Sub - Holmes

UNITED STATES TAX COURT

WASHINGTON, DC 20217 PA

OAKBROOK LAND HOLDINGS, LLC, WILLIAM DUANE HORTON, Tax Matters Partner,	)	
Petitioner,	)	Docket No. 5444-13.
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

ORDER

This case was tried in October 2016 at a special trial session in Birmingham, Alabama. One of the issues was whether Oakbrook owed a 40% gross-valuation-misstatement penalty under I.R.C. § 6662(h)(1) for allegedly overstating the value of its conservation easement by 200% or more. Both parties introduced a great deal of evidence on the value of the donated conservation easement and Oakbrook's return preparation.

But no one tried to introduce evidence about whether the Commissioner met his burden of production under I.R.C. § 6751(b)(1) to show that "the initial determination of such assessment [i.e., of the penalty] [wa]s personally approved (in writing) by the immediate supervisor of the individual making such determination." We hold today in *Graev v. Commissioner*, 149 T.C. ___, ___ (Dec. 20, 2017) (*Graev III*) (slip op. at 13-15), that the Commissioner must show compliance with this section in any deficiency case where penalties are at issue.

The Commissioner saw this coming. On August 2, 2017, he moved to reopen the record to add evidence that he argues shows that he complied with I.R.C. § 6751(b)(1). Oakbrook objects.

In our concurring opinion in *Graev III*, this division of the Court warned that "'[l]ike some ghoul in a late-night horror movie that repeatedly sits up in its grave and shuffles abroad,' [this construction of I.R.C. § 6751] will serve only to frighten little children and IRS lawyers." *Graev III*, 149 T.C. at __ (slip op. at 45) (Holmes, J., concurring) (quoting *Lamb's Chapel v. Ctr. Moriches Union Free Sch. Dist.*, 508 U.S. 384, 398 (1993) (Scalia, J., concurring)).

We rule here on the last of today's *Chai* ghouls; one that is presumptively appealable to the Sixth Circuit.

Background

The petition in this case was filed in March 2013. Before the original trial date in May 2014 the parties asked for their first continuance, which we granted so that they could continue their settlement talks. There was another continuance after that, and the case was briefly consolidated with another before we finally set the case for a special trial session to begin in October 2016.

With the case now going to trial, important filings started coming in. The Commissioner filed a motion for leave to amend his answer in August 2016 -- less than two months before trial. He wanted to amend his answer to raise a 40% gross-valuation-misstatement penalty, because he had only determined a 20% accuracy-related penalty in the notice of deficiency. He also wanted to raise an alternative justification -- substantial-valuation misstatement -- for the previously determined 20% penalty. He didn't allege in either the motion or the amended answer themselves that he had complied with I.R.C. § 6751(b)(1). Oakbrook objected to this motion: It argued that the Commissioner was dilatory; that granting the motion would prejudice it; and that the Commissioner "conveniently overlook[ed] its . . . obligations under I.R.C. § 6751(b)." "In light of the timing of th[e] penalty assertion," Oakbrook argued, "it [was] very unlikely that the [Commissioner] followed proper procedures in raising this new penalty."

A couple weeks before trial we granted the Commissioner's motion for leave to amend. Although he had little reason for delay, we also didn't think it would prejudice Oakbrook -- and we remarked that "absence of prejudice is often decisive."

The parties lodged a first stipulation of facts and exhibits with the Court about ten days before trial. They did not stipulate to the Commissioner's compliance with I.R.C. § 6751(b)(1), and the stipulation included no evidence of supervisory approval for the initial determination of the gross-valuation-misstatement penalty. In an unusual role reversal, though, Oakbrook attached an exhibit to the first stipulation that it identified as the penalty-approval form for the 20% penalty that was determined in the notice of deficiency. Even more unusually, the Commissioner objected to this exhibit as irrelevant and because he said it impermissibly went behind the notice of deficiency. We admitted the penalty-approval form at trial and will have to sort out its importance for the 20% penalty later. For now, we focus on the 40% gross-valuation-misstatement penalty raised for the first time in the amended answer -- and for which neither party provided any evidence of supervisory approval.

