

An Update on Section 6751 Penalties

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Tax penalties are always a hot topic here. The Internal Revenue Service (IRS) has a large arsenal when it comes to grounds for asserting penalties on income tax deficiencies, ranging from the common 20% penalty under Internal Revenue Code (Code) Section 6662(a) to higher penalties ranging from 40% (gross valuation or basis misstatements and economic substance) to 75% (fraud).

However, before the IRS can assert most penalties against taxpayers, it must comply with the procedural requirement in [Code Section 6751\(b\)](#): That the “initial determination” to assert the penalty be “personally approved (in writing) by the immediate supervisor of the individual making such determination.” As the US Court of Appeals for the Second Circuit explained in [Chai v. Commissioner](#), US Congress imposed this requirement because it “believes that penalties should only be imposed where appropriate and not as a bargaining chip” and “[t]he statute was meant to prevent IRS agents from threatening unjustified penalties to encourage taxpayers to settle.”

Over the past several years, there has been substantial litigation over the proper interpretation and application of Code Section 6751(b). The US Tax Court’s recent opinion in *Oxbow Bend, LLC v. Commissioner* is the latest development. In *Oxbow Bend*, the Tax Court rejected the taxpayer’s position that the “initial determination” was made on the date that the examining agent prepared a penalty lead sheet reflecting her recommendation to assert penalties and stated in a telephone conference with the taxpayer’s representative on that same day that penalties were being considered. Approximately three months later, the examining agent’s supervisor approved the penalty lead sheet, and the IRS issued a Notice of Final Partnership Administrative Adjustment asserting the penalties. The Tax Court, relying on its prior precedent, held that the word “determination”:

1. “has an established meaning in the tax context and denotes a communication with a high degree of concreteness and formality”
2. “signifies a consequential moment of IRS action”
3. is not a “mere suggestion, proposal, or initial informal mention of penalties”
4. “will be embodied in a formal written communication that notifies the taxpayer of the decision to assert penalties.”

Thus, under the Tax Court's analysis, an "initial determination" can only be made in a "written" document that is provided to the taxpayer.

Oxbow Bend is a memorandum opinion of the Tax Court and, therefore, is limited to its facts and technically not precedential, as we have [discussed](#) in the past. However, memorandum opinions are often cited by litigants, and the Tax Court does not disregard these types of opinions lightly. One has to wonder whether, under different facts where an examining agent makes an explicit oral statement to a taxpayer that penalties "will" be asserted, courts might reach a different result given Congress's express intent that examining agents should not threaten penalties and use them as a bargaining chip for settlement purposes. Further, Code Section 6751(b) expressly requires that the supervisory approval be "in writing" but contains a written requirement for purposes of the "initial determination."

Practice Point: Courts, particularly the Tax Court, have attempted to provide bright-line tests as much as possible in this area. The holding in *Oxbow Bend* furthers this trend and adds to the ongoing development of the law. Taxpayers facing assertions of penalties by the IRS should take the necessary steps, such as requesting their administrative file or making appropriate discovery requests, to ensure that the IRS has followed the procedural requirements in Code Section 6751(b).

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