

Legislative Recommendation #11**Provide That Assessable Penalties Are Subject to Deficiency Procedures****SUMMARY**

- *Problem:* To judicially challenge “assessable penalties,” a taxpayer must pay the penalty in full and then bring suit in a U.S. district court or the U.S. Court of Federal Claims. The inability of taxpayers to obtain judicial review on a pre-assessment basis and the requirement that taxpayers pay the penalties in full to obtain judicial review on a post-assessment basis can effectively deprive taxpayers of the right to judicial review at all.
- *Solution:* Give taxpayers an opportunity to challenge assessable penalties in the U.S. Tax Court prior to assessment by making these penalties subject to the deficiency procedures.

PRESENT LAW

IRC § 6212 requires the IRS to issue a “notice of deficiency” before assessing certain liabilities. When the IRS issues a notice of deficiency, IRC § 6213 authorizes the taxpayer to petition the U.S. Tax Court within 90 days (or 150 days for notices addressed to a person outside the United States) to review the IRS determination as stated in the notice.

IRC § 6671(a) authorizes the IRS to assess some penalties without first issuing a notice of deficiency.¹ These penalties are generally subject to judicial review only if taxpayers first pay the penalties and then incur the costs of filing suit in a U.S. district court or the Court of Federal Claims to recover the payments.² The district courts and the Court of Federal Claims impose higher court fees than the U.S. Tax Court, and due to the complexities of their rules, taxpayers usually have to retain an attorney to dispute the assessment.

In addition, some assessable penalties are subject to the “full payment rule.” In *Flora v. United States*, 362 U.S. 145 (1960), the U.S. Supreme Court held that, with limited exceptions, a taxpayer must have fully paid the assessment before filing suit in a U.S. district court or the Court of Federal Claims. One exception to the full payment rule applies to “divisible” taxes. In the case of divisible taxes, a taxpayer may pay only a fraction of the tax and judicially challenge the penalty. These penalties include the trust fund recovery penalty under IRC § 6672(a).

1 These “assessable” penalties are generally those that are 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 20.1.9.1.5, Common Terms and Acronyms (Jan. 29, 2021).

2 See IRC § 7422 for requirements relating to refund suits.

By contrast, other assessable penalties require the taxpayer to pay in full to obtain judicial review. These penalties include foreign information reporting penalties under IRC §§ 6038, 6038A, 6038B, 6038C, and 6038D,³ and penalties with respect to reportable transactions under IRC §§ 6707 and 6707A.⁴ Penalties under these sections can be substantial.⁵

REASONS FOR CHANGE

Taxpayers who are savvy enough to request an abatement based on reasonable cause or to request a conference with the IRS Independent Office of Appeals frequently obtain relief from assessable penalties, particularly where the IRS imposes a penalty systemically (rather than imposing it manually during an audit). TAS has previously reported that the IRS abated between 71 percent and 88 percent of dollars systemically assessed under IRC §§ 6038 and 6038A.⁶ Specifying that deficiency procedures apply would prevent the systemic assessments the IRS so often abates, a process that unnecessarily consumes resources for the IRS and imposes undue burdens on taxpayers. Given how substantially these penalties can add up, requiring full payment puts judicial review out of reach for many if not most taxpayers. It is unconscionable to require taxpayers to pay penalties that can run into the millions of dollars without first giving taxpayers an opportunity to obtain judicial review of the IRS's determination. This is particularly important for taxpayers who face large penalties but have limited resources.

Providing that assessable penalties are subject to deficiency procedures would put pre-assessment judicial review of penalties in the hands of the Tax Court. In our view, that is where it belongs. Due to the tax expertise of its judges, the Tax Court is often better equipped to consider tax controversies than other courts. It is also more accessible to less knowledgeable and unrepresented taxpayers than other courts because it uses informal procedures, particularly in disputes that do not exceed \$50,000. Another benefit is that taxpayers are generally offered the option of receiving free legal assistance from a Low Income Taxpayer Clinic or *pro bono* representative. In most instances, the Tax Court is the least expensive and easiest-to-navigate judicial forum for low-income taxpayers.

