

***United States – Internal Revenue Service
International Information Return Penalties,
Recent Litigation, and Penalty Strategies***

Presentation for STEP Hong Kong

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Dan's practice focuses on federal tax and Title 31 matters including civil and criminal defense of IRS audits and investigations and much more. Before founding his own firm, Law Offices of Daniel N. Price, PLLC, Dan served as an attorney for the Office of Chief Counsel of the IRS for more than 19 years. Dan's government service included extensive work in international tax enforcement. Dan's deep expertise concerning the IRS' voluntary disclosure practice, the Streamlined Filing Compliance Procedures, and international penalties allows him craft strategies to mitigate civil penalties and criminal exposure. Dan further assists taxpayers in battling significant penalties assessed by the IRS and certain state tax authorities.

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Disclaimer

These slides are shorthand aids to an oral presentation. Neither these slides nor the oral presentation constitute legal or tax advice.

Agenda

- US Reporting Overview
- IRS Enforcement and Penalty Administration
- Recent Litigation and Enforcement
- Common Compliance Mistakes
- Post-Assessment Penalty Strategies

Form	Code Section	Potential penalties*
Form 926 (Return by a U.S. Transferor of Property to a Foreign Corporation)	6038B(c)	10% of the FMV of property transferred to foreign corporation (max. \$100,000)
Form 3520-A (Annual Information Return of Foreign Trust with a U.S. owner)	6677(b)	The greater of \$10,000 or 5% of the gross value of U.S. person's portion of foreign trust assets (measured as of the close of the U.S. person's tax year)
Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts)	6677 6039F	Up to four penalties may apply. <ul style="list-style-type: none"> • For trust contributions, ownership, or distributions, a separate penalty applies for failure to timely report each transaction. Each penalty is equal to the greater of \$10,000 or (1) 35% of the trust contribution, (2) 5% of the gross value of U.S. person's portion trust assets (at close of U.S. person's tax year), or (3) 35% of the trust distribution • For failure to timely report a foreign gift/bequest, a maximum penalty equal to 25% of the FMV of the foreign gift/bequest may apply
Form 5471 (Information Return of U.S. Persons with Respect to Certain Foreign Corporations)	6038	\$10,000 per form
Form 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in U.S. Trade or Business)	6038A	\$25,000 per form
Form 5713 (International Boycott Report)	999	\$25,000, maximum 1 year imprisonment, or both for willful failure to report
Form 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund)	6501(c)(8)	Statute of limitations for tax year remains open until 3 years after form is filed

* Additional/increased penalties may apply for intentional disregard of reporting requirements and/or continued noncompliance. The statute of limitations may also remain open indefinitely for failure to file the appropriate form (see Section 6501(c)(8))

Form	Code Section	Potential penalties*
Form 8854 (Initial Expatriation Statement)	877A, 6039G	\$10,000 per failure and potential treatment as “covered expatriate” subject to U.S. exit tax
Form 8858 (Information Return of U.S. Persons with respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs))	6038(b)	Form 5471, Category 4/5 filers Form 8865, Category 1/2 filers
Form 8865 (Return of U.S. Persons with Respect to Certain Foreign Partnerships)	6038(b), 6038B(c), 6046A/6679	Multiple penalties may apply: <ul style="list-style-type: none"> • \$10,000 per failure Category 1, 2, and 4 • 10% of FMV of property transferred (capped at \$100,000) per Category 3 failure
Form 8938 (Statement of Specified Foreign Financial Assets)	6038D(d)	\$10,000 per form
Form 8992 (U.S. Shareholder Calculation of Global Intangible Low-Taxed Income)	6038(b); Treas. Reg. 1.6038-5	\$10,000 per form
FBAR	31 USC 5321	<ul style="list-style-type: none"> • Up to \$14,489 (after 1/24/2022) for “non-willful” violations • Up to the greater of \$144,886 (after 1/24/2022) or 50% of account balances, plus potential criminal penalties, for “willful” violations
Section 6662(j): Penalty of 40% of underpayment attributable to transaction involving undisclosed asset under Section 6038, 6038B, 6038D, 6046A, or 6048		

* Additional/increased penalties may apply for intentional disregard of reporting requirements and/or continued noncompliance. The statute of limitations may also remain open indefinitely for failure to file the appropriate form (see Section 6501(c)(8))

Statute of Limitation Concerns

(8) Failure to notify Secretary of certain foreign transfers

(A) In general

In the case of any information which is required to be reported to the Secretary pursuant to an election under § 1295(b) or under § 1298(f), 6038, 6038A, 6038B, 6038D, 6046, 6046A, or 6048, the time for assessment of any tax imposed by this title with respect to any tax return, event, or period to which such information relates shall not expire before the date which is 3 years after the date on which the Secretary is furnished the information required to be reported under such section.

