

How A Procedural Misstep Can Invalidate IRS Penalties

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On remand from the U.S. Court of Appeals for the Eleventh Circuit, the U.S. Tax Court, in *Romano-Murphy v. Commissioner*,^[1] determined that the failure of the Internal Revenue Service to provide a preassessment appeals hearing invalidated the IRS' assessment of the trust fund recovery penalty, or TFRP, under Internal Revenue Code Section 6672 and proposed levy to collect the same.

Background

In July 2006, the IRS sent a letter to Linda Romano-Murphy, who had served as the chief operating officer of a health care staffing company, proposing assessment of a TFRP against her for the business' failure to pay over employment taxes. The letter indicated that Romano-Murphy had the opportunity to protest the decision to the IRS Office of Appeals. The taxpayer sent a timely protest in September 2006, requesting an appeals conference, but the IRS failed to act on it and then subsequently assessed the penalty in October 2017.

After receiving a notice of intent to levy and notice of federal tax lien filing in August and September 2008, Romano-Murphy timely requested a collection due process, or CDP, hearing to challenge the IRS' procedures in assessing the tax.

The settlement officer recognized that Romano-Murphy had timely requested a preassessment appeals hearing but was not given one and allowed her to challenge the substantive appropriateness of the assessment through the CDP hearing consistent with Section 6330(c)(2)(B). However, the settlement officer ruled against her, issuing a determination that the assessment and collection activity, including the proposed levy, were valid, leading to Romano-Murphy's challenge in Tax Court.

The Tax Court upheld the assessment after examining the merits of the underlying liability. Romano-Murphy filed a motion to vacate the Tax Court's order arguing that the failure to provide a preassessment hearing invalidated the assessment and resulted in the statute of limitations running.

The Tax Court denied her motion, dismissing her procedural claim. Romano-Murphy appealed the case to the Eleventh Circuit, arguing that the assessment was invalid because the IRS failed to honor her request for a preassessment appeals hearing.



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The IRS argued that although Section 6672 required the IRS to send the taxpayer notice before assessing a trust fund recovery penalty, it was not required to actually provide the requested appeals hearing.

The IRS further argued that even if it were required to provide the hearing, the error was harmless because the settlement officer considered the substantive correctness of the penalty during the CDP hearing.

In March 2016, the Eleventh Circuit overturned the Tax Court's decision, holding that a taxpayer who timely protested a proposed trust fund recovery penalty assessment was entitled to a preassessment conference under Section 6672, and remanded the case to determine if the failure to provide a preassessment appeals conference was a harmless error.

The Tax Court had refused to rule on the issue indicating that it could see both sides of the argument. On one hand, it stated that the taxpayer was "not completely denied a right to be heard," and thus her due process rights were not violated. But the court also acknowledged the importance of enforcing procedures required by law that an agency failed to follow.

On remand, the Tax Court determined that, as part of the collection review procedure under Section 6330(c)(1), a settlement officer must verify that the preassessment hearing was provided before enforcing the levy. Because Romano-Murphy did not receive the hearing, the Tax Court determined the most appropriate remedy was to invalidate the assessment and the proposed levy.

The Tax Court rejected the IRS' argument that the assessment and subsequent levy were valid because the IRS assessed the TFRP without honoring the taxpayer's timely protest and request for a preassessment appeals conference.

Different Appeals Functions Within the IRS Office of Appeals

The case highlights an important distinction between the key functions and personnel within the IRS Office of Appeals. Appeals has two key functional areas: Examination Appeals and Collection Appeals. Examination Appeals is responsible for cases arising through the examination or audit process, and Collection Appeals is responsible for cases arising from disputes in collection cases. The types of collection cases primarily addressed by collection appeals are: CDP cases, TFRP cases, cases from the Collection Appeals Program, and offer in compromise cases.

Examination Appeals cases are heard by appeals officers, many of whom previously worked as revenue agents performing audits of taxpayer books and records and investigating taxpayer compliance with the tax laws.

Revenue agents often have a technical background in accounting or law that is suitable for the examination function, whereas Collection Appeals cases are heard by settlement officers, many of whom previously worked as revenue officers collecting previously assessed taxes owed to the U.S. Department of the Treasury.

Revenue officers develop expertise in collection practices and investigate the financial assets of taxpayers who owe money to the government. Given the nature of the position, the role of a revenue officer is one of the more important and dangerous jobs within the IRS.

When a taxpayer's case involves a substantive application of the tax law in an appeals case, it is often more advantageous to present the case to an appeals officer based upon their technical knowledge and familiarity with legal authorities. This experience enables appeals officers to evaluate the merits of a case and exercise the judgment necessary to determine if the IRS has hazards of litigation.

