

## The IRS's Assessment of International Penalties Under IRC §§ 6038 and 6038A Is Not Supported by Statute, and Systemic Assessments Burden Both Taxpayers and the IRS

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### TAXPAYER RIGHTS IMPACTED<sup>1</sup>

- *The Right to Quality Service*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Finality*
- *The Right to a Fair and Just Tax System*

### EXPLANATION OF THE PROBLEM

The IRS's treatment of IRC §§ 6038 and 6038A foreign information reporting penalties<sup>2</sup> as systemically<sup>3</sup> assessable is legally unsupportable, administratively problematic, and imposes costs, delays, and stress for taxpayers.<sup>4</sup> Bifurcating income tax and international information penalties has created inefficient, expensive, and unnecessary procedures for taxpayers with offshore income and assets. The IRS assesses the IRC §§ 6038 and 6038A penalties either systemically at the time of a late-filed return or manually at the conclusion of an examination. In the former case, taxpayers are not contacted prior to assessment to determine whether a relevant defense, such as reasonable cause, would apply.<sup>5</sup> Instead, remedial steps and requests for relief become possible only after the penalties have been systemically assessed. This administrative approach is unsuited to

<sup>1</sup> See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the IRC. See IRC § 7803(a)(3).

<sup>2</sup> In this Most Serious Problem, we are focusing on IRC §§ 6038 and 6038A as the most direct means of analyzing problems common to most, if not all, of the other foreign information reporting penalties set forth in Chapter 61. Although we specifically examine the assessability of penalties under IRC §§ 6038 and 6038A, the same arguments are generally applicable to other provisions found in Chapter 61 of the code.

<sup>3</sup> Systemic penalties are those that are electronically asserted as an automatic matter whenever a late-filed corporate or partnership tax return includes an information return required by one of these code sections.

<sup>4</sup> Assessable penalties are generally defined as those due and payable upon notice and demand. Unlike penalties subject to deficiency procedures, assessable penalties carry no rights to a 30-day letter, agreement form, or notice requirements prior to assessment. Internal Revenue Manual (IRM) 20.1.9.1.1, Common Terms (Oct. 24, 2013). As discussed further below, the IRC §§ 6038 and 6038A penalties are sometimes assessed manually during an examination. Although still not ideal, this is somewhat less problematic as, in practice, taxpayers often are given the opportunity to furnish missing information and to avoid the penalty in the first instance or to have it simultaneously abated.

<sup>5</sup> See IRC §§ 6038(c)(4)(B) and 6038A(d)(3).

these penalties, as demonstrated by high abatement rates of 55 percent when measured by number of penalties and 71 percent when measured by dollar value.<sup>6</sup>

The National Taxpayer Advocate applauds Congress and the IRS for their enforcement efforts to curtail international tax abuses. However, the National Taxpayer Advocate's opinion is that the statutory framework provides authority for imposing the IRC §§ 6038 and 6038A penalties, not for summarily assessing those penalties.<sup>7</sup> As with the Report of Foreign Bank and Financial Accounts (FBAR) penalty, enforcement actions to collect these penalties should be brought by the Department of Justice.

## ANALYSIS

### Description of the IRC §§ 6038 and 6038A Penalty Regime

IRC § 6038 requires U.S. persons to furnish certain information regarding foreign business entities they control. This information is typically provided on Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, which is attached to taxpayers' annual income tax returns.<sup>8</sup> Failure to timely provide this information results in a \$10,000 penalty, even if this information does not affect taxpayers' ultimate tax liabilities.<sup>9</sup> The IRS notifies taxpayers that the penalty has been assessed. If the taxpayer does not provide the required information within 90 days, the statute imposes an additional penalty (sometimes referred to as a "continuation penalty") for each 30-day period that the failure continues. This increase is capped at \$50,000.<sup>10</sup>

Similarly, IRC § 6038A requires 25 percent foreign-owned domestic corporations to report specified information as an attachment to the corporate income tax return. This information is generally reported on Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business.<sup>11</sup> The penalty under IRC § 6038A begins at \$25,000, and the continuation penalty, which commences 90 days after notification of assessment, is \$25,000 for each 30-day period, without an upper limit.<sup>12</sup>

Originally, these penalties were imposed manually on taxpayers whose missing filings were discovered during an audit. That manual process is still a part of current audit practice. However, beginning January 1, 2009, the IRS began systemic assessment of the monetary penalty under IRC § 6038(b)(1) regarding Forms 5471 attached to late-filed Forms 1120, U.S. Corporation Income Tax Return.<sup>13</sup> Beginning on January 1, 2014, the IRS expanded its systemic assessment of the monetary penalty under IRC § 6038(b)(1) to Form 5471

6 These numbers reflect data from calendar year (CY) 2018. Abatement rates generally increase as more time elapses from the assessment date. For example, the IRS has abated 64 percent of these penalties assessed in 2017 and 78 percent of the initial amount of the dollar assessments. IRS response to TAS information request (Oct. 8, 2020). These circumstances and a detailed analysis of the abatement rates from CYs 2014 to 2018 are discussed below.

