IRS Insights | A closer look

Court holds that Section 6676 erroneous refund penalty does not apply in Exxon Mobil Corp. v. United States

On January 13, 2021, the US District Court for the Northern District of Texas issued a memorandum opinion and order granting Exxon Mobil Corp.'s ("Taxpayer") motion for partial summary judgment, finding that Taxpayer had a reasonable basis for its disallowed refund claims and that a penalty under Internal Revenue Code section 6766 for erroneous refund claims was inapplicable.[1]

The controversy arose over a dispute about the tax treatment of certain oil and gas ventures that the Taxpayer had undertaken in Qatar and Malaysia. Taxpayer had historically treated these ventures as mineral leases. However, in 2014 and 2015, Taxpayer filed amended returns for tax years 2006–2009, recharacterizing these transactions as purchases and seeking refunds. In 2016, the IRS disallowed these refund claims, contending that the Taxpayer's transactions were mineral leases and that the change in tax treatment constituted an impermissible method change. In addition, the IRS imposed a penalty under section 6676 for an erroneous refund claim in the amount of approximately $200 million. After a separate proceeding resolved the question of the correct tax treatment, the court turned to the remaining issue of whether

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the erroneous refund penalty applied to Taxpayer.

The court began its analysis of the erroneous refund penalty by reviewing the history of section 6676. Enacted in 2007, section 6676 originally provided that if a claim for refund or credit with respect to income tax is made for an excessive amount, a taxpayer is liable for a penalty equal to 20 percent of the excessive amount, unless it is shown that the claim has a reasonable basis. Section 6676 was amended in 2015, substituting "has a reasonable basis" and inserting "is due to reasonable cause".[2] While both parties agreed that the pre-amendment "reasonable basis" standard applied to the penalty at issue in this case, the court noted that the parties disagree as to the meaning of reasonable basis.

The government position is that reasonable basis in section 6676 has the same meaning as reasonable basis in section 6662 and the regulations thereunder.[3] Specifically, the regulations under section 6662 define reasonable basis in the following manner:

> *"Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in § 1.6662–4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in § 1.6662–4(d)(2). (See § 1.6662–4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty."*[4]

The government argued that reasonable basis is a subjective standard, similar to the section 6662 standard recently applied by the Eighth Circuit.[5] In interpreting the negligence defense to the section 6662 penalty, the Eighth Circuit relied on the "only when the taxpayer's return position is reasonably based on one or more of the authorities" language in the section 6662 regulations to conclude that the taxpayer must actually show it relied on those authorities in forming its position.[6] In other words, there is a subjective reliance element inherent in the reasonable basis standard for the section 6662 penalty.

The court here rejected the government's argument, distinguishing the section 6676 erroneous refund claim penalty from the section 6662 negligence penalty at issue in the Eighth Circuit's decision. The court observed that the section 6662 negligence penalty inherently focuses on the taxpayer's subjective conduct. By contrast, section 6676 focuses on whether the claim, not the taxpayer, has a reasonable basis. In addition, the court looked to a report from National Taxpayer Advocate explaining that "reasonable basis" is an objective test.[7]

After clarifying the meaning of the reasonable basis standard applicable to the section 6676 penalty, the court concluded by applying this standard to the question of whether Taxpayer had a reasonable basis for its claims. The court recognized that the proceeding to determine whether the transactions were properly characterized as sales or mineral leases was complex. The court concluded that Taxpayer's position was reasonably based on one or more relevant authorities and, therefore, the court held that a penalty under section 6676 was inapplicable in this case.

9th Circuit holds that the IRS waived the specificity requirement in Harper v. United States

In *Harper v. United States*,[8] the Ninth Circuit Court of Appeals heard an appeal of a lower court's decision to dismiss the taxpayer's complaint for failing to exhaust their administrative remedies with respect to their claim for refunds due to additional research tax credits that they claimed for 2008 and 2010. In reversing the lower court, the appeals court found that, by its actions, the IRS had waived the specificity requirement of Internal Revenue Code Section 6402.