We held the trial on October 6 and October 7. Within the first few minutes of trial, the Commissioner asked the Court to confirm that the 40% gross-valuation-misstatement penalty was at issue. We confirmed that it was and also noted that the parties "get to preserve the *Graev* issue, of course, at issue here, as well." The Commissioner then acknowledged that "the *Graev* issue was with respect to the 40 percent penalty for which there is no [penalty-approval] memo." Despite our prompting and the Commissioner's acknowledgment, he still didn't present any evidence at trial that he had complied with I.R.C. § 6751(b)(1) for the 40% gross-valuation-misstatement penalty.

We issued *Graev v. Commissioner*, 147 T.C. ___ (Nov. 30, 2016) (*Graev II*), less than two months later. In *Graev II* we held that compliance with I.R.C. § 6751(b)(1) is not ripe for review in a deficiency case because the penalty has not yet been "assessed". *Graev II*, 147 T.C. at ___ (slip op. at 24-39).

Oakbrook then filed its posttrial opening brief less than two months after that. It devoted several pages to the requirements of I.R.C. § 6751(b), and argued that the Court "should hold that [the Commissioner] is not allowed to assert the gross valuation misstatement penalty because such assertion violates Section 6751(b) and Tax Court Rule 41(a)." It suddenly became clear to the Court why Oakbrook had introduced the penalty-approval form in this case: It argued in its opening brief that "the initial determination [here], which was approved by the supervisor, was the decision *not* to assert the gross valuation misstatement

penalty," and therefore, "under section 6751(b), the [Commissioner] is precluded from assessing the gross-valuation misstatement penalty." This is a species of *Chai* ghoul whose existence has been predicted in theory, *see Graev III*, 149 T.C. at ___ (slip op. at 46) (Holmes, J., concurring), but which has not previously been seen in nature. Whether its existence is eventually confirmed by observation, Oakbrook was letting the Commissioner know that it meant to put I.R.C. § 6751(b) at issue.

The Commissioner filed his answering brief one month later. He argued that I.R.C. § 6751(b) doesn't apply to deficiency cases before our Court. Citing to the dissent from *Graev II*, he then responded to Oakbrook's argument: He argued that "there is no support in the text of the statute for the contention that a decision not to assert a penalty is an initial determination" because the statute refers to the determination of an assessment that has been made or will be made. He said that the "ultimate assessment" here "will result from the recommendation to seek the penalty, not any recommendation *not* to seek the penalty." He argued, "petitioner's claim that section 6751(b) can never be satisfied is incorrect." The Commissioner made no other claims or arguments about I.R.C. § 6751(b) in his answering brief.

Less than a month later Oakbrook replied. It explained why it disagreed with the Commissioner's I.R.C. § 6751(b) arguments in the answering brief, and it reiterated some earlier arguments. Oakbrook once again argued that "imposition of the [gross-valuation-misstatement] penalty violates Section 6751(b), which precludes assertion of a penalty unless the initial determination of such penalty is approved in writing by the immediate supervisor of the individual making the determination."

Only a week went by before the Second Circuit issued its decision in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), *aff'g in part, rev'g in part* 109 T.C.M. 1206. In it, the Second Circuit held that we were wrong in *Graev II* and that the Commissioner had to show that he complied with I.R.C. § 6751(b)(1) as part of his burdens of production and proof on penalties in deficiency cases. *See Chai*, 851 F.3d at 218-23. Today we adopt the Second Circuit's holding in *Chai* as our own. *See Graev III*, 149 T.C. at ___ (slip op. at 13-15).

