



INTERNATIONAL

The IRS's Approach to International Information Return Penalties Is Draconian and Inefficient

WHY THIS IS A SERIOUS PROBLEM FOR TAXPAYERS

U.S. persons who receive money from abroad or who have certain foreign financial interests and cross-border business activities are potentially subject to a wide range of U.S. reporting requirements. Many of these requirements come with significant penalty exposure when a filing is late, incomplete, or inaccurate. These international information return (IIR) penalties harm sometimes unsuspecting lower-income taxpayers, small businesses, and immigrants. The majority of these penalties are automatically assessed,¹ broadly applied, needlessly harsh, and often unexpected.²

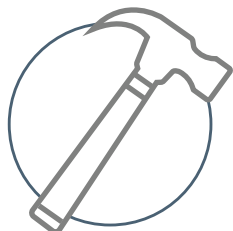
EXPLANATION OF THE PROBLEM

Congress established the IIR penalty regime primarily to combat tax avoidance and discourage U.S. taxpayers from hiding income and assets abroad. The National Taxpayer Advocate appreciates Congress's efforts to prevent tax avoidance; however, most high net worth individuals and large companies have sophisticated advisors and generally avoid these penalties or successfully obtain abatements. By contrast, lower-income individuals, immigrants, and small businesses' advisors do not have the same expertise, and these taxpayers tend to inadvertently trigger the penalty. By statute, many of these information return penalties apply even when there is no underlying tax liability. The statutory structure is wide-ranging, and taxpayers are confronted with a complex series of information reporting requirements and associated penalties covering,

¹ Although penalties may be automatically assessed, taxpayers may seek and, in some cases, receive penalty relief by asserting defenses. See, e.g., Treas. Reg. § 1.6038-2(k)(3)(ii).

² IIR reporting requirements and the related penalties are located in Chapter 61, Subchapter A, Part III, Subpart A & B. These penalties are the primary focus of this Most Serious Problem. Certain other IIR penalties are set forth in Chapter 68, Subchapter B, Part I. These are specifically established as assessable penalties and will be broadly addressed in the latter portion of this Most Serious Problem.

among other things, specified foreign financial assets,³ certain interests in foreign business entities,⁴ and gifts or inheritances from foreign sources.⁵ Although the IRS must follow statutory mandates, it has meaningful discretion in how to implement these requirements. Rather than promoting tax compliance through taxpayer education and support, the IRS has opted to flex its administrative muscle and bring down the enforcement hammer on good-faith taxpayers and bad actors alike.



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As a result of this approach, many taxpayers are exposed to potentially life-changing penalties for failure to meet information filing requirements that are obscure and complex. For example, some “accidental Americans” who were born in the United States but lived the bulk of their lives abroad have faced huge tax liabilities and IIR penalties, even though they never thought of themselves as U.S. citizens.⁶ Likewise, a U.S. person holding a controlling interest in a foreign partnership could face significant penalties, even though the partnership generates no taxable income.⁷ Similarly, a relatively unsophisticated taxpayer receiving a once-in-a-lifetime tax-free gift could lose a substantial portion of that gift to penalties simply because they had no idea of a reporting obligation.⁸

In the foreign gift context, the penalties can be huge; over the years 2018-2021, even taxpayers who reported \$400,000 or less in income received an average penalty of over \$235,000.⁹ Also, the IRS imposes a substantial amount of IIR penalties on the non-wealthy. For instance, 71 percent of individual IRC § 6038 penalties are assessed against lower- to middle-income taxpayers (those reporting under \$400,000 in income).¹⁰ Likewise, 83 percent of systemic business IRC §§ 6038 and 6038A penalties are assessed against small and midsize businesses (those with assets under \$10 million).¹¹

The National Taxpayer Advocate is concerned that IIR penalties:

- Are systemically assessed, without any prior review or opportunity to establish reasonable cause or other defenses;
- Are often erroneously classified as assessable and therefore must be paid before judicial review, which deprives taxpayers of review in the U.S. Tax Court and causes financial hardship; and
- Are disproportionate in comparison with any potential underlying tax and fall particularly hard on lower-income taxpayers and small businesses.

3 IRC § 6038D.

4 IRC § 6038.

5 IRC § 6039F.

6 See, e.g., Vivienne Walt, Why ‘Accidental Americans’ Are Desperate to Give Up Their U.S. Citizenship, TIME, Dec. 23, 2020, <https://time.com/5922972/accidental-americans-fatca/>; Darla Mercado, Why ‘Accidental Americans’ Have an Uphill Battle With the IRS, CNBC, Oct. 3, 2019, <https://www.cnbc.com/2019/10/03/why-accidental-americans-have-an-uphill-battle-with-the-irs.html>.