Settlement officers often do not have the technical background and legal judgment to evaluate hazards of litigation, and in practice do not consider hazards of litigation. Accordingly, taxpayers should strive to timely respond to IRS correspondence and notices to avail themselves of appeals consideration before taxes are assessed or soon after assessment, as the case may be, in order to be heard by an appeals officer.

In recent years, some taxpayers have had to engage in a two-front battle within the IRS Office of Appeals. Situations have arisen in which taxpayers who timely protested assessed penalties have faced collection activity prior to their case being heard by an appeals officer.

This phenomenon requires taxpayers to submit a request for a CDP hearing to halt collection activity until the appeals officer is able to consider the pending appeal. Usually, a settlement officer will work with the appeals officer to coordinate the appeal and collection functions, but taxpayers should be very diligent in communicating with both the settlement officer and the appeals officer throughout the process.

Broader Implications

Although the court's reasoning in Romano-Murphy may provide another path to challenge TFRPs, its application may be limited with respect to other penalties. The Court of Appeals determined that the structure of Section 6672(b) requires the IRS to make a final administrative determination with respect to a taxpayer's timely protest of a proposed TFRP assessment. This is based on language that is unique to TFRPs — namely, that the IRS is required to provide notice of the proposed assessment to the taxpayer and that once the notice is provided, the statute of limitations for assessment is tolled for 90 days following the mailing of the initial notice and if a timely protest is filed, until 30 days after the final administrative decision is made in response to the protest.

This language, added to the Code in 1996, was intended to address practitioner concerns that individuals facing trust fund recovery penalties may be unaware of the issue until they receive a notice and demand, and that there was no formal administrative review of the decision to assess the penalty before notice and demand was issued. The Eleventh Circuit held that the language added by Congress to address these concerns had the effect of creating a right to a preassessment appeals hearing.

Looking Ahead

The circuit court's determination was also supported by procedural Treasury regulations issued under Part 601, which are promulgated by the commissioner of the IRS without Treasury Department review, and parts of the Internal Revenue Manual, which the IRS frequently states is not authoritative.

Specifically, the Eleventh Circuit points to Treasury Regulation Section 601.106(a)(1)(iv),^[2] which governs the IRS Office of Appeals. Although the court acknowledged that such rules "serve merely as guidelines for conducting the internal affairs of the agency," it noted that they were consistent with its interpretation of Section 6672.^[3]

In discussing the right to a post-assessment appeals hearing, the cited regulation states that the right does not apply to trust fund recovery penalties under Section 6672 because the taxpayer has a right to a preassessment appeals hearing.

Perhaps important for taxpayers facing other penalties, the same regulation states that taxpayers facing penalties subject to the deficiency procedures and return preparer penalties are also provided an opportunity for an appeals conference before assessment. The court also points to the language of the Internal Revenue Manual, which contains similar language indicating that taxpayers may protest such penalties, as well as intentional disregard penalties imposed under Section 6721(e) for failure to file information returns required under Section 6050I, before assessment.

It remains to be seen whether the IRS will acquiesce in the decision of the Eleventh Circuit or the Tax Court. In the interim, taxpayers who timely protested penalties and taxes for which IRS regulations or the Internal Revenue Manual provide an opportunity for a preassessment appeals hearing and did not receive one should consider whether to challenge the assessment on the same grounds as Romano-Murphy.

Ultimately, it is unclear that Romano-Murphy's efforts will save her from liability, as it appears that the statute of limitations on assessment under Section 6672(b)(3)(B) may remain open until the IRS makes a final administrative determination with respect to her protest as filed in September 2006. The courts reasoned that the failure of the IRS to grant an appeals conference prevented it from making a final administrative determination. Accordingly, it appears that the IRS could now hold the requested appeals conference, determine that the penalty is appropriate and then reassess the penalty. If the IRS takes that approach, the taxpayer will have had an extended delay in paying — without any accrued interest — but ultimately may be liable for the penalty originally assessed.

The case may bring future litigation if the IRS seeks to impose the penalty on the theory that the statute of limitations remains open indefinitely as long as it denies the taxpayer its right to a preassessment appeals hearing. This argument turns the IRS' failure to satisfy an obligation that the Eleventh Circuit determined was imposed upon the IRS by statute into a sword that it can wield against taxpayers decades later.

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[1] Romano-Murphy v Commissioner, 2019 U.S. Tax Ct. LEXIS 17 (TC May 21, 2019, No. 27236-09L)

[2] Treasury Regulation Section 601.106(a)(1)(iv)

[3] See Flynn v. Comm'r, 269 F.3d 1064, 1072 (D.C. Cir 2001).