7 The statutory authority for the government's collection of the unassessed IRC §§ 6038 and 6038A penalties is found at IRC § 7402(a) (jurisdiction to make and issue in civil actions such judgment and decrees as may be necessary or appropriate for the enforcement of the internal revenue laws) and 28 U.S.C. § 1340 (general jurisdiction of the district courts of the United States in civil actions involving internal revenue). The statute does not provide the IRS with the ability to automatically assess and collect the penalties.

8 IRM 8.11.5.1, Introduction of International Penalties (Dec. 18, 2015). Partnerships are also subject to the IRC § 6038 filing requirement and must attach Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, to their partnership tax return.

9 IRC § 6038(b)(1); Treas. Reg. § 1.6038-2(k)(4).

10 IRC § 6038(b)(2).

11 IRM 8.11.5.1, Introduction of International Penalties (Dec. 18, 2015).

12 IRC § 6038A(d)(1) and (2). See also Treas. Reg. 1.6038A-4 (d)(4).

13 IRM 21.8.2.20.2(1), Form 5471 Penalties Systemically Assessed from Late Filed Form 1120 Series or Form 1065 (Mar. 26, 2018).

attached to late-filed Form 1065, U.S. Return of Partnership Income.<sup>14</sup> Similarly, on January 1, 2013, the IRS began systemically assessing a monetary penalty under IRC § 6038A(d)(1) on Form 5472 attached to late-filed Form 1120 series returns.<sup>15</sup> Thus, the systemic penalty regime has expanded in the last decade to cover a much greater number of taxpayers.

As mentioned, the IRS treats these penalties as summarily assessable, as they are not subject to deficiency procedures, wherein taxpayers receive a notice of deficiency alerting them of the potential assessment and explaining taxpayers' options for contesting or complying with the penalty assessment.<sup>16</sup> The notice of deficiency also informs taxpayers of the last day to petition the Tax Court for pre-assessment and prepayment review.<sup>17</sup> Many penalties related to income tax filings are not summarily assessable (that is, they are generally subject to deficiency procedures). For example, deficiency procedures apply when the IRS determines that noncompliance resulted in an underpayment of tax. Common penalties associated with deficiency actions include IRC § 6662 accuracy-related penalties. This regime requires the IRS to determine a deficiency and allow the taxpayer to petition the Tax Court for a redetermination before making an assessment and initiating any collection action.

Summarily assessable penalties are primarily found in IRC §§ 6671 through 6720C. Chapter 68,<sup>18</sup> Subchapter B, titled "Assessable Penalties," allows the IRS to assess and collect penalties "in the same manner as taxes"<sup>19</sup> without first sending a notice of deficiency. Summary assessments are made without a deficiency determination and "shall be paid upon notice and demand... and collected in the same manner as taxes." Most of these "penalties" are included in Chapter 68 of the IRC. Chapter 68, Subchapter A, titled "Additions to the Tax and Additional Amounts," allows the IRS to impose penalties for failure to file or pay tax, understatements or underpayments of tax, and penalties for fraudulent behavior. However, Chapter 61 penalties, which include the IRC §§ 6038 and 6038A penalties, are not in Chapter 68, and, in the view of the National Taxpayer Advocate, among others, are therefore not assessable.<sup>20</sup>

### **The IRC §§ 6038 and 6038A Penalties Are Convoluting and Punitive in Their Operation**

To systemically impose a \$10,000 penalty per missing or incomplete Form 5471 (\$25,000 for Form 5472) when the taxpayer may be missing tens or even hundreds of such forms can cause a highly disproportionate penalty, particularly when failure to file may not affect the underlying tax liability. Further, these penalties can increase dramatically if the taxpayer becomes subject to the continuation penalty, which is manually assessed upon examination. This punitive approach runs counter to the guiding principles of IRS penalties. As cautioned in the IRS penalty handbook, "Penalties should... be objectively proportioned to the offense [and] be used as an opportunity to educate taxpayers and encourage their future compliance."<sup>21</sup>

14 IRM 21.8.2.20.2(2), Form 5471 Penalties Systemically Assessed from Late Filed Form 1120 Series or Form 1065 (Mar. 26, 2018).

15 IRM 21.8.2.21.2(1), Form 5472 – Information Return of a 25% Foreign Owned U.S. Corporation or a Foreign Corporation Engaged in a Trade or Business (Oct. 1, 2016).

16 IRM 4.8.9.8(1), Preparing Notices of Deficiency (July 9, 2013).

17 See IRM 4.8.9.10.2, Dating Notices (July 9, 2013); see paragraphs 1 and 3.

18 Chapter 68 is contained within Title 26, Subtitle F.

19 IRC § 6671(a).

20 There are, however, some "penalties" that are not found in Chapter 68, but these are authorized by a cross-reference to a code section within Chapter 68 or to another code section that authorizes the Secretary to summarily assess the penalty without first sending a notice of deficiency.

21 IRM 20.1.1.2.1, Encouraging Voluntary Compliance (Nov. 25, 2011).

The impact of the IRC §§ 6038 and 6038A penalties on taxpayers does not end with the initial penalty and potential continuation penalty. When these penalties are asserted, the IRS can propose a reduction of the foreign tax credit (FTC) on the underlying return. Ultimately, the initial penalty can reduce the FTC by ten percent of any FTC claimed or deemed paid to any foreign country, and the continuation penalty reduces the FTC by an additional five percent per 90-day period.<sup>22</sup> Failure to provide the information required by IRC §§ 6038 and 6038A can also result in an accuracy-related penalty. All these consequences can have a serious financial impact on a taxpayer, even though the information on the missing form itself may result in no change to the taxpayer's underlying liability, and therefore should be applied only when appropriate.