7 IRC § 6038(a).

8 IRC § 6039F.

9 IRS, Compliance Data Warehouse (CDW), Individual and Business Master File (IMF/BMF), Individual and Business Returns Transaction File (IRTF/BRTF) (Sept. 2023). Throughout this narrative, all penalty statistics associated with total assets/income stratification reflect data from the most common income tax returns, representing about 96 percent of businesses filing Forms 1120, 1120F, or 1065 and at least 75 percent of individuals filing Form 1040 for which IIR penalties were assessed. All data from CDW referenced in this Most Serious Problem narrative is based on the analysis of IIR penalties assessed in calendar years 2018-2021.

10 IRS, CDW, IMF and IRTF (Sept. 2023).

11 IRS, CDW, BMF and BRTF (Sept. 2023).

ANALYSIS

International Information Return Penalties Are Disproportionately Harsh When Compared With the Offense

Taxpayers Can Fall Victim to International Information Return Penalties in a Range of Situations

The IIR penalty framework, established by statute, generally follows a common approach for information returns that are late, missing, or incomplete.¹² Typically, upon learning of their filing obligation, taxpayers voluntarily file missing information returns – albeit late – only to have their compliance rewarded with a harsh penalty. Upon receipt of a late IIR, the IRS’s computer system automatically assesses the penalty, and the IRS begins its collection procedures.¹³ To add insult to injury, many of these penalties bear no relation to any underlying taxable income.

The IRS also assesses these penalties manually at the conclusion of the examination process. During an examination, if the examiner becomes aware of a missing or incomplete form, they notify the taxpayer of the penalty and provide time to undertake the requisite reporting. If the taxpayer does not provide the information timely, the IRS can, in many cases, propose a continuation penalty, which can aggregate to alarming levels.

For example, IRC § 6038D requires a person holding specified foreign financial assets to undertake reporting with respect to those assets on a Form 8938, Statement of Specified Foreign Financial Assets, attached to their annual income tax return.¹⁴ The initial penalty for failing to do so is \$10,000, and if taxpayers do not respond in the first 90 days, the IRS assesses an additional \$10,000 every 30 days, up to a ceiling of \$50,000.¹⁵ IRC § 6038(b) imposes an identical reporting requirement and penalty on U.S. persons who control certain foreign business entities.¹⁶ In neither case does the taxable income, or lack thereof, generated by the applicable assets or entities impact the penalties.

Similarly, IRC § 6048 generally imposes a reporting requirement upon, among other things, parties responsible for certain foreign trusts,¹⁷ which often includes expatriates with retirement funds in their countries of residence.¹⁸ These responsible parties must provide information on Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, or Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner, within the applicable deadline¹⁹ or face penalties under IRC § 6677.²⁰ That code section provides for an initial penalty equal to the greater of \$10,000 or 35 percent²¹ of the gross reportable amount, and if taxpayers have not provided responsive information after

12 See generally IIR penalties in Chapter 61, Subchapter A, Part III, Subpart A, and Chapter 68, Subchapter B, Part I. These penalties are not applied in a completely uniform manner. However, they generally follow a common approach.

13 Systemically assessed penalties are those that are automatically assessed electronically without initial review or action from IRS personnel. Assessments made based on actions taken by IRS personnel are referred to as “manual assessments.”

14 IRC § 6038D(a).

15 IRC § 6038D(d).

16 IRC § 6038.

17 IRC § 6048(a).

18 Rev. Proc. 2020-17, 2020-12 I.R.B. 539, and Rev. Proc. 2014-55, 2014-44 I.R.B. 753, provide exemptions from this information reporting requirement in some situations, but the exemptions are not comprehensive enough to resolve all situations where taxpayers may be subject to penalties for interacting with their own retirement funds.

19 The due dates for Forms 3520 and 3520-A were provided in IRS Notice 97-34, 1997-1 CB 422, Information Reporting on Transactions with Foreign Trusts and on Large Foreign Gifts, and were later amended and codified by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (Surface Transportation Act), Pub. L. No. 114-41, 129 Stat. 443, in an off-code provision.

20 IRC § 6677. There is a reasonable cause exception for the penalties under IRC § 6677(d) and relief provided under Rev. Proc. 2020-17 for transactions with certain tax-favored foreign retirement trusts and tax-favored nonretirement trusts.

21 In the case of reporting required of U.S. persons under IRC § 6048(b), the initial penalty is reduced to the greater of \$10,000 or five percent of the gross reportable amount.

90 days, then every 30 days the IRS assesses a \$10,000 continuation penalty up to the full gross reportable amount.²² Penalties measured against the gross reportable amount, which can include something as simple as biweekly contributions to certain self-funded foreign retirement plans,²³ can multiply quickly.