Within a month, Oakbrook filed a notice of supplemental authority to alert the Court to *Chai*'s relevance. In addition to its earlier arguments, Oakbrook now also argued that, even if we assume the Commissioner could determine a gross-valuation-misstatement penalty "after initially determining not to assert it," he "did not meet his burden of establishing that written approval was obtained pursuant to section 6751(b)." Oakbrook said that "[t]here is no evidence in the record of written approval by the supervisor of the person making the initial determination to assert the gross valuation misstatement penalty." And it argued that this means "the Commissioner has not met his burden of demonstrating the elements of section 6751(b) were met in this case with respect to the gross valuation misstatement penalty."

This is the most common species of *Chai* ghoul -- the missing-paperwork species -- and is the same one we dissect and describe in this divison's other designated orders released today. The Commissioner wants to tame the ghoul in this case by reopening the record to add a declaration by the IRS Chief Counsel supervisor who purportedly approved in writing the IRS Chief Counsel lawyer's "initial determination" of the gross-valuation-misstatement penalty. With that declaration, he also wants the Court to admit a "file copy" of the Commissioner's motion for leave to amend the answer, which the supervisor says he initialed on the date that the Commissioner filed it with the Court. The IRS Chief Counsel supervisor says in his declaration that his initials on the "file copy" of the motion were intended as his written approval of the IRS Chief Counsel lawyer's initial determination of the gross-valuation-misstatement penalty. But he also admits that it is unclear whether he initialed the document before or after the motion was filed with the Court.

Should we reopen the record now to let the declaration and the "file copy" of the motion in? Oakbrook says we shouldn't. Its first argument is that we shouldn't reopen the record because the Commissioner's failure to introduce any evidence of I.R.C. § 6751(b) compliance at trial shows a lack of diligence or, worse, a "calculated risk" that didn't work out, and Oakbrook would be prejudiced if the declaration and the "file copy" of the motion were admitted into evidence now when it doesn't have the opportunity to cross-examine the IRS Chief Counsel supervisor. Its second argument is that we shouldn't reopen the record to admit the additional evidence because the declaration is inadmissible hearsay.

Analysis

The decision to reopen the record to admit additional evidence is within our discretion. *Zenith Radio Corp. v. Hazeltine Research, Inc.*, 401 U.S. 321, 331 (1971). Indeed, "[t]here is no doubt that a decision to reopen the evidence is committed to the sound discretion of the trial court," *In re Chattanooga Wholesale Antiques, Inc. v. Rossville Bank*, 930 F.2d 458, 464 (6th Cir. 1991) (citations omitted), and our "determination will not be overturned except for its clear abuse." *Blytheville Cotton Oil Co. v. Kurn*, 155 F.2d 467, 470 (6th Cir. 1946) (citations omitted).

Our discretion is not unbounded. As a threshold matter, we will not reopen the record "unless the evidence to be presented was not available for use at the original trial or could not have been obtained with reasonable diligence." *Snuggery-Elvis P'ship v. Commissioner*, 64 T.C.M. 1128, 1132 (1992) (citing *Zenith Radio Corp.*, 401 U.S. at 332-33; *Purex Corp. v. Procter & Gamble Co.*, 664 F.2d 1105, 1109 (9th Cir. 1981); *Mayer v. Higgins*, 208 F.2d 781, 783 (2d Cir. 1953); *Glagola v. Commissioner*, 59 T.C.M. 321 (1990)); *see also Estate of Kaplin v. Commissioner*, 815 F.2d 32, 33 (6th Cir. 1987) (Tax Court didn't abuse its discretion when it failed to reopen the record to admit evidence that "was in the taxpayers' possession at the time of trial and was not offered then"), *rev'g on other grounds* 51 T.C.M. 927 (1986); *Cloes v. Commissioner*, 79 T.C. 933, 937 (1982) ("Proper judicial administration demands that there be an end to litigation and that bifurcated trials be avoided"); *Markwardt v. Commissioner*, 64 T.C. 989, 998 (1975) (It is our Court's "policy . . . to try all issues raised in a case in one proceeding and to avoid piecemeal and protracted litigation"). And we'll weigh the Commissioner's diligence (or lack thereof) against any possible prejudice to Oakbrook if we were to grant the motion to reopen the record. *See Ramsey v. United Mine Workers of America*, 481 F.2d 742, 753 (6th Cir. 1973) (recognizing that "reopening proof on the motion of one party long after trial has been completed can put the opposite party at a distinct disadvantage"). "Prejudice" in this context focuses on whether the submission after trial prevents the nonmoving party from examining and questioning the evidence as it would have during the proceeding. *Estate of Freedman v. Commissioner*, 93 T.C.M. 1007, 1013 (2007); *Megibow v. Commissioner*, 87 T.C.M. 987, 991 (2004).