I.R.C. § 6501(c)(8)

Statute of Limitation Concerns (cont'd)

Reasonable cause defense limits income to the foreign financial asset.

I.R.C. § 6501(c)(8)(B) Application to failures due to reasonable cause. If the failure to furnish the information referred to in subparagraph (A) is due to reasonable cause and not willful neglect, subparagraph (A) shall apply only to the item or items related to such failure.

- The IRS considers reasonable cause, discussed later, to be a very high standard

IRS Enforcement and Penalty Administration

International Penalties Remain an IRS Priority

- IRS is committed to international information return enforcement and views penalties as revenue
- IRS is using data analytics to identify variances in reporting among information returns to open examinations
- Examiners actively identify international penalty issues

International Penalties Remain an IRS Priority (cont'd)

- Treasury Inspector General For Tax Administration, Rep. No. 2023-30-019, The IRS Large Business and International Division Should Consider Shifting Individual Examination Resources to More Productive Examinations (May 25, 2023)
- LB&I WEIIC focuses on individual examinations involving international issues.
- Ninety percent of WEIIC individual examination closures reported less than \$200,000 total positive income (TPI) for Fiscal Years 2017 through 2021. pg. 7.
- “[T]he majority (73 percent) of WEIIC examinations conducted by its GS-13 revenue agents were of taxpayer returns reporting TPI less than \$200,000” for 2016 through 2020. pg. 11.
- “The IRS stated that the Dollars per Hour metric does not include the assessment of penalties, and that **penalties are a significant focus of [LB&I] WEIIC’s compliance effort.**” pg. 6.
- Takeaway point: LB&I WEIIC has spent the vast majority of its examination resources pursuing middle class taxpayers focusing on penalties.

International Penalties Remain an IRS Priority (cont'd)

- Specific leads may spark examinations focusing on international penalty issues
 - Whistleblowers
 - [Foreign Account Tax Compliance Act](#) (a.k.a. FATCA)
 - Inter-governmental cooperation
 - Legacy use of [Swiss Bank Program](#) data and leads resulting from new non-prosecution agreements with DOJ Tax Division
 - [LB&I Campaigns](#)
 - John Doe Summonses

IRS Penalty Administration Is Broken



IRS Penalty Administration Is Broken

- Examinations often result in IRS agents asserting maximum penalties
 - Not uncommon for total penalties asserted to exceed the underlying account balance
 - “Innocent” mistakes are recast by IRS as willful errors
 - Benign taxpayers who participated in legitimate transactions may be contacted by Criminal Investigation Special Agents



IRS Penalty Administration Is Broken (cont'd)

- Systemic campus-based penalty assessments for international information returns brutalize taxpayers for doing the right thing
 - Form 3520 and Form 3520-A enforcement by Ogden Campus
 - Systemically applied penalties without considering reasonable cause
 - High rate of campus errors and high abatement rates
 - Form 5471 and Form 5472 for business filers
 - Systemically applied penalties without considering reasonable cause
 - High abatement rates

IRS Penalty Administration Is Broken (cont'd)

- The IRS treats timely filings untimely and penalizes them
 - Ueland v. United States, docket no. 1:23-cv-00931 (Court of Federal Claims)
 - IRS ignored the filing of a Form 7004 extension of time to file and treated Form 3520-A as untimely
 - IRS penalized taxpayers nearly \$100,000 for timely filing of Forms 3520-A reporting Australian Superannuation funds
 - IRS took nearly \$100,000 from the next year's refund for the penalty
 - IRS failed to notify taxpayers of penalty assessment
 - IRS failed to provide penalty computation under I.R.C. sec 6751(a)
 - IRS failed to establish a supervisor approved the penalty in writing prior to assessment under I.R.C. § 6751(b)(1)
 - IRS Independent Office of Appeals lost request appealing penalty
 - Taxpayers were forced to hire attorneys and sue
 - DOJ Tax Division conceded the case without filing a responsive pleading