To make matters worse, the IRS often does not immediately consider requests for reasonable cause relief for IIR penalties. Taxpayers are exposed to IIR penalties either when missing returns are identified during an audit or when they come forward and file late information returns. The IRS tells taxpayers that they can submit requests for reasonable cause relief, but that it may not consider those requests, in which case they will have to resubmit them later in the process.²⁴ This cavalier approach is unfair to taxpayers and inefficient for the tax system. As a result, the IRS should review reasonable cause relief requests before assessing penalties.

IIR penalties begin as substantial and can grow to be exorbitant. This alone is concerning, but the scope of these penalties is especially troubling when considering that the statute provides that the IRS can impose them when there is little or no underlying taxable income involved. Additionally, these penalties can fall particularly hard on immigrants who retain interests from their home countries.²⁵ Often, these interests can generate substantial U.S. tax penalties, even when they are relatively small interests and even though they may not generate any taxable income.

Gifts From Foreign Persons Are Traps for the Unwary

The approach taken to reporting foreign gifts and bequests well illustrates the inherent unfairness of the IIR penalty regime. IRC § 6039F requires U.S. persons who receive foreign gifts or bequests worth more than \$10,000²⁶ to submit information returns to the IRS. For each month that the taxpayer fails to report the gift or bequest, the IRS can assess a penalty of five percent of the total amount of the gift, up to a maximum of 25 percent. For gifts and bequests from foreign individuals or estates, the IRS provides administrative guidance raising the reporting threshold to \$100,000,²⁷ but the penalties themselves remain the same.²⁸ The code's explicit requirement impacts gifts from foreign corporations and partnerships, whereas the IRS's administrative guidance impacts those from foreign individuals and estates.

These penalties can be unexpected and severe for unsophisticated taxpayers. Imagine a lower- or middle-income U.S. taxpayer receiving a \$500,000 inheritance from a foreign relative. Because this bequest is excludable from income,²⁹ the taxpayer may not realize that there was an information reporting requirement until after the fact. In this scenario, the recipient of the tax-free inheritance could suddenly end up with an IIR penalty of up to \$125,000, depending on how many months have elapsed since the receipt of the inheritance. As with several other IIR penalties, these penalties are potentially subject to an abatement for reasonable cause.³⁰ Nevertheless, the taxpayer cannot be certain that the IRS will grant this relief and, in the meantime, is exposed to the delay, cost, and stress inherent in seeking relief from the IRS.

22 IRC § 6677(a).

23 IRC § 6048(a)(3)(B)(ii)(I). Contributions to certain employer-funded retirement plans are excludable from IRC § 6048(a) reporting.

24 IRS, Delinquent International Information Return Submission Procedures, <https://www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures> (last visited Nov. 20, 2023).

25 Discussions with outside stakeholders (Aug. 15, 2023).

26 IRC § 6039F(d) provides for a cost-of-living adjustment to the \$10,000 threshold.

27 This increased threshold is not subject to a cost-of-living adjustment, unlike the \$10,000 statutory threshold.

28 Notice 97-34, § VI-B.1.

29 IRC § 102.

30 IRC § 6039F(c)(2).

The available data shows that the IRC § 6039F penalty can be severe. Between 2018 and 2021, there were over 4,000 penalties assessed against individuals and businesses, totaling \$1.7 billion.³¹ During this period, the average penalty was approximately \$426,000 while the median penalty was approximately \$58,000,³² as shown in Figure 2.8.1.

FIGURE 2.8.1, IRC § 6039F Penalty Data, Businesses and Individuals, Aggregated for 2018-2021³³

Number of Penalties	Total Dollars Assessed	Average Penalty (Mean)	Median Penalty
4,038	\$1,718,381,301	\$425,553	\$57,714

The IRC § 6039F penalties have an especially heavy impact on individual taxpayers: 92 percent were assessed against individuals.³⁴ Figure 2.8.2 shows penalty data by year for individual taxpayers.

FIGURE 2.8.2, IRC § 6039F Penalty Data for Individuals, 2018-2021³⁵

Year	Total Penalties Assessed	Total Dollars Assessed	Average Penalty (Mean)	Median Penalty
2018	586	\$77,274,037	\$131,867	\$39,160
2019	1,015	\$238,326,771	\$234,805	\$56,560
2020	837	\$282,289,168	\$337,263	\$60,000
2021	1,297	\$246,414,866	\$189,988	\$52,978

Further, a startling number of these penalties are assessed against lower- and middle-income individuals. Figure 2.8.3 illustrates the income breakdown of these assessments.

