not legitimately claim an outside basis greater than zero when a partnership is disregarded as a sham, so it easily concluded that Lincoln's outside basis in Kearney was an affected item.[68] The court also found nothing in the statutory text that would compel a different result when partners in small partnerships are involved.[69]

The Taxpayers argued that Lincoln's outside basis in Kearney was not an affected item by analogizing Lincoln to a partnership subject to the TEFRA.[70] According to the Taxpayers, an upper-tier TEFRA partnership's outside basis in a lower-tier TEFRA partnership would be a partnership item of the upper-tier partnership.[71] Applying the same treatment to small partnerships, a small partnership's outside basis in a lower-tier TEFRA partnership would be a partnership item of the small partnership.[72] Thus, argued the Taxpayers, Lincoln's outside basis in Kearney was a "'partnership-level' nonpartnership item" that should have been addressed in a separate partnership-level proceeding against Lincoln.[73]

62. *Id.* at § 6229(a) (2012).
63. *Id.* at § 6501(n)(2); I.R.C. § 6229(d).
64. Wolf v. Comm'r, 4 F.3d 709, 714 (9th Cir. 1993).
65. *Sarma*, T.C. Memo. 2018-201, at *36.
66. Sarma v. Commissioner, 45 F.4th 1272, 1316.
67. *Id.* at 1320.
68. *Id.* at 1320–21.
69. *Id.* at 1321.
70. *Id.*
71. *Id.*
72. *Id.*
73. *Id.*

The Eleventh Circuit easily and definitively dispatched the Taxpayers' argument as "contrary to the text and structure of TEFRA."[74] Although there is a textual argument that outside basis in a lower-tier TEFRA partnership is a partnership item with respect to an upper-tier TEFRA partnership, Lincoln could not have any partnership items because it was a small partnership.[75] Thus, the textual bar that arguably prevents an upper-tier TEFRA partnership's outside basis in a lower-tier TEFRA partnership from being an affected item was absent.[76]

Nor does the TEFRA's tiered structure indicate congressional intent for like treatment of "nonpartnership 'partnership-level' items"[77] of small partnerships.[78] The TEFRA provides for the resolution of partnership-level items in a single, unified proceeding so that those items can be uniformly applied to the partners.[79] It does not, and was not intended to, provide uniform treatment for all entities filing tax returns as partnerships.[80] Indeed, any distinction between partner-level and partnership-level items is irrelevant to small partnerships that are "exempt from having entity-level items resolved in entity-level proceedings."[81]

Having addressed the Taxpayers' arguments, the Eleventh Circuit upheld the Tax Court's determination that the assessment was not barred by the statute of limitations.[82] The timely-issued FPAA suspended the statute of limitations for assessment with respect to affected items until January 11, 2017—one year after the *Kearney* decision became final.[83] The 2016 Notice was issued on September 9, 2016, and it asserted a deficiency attributable to an affected item. Accordingly, the statute of limitations had not expired when the 2016 Notice was issued.[84]

2. Was the Notice of Deficiency Valid?

The Eleventh Circuit then considered the validity of the 2016 Notice.[85] The IRS generally cannot issue multiple notices of deficiency to the same

74. *Id.*
75. *Id.*
76. *Id.* at 1321–22.
77. *Id.* at 1321.
78. *Id.* at 1322.
79. *Id.*
80. *Id.*
81. *Id.*
82. *Id.*
83. *Id.*
84. *Id.*
85. *Id.* at 1323.

taxpayer for the same tax year.[86] The Tax Court has jurisdiction to redetermine a deficiency only if, *inter alia*, a valid notice of deficiency is issued.[87] The IRS had issued two deficiency notices to the Taxpayers for 2001 through 2004 before issuing the 2016 Notice.[88] According to the Taxpayers, these prior notices rendered the 2016 Notice invalid, depriving the Tax Court of jurisdiction.[89]