**As cautioned in the IRS penalty handbook, “Penalties should... be objectively proportioned to the offense [and] be used as an opportunity to educate taxpayers and encourage their future compliance.”**

IRC §§ 6038 and 6038A penalties are systemically assessed as an automatic matter when IRS systems detect late information returns.<sup>23</sup> As evidenced by high abatement rates (discussed below), much of this late filing is ultimately determined to result from benign circumstances, including ignorance of the filing requirements, unavailability of the requisite information, and IRS error.<sup>24</sup>

The inequities in the IRS's approach are exacerbated by treating these penalties as summarily assessable. Often, these penalties are due and owing even before taxpayers know of their existence.<sup>25</sup> The IRS does allow taxpayers to seek a post-assessment, pre-payment review in the IRS Independent Office of Appeals, which can include a reasonable cause defense.<sup>26</sup> Nevertheless, administrative relief depends on IRS discretion, which, in the case of these penalties, is generally only subject to judicial oversight if taxpayers can afford to first pay the penalty and then incur the cost of taking the case to federal court.<sup>27</sup> Further, some tax practitioners have reported accelerated collection activity, even while the penalties are still under review.<sup>28</sup>

22 IRC § 6038(c). The FTC reduction is not to exceed the greater of \$10,000 or the income of the foreign business entity for the tax period. The extent of the FTC reduction is offset by the monetary penalty.

23 See IRM 21.8.2.20.2, Form 5471 Penalties Systemically Assessed from Late-Filed Form 1120 Series or Form 1065 (Mar. 26, 2018); IRM 21.8.2.21.2, Form 5472 Penalties Systemically Assessed from Late-Filed Form 1120 Series (Oct. 1, 2019). IRS response to TAS information request (Oct. 1, 2020).

24 These examples are drawn from TAS's observations in this area. See also IRS response to TAS information request (Oct. 1, 2020).

25 IRM 20.1.9.3.2, Penalty Letters, Notice Letters, and Notices (Nov. 30, 2015). See also IRM 20.1.9.3.3.(2), Penalty Assertion (Mar. 21, 2013); IRM 21.8.1.26.1, Form 5471 Penalties (Oct. 1, 2019).

26 IRS response to TAS information request (Oct. 1, 2020); IRC §§ 6038(c)(4)(B) and 6038A(d)(3); IRM 8.11.5.1, Introduction of International Penalties (Dec. 18, 2015).

27 Chief Counsel Directives Manual 34.2.1.1, Suits for a Refund of Tax/Counterclaims (Aug. 11, 2004). For a legislative recommendation to address the issue of “pay to play” judicial review, see National Taxpayer Advocate 2018 Annual Report to Congress 364-386 (Legislative Recommendation: *Fix the Flora Rule: Give Taxpayers Who Cannot Pay the Same Access to Judicial Review as Those Who Can*). Taxpayers can seek review in the applicable federal district court or Court of Federal Claims.

28 Andrew Velarde, *Practitioners Fault Accelerated Assessable Penalty Collection*, TAX NOTES TODAY (Mar. 18, 2020); Megan Brackney, *Problems Facing Taxpayers with Foreign Information Return Penalties and Recommendations for Improving the System (Part 2)*, PROCEDURALLY TAXING (Jan. 7, 2020), <https://procedurallytaxing.com/the-irs-and-foreign-information-return-penalties-part-2/>.

## Several Commentators Have Questioned the IRS's Legal Authority to Treat These Penalties as Assessable

The IRS justifies the taxpayer-unfriendly regime surrounding the IRC §§ 6038 and 6038A penalties by explaining that it has little choice regarding the treatment of these penalties.<sup>29</sup> These penalties are neither imposed on tax deficiencies nor calculated referencing anything on the return itself. Further, they are not subject to deficiency procedures that would allow a pre-payment judicial review.<sup>30</sup> The IRS's position is that since deficiency procedures are unavailable, the penalties must be summarily assessable<sup>31</sup> even though they are not listed in Chapter 68, Subchapter B of the IRC, which is where assessable penalties are enumerated.<sup>32</sup>

The IRS finds a sweeping grant of authority to assess these penalties in IRC § 6201(a), which allows the IRS to assess “taxes (including interest, additional amounts, additions to the tax, and assessable penalties).”<sup>33</sup> In *NFIB v. Sebelius*,<sup>34</sup> the Supreme Court agreed that the plain language of IRC § 6201 places assessable penalties within the definition of a tax for purposes of granting the IRS the authority to assess those penalties.<sup>35</sup> To the IRS, this in turn gives it the ability to summarily assess penalties not subject to deficiency procedures, whether or not those penalties are listed in Chapter 68, Subchapter B.<sup>36</sup> In other words, even though the IRC fails to explicitly recognize these penalties as assessable, they must be treated as assessable because they are not subject to deficiency procedures. In the National Taxpayer Advocate's view, this is a circular argument without legal support.