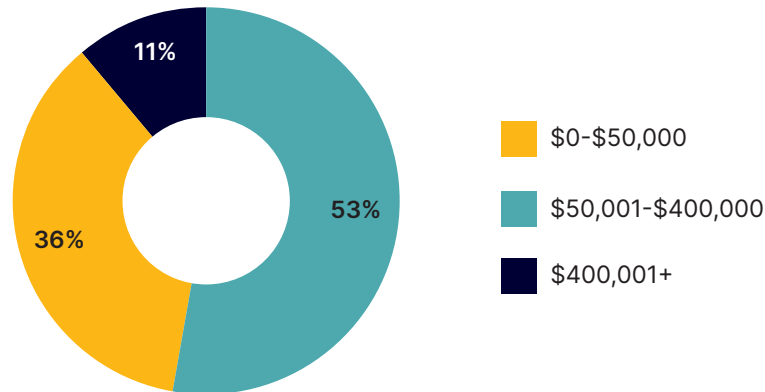
31 IRS, CDW, IMF/BMF (Sept. 2023).

32 *Id.* The median is the value in the middle of a data set, meaning that 50 percent of data points have a value smaller or equal to the median and 50 percent of data points have a value higher or equal to the median.

33 IRS, CDW, IMF/BMF (Sept. 2023). Because of such factors as the broad penalty relief provided in IRS Notice 2022-36, 2022-36 I.R.B. 188, Penalty Relief for Certain Taxpayers Filing Returns for Taxable Years 2019 and 2020, and processing delays due to COVID-19, penalty data in any given recent year may not be illustrative of long-term trends. For this reason, we are presenting a four-year average alongside annual data. TAS provides penalty data based on when penalties are assessed rather than by the tax year for which they are assessed to facilitate presentational clarity and to illustrate current policy and trends. The IRS states that IRC § 6039F penalty data is not necessarily indicative of its future expectations due to recent changes undertaken with the administration of the program. IRS response to TAS fact check (Nov. 16, 2023).

34 IRS, CDW, IMF/BMF (Sept. 2023). This 92 percent is based on the total number of IRC § 6039F penalties assessed.

35 IRS, CDW, IMF (Sept. 2023).

FIGURE 2.8.3³⁶**IRC § 6039F Penalties by Total Positive Income, 2018-2021**

The penalties assessed against the lower- and middle-income individuals are daunting. During the years 2018-2021, the mean penalty for taxpayers with \$50,000 or less in total positive income was \$226,000 while the median penalty was \$50,000.³⁷ For taxpayers with between \$50,000 and \$400,000 in total positive income, the mean penalty was \$242,000 and the median was \$53,000.³⁸ These penalties are excessively punitive and go well beyond what the IRS needs to promote tax compliance.

The IRS abates these penalties at rates often exceeding 50 percent, which highlights the stress and burden this framework places on taxpayers.³⁹ Taxpayers should not be receiving startling letters informing them of \$200,000 penalties that are more likely to be abated than collected. This problem is exacerbated by the circumstance that these penalties are not directly eligible for the first-time abatement (FTA). Further, when taxpayers provide reasonable cause statements for their late filing, IRS Campus employees routinely ignore the reasonable cause statement, assess the penalty, and furnish taxpayers with their right to go to the IRS Independent Office of Appeals, which often concedes these penalties based on factors such as reasonable cause.⁴⁰ It should not go unnoticed that most of the late filings are voluntarily filed, and the IRS rewards taxpayers by assessing penalties. The IRS's actions cause undue hardship, burden taxpayers, and create unnecessary work for other IRS operating divisions.

In many cases, failures to file simply result from a basic ignorance of reporting obligations. This is particularly true when there are no federal income tax consequences involved. Additional transparency and clarity regarding filing requirements could contribute significantly to compliance, which would be beneficial to both taxpayers and the IRS. For example, the IRS should update Schedule B (Form 1040), Interest and Ordinary Dividends, and the related instructions to include foreign gifts as potentially reportable transfers.

³⁶ IRS, CDW, IMF and IRTF (Sept. 2023). Total positive income reflects the total of all positive income and adjustment lines.

³⁷ IRS, CDW, IMF and IRTF (Sept. 2023).

³⁸ *Id.*

³⁹ IRS, CDW, IMF (Sept. 2023). After being systemically flagged, these penalties are manually assessed. However, at that time, IRS personnel simply perform a mechanical function and do not apply judgment regarding discretionary factors, such as whether reasonable cause should be provided. See Internal Revenue Manual (IRM) 21.8.2.19.2, Form 3520 & Applicable Penalties (Oct. 4, 2022), https://www.irs.gov/irm/part21/irm_21-008-002r; IRM 21.8.2.19.3, Form 3520-A & Applicable Penalties (Nov. 7, 2022), https://www.irs.gov/irm/part21/irm_21-008-002r.