Section 6230, however, provides an exception to the "no second notice of deficiency" rule for AINDs.[90] Because the 2016 Notice was an AIND, the 2016 Notice was valid.[91] Accordingly, the Eleventh Circuit affirmed the Tax Court on this issue.[92]

3. Should the Lincoln Sale be Recharacterized as an Asset Sale?

Turning to the final main issue, the Eleventh Circuit addressed the Taxpayers' argument that the transactions should be recast as an asset sale.[93] When a partnership is disregarded as a sham, the activities of the purported partnership are attributed to one or more of the purported partners.[94] The Taxpayers argued that the district court's finding in *Kearney* effectively rendered Lincoln's sale of its Kearney interest a sale of assets by Lincoln for tax purposes.[95] The Taxpayers contended that such characterization necessitated a resolution of Lincoln's basis in Kearney's assets by the Tax Court. According to the Taxpayers, Lincoln had a cost basis of $80.8 million in assets that it sold for $717,868. The Tax Court declined the Taxpayers' invitation to recast the transaction as an asset sale, sustaining disallowance of the claimed loss.[96]

The Eleventh Circuit noted that sham partnerships are generally disregarded and treated as an agent or nominee of the purported partners.[97] However, filing a partnership tax return by a sham partnership subjects that partnership to the TEFRA regime, giving a reviewing court the jurisdiction to determine the would-be partnership

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86. I.R.C. § 6212(c)(1) (2018).
87. GAF Corp. v. Comm'r, 114 T.C. 519, 521 (2000).
88. *Sarma*, T.C. Memo. 2018-201, at *19.
89. *Sarma*, 45 F.4th at 1323.
90. I.R.C. § 6230(a)(2)(C) (2012).
91. *Sarma*, 45 F.4th at 1323.
92. *Id.*
93. *Id.*
94. 436, Ltd, Heitmeier. v. Comm'r, T.C. Memo. 2015-28, *34–*35.
95. *Sarma*, 45 F.4th at 1323.
96. *Sarma*, T.C. Memo. 2018-201, at *42–*44.
97. *Sarma*, 45 F.4th at 1323.

items in a partnership-level proceeding.[98] That is precisely what the district court did in *Kearney*: it determined Kearney's partnership-level items by disregarding the Straddles as shams.[99]

The instant case, however, is a partner-level case. Recharacterizing the transaction as an asset sale by Lincoln would have required the Tax Court to determine the basis of Kearney's assets.[100] Kearney's basis in its assets would be a partnership item for Kearney.[101] Thus, the Tax Court was without jurisdiction to adjust those items.[102] Although the Taxpayers cited various cases in support of their argument, those cases were distinguishable because they involved purported partnerships that distributed assets to their purported partners.[103] Here, however, Lincoln did not distribute and was not treated as having distributed assets to Lincoln in any of the prior litigation.[104] Nor was Lincoln ever treated as the owner of Kearney's assets.[105]

Moreover, recharacterizing the Kearney Sale as a sale of assets by Lincoln would violate the longstanding principle that taxpayers generally cannot disavow the form of transaction they choose.[106] Taxpayers are generally free to choose the form of their transaction.[107] However, once a form is chosen, taxpayers are bound by that form.[108] The judicially-created "substance over form" doctrine permits the IRS to recharacterize transactions and tax them according to the "objective economic realities of a transaction rather than to the particular form the parties employed."[109] This is true even though the form of the transaction may fall within the boundaries of the law.[110] Taxpayers are permitted to offensively use the substance over form doctrine to disavow the form of a transaction, but only in "exceptional" circumstances.[111]

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98. *Id.*

99. *Id. See also* Kearney Partners Fund, LLC v. United States, No. 10-cv-153-FtM-37CM, 2014 U.S. Dist. LEXIS 29652, at *14.

100. *Sarma*, 45 F.4th at 1324.

101. *Id.*

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.*

106. *Id.* (quoting Meruelo v. Comm'r, 923 F.3d 938, 945 (11th Cir. 2019) (quoting Comm'r v. Nat'l. Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974))).

