



# TaxNewsFlash

## United States

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### Second Circuit: Underreporting of income, subject to self-employment income tax

The U.S. Court of Appeals for the Second Circuit today heard a case of cross appeals from orders of the U.S. Tax Court relating to whether the taxpayer underreported income on the 2004 income tax return and whether the taxpayer was subject to self-employment income tax plus a penalty on a \$2 million payment received from a now-defunct tax-shelter scheme.

The case is: *Chai v. Commissioner*, 15-1653 (L) (2d Cir. March 20, 2017). Read the Second Circuit's [opinion](#).

#### Summary

Prior to a determination in the Tax Court proceeding, the Tax Court held in a Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) proceeding that partnership losses for another partnership in which the taxpayer was a partner were disallowed. The IRS then asserted in an amended answer in the taxpayer's deficiency case to increase the deficiency from the loss in the other partnership matter. The Tax Court sustained the self-employment deficiency and related penalty, but dismissed the Service's later asserted income tax deficiency from the TEFRA partnership matter. The Tax Court also rejected the taxpayer's argument as untimely that the Commissioner had failed to carry his burden to show compliance with the requirement that a supervisor approved the penalty assertion prior to the issuance of the notice of deficiency as required by the statute.

The Second Circuit addressed the problems of "marrying" TEFRA and deficiency proceedings and held that procedural oddities do not mean the tax is uncollectable. The Second Circuit ultimately held that the Tax Court had jurisdiction with respect to the income tax deficiency relating to the other partnership. Thus, the Second Circuit remanded the case to the Tax Court to enter a revised decision upholding the additional income-tax deficiency as the taxpayer conceded the \$2 million payment is

fully taxable, and affirmed the Tax Court's order upholding the self-employment tax deficiency.

However, the Second Circuit reversed the portion of the Tax Court's order upholding the accuracy-related penalty relating to the deficiency proceeding. The Second Circuit disagreed with the majority holding in *Graev v. Commissioner*, 147 T.C. No. 16 (Nov. 30, 2016). In a split holding in *Graev*, (nine judges in the majority and 5 judges in dissent) the majority rejected that the taxpayer's argument that an IRS supervisory approval was required prior to the issuance of the statutory notice. The majority held that this argument was premature and that an IRS supervisor could still approve the penalty prior to the assessment which was currently suspended during the Tax Court proceeding.

The Second Circuit looked at the statutory provision, the legislative history, and the Internal Revenue Manual and determined that section 6751(b) required the IRS supervisory approval prior to the issuance of a notice of statutory deficiency (or before the IRS files an answer or amended answer) asserting a penalty. Further that compliance with section 6751(b) is part of the Commissioner's burden of production and proof in a deficiency case in which a penalty is asserted that falls under section 7491(c). Section 7491(c) only applies to individuals.

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