⁴⁰ Letter from Blake Vickers, Chair, Am. Inst. of Certified Pub. Accts. Tax Exec. Comm., to Andrew Keyso, Chief, IRS Indep. Off. of Appeals, and Lia Colbert, Comm'r, Small Bus./Self-Employed (Aug. 14, 2023), <https://view.officeapps.live.com/op/view.aspx?src=https%3A%2F%2Fus.aicpa.org%2Fcontent%2Fdam%2Faicpa%2Fadvocacy%2Ftax%2Fdownloadabledocuments%2F2023%2Faicpa-letter-on-form-3520-appeals-acm-to-campus-submit.docx>.

The IRS has already used its discretion to create an increased threshold for reporting in the case of taxpayers receiving gifts or bequests from foreign individuals or estates rather than from business entities. TAS appreciates this decision and guidance, insofar as they go, but they are incomplete. Whereas IRC § 6039F(d) provides for a cost-of-living adjustment to the \$10,000 reporting threshold, the IRS's administrative guidance providing the \$100,000 threshold creates no such cost-of-living adjustment. The IRS should revise Notice 97-34 to create a comparable cost-of-living adjustment for the \$100,000 threshold, which would enable more taxpayers to avoid the burden of reporting and the perils of misreporting gifts and bequests that would be completely unreportable by beneficiaries if received from a U.S. source instead of a foreign source.⁴¹ While this step would not solve the problem of disproportionate IIR penalties, it would represent significant and very feasible progress toward more equitable treatment of gifts and bequests from foreign individuals and estates.

International Information Return Penalties Are Not Just the Problem of the Rich

These penalties are sometimes thought of as a niche issue impacting only the very wealthy with lucrative and vast holdings abroad. Nevertheless, data with respect to IRC § 6039F, as well as IRC §§ 6038 and 6038A, make clear that this is far from the case. Instead, the IIR regime sweeps lower- and middle-income taxpayers into its broad and punitive grasp.



These penalties are sometimes thought of as a niche issue impacting only the very wealthy with lucrative and vast holdings abroad. But the international information return regime sweeps lower- and middle-income taxpayers into its broad and punitive grasp.

For example, as Figure 2.8.3 shows, the IRS imposed 53 percent of IRC § 6039F penalties against taxpayers with between \$50,000 and \$400,000 of income.⁴² Remarkably, another 36 percent of the taxpayers incurring this penalty had income between zero and \$50,000.⁴³ Collectively, this group of taxpayers, whose income ranged from zero to \$400,000, was assessed an average penalty of over \$235,000.⁴⁴ This is not just a rich person's problem and overwhelmingly impacts unsophisticated lower- and middle-income taxpayers.

This same phenomenon is apparent in the context of IRC §§ 6038 and 6038A penalties. When the IRS applies IRC § 6038 penalties to individuals, 71 percent are assessed against taxpayers with income of \$400,000 or less.⁴⁵ The average penalty amount for these individuals is over \$42,500.⁴⁶ Figure 2.8.4 shows this income stratification.

41 According to the U.S. Bureau of Labor Statistics, \$100,000 in 1997, when the IRS created this guidance, is today the equivalent of over \$190,000. U.S. Bureau of Lab. Stats., CPI Inflation Calculator, https://www.bls.gov/data/inflation_calculator.htm (last visited June 13, 2023).

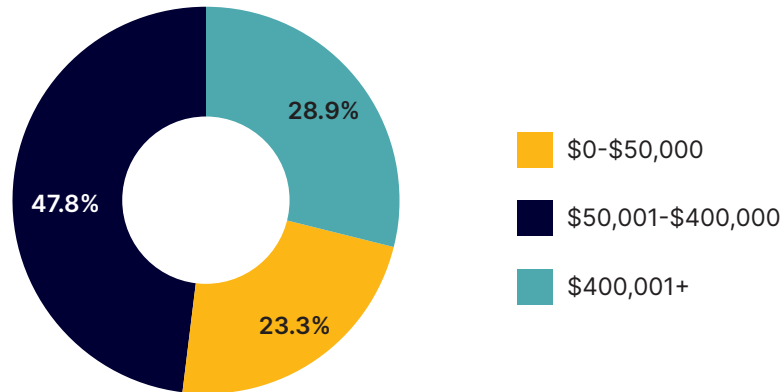
42 IRS, CDW, IMF and IRTF (Sept. 2023).