107. *Nat'l Alfalfa Dehydrating & Milling Co.*, 417 U.S. at 149.

108. *Meruelo*, 923 F.3d at 945.

109. Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978).

110. Gregory v. Helvering, 293 U.S. 465, 469–70 (1935).

111. *Meruelo*, 923 F.3d at 945.

The transaction at issue was reported by Lincoln as a sale of its interest in Kearney.[112] In the ensuing audit and litigation, Kearney was found to be a sham, and the tax consequences of the tax shelter were eliminated at the partnership level. That outcome enabled the IRS to reduce Lincoln's outside basis in Kearney and disallow the $77.6 million loss the Taxpayers claimed on their tax return. The taxpayers may not have contemplated that outcome, but they are bound by it.[113] As noted by the court, there was nothing unjust about holding the Taxpayers to the form of the transaction they chose, particularly when the transaction is an abusive, pre-planned tax shelter.[114] Accordingly, the Eleventh Circuit concluded that the Tax Court appropriately declined to recharacterize the Kearney Sale as an asset sale.[115]

D. Conclusion

Because the TEFRA regime does not apply to partnerships for taxable years beginning after December 31, 2017, the number of partnership audits conducted under the TEFRA regime will continue to decline. In that context, *Sarma* can be characterized as somewhat of a rare breed. On the other hand, it illustrates the complexity and expanse of the TEFRA audits (recall that the 2016 Notice related to tax years 2001 through 2004). Numerous other TEFRA audits and cases are working their way through the examination or litigation process, and the *Sarma* decision will guide taxpayers, the IRS, and courts alike until the "well-worn law"[116] finally wears out.

II. KRONER V. COMMISSIONER

In *Kroner v. Commissioner*, the United States Court of Appeals for the Eleventh Circuit was called upon to address an issue of first impression involving the procedures prescribed by § 6751[117] for approving the imposition of penalties.[118] Although the court had previously addressed questions involving § 6751,[119] it had never addressed *when* the approval required by § 6751 must occur.[120] The Eleventh Circuit found that the

112. Sarma v. Commissioner, 45 F.4th 1272, 1324.
113. *Id.*
114. *Id.*
115. *Id.* at 1325.
116. *Sarma*, T.C. Memo. 2018-201, at *44.
117. I.R.C. § 6751 (2020).
118. Kroner v. Commissioner, 48 F.4th 1272, 1274.
119. TOT Prop. Holdings, LLC v. Comm'r, 1 F.4th 1354, 1372–74 (11th Cir. 2021).
120. *Id.* at 1372 n.25.

United States Tax Court's interpretation of the statute was contrary to the statutory text and reversed the Tax Court's decision.[121]

A. Facts of the Case

From 2005–2007, Burt Kroner (the petitioner) received approximately $25 million in transfers from a business associate.[122] The petitioner, having been advised by his tax advisers that the transfers were gifts,[123] did not report any of the transfers as income during the years at issue.[124]

The IRS audited the petitioner's 2005–2007 tax returns and determined that the transfers were taxable income.[125] On August 6, 2012, the IRS delivered Letter 915[126] to the petitioner's representatives at a closing conference.[127] That letter (and its attachments) proposed the imposition of accuracy-related penalties under § 6662.[128] The petitioner and the IRS continued to negotiate the proposed changes but were unable to reach an agreement.[129]

On October 31, 2012, the IRS mailed Petitioner Letter 950[130] signed by the examining agent's direct supervisor.[131] That same day, the examining agent's direct supervisor signed a form approving the imposition of the § 6662 penalties proposed in Letter 950. The parties never came to an agreement, so the IRS mailed the Petitioner a statutory notice of deficiency dated July 10, 2014.[132]

Petitioner timely petitioned the Tax Court for redetermination of the deficiency.[133] The Tax Court sustained the IRS's determination that the

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121. *Kroner*, 48 F.4th at 1281.