Several commentators find the IRS's analysis to be overly broad and unpersuasive.<sup>37</sup> For example, Collins and Hahn point out that “a statute providing for a penalty and the IRS's authority to assess that penalty are two very distinct issues.”<sup>38</sup> In their view, although the IRC §§ 6038 and 6038A penalties are provided for in the IRC, the authority to assess those penalties is not. To collect these penalties, the Department of Justice must sue the taxpayer to collect any unpaid penalties. To these authors, the contention that IRC § 6201 allows the assessment of IRC §§ 6038 and 6038A penalties represents an overreach. As they see it, the authority granted by IRC § 6201(a) applies to the enumerated items, which, although extensive, do not include IRC §§ 6038 and 6038A penalties residing within Chapter 61. Thus, although IRC § 6201 contemplates the collection of assessable penalties enumerated in Chapter 68, Subchapter B, it does not provide authority, either directly or indirectly, for the assessment of IRC §§ 6038 and 6038A penalties. Collins and Hahn raise the possibility that the last ten years of assessments are legally dubious and therefore open to challenge.<sup>39</sup>

29 IRS response to TAS information request (Oct. 1, 2020).

30 IRM Exhibit 20.1.9-4, International Penalties Subject to or Not Subject to Deficiency Proceeding (July 8, 2015).

31 IRS response to TAS information request (Oct. 1, 2020); IRM 8.11.5.1, Introduction of International Penalties (Dec. 18, 2015).

32 Chapter 68, Subchapter B includes IRC §§ 6677 through 6725.

33 IRS response to TAS information request (Oct. 1, 2020).

34 *NFIB v. Sebelius*, 567 U.S. 519 (2012), 546. See also IRS response to TAS information request (Oct. 1, 2020).

35 In support of its position, the IRS also cites *Wheaton v. U.S.*, 888 F. Supp. 622, 626 (D.N.J. 1995) (acknowledging that penalties under IRC § 6038 are not subject to deficiency procedures). It also relies on *Heydemann v. United States*, 2008 WL 2502188 at \*2 (D. Md. April 23, 2008) (there is “no requirement that the initial assessment of § 6038 penalties requires prior notice”). While these decisions arguably support the proposition that deficiency procedures are inapplicable to IRC § 6038 penalties, they do not directly consider the legal questions of whether the IRS has statutory authority to assess these penalties.

36 IRS response to TAS information request (Oct. 1, 2020).

37 To date, courts have not directly ruled on this issue.

38 Erin Collins and Garrett Hahn, *Foreign Information Reporting Penalties: Assessable or Not?* TAX NOTES TODAY (July 9, 2018) 211-213. After publication of this article, Erin Collins was appointed IRS National Taxpayer Advocate.

39 *Id.*

Following a slightly different line of analysis, Horwitz concludes that the IRS has no direct means of assessing or otherwise collecting IRC §§ 6038 and 6038A penalties or any other penalties in Chapter 61.<sup>40</sup> He reasons that because these penalties are not a tax and are not assessed and collected in the same way as a tax, “(1) the IRS is not authorized to assess them; (2) the IRS cannot file tax liens or levy against assets to collect them; and (3) the collection due process provisions do not apply.”<sup>41</sup> Horwitz concurs with Collins and Hahn that the IRS’s only recourse is to ask the Department of Justice to sue the taxpayer seeking to collect any unpaid penalties.

Agostino and Colasanto summarize an emerging consensus among commentators: “Like Collins, Hahn, and Horwitz, we conclude that there is no authority in the code authorizing the summary assessment of these penalties.”<sup>42</sup> Further, Agostino and Colasanto suggest that these penalties should be adjudicated as part of the deficiency procedures.<sup>43</sup> They also contend that penalties made the subject of summary assessments should be abated by the IRS.<sup>44</sup>

Although these commentators follow slightly different analytical paths, they all arrive at the same conclusion. Each argues that the IRS lacks the legal ability to treat IRC §§ 6038 and 6038A as giving rise to assessable penalties. This is an area of controversy that could easily generate unwelcome litigation for the IRS, but more important, one that imposes unreasonable burdens on taxpayers and is inconsistent with the statutes.

### Systemic Assessment Is Resulting in the Reversal of Many Unnecessary Penalties

What makes this issue more than academic is that taxpayers are adversely impacted by the IRS’s treatment of these penalties as summarily assessable. Even if, as a legal matter, the IRS has the right to summarily assess these penalties on the late-filed return, this does not mean it should do so. The penalty regime, as applied by the IRS, is highly burdensome for taxpayers. The IRS should adopt a different path forward that will be more equitable for taxpayers and administratively more effective for all concerned.

An overhaul of the IRC §§ 6038 and 6038A penalty regime is long overdue. The need for this reinvention is evidenced by the prevailing abatement rates. Although abatements are always preferable to improperly assessed and collected penalties, high abatement rates indicate flawed policies. For the IRC §§ 6038 and 6038A penalties, these abatement rates, in the aggregate, are exorbitantly high. Such is the case where the penalties are systemically imposed as a preprogrammed, automatic matter. Penalties applied manually during examination are abated at a lower rate in comparison with those of the systemic penalties.