43 *Id.*

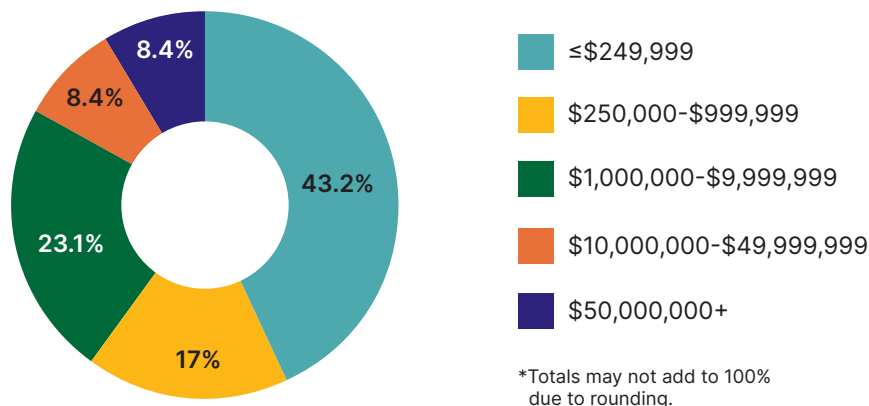
44 *Id.*

45 *Id.*

46 *Id.*

FIGURE 2.8.4⁴⁷**Individual IRC § 6038 Penalties by Total Positive Income, 2018-2021**

IIR penalties do not only impact lower- and middle-income individual taxpayers. Small and midsize businesses also bear a disproportionate burden. Specifically, small and midsize businesses comprise the overwhelming majority (83 percent) of systemic IRC §§ 6038 and 6038A penalty assessments, with the remaining 17 percent attributed to large businesses with assets greater than or equal to \$10 million.⁴⁸ In dollar terms, small and midsize businesses are subject to 64 percent of the aggregate business penalties imposed under IRC §§ 6038 and 6038A.⁴⁹ Figure 2.8.5 illustrates this distribution.

FIGURE 2.8.5⁵⁰**Systemic Business IRC §§ 6038 and 6038A Penalties by Total Assets, 2018-2021**

⁴⁷ IRS, CDW, IMF and IRTF (Sept. 2023).

⁴⁸ IRS, CDW, BMF and BRTF (Sept. 2023). The IRS classifies business size based on amount of assets. In this subsection, we focus on businesses receiving systemic assessments, as the vast majority of IIR penalties assessed to businesses are imposed via that mechanism.

⁴⁹ IRS, CDW, BMF and BRTF (Sept. 2023).

⁵⁰ *Id.*

IRC §§ 6038 and 6038A do provide for abatements based on reasonable cause. Even here, though, better outcomes correlate to greater resources. Analysis undertaken by TAS Research indicates that abatements of IRC § 6038 penalties are more likely to be received by larger businesses.⁵¹

The reach of IIR penalties goes far beyond the mega-wealthy and the Fortune 500. It broadly affects lower- to middle-income individuals and small and midsize businesses. The often-large penalties generated by the regime, combined with other compounding factors raise serious concerns regarding equity, due process, and access to justice.

Interplay With Foreign Account Tax Compliance Act and Report of Foreign Bank and Financial Accounts Penalties

IIR penalties intertwine with related reporting obligations, which complicates compliance and increases penalty exposure. For example, taxpayers with foreign accounts and assets must substantially duplicate information reporting required by the Foreign Account Tax Compliance Act (FATCA) regime⁵² and the information reporting required by the Financial Crimes Enforcement Network (FinCEN), which is satisfied by submitting the Report of Foreign Bank and Financial Accounts (FBAR).⁵³ Much of the information requested by the two Treasury Department bureaus is duplicative, yet affected individuals must complete separate forms for each, and failures to report correctly and completely in either or both contexts result in a separate, overlapping set of penalties, even when little or no tax is owed. This duplication is costly and burdensome and can lead to the mistaken belief that reporting for one has satisfied the requirement for the other.⁵⁴ Such is not the case, however, and taxpayers are at risk of potentially causing IIR penalties or FBAR penalties, the latter of which can be exorbitant if the FBAR reporting failure is deemed to be “willful.”⁵⁵

The IRS has become increasingly aggressive in asserting that taxpayers’ failures to file are willful, which leads to draconian penalties for good-faith errors.⁵⁶ In prior years, the National Taxpayer Advocate has proposed legislative recommendations to address these problems:

1. Reduce taxpayer reporting burden and government costs to process and store the same or similar information twice by eliminating duplicative filing requirements for taxpayers with foreign accounts and assets;⁵⁷

51 IRS, CDW, BMF and BRTF (Sept. 2023). The abatement rate for these penalties assessed from 2018 through 2021 was 72 percent for partnerships and corporations reporting less than \$1 million in total assets, compared to an abatement rate of 85 percent for those corporations and partnerships reporting \$100 million or more of total assets.

52 See Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat 71 (2010) (adding Chapter 4 of IRC §§ 1471-1474; IRC § 6038D), collectively referred to as the Foreign Account Tax Compliance Act; 31 U.S.C. § 5314 and 31 C.F.R. §§ 1010.350, 1010.306(c).

53 See *id.*

54 See also National Taxpayer Advocate 2024 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration (Eliminate Duplicative Reporting Requirements Imposed by the Bank Secrecy Act and the Foreign Account Tax Compliance Act)*.