122. Kroner v. Comm'r, T.C. Memo. 2020-73, at *3–4 (2020).

123. Gifts are not included in a taxpayer's gross income. I.R.C. § 102(a) (2018).

124. *Kroner*, T.C. Memo. 2020-73, at *4–*5.

125. *Id.* at *5.

126. Letter 915 is used to explain adjustments in the amount of tax following an IRS examination of a tax return. *Letters and Notices Offering an Appeal Opportunity*, INTERNAL REVENUE SERVICE (Feb. 26, 2023), https://www.irs.gov/appeals/letters-and-notices-offering-an-appeal-opportunity [https://perma.cc/6ABJ-4ALN].

127. *Kroner*, T.C. Memo. 2020-73, at *5.

128. *Id.*; I.R.C. § 6662 (2020).

129. *Kroner*, 48 F.4th at 1275.

130. Letter 950 is also used to explain adjustments in the amount of tax, generally in cases where the IRS and the taxpayer do not agree on the proposed adjustments. *Letters and Notices Offering an Appeal Opportunity*, *supra* note 127. It is colloquially referred to as the "30-day letter" because it gives taxpayers thirty days to protest the changes with the Independent Office of Appeals. *See* SALTZMAN & BOOK, IRS Practice & Procedure ¶ 8.01[2]. (Thomson Reuters/Tax & Accounting, Rev. 2d ed. 2022).

131. *Kroner*, T.C. Memo. 2020-73, at *5.

132. *Id.* at *6.

133. *Id.*

transfers were taxable income.[134] However, the Tax Court determined that Petitioner was not liable for the accuracy-related penalties imposed under § 6662 because they were not approved in a timely manner.[135]

B. Issue Presented: Were the Proposed Penalties Approved in a Timely Manner?

The sole issue on appeal was whether supervisory approval for imposition of accuracy-related penalties under § 6662 was obtained in a timely manner.[136] Under § 6751, the IRS cannot assess a penalty "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."[137] The statute prescribes what must be approved—the initial determination of an assessment—and who must approve it—the recommending individual's immediate supervisor. However, the statute does not prescribe when the approval must occur.[138]

The Tax Court had previously considered the supervisory approval requirement of § 6751.[139] In *Clay v. Commissioner*,[140] the Tax Court concluded that an "initial determination" for purposes of § 6751 occurs no later than when the IRS issues a revenue agent's report proposing adjustments and imposition of penalties.[141] In *Belair Woods, LLC v. Commissioner*,[142] the Tax Court held that the "initial determination" of a penalty assessment is "embodied in the document by which the Examination Division formally notifies the taxpayer, in writing, that it has completed its work and made an unequivocal decision to assert penalties."[143]

Applying these decisions, the Tax Court determined that the "initial determination of [] assessment"[144] was Letter 915, issued on August 6, 2012.[145] The Tax Court held that the approval came too late and disallowed the penalty because supervisory approval for the proposed

134. *Id.* at *25.
135. *Id.* at *36.
136. *Kroner*, 48 F.4th at 1275.
137. I.R.C. § 6751(b)(1) (2020).
138. *Id.*
139. Clay v. Comm'r, 152 T.C. 223 (2019).
140. *Id.*
141. *Id.* at *250.
142. 154 T.C. 1 (2020).
143. *Id.* at *9.
144. I.R.C. § 6751(b)(1).
145. Kroner v. Comm'r, T.C. Memo. 2020-73, at *30.

accuracy-related penalty was not obtained until October 31, 2012.[146] The Eleventh Circuit disagreed and provided three reasons for its decision.[147]

1. The Tax Court's Interpretation Was Inconsistent with the Plain Meaning of the Phrase "Initial Determination of Such Assessment"

The Eleventh Circuit first found the Tax Court's interpretation to be inconsistent with the statutory text.[148] The statute provides that "[n]o 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."[149] The critical word in the statutory text is "assessment," which refers to the act of recording a taxpayer's liability on the government's books—essentially, a bookkeeping entry.[150] Applying general principals of statutory interpretation, the term "assessment" should be given its acquired legal meaning throughout the Internal Revenue Code.[151]