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- 3 Although IRC § 6671(a) specifically references only the "penalties and liabilities provided by this subchapter" (*i.e.*, IRC Chapter 68, Subchapter B), the IRS takes the position that various international information reporting penalties in Chapter 61 are also immediately assessable without the issuance of a notice of deficiency, including the penalty under IRC § 6038 for failure to file Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. See IRC §§ 6201(a); 7806(b). This position has also been accepted by some federal courts at least as to IRC § 6038. See *Deweese v. U.S.*, 272 F.Supp.3d 96 (D.D.C. 2017), *aff'd without published opinion*, 767 Fed.Appx. 4 (D.C. Cir. 2019), *cert. denied*, 140 S.Ct. 48 (2019) (holding that the failure to offer a preassessment opportunity for judicial review of a penalty under IRC § 6038 did not violate due process under the Fifth Amendment); *Wheaton v. U.S.*, 888 F.Supp. 622 (D.N.J. 1995) (holding the IRC § 6038 penalty was not subject to deficiency procedures). *Wheaton* also holds that IRC § 6038 penalties are subject to the *Flora* full payment rule. 888 F.Supp. at 627. See also *Gaynor v. U.S.*, 150 Fed. Cl. 519 (2020) (holding that a refund suit to challenge IRC § 6038 penalty for failure to file Form 5471 is subject to the full payment rule of *Flora*).
 - 4 Courts ruled that full payment was required prior to a judicial challenge of the IRC § 6707 penalty in *Pfaff v. U.S.*, No. 14-cv-03349, 2016 WL 915738 (D. Colo. Mar. 10, 2016) and *Diversified Group v. U.S.*, 841 F.3d 975 (Fed. Cir. 2016).
 - 5 The penalty under IRC § 6038 for failure to file Form 5471 with respect to certain foreign corporations and partnerships is \$10,000 for each accounting period for each failure to file Form 5471 with respect to certain foreign corporations and partnerships. IRC § 6038(b). An additional "continuation penalty" of up to \$50,000 can be added to each penalty if the failure continues for more than 90 days after the IRS sends notice of the failure. IRC § 6038(b)(2). The IRC § 6038 penalty in *Gaynor* totaled \$120,000. *Gaynor*, 150 Fed.Cl. at 525, 527. The amount of the IRC § 6707 penalty is \$50,000 for failure to furnish information regarding reportable transactions, other than listed transactions. IRC § 6707(b)(1). If the penalty is with respect to a listed transaction, the amount of the penalty is the greater of the following: \$200,000, or 50 percent of the gross income derived by the material advisor with respect to aid, assistance, or advice which is provided before the date the information return is filed under IRC § 6111. IRC § 6707(b)(2). In *Diversified*, the penalties assessed under IRC § 6707 for failure to register their tax shelter totaled \$24.9 million. *Diversified Grp., Inc. v. U.S.*, 123 Fed. Cl. 442, 445 (2015), *aff'd*, 841 F.3d 975 (Fed. Cir. 2016).
 - 6 See National Taxpayer Advocate 2020 Annual Report to Congress 119, 124-125 (Most Serious Problem: *International: 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*) (reporting that when penalties under IRC §§ 6038 and 6038A were applied systemically, the abatement percentage measured by number of penalties ranged from 55 to 72 percent and the abatement percentage measured by dollar value of penalties ranged from 71 to 88 percent in fiscal year 2020), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2021/01/ARC20_MSP_08_International.pdf. The IRS abated manual assessments at rates ranging from 17 percent to 39 percent by number and from eight percent to 66 percent by dollar value.

The National Taxpayer Advocate does not agree with the IRS's legal position that foreign information reporting penalties in Chapter 61 may be assessed without the issuance of a notice of deficiency under current law.⁷ In light of the IRS's position, however, we believe Congress should clarify the point through legislation.

RECOMMENDATION

- Amend IRC § 6212 to require the IRS to issue a notice of deficiency before assessing any “assessable penalty.”

⁷ See National Taxpayer Advocate 2020 Annual Report to Congress 119-131 (Most Serious Problem: *International: 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*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2021/01/ARC20_MSP_08_International.pdf.