55 See also National Taxpayer Advocate 2024 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration (Modify the Definition of “Willful” for Purposes of Determining Report of Foreign Bank and Financial Accounts Violations and Reduce the Maximum Penalty Amounts)*.

56 See Erin M. Collins, Foreign Information Penalties: Part Three: Keeping a Watchful Eye on the FBAR Guard Dog, NATIONAL TAXPAYER ADVOCATE BLOG (May 2, 2023), <https://www.taxpayeradvocate.irs.gov/news/nta-blog-chapter-61-foreign-information-penalties-part-three/>.

57 National Taxpayer Advocate 2023 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration 13 (Eliminate Duplicative Reporting Requirements Imposed by the Bank Secrecy Act and the Foreign Account Tax Compliance Act)*, https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2023/01/ARC22_PurpleBook_02_ImproveFiling_6.pdf.

2. Clarify that the government has the burden to establish willfulness by clear and convincing evidence before asserting a civil willful FBAR penalty and that the government cannot meet this burden by relying on the Schedule B attached to a return;⁵⁸ and
3. Eliminate 31 U.S.C. § 5321(a)(5)(C)(i)(I), which would narrow the statutory maximum civil penalty for a willful FBAR violation to no greater than 50 percent of the balance in the account at the time of the violation so that a \$100,000 penalty is not imposed with respect to low-balance accounts.⁵⁹ These challenges continue to be a thorn in the side of U.S. taxpayers and cause unnecessary burdens.

Systemic Application of International Information Return Penalties Squanders the Resources of Both Taxpayers and the IRS

The disproportionality of IIR penalties is bad enough when considered in isolation. The harsh results sometimes generated by these penalties, however, are exacerbated because IIR penalties are systemically assessed. This occurs as an automatic matter when IRS systems process late information returns.⁶⁰ Systemically assessing penalties when taxpayers willingly come forward and file their late returns discourages voluntary compliance.⁶¹ This is especially problematic because these penalties, assessed in haste and without consideration of case-specific facts and circumstances, can only be dealt with after the time-consuming and burdensome dedication of resources by both taxpayers and the IRS.

For many IIR penalties, much of this late filing is ultimately determined to result from innocent circumstances, including unavailability of the requisite information and IRS error.⁶² This situation inevitably generates a large number of penalty abatements. Although abatements are always preferable to improperly assessed and collected penalties, high abatement rates indicate flawed policies and that there may be a better way to proceed.

TAS analyzed abatement rates for the IRC §§ 6038 and 6038A penalties since they are the most frequently assessed IIR penalties, averaged across 2018-2021. We analyzed this data for systemic and for manual (Individual Master File) assessments in terms of both numbers and dollars, as shown in Figure 2.8.6.⁶³ Across these four years, for systemic assessments, the abatement percentage, measured by number of penalties, was 74 percent and by dollar value was 84 percent.⁶⁴ Manual assessments for individual taxpayers were abated at a rate of only 27 percent by number and 16 percent by dollar amount.⁶⁵

58 National Taxpayer Advocate 2023 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration* 75 (Modify the Definition of "Willful" for Purposes of Finding Report of Foreign Bank and Financial Accounts Violations and Reduce the Maximum Penalty Amounts), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2023/01/ARC22_PurpleBook_04_ReformPenInts_34.pdf.

59 *Id.*

60 The IRS uses systemic assessment for business taxpayers rather than individual taxpayers. See IRM 21.8.2.20.2, Form 5471 Penalties Systemically Assessed from Late-Filed Form 1120 Series or Form 1065 (Oct. 1, 2023), https://www.irs.gov/irm/part21/irm_21-008-002r; IRM 21.8.2.21.2, Form 5472 Penalties Systemically Assessed from Late-Filed Form 1120 Series (Oct. 1, 2023), https://www.irs.gov/irm/part21/irm_21-008-002r.

61 See Daniel N. Price, Response to request for public comments on Forms 3520 and 3520-A, OMB No. 1545-0159 (Feb. 9, 2023), https://www.pricetaxlaw.com/_files/ugd/6311c3_2d54fe7a201141bb9b89af2da098e83e.pdf.

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

63 IRS, CDW, IMF/BMF (Sept. 2023). 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.

64 IRS, CDW, BMF (Sept. 2023).

65 IRS, CDW, IMF (Sept. 2023).

FIGURE 2.8.6, IRC §§ 6038 and 6038A Data, Annual Averages for 2018-2021⁶⁶

Type of Assessment	Number of Penalties Assessed	Dollar Amount Assessed	Number of Abatements	Dollars Abated	Abatement Percentage by Number	Abatement Percentage by Dollar
Systemic	10,052	\$390.8 million	7,484	\$327.8 million	74%	84%
Manual (Individual Master File)	915	\$44.0 million	248	\$7.2 million	27%	16%

With abatement rates as high as 74 percent by number of penalties, the IRS should not be burdening taxpayers with a procedure that automatically and mechanically assesses penalties and then leaves things to be worked out later. Instead, it is more sensible and equitable for the IRS to apply an element of caution in IIR penalty administration. This is precisely what occurs when the IRS applies penalties manually, which involves discretion and oversight of IRS personnel. The result of this human deliberation, as opposed to unthinking, systemic action, is the assessment of far fewer penalties that the IRS must subsequently abate.