Even if the Commissioner crosses that threshold, we still won't let him past the foyer unless the evidence he seeks to add to the record is not merely cumulative or impeaching, is material to the issues involved, and probably would change the outcome of the case. *Butler v. Commissioner*, 114 T.C. 276, 287 (2000), *abrogated on other grounds by Porter v. Commissioner*, 132 T.C. 203 (2009). This second test is consistent with the Sixth Circuit's framework for analyzing a motion to reopen the record. *See, e.g.*, *Ramsey*, 481 F.2d at 753 (trial court didn't abuse its discretion when it denied a motion to reopen the record because, among other things, the evidence wouldn't change the outcome of the case and was cumulative). Indeed, it would be futile to reopen the record -- and bifurcate the trial -- only to let in evidence that has no impact on the outcome of the case.

We'll consider diligence and prejudice first. The timeline here makes the question of the Commissioner's diligence a little muddled. I.R.C. § 6751 made its debut in the Code almost twenty years ago, but we didn't take notice of it in deficiency cases until 2015. *See Chai v. Commissioner*, 109 T.C.M. 1206 (2015); *Legg v. Commissioner*, 145 T.C. 344 (2015).[1] In *Chai*, we avoided the issue because the taxpayer didn't raise it until his posttrial brief. *See Chai*, 109 T.C.M. at 1212. And in *Legg* we found that the Commissioner had complied with I.R.C. § 6751(b)(1), even if we didn't say whether it was necessary for him to do so before a case came to our Court. *See Legg*, 145 T.C. at 349-51.

The Commissioner says in his motion that "[t]here was no obligation to show compliance with section 6751(b)(1) in a deficiency case at the time this case was submitted and at the time the briefing schedule was completed." The Commissioner appears to be referring to our opinion in *Graev II*, which we admit did complicate things a bit. But *Graev II* wasn't released until more than a month after the trial here. That weakens the Commissioner's excuse, especially when we reminded him at the beginning of the trial to "preserve the *Graev* issue" and the text of I.R.C. § 6751 has been the same for nearly twenty years.

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[1] Note also *Lindberg v. Commissioner*, 99 T.C.M. 1273, 1279 (2010), where § 6751 briefly premiered only to be dismissed as inapplicable to a penalty under § 6702.

And the Commissioner has an even bigger problem: Our decision in *Graev III* didn't create new law; it interpreted a section of the Code that was in effect at the time of the trial in this case, and which we today announce we apply to the parties before us in *Graev III*. *See Harper v. Va. Dept. of Taxation*, 509 U.S. 86, 97 (1993) (when the Court applies a rule of federal law to the parties in a case, that rule "must be given full retroactive effect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate the announcement of the rule"); *Broom v. Strickland*, 579 F.3d 553, 556 (6th Cir. 2009) (after *Harper* there is a "strict rule requiring retroactive application of new decisions to all cases still subject to direct review") (internal quotations omitted). So we have to treat our construction of I.R.C. § 6751(b)(1) in *Graev III* as being the correct construction of the section as of the date of the trial in this case.