The petitioner argued, and the Tax Court implicitly held, that the term "assessment" as used in § 6751(b) meant a communication that advises a taxpayer that penalties will be proposed.[152] The Eleventh Circuit noted that Congress explicitly addressed communications between the IRS and taxpayers in § 6751(a), requiring the IRS to provide penalty computations as a part of "each notice of penalty."[153] In contrast, § 6751(b) addresses the approval of an "assessment."[154] This "dual-track structure" shows that Congress meant for penalty notices and initial determinations of assessment to mean different things.[155] Accordingly, the court rejected the petitioner's argument and concluded that "assessment" as used in § 6751(b) refers to the ministerial act of recording a liability on the tax rolls, with the initial determination occurring when the IRS concludes that it has the authority to assess a penalty.[156]

146. *Id.* at *30–*31.
147. Kroner v. Commissioner, 48 F.4th 1272, 1276.
148. *Id.* at 1277.
149. *Id.* at 1276 (quoting I.R.C. § 6751(b)(1)) (emphasis in original).
150. *Kroner*, 48 F.4th at 1277.
151. *Id.*
152. *Id.* at 1276.
153. *Id.* at 1277 (quoting I.R.C. § 6751(a) (2020)).
154. *Kroner*, 48 F.4th at 1277.
155. *Id.*
156. *Id.* at 1278.

2. The Tax Court's Interpretation Was Inconsistent with the Lack of a Timing Requirement in the Statute

Next, the court addressed when supervisory approval of a penalty must occur.[157] The statute simply provides that "no penalty . . . shall be assessed unless the initial determination of such assessment is . . . approved."[158] The only connection between the assessment of the penalty and its approval is the word "unless."[159] The use of the word "unless" in the statute establishes a condition that approval is required to assess a penalty, but it does not require that the condition occurs at a particular time.[160]

Nor does the use of the word "initial" in the phrase "initial determination of such assessment," establish a timing requirement.[161] The word "initial" modifies the phrase "determination of such assessment," which is part of the larger statutory clause concerning *what* must be approved.[162] It does not impose any requirement on when supervisory approval must occur.[163]

3. Tax Court's Interpretation Was Inconsistent with the Statutory Purpose

Finally, the Eleventh Circuit concluded that the Tax Court's interpretation was inconsistent with the statute's purpose.[164] In doing so, it noted that the Tax Court's decision (and the petitioner's argument on appeal) relied upon the United States Court of Appeals for the Second Circuit's decision in *Chai v. Commissioner*,[165] a case interpreting the same statute.[166] In *Chai*, the Second Circuit found the phrase "initial determination of such assessment" in § 6751(b) to be ambiguous and turned to the statute's legislative history, finding that the purpose of § 6751 was to prevent penalties from being used as bargaining chips in pre-assessment negotiations.[167] Based on that understanding, the court in *Chai* concluded that § 6751(b) requires that supervisory penalty

157. *Id.*
158. *Id.* (quoting I.R.C. § 6751(b)(1)).
159. *Kroner*, 48 F.4th at 1279.
160. *Id.*
161. *Id.* at 1278–79.
162. *Id.* at 1278.
163. *Id.*
164. *Id.* at 1279.
165. 851 F.3d 190 (2d Cir. 2017).
166. *Kroner*, 48 F.4th at 1279.
167. *Chai*, 851 F.3d at 219.

approval be obtained before the IRS issues a statutory notice of deficiency.[168]

The Eleventh Circuit found several problems with petitioner's and the Tax Court's reliance on *Chai*.[169] First, *Chai* overlooked an important aspect of § 6751's purpose.[170] The Eleventh Circuit found that § 6751(b) serves two purposes: (1) to ensure that penalties are imposed where appropriate and (2) to prevent penalties from being used only as bargaining chips during negotiation.[171] The first purpose is served as long as a supervisor approves a penalty before it is assessed.[172] That purpose is particularly important in the case of penalties which are not subject to pre-assessment review in the Tax Court. *Chai* did not discuss that purpose at all.[173]