Taxpayer husband was a sole owner of a construction company that specialized in military design build projects. For the 2008 and 2010 tax years, Taxpayers filed amended returns claiming that they were entitled to special tax credits under IRC Section 41 for increasing research and development expenses. The lower court held that it did not have subject matter jurisdiction over the case because the claims for credit did not meet the specificity requirement of IRC Section 6402 and the Treasury Regulations promulgated thereunder.[9]

The appeals court began its analysis by noting that Section 7422 controls a federal court's jurisdiction to review a taxpayer's claim. The court's jurisdiction is conditioned on the taxpayer filing a claim for credit or refund in accordance with the provisions of law and regulations established by the Treasury Secretary.[10] This includes the specificity requirement, an administrative exhaustion provision that ensures that the IRS receives adequate notice of each claim, allowing the IRS to conduct an administrative investigation and determination.[11]

The IRS can waive satisfaction of the specificity requirement.[12] However, caselaw provides that the waiver must be an "unmistakable" showing that the Commissioner had dispensed with the formal requirements and examined the merits of the claim.[13] In the current case, the appeals court noted that the IRS had asked targeted questions and requested documents specifically with respect to Taxpayers' eligibility for the increased research credit that were the subject of the Taxpayers' refund claims. Upon receiving hundreds of thousands of pages of documentary support, the IRS determined that the Taxpayers were not eligible for the increased research credit and denied the claims for refund. In reversing the district court's ruling, the appeals court found that the IRS's substantive examination constituted a textbook case of waiver.

The appeals court noted that while the IRS is entitled to require that a taxpayer provide information with respect to its refund claim in a specific form so that the IRS is appropriately advised of the nature of the taxpayer's claim, "the IRS is equally entitled to seek the information it needs through investigation and waive the specificity requirement" and that it did so here by accepting Taxpayers' properly filed Forms 6765, *Credit for Increasing Research Activities*, and substantively examining Taxpayers' specific claims.[14] The appeals court concluded that the IRS's targeted investigation and final determination demonstrates that it understood the taxpayer's claims and the exact basis thereof.

The appeals court also rejected the government's argument that the Taxpayers waived their argument that the IRS had waived the specificity requirement. The appeals court specifically found that the Taxpayers did not, in fact, waive this argument and concluded further that the government's waiver of the specificity requirement was dispositive of the issues in the Taxpayers' refund claims. Therefore, the IRS reversed the district court and remanded the case for further proceedings consistent with the appeals court's decision.

In Gregory v. Commissioner, Third Circuit rules that the IRS should have known taxpayer's actual address

In *Gregory v. Commissioner*,[15] the Third Circuit Court of Appeals heard an appeal of the Tax Court's determination that the IRS properly sent a notice of deficiency to the taxpayers' last known address. The Third Circuit vacated the judgment of the Tax Court, determining that the IRS failed to send statutory notices of deficiency to the Gregorys' correct address, despite the fact that the IRS had actual notice of the taxpayers' last known address.

In 2015, the Gregorys relocated; however, they failed to update their address on IRS records by not submitting an official change of address form (Form 8822) to the IRS. This mistake was further compounded when the Gregorys' CPA listed their old home address on the Gregorys' 2014 tax return.

In 2014, the IRS began examining the Gregorys' 2013 return. The Gregorys' CPA sent the IRS agent conducting the exam a Form 2848, Power of Attorney and Declaration of Representative. The Form 2848 provided the Gregorys' new address; however, the instructions to the Form 2848 state that its only purpose is appointing representatives before the IRS, not updating a taxpayer's address of record. Similarly, in April 2016, the Gregorys filed a Form 4868 to extend the time to file their 2015 tax return. This Form 4868 also listed their new address, but like Form 2848, it is not an official way of updating a taxpayer's address with the IRS. In 2016, the Gregorys' CPA informed the IRS agent conducting the audit of their 2013 tax return that the Gregorys had moved. Despite this, the IRS agent continued to send notices to the Gregorys' old address. Later in 2016, the IRS mailed a statutory notice of deficiency for the 2013 and 2014 tax years to the Gregorys' old address. The notice began the ninety-day period for the Gregorys to petition the Tax Court for review of the proposed deficiencies in tax for 2013 and 2014.

By the time the Gregorys learned of the statutory notices of deficiency, the 90-day period to petition the Tax Court had expired. Nonetheless, the Gregorys filed a petition with the Tax Court. The Tax Court held that it did not have jurisdiction to hear the case because the petition was untimely. The Gregorys appealed the Tax Court's decision to the Third Circuit.