The Commissioner has little reason to complain about any unfairness here: Oakbrook raised § 6751(b)(1) before trial in its response to the Commissioner's motion for leave to amend his answer, we told the Commissioner to preserve the issue at trial, and the Commissioner presented evidence that he had complied with I.R.C. § 6751(b)(1) in at least one other case -- another conservation-easement case -- that had already been decided, *see Legg*, 145 T.C. at 347. The Court alerted the Commissioner that evidence that he complied with I.R.C. § 6751(b) was relevant, and the Commissioner had the "file copy" of the motion at the time of trial. But he didn't make any effort to introduce this "file copy" into evidence or call the IRS Chief Counsel supervisor to testify about it. The Commissioner does not argue that it would have been difficult for him to get the supervisor to testify, which also makes his failure look like a lack of diligence.

The proffered evidence was of reasonably foreseeable importance: Even if I.R.C. § 6751(b) hadn't yet been analyzed by any Court, its existence at the time of trial is undisputed and Oakbrook made it clear that it intended to raise it as one of its attacks on penalties. If the Commissioner had presented the "file copy" or called the supervisor to testify Oakbrook could have cross-examined the supervisor or explored the drafting history of the "file copy." But the trial is over and the record closed -- "[i]t is normal to wish to present additional evidence after [trial] once having lost a dispute of fact," but, "of course, such a practice would lead to never-ending litigation." *Ramsey*, 481 F.2d at 753. That is why a trial court properly denies a motion to reopen the record when the evidence was in the moving party's possession at the time of trial, *see Estate of Kaplin*, 815 F.2d at 33,

particularly when granting the motion would prejudice the nonmoving party. *See Ramsey*, 481 F.2d at 753.

And we do agree with Oakbrook that it would be prejudiced if we admitted the declaration and "file copy" of the motion -- it would lose a chance to examine and question the evidence as it would have at trial. *Estate of Freedman*, 93 T.C.M. at 1013; *Megibow*, 87 T.C.M. at 991. Oakbrook argues that "[t]he Declaration is a self-serving statement prepared . . . nearly 10 months after the trial in this case concluded," and correctly states that it can't cross-examine a piece of paper.

We won't guess at how Oakbrook's cross-examination might have gone. But we do agree that there is prejudice in the loss of a chance to cross-examine the supervisor. *See Megibow*, 87 T.C.M. at 991 (explaining that the nonmoving party is prejudiced when the moving party submits evidence after trial, because the nonmoving party is "deprived . . . of any opportunity to examine or question them during the proceeding").

There is another problem here: Recall that our discretion to reopen the record is limited by the additional requirement that the moving party must show that the additional evidence probably would change the outcome of the case. *Butler*, 114 T.C. at 287. On this part, the Commissioner has a serious problem. It is indeed possible that the "file copy" of the motion might move the needle on the I.R.C. § 6751(b) issue, but by itself it is at best ambiguous. The supervisor's declaration provides the necessary explanation, but it is inadmissible hearsay. *See* Fed R. Evid. 801(c), 802; *see also, e.g.*, *Paradiso v. Commissioner*, 90 T.C.M. 110, 113 (2005) (citing, among other cases, *Woodall v. Commissioner*, 84 T.C.M. 700 (2002)).

The Commissioner does argue that the declaration is admissible under the business-records exception to hearsay, *see* Fed. R. Evid. 803(6), but we can't agree: It was prepared a year after the "file copy" of the motion and the amended answer, and it doesn't appear to be a document that is kept in the course of a regularly-conducted activity of the IRS. And it *is* offered here for the truth of the matters asserted in it -- that the IRS Chief Counsel supervisor approved the IRS Chief Counsel lawyer's "initial determination" of penalties and that his scrawled initials on the "file copy" of the motion were intended as that written supervisory

approval. Even if we found that the Commissioner was diligent and Oakbrook wouldn't be unfairly prejudiced, we still wouldn't reopen the record to admit the declaration because it's inadmissible hearsay. And without the declaration, we wouldn't reopen the record to admit the "file copy" of the motion because it alone wouldn't change the outcome of the case.

It is therefore

ORDERED that respondent's August 2, 2017 motion to reopen the record is denied.

(Signed) Mark V. Holmes
Judge

Dated: Washington, D.C.
December 20, 2017