IRS Penalty Administration Is Broken (cont'd)

- The IRS ignores the law concerning reasonable cause
 - Wrzeninski v. United States, case no. 2:22-cv-03568-CFK (E.D. Penn.)
 - Mr. Wrzeninski received \$800,000 in gifts from mom in Poland after mom won the Polish lottery. Gift made in 4 transfers in 2010 and 2011.
 - Mr. Wrzeninski told return preparer about gifts and relied on his return preparer in failing to report the large foreign gifts
 - Later Mr. Wrzeninski was advised of the requirement to file Form 3520 pursuant to I.R.C. § 6039F
 - Mr. Wrzeninski relied on the Old DIIRSP and filed delinquent Forms 3520
 - IRS assessed the maximum penalties
 - Appeals offered a hazards of litigation settlement not accepting reasonable cause for late reporting
 - Appeals abated \$70,000 of the \$87,000 penalty assessed for tax year 2010 and \$96,000 of the \$120,000 penalty assessed for tax year 2011 (2010 abatement ratio was 80.4% abated v. 19.6% sustained and 2011 abatement ratio was 80% abated v. 20% sustained)
 - DOJ Tax Division conceded the case without filing a responsive pleading

IRS Penalty Administration Is Broken (cont'd)

- Penalty computations are often wrong
- At times IRS notices reference completely incorrect penalties
 - Late Form 3520-A reporting foreign trust, IRS assessed a penalty under § 6725 for failure to report a vessel or facility under § 4101(d)
 - In other words, IRS penalty assessments can be completely disconnected from reality
- No consideration of facts if submitted with late filings
- IRS approach is to penalize at maximum levels and force taxpayers to beg for relief through a lengthy administrative process

Typical Process for Systemic Penalties involving Forms 3520 and 3520-A

- Late filing of Form 3520/3520-A with reasonable cause statement
- Penalty assessed at maximum rates; Ogden ignores reasonable cause
- Ogden issues Penalty Notice CP15 “Notice of Penalty Charge”
- Appeal “Notice of Penalty Charge” within 30 days with reasonable cause
- **IRS Collection begins efforts to collect the assessed penalty**
- Ogden issues letters 2644C notifying it needs time to consider submission
- Ogden denies reasonable cause and issues a Letter 854C
- Appeal Letter 854C within 60 days for review by the Independent Office of Appeals (Appeals)
- Case enters queue for Appeals

Recent Litigation

Farhy v. Commissioner, 160 T.C. No. 6 (April 3, 2023)

- Taxpayer challenged the IRS' assessment authority for IRC § 6038 penalty for failing to file Forms 5471
- Assessment is the formal process of entering a liability on the IRS' books
- Penalty at issue is under Chapter 61 of the Internal Revenue Code
- Most penalties under Chapter 61 do not address assessment or collection

Farhy v. Commissioner (cont'd)

- Tax Court used a textual analysis in holding that the IRS lacks statutory authority to assess and collect penalties under IRC § 6038(b)
- Lack of assessment authority means the IRS cannot use its normal tools to collect tax
 - IRS must rely on the Department of Justice to bring a collection lawsuit
 - Added burden on taxpayers, government, court system, and tax administration

Implications of Farhy

- Other Chapter 61 penalties are subject to the argument that the IRS lacks authority to assess and collect:

Section	Reporting Form
6038	Forms 5471, 8865, 8858
6038A	Forms 5472
6038B	Forms 926, 8865 Schs G, H, O
6038C	Form 5472
6038D	Form 8938
6039F	Form 3520, Part IV
6039G	Form 8854

IRS Reaction to Fahry and Predictions

- IRS has appealed Farhy, and the appeal is pending in the D.C. Circuit
- IRS Independent Office of Appeals will concede cases if exactly aligned with facts of Fahry (attempted collection of Form 5471 penalties)
- Prediction: IRS will continue “business as usual” and assess penalties that it has no legal authority to assess
- Prediction: IRS will force litigation on other Chapter 61 penalties with similar language to § 6038 penalties for Form 5471

Aroeste v. United States, 2023 U.S. Dist. LEXIS 208582; 2023 WL 8103149 (S.D. Cal. Nov. 20, 2023)