TAS analyzed abatement rates for the IRC §§ 6038 and 6038A penalties in terms of both numbers and dollars. Along the way, we paid particular attention to the abatement rates for systemic versus manual assessments, which are substantially disparate, as demonstrated in Figures 1.8.1-3.<sup>45</sup> When these penalties are applied systemically, the abatement percentage, measured by number of penalties, ranges from 55 to 72 percent, and by

40 Robert Horwitz, *Can the IRS Assess or Collect Foreign Information Reporting Penalties?* TAX NOTES TODAY (Jan. 31, 2019) 301-305.

41 *Id.* at 301.

42 Frank Agostino and Phillip Colasanto, *The IRS’s Illegal Assessment of International Penalties*, TAX NOTES TODAY (Apr. 8, 2019) 261-269.

43 *Id.*

44 *Id.*

45 IRS response to TAS information request (Oct. 8, 2020). Because the numbers for the manual versus systemic assessments under each Code section were in similar proportion, if not similar volumes, TAS has combined the data for these two penalties to present more simplified numbers. Abatement rates generally increase as more time elapses from the assessment date. Assessments and abatements of zero dollars are excluded from this analysis.



dollar value of penalties ranges from 71 to 88 percent.<sup>46</sup> Manual assessments are abated at rates ranging from 17 percent to about 39 percent by number, and from eight percent to about 66 percent by dollar.<sup>47</sup>

**FIGURE 1.8.1, Systemic Assessments of IRC §§ 6038 and 6038A Penalties<sup>48</sup>**

Calendar Year Penalty Assessed	Number of Penalties Assessed	Dollar Amount Assessed	Number of Abatements	Dollars Abated	Abatement Percentage by Number	Abatement Percentage by Dollar
2014	9,736	\$282,345,000	7,050	\$241,801,922	72%	86%
2015	9,316	\$236,038,000	6,632	\$194,566,666	71%	82%
2016	9,170	\$366,397,100	6,166	\$322,142,928	67%	88%
2017	8,892	\$220,715,000	5,653	\$172,101,999	64%	78%
2018	9,889	\$253,087,500	5,468	\$179,532,000	55%	71%

**FIGURE 1.8.2, Manual Assessments of IRC §§ 6038 and 6038A Penalties<sup>49</sup>**

Calendar Year Penalty Assessed	Number of Penalties Assessed	Dollar Amount Assessed	Number of Abatements	Dollars Abated	Abatement Percentage by Number	Abatement Percentage by Dollar
2014	389	\$33,268,121	150	\$21,875,043	39%	66%
2015	241	\$5,695,002	41	\$721,000	17%	13%
2016	610	\$45,148,635	180	\$4,571,000	30%	10%
2017	708	\$38,371,300	194	\$3,622,433	27%	9%
2018	1097	\$58,328,617	268	\$4,906,750	24%	8%

<sup>46</sup> IRS response to TAS information request (Oct. 8, 2020).

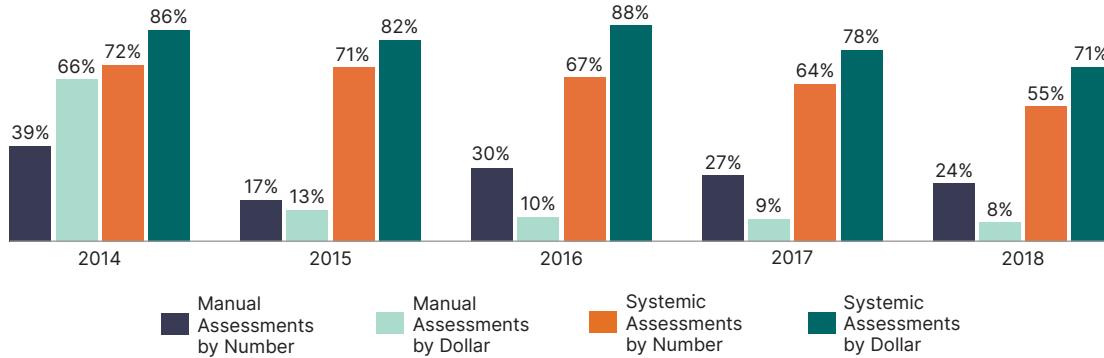
<sup>47</sup> Compliance Data Warehouse (CDW) Individual Master File (IMF) and Business Master File (BMF) data as of the end of fiscal year (FY) 2020.

<sup>48</sup> Figure 1.8.1 presents BMF data. Figure 1.8.2 presents a combination of data from BMF and IMF sources. IRS response to TAS information request (Oct. 8, 2020).

<sup>49</sup> IRS response to TAS information request (Oct. 8, 2020); CDW IMF and BMF data as of the end of FY 2020.

FIGURE 1.8.3<sup>50</sup>

## Abatement Rates: Manual Versus Systemic Assertions



As demonstrated in the above analysis, the abatement rates for penalties applied manually during exams are higher than they could be. However, the extent of systemically applied penalties that are later abated indicates a broken system. Taxpayers subject to the systemic penalty receive a letter in the mail informing them, generally for the first time, of a late return and that they must pay the assessed penalty.<sup>51</sup> The IRS then offers various avenues of administrative relief, including reasonable cause abatements.<sup>52</sup> When the IRS undertakes these reviews, it grants abatements at a startling rate, thus raising the inference that the reason for noncompliance was benign.

