

Treasury Finalizes Controversial Regulations on IRS Penalty Oversight, but Debate Continues

Section 6751(b), designed to ensure supervisory oversight amid rising penalty assertions in settlement negotiations, has been contentious due its ambiguity, and the final regulations may not resolve the debate.

Key Points:

- The IRS, which once rarely assessed penalties in corporate disputes, now routinely asserts and assesses them, typically on audit and sometimes even during litigation.
- Section 6751(b) was designed to prevent penalties from being used as a negotiation tool, but its ambiguity has caused nearly a decade of disputes and compliance issues.
- Despite extensive comments from the tax community, the Treasury Department and IRS finalized regulations establishing government-favorable timing rules, requiring only last-minute supervisory sign-off before penalties are assessed.
- Taxpayers should continue to consider Section 6751(b) arguments, especially in light of historic IRS noncompliance and given the potential for further legislative or judicial intervention.

Overview of the Final Regulations

On December 23, 2024, the Treasury Department and the IRS issued final regulations under the penalty approval statute, Internal Revenue Code Section 6751(b).¹ Section 6751(b)(1) 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 or such higher level official as the Secretary may designate.” The final regulations are intended to address the uncertainty regarding supervisory approval of penalties that have arisen due to the differing judicial interpretations.²

Corporate taxpayers now routinely find penalties asserted and increasingly assessed in their disputes with the IRS — a development that was once rare. These penalties are typically raised during audits but can also emerge throughout litigation.³ Penalties should be used to “encourage voluntary compliance” and not as a “bargaining point” for resolving tax adjustments.⁴ Yet, both taxpayers and IRS personnel often perceive them as such. Taxpayers and their representatives frequently agree to a larger portion of a deficiency in exchange for a government concession on penalties, while the IRS may threaten penalties to push for settlements.⁵ The supervisory approval requirement under Section 6751(b) was enacted to prevent IRS agents from using penalties in this manner.⁶

Implementation Challenges and Judicial Interpretations

Despite the intention of Section 6751(b), its implementation has been fraught with litigation and varying judicial interpretations. The statute's ambiguous language has left courts to grapple with the timing of supervisory approval. For instance, the Tax Court requires approval before the first formal written communication of the penalty, such as in an audit-closing "30-day letter," which triggers the right to file a protest with the IRS Independent Office of Appeals.⁷ Other courts require supervisory approval before the IRS issues a notice of deficiency or "90-day letter," which triggers the right to file a petition in US Tax Court,⁸ while some courts only require approval before the formal entry of a penalty assessment on the IRS books.⁹ Because the Tax Court must adhere to its own interpretation unless there is precedent in the relevant appellate circuit, it continues to follow its interpretation in cases appealable to circuits other than the Ninth, Tenth, and Eleventh Circuits.¹⁰ A recent draft bipartisan bill from the Senate Finance Committee would adopt a rule similar to the Tax Court's.¹¹

The Treasury Department and IRS proposed regulations on the meaning of Section 6751(b) to address the uncertainty from those varying judicial interpretations.¹² The tax community, including the American Bar Association (ABA) Section of Taxation, the National Taxpayers Union, and the State Bar of Texas Tax Section, submitted comments on the proposed Section 6751(b) regulations. These comments advocated for a statutory interpretation of the ambiguous statute that aligns more closely with the legislative intent of Section 6751(b). The ABA, for instance, advocated for supervisory approval before the issuance of a 30-day letter to not only safeguard against misuse of penalties, but also to adhere to a more faithful reading of the statute and its legislative history.

The Final Penalty Approval Regulations

The Treasury Department and IRS largely rejected the tax community's recommendations, arguing that the final regulations' timing requirements are consistent with the statutory text and promote nationwide uniformity, administrability, and ease. The final regulations, effective for penalties assessed on or after December 23, 2024,¹³ establish the following government-favorable timing rules for when supervisory approval must be obtained:

- For penalties subject to pre-assessment review, supervisory approval must be obtained at any time on or before the IRS mails the notice providing a basis for Tax Court jurisdiction (i.e., the notice of deficiency).
- For penalties raised in Tax Court after a petition is filed, supervisory approval may be obtained at any time before the Commissioner requests that the court determine the penalty.
- For penalties not subject to pre-assessment review, supervisory approval must be obtained at any time prior to assessment.¹⁴

Notably, each of these rules permits last-minute supervisory approval to be considered timely.

In addition to the timing requirements, the final regulations also adopt, with either no or minor modifications, the definitions in the earlier proposed regulations.¹⁵ As for the minor modifications, the final regulations clarify that for purposes of determining which individual first proposed a penalty, the individual must have proposed the penalty either to a taxpayer or to the individual's supervisor or designated higher-level official. This requirement is to preclude informal suggestions of coworkers or supervisors as being treated as the initial determination of a penalty assessment.¹⁶

The definition of “immediate supervisor” was also modified. Rather than defining “immediate supervisor” as “any individual with responsibility to approve another individual’s proposal of penalties,” the adopted definition defines it as “any individual with responsibility to review another individual’s proposal of penalties.” This change was intended to recognize that a person assigned to review a penalty proposal has the responsibility to make a judgment call about the appropriateness of the penalty.¹⁷

Ongoing Debate and Legislative Developments

The final supervisory approval regulations do not change the fact that taxpayers should continue to monitor Section 6751(b) compliance, particularly given historic instances of IRS noncompliance and the potential for a legislative or judicial intervention.¹⁸ Taxpayer challenges continue to reveal instances in which the IRS has failed to meet this requirement.¹⁹ Taxpayers should thus be aware of these procedural requirements and continue to consider raising challenges when facing penalties.