- Long held IRS positions
 - Lawful permanent residents (green card holders) must file FBARs and report interests in foreign financial accounts
 - Treaty based positions must be made on timely filed returns, otherwise waived
- Mr. Aroeste filed Forms 1040 and years later amended reporting filing Forms 1040-NR with a treaty based position as resident of Mexico

Aroeste v. United States (cont'd)

- District court held in favor of taxpayer
 - Allowed late treaty based filing position
 - Determined non-resident under treaty negated requirement to file FBARs even for taxpayers that are lawful permanent residents
 - Held that Notice 2007-83 was invalid because it failed to follow public notice and comment procedures under the Administrative Procedure Act

Aroeste v. United States (cont'd)

- IRS appealed decision on January 18, 2024
- Predictions
 - IRS will cling to its long-held position on requiring FBARs from lawful permanent residents
 - IRS will continue to assert that treaty-based positions must be made on timely filed returns

Bittner v. United States, 598 U.S. ___ (2023)

- The opposing views of non-willful FBAR penalties
 - IRS: each unreported **account** is subject to a \$10,000 penalty
 - Example: 2020 FBAR missing 160 accounts: $160 \times \$10,000 = \1.6 million
 - Taxpayer: each incorrect **report** is subject to a \$10,000 penalty
 - Example: 2020 FBAR missing 160 accounts: $1 \times \$10,000 = \$10,000$

Bittner v. United States (cont'd)

Supreme Court interpreted the statutory provision governing the application of the FBAR non-willful penalty, holding that under 31 U.S.C. § 5321(a)(5)(B)(i), only one penalty in the amount of \$10,000 is applied per FBAR form, irrespective of the number of accounts that were either incorrectly reported or unreported.

- Prediction: The IRS will assert more willful FBAR penalties
- Prediction: Language in the opinion on the “rule of lenity” may be useful in litigating willful FBAR penalties.

Recent Cases on Written Supervisory Approval of Penalties

“No 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.”

I.R.C. § 6751(b)(1).

Written Supervisory Approval of Penalties (cont'd)

- Purpose of this statute: To prevent the IRS from using unapproved penalties as a bargaining chip.
 - Senate Report: “Penalties should only be imposed where appropriate and not as a bargaining chip.”
 - Joint Committee Report: IRS must present evidence that “it is appropriate to apply a particular penalty to the taxpayer before the court can impose a penalty.”
 - Conference Report: “The IRS must treat the American people with respect.” “[This bill] will help protect taxpayers by increasing oversight, holding IRS employees accountable and insuring taxpayers are treated with fairness”

Written Supervisory Approval of Penalties (cont'd)

Caselaw has evolved and vacillated

- Early cases requiring pre-assessment approval focused on date IRS issued notice of deficiency
 - *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017)
 - *Graev v. Commissioner*, 149 T.C. 485 (2017), vacating 147 T.C. 460 (2016)

Written Supervisory Approval of Penalties (cont'd)

Clay v. Commissioner, 152 T.C. 223 (2019)

No later than (1) the date on which the IRS issues the notice of deficiency or (2) the date, if earlier, on which the IRS formally communicates to the taxpayer the Examination Division's determination to assert a penalty and notifies the taxpayer of his right to appeal that determination.

Belair Woods, LLC v. Commissioner, 154 T.C. 1 (2020)

No later than when the IRS sends a letter “formally notifi[ng]” the taxpayer that “the Examination Division had completed its work and ... had made a definite decision to assert penalties.”

Written Supervisory Approval of Penalties (cont'd)

Reversing course to notice of deficiency as bright line

Laidlaw's Harley Davidson Sales, Inc. v. Commissioner, 29 F.4th 1066 (9th Cir. 2022)

At anytime when the supervisor still has discretion to withhold approval (before assessment)

Kroner v. Commissioner, 48 F.4th 1272 (11th Cir. 2022)

Before the assessment is made

Written Supervisory Approval of Penalties- Proposed Regulations

- Proposed regulations published April 11, 2023
<https://www.federalregister.gov/documents/2023/04/11/2023-07232/rules-for-supervisory-approval-of-penalties>
- Proposed regulations have exceedingly pro-IRS slant
- Timing for penalties subject to deficiency procedures: any time before issuance of a notice of deficiency
- Strong public opposition was received, and IRS is currently finalizing regulations

Written Supervisory Approval of Penalties (cont'd)