The IRS deserves credit for properly abating penalties that should not be enforced. It also has implemented some taxpayer-favorable measures, such as allowing an abatement of these penalties whenever a related IRC § 6651 penalty receives a first-time abatement.<sup>53</sup> However, the IRS is administering a systemic penalty regime that abates penalties at least 55 percent of the time and has a reversal rate of about 71 percent when measured in terms of dollars.<sup>54</sup> Notwithstanding the high number of eventual abatements, taxpayers can still experience a significantly adverse impact from the initial assessment. Taxpayers, many of whom are making good-faith efforts to comply with often-onerous U.S. information reporting regimes, are sometimes confronted with unexpected penalties that can be disproportionate and punitive. They can cause stress, create distractions, and cost legal fees to defend. Because these penalties are summarily assessed, taxpayers must depend on the IRS's benevolence and discretion as they seek administrative relief.<sup>55</sup> If either is in short supply,

50 IRS response to TAS information request (Oct. 8, 2020); CDW IMF and BMF data as of the end of FY 2020. Note, the percentages in this figure do not add up to 100 percent because each bar represents the individual abatement rate for a particular mode of assessment (manual or systemic) presented in terms of dollars abated and in terms of number of abatements.

51 IRM 20.1.9.3.2, Penalty Letters, Notice Letters, and Notices (Nov. 30, 2015).

52 IRS response to TAS information request (Oct. 1, 2020). For Form 5471, see IRM 20.1.9.3.5, Reasonable Cause (July 8, 2015), and Treas. Reg. 1.6038-2(k)(3); for Form 5472, see IRM 20.1.9.5.5, Reasonable Cause (July 8, 2015), and Reg. 1.6038A-4(b). See also IRM Exhibit 20.1.9-7, Sample CP 215 Notice (Nov. 30, 2015).

53 The IRS estimates that approximately 40 percent of the systemic abatements result from this circumstance, and another 25 percent of abatements are attributable to corrections from taxpayers or the IRS. IRS response to TAS information request (Oct. 1, 2020).

54 IRS response to TAS information request (Oct. 8, 2020). These numbers reflect data from CY 2018. Abatement rates generally increase as more time elapses from the assessment date.

55 Although the IRS points out that many of these penalties are abated in ways that often require little intervention from taxpayers, taxpayers find it far more desirable to avoid unnecessary penalties than to obtain relief later. IRS response to TAS information request (Oct. 1, 2020). For example, TAS knows from its own experience in advocating for taxpayers how difficult it can sometimes be to obtain a first-time abatement, even where such relief is governed by mechanical rules that should be easily applied.



taxpayers must pay the penalty to seek judicial review. Further, where the penalty amount is \$10,000, some taxpayers may reluctantly agree to the penalty rather than incur the accounting or legal fees to fight against it.

### **Systemic Application and Subsequent Abatement of the IRC §§ 6038 and 6038A Penalties Squanders IRS Resources and Risks Future Noncompliance by Taxpayers**

Although the burden of these assessments falls most heavily on taxpayers, it also negatively affects the IRS itself. Systemic application of the penalties is easy, but the subsequent reversals represent a drain on IRS resources. Any time a taxpayer contests the penalties, they must be reviewed by an examiner.<sup>56</sup> If the penalties cannot be resolved at that level, then taxpayers can seek an independent pre-payment appeal. All these proceedings require individual attention from IRS personnel.<sup>57</sup> Over time these demands not only squander scarce IRS funds, but also necessitate the dedication of significant personnel hours. These hours could be more productively allocated elsewhere if the IRS implemented a narrowly tailored penalty system that accurately detected bad actors.

Instead, the current approach does little more than irritate taxpayers and paint the IRS in a bad light. Some taxpayers and practitioners have realized that if they do not attach these forms to a late return, they can avoid systemic assessment of the penalties. Such an approach is antithetical to good tax administration. The IRS's accuracy rate regarding these penalties would be significantly improved if it simply relied on the flip of a coin or the spin of a roulette wheel. This reality cannot help but breed irritation against the IRS and disrespect for the reliability of its procedures. Almost inevitably, this will generate additional noncompliance not only in the international information reporting area, but in other aspects of taxpayers' interactions with the IRS.<sup>58</sup> As the Internal Revenue Manual itself recognizes, "A wrong [penalty] decision, even though eventually corrected, has a negative impact on voluntary compliance."<sup>59</sup> It is imperative that the IRS get this right, both to facilitate good tax administration and to protect taxpayer rights.

## **CONCLUSION AND RECOMMENDATIONS**

Beyond legal concerns, the current approach of systemically assessing the IRC §§ 6038 and 6038A penalties as summarily assessable harms taxpayers and is disadvantageous to the IRS.<sup>60</sup> The IRS should rethink this practice and provide a more effective system that is proportional and educational. Doing so would protect taxpayer rights, increase tax compliance, and preserve IRS resources. The IRS should discontinue its policy of treating the IRC §§ 6038 and 6038A penalties as assessable, as the IRC does not provide the authority for such actions.

The penalty regime could be improved in several ways, and TAS would partner with the IRS in exploring and formulating these best practices. The IRS could utilize systemically generated soft letters for late filed returns

<sup>56</sup> IRS response to TAS information request (Oct. 1, 2020).