The Third Circuit began its analysis by observing the rule that the IRS must send statutory notices of deficiency to a taxpayer's "last known address."[16] The Treasury Regulations provide that a taxpayer's last known address is the address provided on its most recently filed, properly processed federal tax return, unless the IRS has been given "clear and concise" notification of a different address.[17] According to the IRS Revenue Procedure, in order for a taxpayer to provide a "clear and concise" written notice, a taxpayer must provide a signed written notice that includes their new address, their full name, Social Security number, and old address.[18] The court pointed out that the Revenue Procedure excludes application for extension of time to file a return or power or attorney from serving as name change notification forms.[19]

The Third Circuit also noted that courts have imposed their own standard on the IRS for determining a taxpayer's last known address.[20] Courts judge whether the IRS exercised reasonable diligence in determining a taxpayer's last known address by examining what the IRS knew or should have known at the time the notice of deficiency was sent.[21] This includes information the IRS should have known based on the information in its computer system.[22]

The Gregorys argued that their power of attorney forms and extension constitute a clear a concise notification of their new address. Moreover, the Gregorys contended that the IRS agent conducting the audit was directly informed of the Gregorys' change of address. The IRS argued that the Gregorys failed to file the clear guidance the IRS has issued on taxpayers notifying the IRS of a change in their address.

The court acknowledged the rationale behind the IRS's bright line argument but found that Form 8822 was not consistently required to notify the IRS of a change in address. The court determined that the proper inquiry in order to determine if the IRS had a clear and concise notice of address was what the IRS knew or should have known at the time that the notices of deficiency were sent.

In this case, the court found that the IRS had actual notice that the Gregorys had moved prior to the issuance of the notice of deficiency. In addition to the Form 2848 and Form 4868, the IRS agent conducting the interview received direct communication that the Gregorys had moved before the statutory notices of deficiency were issued. The court determined that based on the actual notice to the IRS agent, when taken in combination with the updated address provided on the two forms, the IRS had sufficient information so that it knew or should have known that the Gregorys had changed addresses. As a result, the Third Circuit vacated the Tax Court's judgment and remanded the case to the Tax Court for action consistent with the Third Circuit's ruling.

IRS's LB&I announces a new campaign Taxable Asset Transactions – Matching Buyers and Sellers

The Internal Revenue Service ("IRS") Large Business and International Division ("LB&I") recently announced a new compliance campaign as part of its ongoing campaign examination program. On January 27, 2021, LB&I announced a new campaign Taxable Asset Transactions – Matching Buyers and Sellers.

The LB&I campaign approach is designed to target IRS examinations resources on certain identified issues that present potential compliance risk. These issues are addressed through a variety of different treatment streams formulated to achieve compliance objectives.

The new campaign is focused on parties that enter into taxable asset transaction under either IRC sections 1060 or 338(h)(10). These transactions must be reported on either Form 8594, Asset Acquisition Statement Under Section 1060, or Form 8883, Asset Allocation Statement Under Section 338, attached to the taxpayer's tax return. The campaign addresses business entities that either did not report a transaction on Form 8594 or Form 8883, or that reported the transaction inconsistently with the other party's reporting of the transaction.

Endnotes

1. *Exxon Mobil Corp. v. United States*, N.D. Tex., No. 3:16-cv-2921, 2/19/21.
2. Pub. L. 114-113, Div. Q, Title II, § 209(c)(1), 129 Stat. 3040, 3085 (2015).
3. *See* IRS Program Manager Technical Advice 2014-15, at 5–6 (August 6, 2014).
4. Treas. Reg. § 1.6662–3(b)(3).
5. *See* Wells Fargo & Co. v. United States, 957 F.3d 840 (8th Cir. 2020).
6. *Id.* at 852.
7. National Taxpayer Advocate, Annual Report to Congress (Legislative Recommendation: Amend Section 6676 to Permit Reasonable Cause Relief) at 351 (Dec. 31, 2014)
8. *Harper v. United States*, No. 19-55933 (9th Cir. Feb. 25, 2021).
9. Treas. Reg. § 301.6402–2(b)(1).
10. Section 7422; Boyd v. United States, 762 F.3d 1369, 1371 (9th Cir. 1985).
11. *Quarty v. United States*, 170 F.3d 961, 972 (9th Cir. 1999).
12. *Angelus Milling Co. v. Comm'r of Internal Revenue*, 325 U.S. 293, 297 (1945).
13. *Id.* At 29
14. *Angelus Milling*, 325 U.S. at 297.
15. *Gregory v. Commissioner of Internal Revenue*, No. 19–2229 (3d Cir. 2020).
16. *See* I.R.C. § 6212(b).
17. *See* Treas. Reg. § 301.6212–2(a).
18. Rev. Proc. 2010–16.
19. See *Rev. Proc*. 2010–16 § 5.01(4).
20. See *Gyorgy v. Comm'r*, 779 F.3d 466, 478 (7th Cir. 2015); Terrell v. Comm'r, 625 F.3d 254, 260 (5th Cir. 2010).
21. *Terrell*, 625 F.3d at 260.
22. *Abeles v. Comm'r*, 91 T.C. 1019,1035 (1988).