Indeed, ongoing legislative and court developments suggest that the debate on supervisory approval of penalties is far from over. The Supreme Court’s recent decision in *Loper Bright* fundamentally shifted historic deference to agency interpretation of statutes.²⁰ *Loper Bright* established that courts must determine the single, best meaning of a statute, even in cases of ambiguity. If regulations are contrary to that single, best meaning, courts will not hesitate to invalidate them.²¹ Thus, given the varying judicial interpretations of Section 6751(b), these final regulations are unlikely to end the ongoing debate as to the meaning of Section 6751(b).

Additionally, the Senate Finance Committee’s recent draft bipartisan bill would require supervisory approval of “the first determination, provided in a written notice to a taxpayer, that, based on specific facts and circumstances with respect to such taxpayer” specific penalties apply to such taxpayer.²² This aligns more closely with the Tax Court’s approach and shows renewed legislative effort to ensure penalties are not used as a bargaining chip. By clarifying the timing and nature of supervisory approval, this proposed legislation reinforces the original intent of Section 6751(b) to prevent the misuse of penalties in tax disputes.

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Endnotes

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- ¹ Rules for Supervisory Approval of Penalties, 89 Fed. Reg. 104419 (Dec. 23, 2024) (to be codified at 26 C.F.R. pt. 301).
- ² *Id.* at 104419.
- ³ See Internal Revenue Manual (I.R.M.) 20.1.5.4 (08-31-2021) (Examination Penalty Assertion); I.R.M. 35.2.2.3.9(2) (08-13-2021) (Affirmative (New) Issues).
- ⁴ I.R.M. 20.1.1.2 (Nov. 21, 2017); CC-2004-036 at 1 (2004).
- ⁵ CC-2004-036 at 1 (2004); Hearings on H.R. 2676 Before the S. Finance Comm., 105th Cong. 92 (1998) (statement of Stefan F. Tucker, Chair-Elect, Section of Taxation, American Bar Association).
- ⁶ S. Rep. No. 105–174, at 65 (1998), 1998–3 C.B. 537, 601.
- ⁷ *Belair Woods, LLC v. Commissioner*, 154 T.C. 1 (2020); *Clay v. Commissioner*, 152 T.C. 223 (2019).
- ⁸ *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017).
- ⁹ *Kroner v. Commissioner*, 48 F.4th 1272 (11th Cir. 2022).
- ¹⁰ See T.D. 10017, 89 Fed. Reg. 104419, *supra* note 1, at 104420 (and cases cited therein).
- ¹¹ Draft Taxpayer Assistance and Service Act, 119th Congress, sec.113 (January 31, 2025) available at https://www.finance.senate.gov/imo/media/doc/tax_admin_bill.pdf.
- ¹² Prop. Treas. Reg. § 301.6751(b)-1, 88 Fed. Reg. 21564 (Apr. 11, 2023).
- ¹³ The finality of these Section 6751(b) regulations could be impacted by ongoing and future executive actions related to the change in administration. For more information, see Latham’s blog, [The Trump Administration: First 100 Days](#).
- ¹⁴ See T.D. 10017, 89 Fed. Reg. 104419, *supra* note 1, at 104423 (to be codified at 26 C.F.R. 301.6751(b)-1(b)-(d)).
- ¹⁵ *Id.* at 104420–21. The finalized regulations define key terms, such as “individual who first proposed the penalty,” “immediate supervisor,” “higher level official,” “personally approved (in writing),” and “automatically calculated through electronic means.” *Id.* at 104423 (to be codified at 26 C.F.R. 301.6751(b)-1(a)(3)).
- ¹⁶ *Id.* at 104420.
- ¹⁷ *Id.* at 104421.
- ¹⁸ Section 6751(b) does not apply to any addition to tax under Section 6651, 6654, 6655, or 6662 (but only with respect to an addition to tax by reason of paragraph (9) or (10) of subsection (b) thereof) or any other penalty automatically calculated through electronic means. I.R.C. § 6751(b)(2).
- ¹⁹ See, e.g., *Jadhav v. Commissioner*, T.C. Memo 2023-140 (finding that the Commissioner did not produce evidence of Section 6751(b) compliance for the increases the penalties asserted in the amended answer); *Lakepoint Land II, LLC v. Commissioner*, T.C. Memo. 2023-111 (finding that the IRS revenue agent backdated the penalty approval documents).
- ²⁰ See *Loper Bright Enters. v. Raimondo*, 144 S. Ct. 2244 (2024).
- ²¹ *Varian Medical Systems, Inc. v. Commissioner*, 163 T.C. No. 4 (Aug. 26, 2024).
- ²² See Draft Taxpayer Assistance and Service Act, *supra* note 11.