<sup>57</sup> For example, according to the IRS, five to ten percent of abatements in this area are attributable to reasonable cause, which is an especially time-consuming way of providing relief. IRS response to TAS information request (Oct. 1, 2020).

<sup>58</sup> In a study of Schedule C filers, TAS found that when these taxpayers were subject to penalties that could reasonably be perceived as unfair — those assessed by default, abated, or appealed — they had lower levels of compliance in subsequent years. National Taxpayer Advocate 2013 Annual Report to Congress vol. 2, at 1-14 (*Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?*).

<sup>59</sup> IRM 20.1.1.3(4), Responsibilities (Nov. 21, 2017).

<sup>60</sup> These problems and many of the observations set forth below are equally applicable to other foreign information reporting penalties set forth in Chapter 61.

informing the taxpayer of the relevant penalty. These letters could educate taxpayers regarding applicable law, identify the missing or late information returns, and provide taxpayers an opportunity to comply with their filing requirements as a means of forestalling assertion of the penalty.<sup>61</sup> Similarly, the IRS could provide a first-time abatement for all Chapter 61 penalties, including the IRC §§ 6038 and 6038A penalties, to educate taxpayers and streamline tax administration.<sup>62</sup> These approaches would benefit all parties in that it would foster a better understanding of the law by taxpayers, facilitate information gathering, and substantially decrease the number of penalties asserted. Good faith taxpayers would have their rights protected, while the IRS would still receive the desired information. Likewise, both parties would be freed from the respective burdens generated by unnecessary penalties.

To protect taxpayer rights and reduce taxpayer burden, we strongly recommend that Congress amend the IRC to allow deficiency procedures for all Chapter 61 penalties, including the IRC §§ 6038 and 6038A penalties. As one possibility, these IRC sections could be amended to add a cross-reference directing that the penalties be asserted in the same way as other IRC sections subject to deficiency procedures. This approach would allow taxpayers to contest these penalties before Tax Court judges familiar with tax law in a pre-payment judicial forum.

### Preliminary Administrative Recommendations to the IRS

The National Taxpayer Advocate preliminarily recommends that the IRS:

1. Stop erroneously assessing Chapter 61 penalties, including the IRC §§ 6038 and 6038A penalties, and refer assessment and collection efforts to the Department of Justice when appropriate.
2. Send soft notices to taxpayers upon discovery of late-filed international information returns as a means of enhancing compliance and minimizing the number of penalties being asserted.
3. Extend eligibility for the first-time abatement to all Chapter 61 penalties, including the IRC §§ 6038 and 6038A penalties, regardless of whether the underlying return was filed late.

### Legislative Recommendation to Congress

The National Taxpayer Advocate recommends that Congress:

1. Expand deficiency procedures to cover Chapter 61, including the IRC §§ 6038 and 6038A penalties.<sup>63</sup>

61 The IRS uses such letters in the case of the continuation penalties discussed above. It also sends mailings that it refers to as “soft letters” in similar circumstances. See, e.g., Letter 6290 relating to failure to report foreign accounts on Form 8938, Statement of Specified Foreign Financial Assets, or failure to file Form 8938. This latter group of letters, however, does not provide previously noncompliant taxpayers with a mechanism for avoiding application of penalties in the first instance.

62 IRM 20.1.1.3.3.2.1, First Time Abate (FTA) (Nov. 21, 2017); IRM 20.1.9.3.5(3), Reasonable Cause (July 7, 2015); 20.1.9.5.5(3), Reasonable Cause (July 8, 2015). The first-time abatement is applied to the IRC §§ 6038 and 6038A penalties when it is applied to the underlying return, but it could also be applied more broadly without reference to the underlying return.

63 See Legislative Recommendation: *Repeal Flora and Expand the Tax Court’s Jurisdiction, Giving Taxpayers Who Cannot Pay The Same Access to Judicial Review as Those Who Can*, *infra*.

## IRS COMMENTS

While the U.S. income tax system is based on self-disclosure and self-assessment by taxpayers, there are inherent challenges with obtaining and verifying taxpayer information in the international context. Accordingly, Congress enacted statutory penalties in Internal Revenue Code (IRC) Chapter 61 for failure to timely file information returns relating to cross-border business activities. These information returns relate to both foreign taxpayers' activities and investments in the U.S. and U.S. taxpayers' activities and investments abroad. The IRS also utilizes the information in these annual returns to monitor and enforce tax compliance for other tax years and for other taxpayers (such as other shareholders or partners). The Treasury Inspector General for Tax Administration (TIGTA) recommended that the IRS consider systemic assessment of these penalties in 2006. After studying the issue further, the IRS began systemic assessment of some international information return penalties in 2009, and TIGTA evaluated IRS progress with implementing systemic assessment in 2013.

We disagree with the fundamental premise of the MSP that the IRS lacks legal authority to assess Chapter 61 penalties. The IRC provides two methods to assess penalties, either (1) pursuant to deficiency procedures or (2) as assessable penalties, that is, those penalties not subject to deficiency procedures. Penalties under Chapter 61, including IRC § 6038 and § 6038A, are meant to enforce reporting requirements and are not based on the tax shown on a return or the existence of a deficiency. As such, there is no legal basis for us to apply deficiency procedures to these penalties and the IRS has consistently treated Chapter 61 penalties as assessable.