- Why is written supervisory approval of penalties important to international tax matters?
 - IRS tax enforcement for international individuals and small businesses focuses on penalties
 - IRS has weaponized international penalties in audits
 - United States Tax Court sanctioned IRS for backdating supervisory approval of penalties in LakePoint Land II LLC et al. v. Commissioner, T.C. Memo. 2023-111
 - IRS brutalizes taxpayers with “systemic” penalties for late filed information returns, CPA errors, innocent foot-faults, and taking corrective action
 - Overturning penalties on “technicalities” is a must because the IRS ignores facts and equity

Moore v. United States

- Pending in the United States Supreme Court
- Challenge to § 965 transition tax
- § 965 tax is a one-time mandatory repatriation tax
- Taxpayer raised a constitutional challenge to the sec 965 tax arguing it violates the Sixteenth Amendment to the United States Constitution
- Focus is on basic tax principles including whether the realization of income is a constitutional requirement for an income tax

Malta Pension Plans

- The US and Malta governments negotiated a tax treaty, and the US Senate ratified it
- Treaty included some special rules for retirement plans
- IRS failed to anticipate ramifications of the retirement plan provisions
- Attorneys used the terms of the treaty to formulate a position allowing U.S. persons to defer or avoid U.S. income tax on transferred property, income, and distributions from Malta pension plans

Malta Pension Plans (cont'd)

- IRS views the textual use of the treaty improper, abusive, and even criminal
- 2022 IRS and Malta issued a retroactive reinterpretation of the treaty
- 2023 IRS classified Malta Pension Plans claiming treaty benefits a listed transaction
- 2023 IRS launched a wide scale, sweeping, and unprecedented joint criminal and civil investigation. See I.R.M. 25.1.4 (administrative joint investigation).

Malta Pension Plans (cont'd)

- IRS has three buckets of Malta Pension Plan participants
 - UK pension to Malta pension QROPS
 - Contribution of highly appreciated assets to Malta pension
 - Use of Malta pension as a wrapper for active investment
- Criminal Investigation states it is focusing on “facilitators”
 - Attorneys
 - Accountants
 - Financial advisors
 - Pension administrators

Malta Pension Plans (cont'd)

- IRS Criminal Investigation issued hundreds of summonses demanding information and documents
- IRS methods have been novel and not aligned with traditional methods of case development
- IRS' use of joint civil-criminal investigation may indicate future aggressive enforcement

Malta Pension Plans (cont'd)

- What are some of the practical lessons we learn from the IRS' investigation?
 - IRS considers benign QROPS transactions as improper and is targeting middle-class retirees from the UK
 - IRS is willing to use patently unenforceable summonses to gather information
 - IRS is willing to bully individual taxpayers to “turn” on facilitators
 - IRS is willing to use Special Agents with guns to collect massive amounts of information

Common Compliance Mistakes

Common Mistakes

- Failing to identify an information return is due
- Form 5471 – Overlooking constructive ownership/attribution rules; mistaking foreign entity default rules; § 965 Transition Tax; not identifying all applicable filer categories; adjusting financials for GAAP
- Form 3520 – Failing to timely report large foreign gifts and inheritances; not disclosing U.S. owner of foreign trust; failure to disclose distributions from foreign trusts (e.g., uncompensated use of trust property, loans that are not qualified obligations); failing to timely file by 10/15 for taxpayers residing abroad with 12/15 filing deadlines.

Common Mistakes (cont'd)

- Form 3520-A
 - Failing to timely file because the deadline is not the same as the deadline for Form 1040 unless it is filed as a substitute Form 3520-A
 - Not filing Form 7004 to request an extension of time to file for Form 3520-A
 - Failing to indicate at the top of Form 3520-A that it is a fiscal year filing
 - Failing to use most recently assigned EIN if IRS assigned an EIN

Common Mistakes (cont'd)

- Misclassifying foreign pensions and other plans as exempt from Form 3520 and Form 3520-A reporting under Rev. Proc. 2020-17
 - See Rev. Proc. 2020-17 § 5.03 (tax-favored retirement trusts) and § 5.04 (tax-favored foreign non-retirement savings trust)
 - Critical requirements:
 - “Only contributions with respect to income earned from the performance of personal services are permitted”
 - Specific annual / lifetime contribution limits
 - Some practitioners are ignoring/stretching the requirements for relief