Next, the Eleventh Circuit noted that although the court in *Chai* understood § 6751(b)'s purpose to be the policing of pre-assessment settlement negotiations, taxpayer-IRS negotiations do not end once the penalty is assessed.[174] For example, the taxpayer could pay the asserted penalty and then sue for a refund. The parties could then be encouraged to pursue settlement negotiations to avoid a costly trial. To that end, the statute functions even without a pre-assessment approval. But even assuming that the court in *Chai* was correct to focus on pre-assessment bargaining, § 6751(b) still affects the negotiations since both the taxpayer and the examining agent know that supervisory approval will be required before any penalty can be assessed. The statute, therefore, encourages supervisory involvement early in the negotiation process and disincentivizes the use of penalties solely for the sake of negotiations. Thus, a pre-assessment deadline attaching to mere communications is not required for the statute to function.[175]

Finally, *Chai*'s analysis focused heavily on one congressional purpose to the detriment of the other.[176] Congress balanced two competing governmental interests: imposing penalties where appropriate and avoiding the use of "inappropriate penalties as bargaining chips."[177] *Chai*'s analysis focused so heavily on the latter interest that it actually

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168. *Id.* at 221.
169. *Kroner*, 48 F.4th at 1279.
170. *Id.*
171. *Id.*
172. *Id.*
173. *Id.*
174. *Id.*
175. *Id.* at 1280–81.
176. *Id.* at 1281.
177. *Id.*

harmed the former interest by limiting the IRS's ability to assess appropriate penalties.[178] Indeed, the Eleventh Circuit noted that the Tax Court's decision would prevent the IRS from assessing penalties that the Tax Court itself previously concluded were appropriate.[179] Thus, the Eleventh Circuit reversed the decision of the Tax Court disallowing the penalties under § 6662.[180]

Judge Newsom joined the court's opinion but felt that the court was a bit too generous in considering the statutory purpose evidenced by the legislative history.[181] He seemingly would have preferred that the court stick to examination of the enacted statutory text.[182] According to Judge Newsom, the problem with legislative history is that one can, without much effort, find different (and sometimes conflicting) congressional "purposes."[183] Thus, he (again) found legislative history to be "utterly unenlightening."[184] Notwithstanding his preference for the statutory text, he did enjoy the Court's "persuasive takedown" of the Tax Court's legislative history analysis.[185]

C. Conclusion

The Court's decision in *Kroner* provides important clarity to both taxpayers and the IRS. With increased IRS enforcement activity forthcoming,[186] one would also expect penalty assessments to increase. Given the Tax Court's recent decisions involving § 6751, Taxpayers may have thought that they could find some success challenging penalties on procedural grounds. *Kroner*, however, will make it more difficult for taxpayers in the Eleventh Circuit to challenge the timeliness of penalty approvals successfully.

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178. *Id.*

179. *Id.*

180. *Id.*

181. *Id.* at 1281–82 (Newsom, J., concurring).

182. *Id.* at 1281 (Newsom, J., concurring).

183. *Id.* at 1281–82 (Newsom, J., concurring).

184. *Id.* at 1282 (Newsom, J., concurring) (quoting Oak Grove Res., LLC v. Dir., OWCP, 920 F.3d 1283, 1292 n.6 (11th Cir. 2019)).

185. *Kroner*, 48 F.4th at 1281 (Newsom, J., concurring).

186. *See, e.g.*, Jonathan Curry, *A Look Ahead: Will IRS and Treasury Assert Themselves in 2023?*, TAX NOTES (Jan. 5, 2023), https://www.taxnotes.com/tax-notes-today-federal/trusts-and-estates-taxation/look-ahead-will-irs-and-treasury-assert-themselves-2023/2023/01/05/7fgzm?highlight=enforcement [https://perma.cc/N39W-RKZJ].