IRC § 6201(a) provides the IRS authority to assess assessable penalties, that is, those penalties not subject to deficiency procedures. Neither that section nor the IRC in general limits assessable penalties to those described under IRC Subchapter 68B. To read the "Assessable Penalties" heading of that subchapter as the exclusive location of assessable penalties would be contrary to IRC § 7806, which expressly prohibits giving any legal effect to descriptive matter relating to the content of the IRC. Accordingly, there is authority to treat these penalties as immediately assessable, and the IRS is not required to first request that the Department of Justice file a suit to obtain a judgement for the penalties before collecting them.

The assessment of these penalties at filing, much like with other assessable penalties, provides the most equitable treatment of enforcement as it doesn't require the IRS to apply case selection criteria for examination. Meaning, all corporations and partnerships are held to the same standards of the law. The IRS recognizes the abatement rates for these systemically assessed penalties on corporations and partnerships are relatively high. We look forward to partnering with TAS to explore whether there are more efficient methods of administering these penalties while maintaining the equitable treatment afforded through systemic assessments.

## TAXPAYER ADVOCATE SERVICE COMMENTS

TAS agrees with the IRS regarding the importance of international information returns for tax administration and voluntary compliance. We understand that systemic assessment is sometimes the best and most equitable way to impose certain penalties for the IRS — but such is not always the case for taxpayers. When the majority of assessed penalties is ultimately abated, however, this indicates that other, more effective and efficient ways of seeking taxpayer compliance should be explored.

TAS looks forward to collaborating with the IRS to develop and implement programs and policies that drive compliance through communication and education. Such programs could include the issuance of soft letters prior to the assessment of penalties so that taxpayers have the opportunity to avoid penalties when they come into compliance. Also, if the IRS implemented a systemic first-time abatement for these penalties, this would represent a more streamlined and comprehensive version of what is already occurring as a practical matter for many systemically assessed IRC §§ 6038 and 6038A penalties. Both the soft letters and the systemic first-time abatement we recommend would present a means of generating compliance in a manner that preserves resources and reduces burdens for taxpayers and the IRS.

From a broader perspective, the National Taxpayer Advocate is unpersuaded by the IRS's legal argument that it has the right to assess these penalties. TAS concurs with the IRS that the IRC does not provide authority for the use of deficiency procedures with respect to Chapter 61 penalties. Nevertheless, the IRS has not provided any unambiguous statutory language or on-point judicial rulings based on which these penalties can be assessed.

IRC § 6201 simply states that assessable penalties can be assessed and the cases cited by the IRS only decide that penalties not subject to deficiency procedures do not require deficiency procedures.<sup>64</sup> These circumstances, either individually or in combination, cannot provide a basis for determining that Chapter 61 penalties are assessable in the first instance. The IRS primarily relies on the circular logic that just because the IRS cannot apply deficiency procedures, it therefore, by definition, must be able to resort to summary assessments. These are not either/or propositions, and the authority to assess is in no way conferred by the unavailability of deficiency procedures. Based on the National Taxpayer Advocate's reading of the law, and that of some commentators, the IRS simply has no ability to assess Chapter 61 penalties under the IRC as currently codified. This unfortunate and likely unintended situation is why assessment and collection of Chapter 61 penalties should be referred to the Department of Justice.

Although under current law, deficiency procedures do not apply to Chapter 61 penalties, we strongly recommend that Congress provide taxpayers with a statutory notice of deficiency giving them the opportunity to petition the U.S. Tax Court for reconsideration of the penalty. All taxpayers should have the chance to obtain judicial review of adverse IRS determinations. The IRS's position is that Chapter 61 penalties are assessable and not subject to judicial review unless a taxpayer is wealthy

64 See *Wheaton v. U.S.*, 888 F. Supp. 622, 626 (D.N.J. 1995); *Heydemann v. United States*, 2008 WL 2502188 (D. Md. Apr. 23, 2008).

enough to first fully pay the penalties assessed and proceed to U.S. District Court or the U.S. Court of Federal Claims.

Long-term reliance on the Department of Justice for such enforcement is not an efficient and taxpayer-favorable long-term outcome. TAS welcomes the prospect of working with the IRS and Congress to seek legislation making Chapter 61 penalties subject to deficiency procedures. In the meantime, we look forward to collaborating with the IRS in pursuing our administrative recommendations that would yield a fair and just tax system for both taxpayers and the IRS.

## RECOMMENDATIONS

### Administrative Recommendations to the IRS

The National Taxpayer Advocate recommends that the IRS:

1. Stop erroneously assessing Chapter 61 penalties, including the IRC §§ 6038 and 6038A penalties, and refer assessment and collection efforts to the Department of Justice when appropriate.
2. Send soft notices to taxpayers upon discovery of late-filed international information returns as a means of enhancing compliance and minimizing the number of penalties being asserted.
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### Legislative Recommendation to Congress

The National Taxpayer Advocate recommends that Congress:

1. Expand deficiency procedures to cover Chapter 61, including the IRC §§ 6038 and 6038A penalties.<sup>65</sup>

<sup>65</sup> See Legislative Recommendation: *Repeal Flora and Expand the Tax Court's Jurisdiction, Giving Taxpayers Who Cannot Pay The Same Access to Judicial Review as Those Who Can*, *infra*.