Common Mistakes (cont'd)

- Form 8621 – Failing to identify an investment as foreign mutual fund subject to PFIC reporting
- Form 8938 – Failing to report less common foreign financial assets such as stock in foreign corporations, foreign pensions, promissory notes issued by foreign persons, interests in foreign estates
- Form 8854 – Long term permanent residents surrender green card triggering mark-to-market exit tax
- FBAR – Overlooking certain familial arrangements for foreign bank accounts where taxpayer either has authority over the account or is named as beneficial owner of the account
- Form 5472 – Failing to file pro-forma Form 1120 and Form 5472 for foreign owned domestic disregarded entity

Post-Assessment Penalty Strategies

Compliance Options for Taxpayers with International Information Return Issues

1. Streamlined Filing Compliance Procedures
 - Streamlined Foreign Offshore
 - Streamlined Domestic Offshore
2. Filing Amended/Delinquent Returns (a.k.a. “quiet disclosure”)
3. Prospective compliance (a.k.a. “silent disclosure”)
4. Delinquent FBAR Submission Procedures- still viable if fully tax compliant
5. Voluntary Disclosure Practice

Appeals Settlement Possibilities for International Penalties

- First Time Abate
- Reasonable cause
- § 6751(b)(1) supervisory approval
- Hazards of litigation
- Penalty mitigation

See generally IRM 8.11.1 “Return Related Penalties in Appeals”

Other Arguments to Raise

- § 6751(a) lack of penalty computation
- Reliance on IRS FAQs or oral advice
- Constitutional Due Process

Policy Statement 8-47 at IRM 1.2.1.9.6

“Appeals will ordinarily give serious consideration to an offer to settle a tax controversy on a basis which fairly reflects the relative merits of the opposing views in the light of the hazards which would exist if the case were litigated. However, **no settlement will be made based upon nuisance value of the case to either party.** If the **taxpayer makes an unacceptable proposal** of settlement under circumstances indicating a good-faith attempt to reach an agreed disposition of the case on a basis fair both to the Government and the taxpayer, the Appeals official generally should give an **evaluation of the case in such a manner as to enable the taxpayer to ascertain the kind of settlement that would be recommended for acceptance. ...**”

First Time Abate (FTA)

- For general information, see <https://www.irs.gov/payments/penalty-relief-due-to-first-time-abate-or-other-administrative-waiver>
- **General rule:** FTA does not apply to IIR penalties. IRM 8.11.5.1 (12) Note states: “The First Time Abatement (FTA) administrative waiver is not applicable to International Penalties addressed in IRM 8.11.5.”
- **Exception:** IRM 20.1.9.3.5(3) noted that if FTA is provided for the associated Form 1120 or Form 1065, then FTA may be provided for Form 5471 penalties if no similar penalties in the last three years and Form 1120/Form 1065 not filed late in the last three years.
 - December 7, 2022 John Hinding Memo to Appeals regarding FTA for systemic Form 5471 and Form 5472 penalties

Reasonable Cause

- Often all or nothing resolution but hazards may apply to reasonable cause settlements
- Appeals often considers
 - Taxpayer compliance history
 - Length of time to come into compliance
- Appeals has favorite cases to cite and consider in nearly all reasonable cause disputes
 - Appeals training material provides a good roadmap of cases to address
 - Key portions of Appeals' training material that was released in a FOIA is available at <https://www.pricetaxlaw.com/penalty-abatement>

Reasonable Cause (cont'd)

I.R.M. 20.1.1.3.2.2.6 (11-25-2011) provides the following factors to consider in the context of mistakes based on ignorance of the law:

(1) In some instances taxpayers may not be aware of specific obligations to file and/or pay taxes. The ordinary business care and prudence standard requires that taxpayers make reasonable efforts to determine their tax obligations. ...

Reasonable Cause (cont'd)

I.R.M. 20.1.1.3.2.2.6(2) Reasonable cause may be established if the taxpayer shows ignorance of the law in conjunction with other facts and circumstances. For example, consider the following:

- a. The taxpayer's education.
- b. If the taxpayer has previously been subject to the tax.
- c. If the taxpayer has been penalized before.
- d. If there were recent changes in the tax forms or law which a taxpayer could not reasonably be expected to know.
- e. The level of complexity of a tax or compliance issue.

Reasonable Cause (cont'd)

- United States v. Boyle, 469 U.S. 241 (1985)
 - The timely filing of a tax return is not excused by the taxpayer's reliance on an agent
- Neonatology Assocs., P.A. v. Commissioner, 115 T.C. 43, 98–99 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002)
 1. the advisor is competent
 2. the taxpayer provided necessary and accurate information to the advisor
 3. the taxpayer relied in good faith on the advisor

Documenting the Neonatology Factors

1. The advisor is competent
 - A. Firm website
 - B. LinkedIn profiles
 - C. Articles and blogs
2. The taxpayer provided necessary and accurate information to the advisor
 - letter, declaration, or affidavit from the CPA admitting error and admitting taxpayer provided all information requested
 - CPAs are naturally reluctant to admit error
 - Delicate negotiations are required to obtain written admissions of error

Documenting the Neonatology Factors (cont'd)

3. The taxpayer relied in good faith on the advisor
 - A. Written statement from CPA can address this factor
 - B. Explain the taxpayer's reliance in the protest in detail

Drafting Tips Reasonable Cause Statements

- Put effort into the abatement request: identify the issue, include all the facts, summarize the law and policy, and apply the law and policy to the facts
- Write the facts to fit into the theme of “reasonable cause” as developed by caselaw
- Humanize your client and tell a story
- Argue the equities and any other compelling facts to support your reasonable cause request
- Stacy Caplow, *Putting the “I” in Writing: Drafting an A/Effective Personal Statement to Tell a Winning Refugee Story*, 14 *Legal Writing: J. Legal Writing Inst.* 249 (2008).
 - Draft a moving personal account in the first person
 - Persuade a jaded decision maker to grant relief
 - Article has some good tips on writing a compelling story

IRC § 6751(b)(1)

Confirm written supervisory approval of penalties.

IRC § 6751(b) states: “No 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.”



IRC § 6751(b)(1) supervisory approval

- Generally all or nothing resolution
- Appeals Officers should verify timing of penalty approval by locating source document in administrative file
 - Not explicit but implicit at IRM 8.11.1.2.1
- For international information return penalties, locating source document may be difficult for Appeals
- Practitioner best practice- explicitly raise supervisory approval in protest

IRC § 6751(b)(2)

Exceptions to written supervisory approval of penalties under IRC § 6751(b)(2):

(A) any addition to tax under § 6651, 6654, 6655, or 6662 (but only with respect to an addition to tax by reason of subsection (b)(9) thereof); or

(B) any other penalty **automatically calculated through electronic means**

- IRS position is that some international information return (IIR) penalties are automatically calculated through electronic means including some Form 5471 and Form 5472 penalties.



FOIA to Optimize § 6751(b)(1) Presentation to Appeals

- As soon as you anticipate a penalty dispute, send the IRS a FOIA for § 6751(b)(1) documents concerning written supervisory approval
- In context of IIRs that are campus assessed, highly likely that IRS will not produce actual record satisfying § 6751(b)(1)
- Appeal the FOIA production
- In the Appeals protest on the penalties, provide Appeals the records obtained in FOIA to make the Appeals Officer's job easier



Freedom of Information Act Request Relating to IRC § 6751(b)

- Was supervisory approval documented in writing?
- Was supervisory approval timely?
- Do you suspect penalty backdating?
- Was person who provided written approval a supervisor as required by the IRC?

Hazards of Litigation

- IRM 8.11.1.2.7.5 states:
 - (4) The hazards of litigation are the uncertainties of the outcome of the court's decision in the event of a trial.
 - (5) Litigating hazards generally fall into three categories: factual, legal and evidentiary.
Note: Lack of case law should not be considered a hazard of litigation.
- Factual hazards- salient facts are unclear as to whether the taxpayer meets reasonable cause. Examples:
 - Taxpayer claims he was ill at the time a return was due but the facts are inconclusive
 - Taxpayer filed a return 10 days late and the facts are inconclusive regarding whether he timely postmarked his filing.
- Legal hazards- status of case law, law of circuit, etc.
- Evidentiary hazards- (admissibility, willingness/availability of witnesses)

Hazards of Litigation - Wrzesinski

- I.R.C. § 6039F penalty refund case
- Appeals offered a hazards of litigation settlement for a case that appears to have textbook reasonable cause for late reporting
- Taxpayer received \$800,000 in gifts from mom in Poland after mom hit the Polish lottery. Gift made in 4 transfers in 2010 and 2011.
- Taxpayer relied on EA's advice that gift was not taxable or reportable
- Later discovered requirement to report on Form 3520 and used DIIR to file late Forms 3520
- IRS assessed maximum penalties
- Appeals abated \$70,000 of the \$87,000 penalty assessed for tax year 2010 and \$96,000 of the \$120,000 penalty assessed for tax year 2011
 - 2010 abatement ratio was 80.4% abated v. 19.6% sustained
 - 2011 abatement ratio was 80% abated v. 20% sustained
- DOJ Tax Division conceded the case without filing a responsive pleading - March 2023.

The Mystery of Mitigation in Appeals

- Tax Analysts made a FOIA request to the IRS on Appeals' training material on international penalties
- FOIA production shed light on trend observed by practitioners
 - How do I get this Appeals' training material?
<https://www.pricetaxlaw.com/penalty-abatement>
- Essence of mitigation:
 - Compelling facts that do not equate to reasonable cause
 - Significant portion of penalty is abated
 - IRS wants taxpayer to feel some pain to “learn”

The Mystery of Mitigation in Appeals (cont'd)

- Practitioners have observed Appeals International forcing taxpayers with reasonable cause or highly sympathetic facts to eat 25-40% of assessed penalties in settlements
- Product of Appeals' "review and concurrence" process for certain issues
 - See IRM 8.7.3.4.1 Review and Concurrence
 - Issue coordinators insulated from taxpayer contact, may be overconfident in government's position, ignorant of caselaw, jaded, or cavalier
 - When issue coordinators don't approve reasonable cause, Appeals Officers are left with mitigation

The Mystery of Mitigation in Appeals (cont'd)

- Formally adopted in FBAR context by Exam – IRM Exhibit 4.26.16-2
- Minimal or no hazards
- Extenuating circumstances exist
- According to Appeals penalty training material: “Mitigation is available but should be used sparingly.”

The Mystery of Mitigation in Appeals (cont'd)

- IRS Foundation for penalty mitigation
- Application of macro-level penalty policy to reduce the severity of the penalty
- IRM 20.1.1.2.1 “Encouraging Voluntary Compliance”

IRM 20.1.1.2.1 (8) The IRS has the obligation to advance the fairness and effectiveness of the tax system. Penalties should do the following:

- **Be severe enough to deter noncompliance,**
- Encourage noncompliant taxpayers to comply,
- Be objectively proportioned to the offense, and
- Be used as an opportunity to educate taxpayers and encourage their future compliance.

When Appeals Offers Your Client Mitigation

- You've established reasonable cause, the Appeals Officer hinted that you established reasonable cause, and then after "review and concurrence" the Appeals Officer offers a mitigated penalty. Is it game over?
- Ask for a managerial conference to elevate the disagreement over mitigation
- Managerial conferences in Appeals are discretionary
- See IRM 8.7.3.4.1 about review and concurrence: "If the settlement is not acceptable [to the reviewer], provides a written response (rebuttal) to the Appeals Officer. If agreement is not reached, the respective managers attempt to resolve the dispute. If the Appeals Team Managers (ATMs) cannot resolve the dispute, the ATMs will refer it to ..."
 - Key - beg to get the ATM involved to push back against the reviewer

Litigation – The Last Resort

- Appeals' unreasonableness on IIRs is forcing more taxpayers into costly litigation
- Pay penalty (or penalty was paid by refund offset)
- Request penalty to be refunded (Form 843)
- Sue for refund

Litigation – The Last Resort (cont'd)

- Issues to consider
 - Liquidity issues to pay penalty
 - Costs of litigation and possibility of attorney fees
 - Favorable facts to shame government and seek press attention (Wrzesinski or Ueland type facts may promote prompt government concession)
 - Malpractice claim against CPA and tolling agreement
 - Public record of litigation (especially for Form 3520 penalties, transactions indicating wealth will become known publicly and may jeopardize foreign family members' safety)

Resources

About the Images in This Presentation

- Several images used in this presentation were AI generated using DALL-E2
- For more information on AI art, see <https://openai.com/dall-e-2>
- Sample- accountant smashing calculator with hammer
- Some images are useable, some are humorous