The IRS should also adopt an approach that elevates education over retribution. As TAS previously proposed, the IRS should extend FTA to cover IIR penalties, which it could implement systemically.⁶⁷ This policy would represent a more streamlined and comprehensive version of what is already occurring as a practical matter for many systemically assessed and subsequently abated IIR penalties.⁶⁸

The IRS could mail a letter to taxpayers who would have incurred an IIR penalty but for use of such an FTA to inform them of the waiver, clarifying where they went wrong and explaining that there will be no more administrative waiver for the next three years. This policy would add an important element of humane tax administration to the otherwise heavy-handed and mechanical functioning of the IIR penalty regime.

Classification of International Information Return Penalties as Immediately Assessable Can Subject Taxpayers to an Additional Layer of Hardship

Some Taxpayers May Face What Feels Like Strict Liability

The IRS is best served by focusing on compliance rather than retribution. Nevertheless, IIR penalties disproportionately and indiscriminately punish taxpayers while narrowing their options for judicial review. This limitation on the terms of judicial oversight is especially problematic given the harsh terms of IIR penalties.

66 IRS, CDW, IMF (Sept. 2023). Because of such factors as the broad penalty relief provided in IRS Notice 2022-36 and processing delays due to COVID-19, penalty data in any given recent year may not be illustrative of long-term trends. For this reason, we are presenting a four-year average.

67 National Taxpayer Advocate 2020 Annual Report to Congress 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.

68 FTA is applied to IIR penalties when it is applied to the underlying return, but it could also be applied more broadly without reference to the underlying return. National Taxpayer Advocate 2020 Annual Report to Congress 128 (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.

Some IIR penalties are specifically designated as assessable by Chapter 68, Subchapter B of the IRC, or explicitly cross-reference other portions of the IRC providing authority to immediately assess the penalties.⁶⁹ Other IIR penalties, residing within Chapter 61, Subchapter A, such as the IRC §§ 6038, 6038A, and 6039F(c)(1)(B) penalties, have historically also been treated by the IRS as assessable. The IRS immediately assesses such penalties, and taxpayers have no recourse to U.S. Tax Court review because jurisdiction in that court generally depends on the existence of a deficiency.⁷⁰ Instead, taxpayers wishing to obtain judicial review of an assessable penalty must pay that penalty, and only then are they able to contest it in a federal district court or the U.S. Court of Federal Claims.⁷¹

This jurisdictional requirement and the out-of-pocket expense it entails can be exasperating for many taxpayers, but where IIR penalties are concerned, it can represent an insurmountable obstacle on account of the sometimes-huge penalty assessments. Such is particularly the case for lower- to middle-income taxpayers, who may be prevented from seeking judicial review, even of obviously incorrect IRS determinations, by the combined cost of the penalty and associated legal fees. One professional group explained to TAS that the government often delays settlement discussions until late in the litigation process, effectively requiring litigants to incur legal fees in the range of \$100,000 just to contest the penalties in court.⁷²

JUDICIAL REVIEW FOR SOME TAXPAYERS

$$\text{Cost of Penalty} + \text{Legal Fees} = \text{Insurmountable Obstacle}$$

The IRS does allow taxpayers to seek a post-assessment, prepayment review in the IRS Independent Office of Appeals, which can include a reasonable cause defense. Nevertheless, administrative relief depends on IRS discretion, which leaves many at the mercy of the IRS given the limited options for judicial review.⁷³ For non-wealthy taxpayers, treatment of IIR penalties as assessable can create a *de facto* strict liability situation, in which these taxpayers are effectively barred from challenging IRS administrative decisions because of their lack of sufficient wealth. The entire IIR penalty regime, incorporating disproportionately large penalties that are systemically assessed and can be difficult to challenge, raises serious concerns regarding equity, due process, and access to judicial review.

69 See, e.g., IRC §§ 6039F(c)(1)(B), 6677(e), 6679(b). By contrast, penalties calculated by looking to an understatement of tax on taxpayers' underlying returns are generally subject to deficiency procedures. In this circumstance, the IRS must issue taxpayers a statutory notice of deficiency giving them the opportunity for prepayment review in Tax Court. If the case cannot be resolved administratively, the IRS can only assess and collect the penalty when no judicial review is sought or when the Tax Court and other subsequent appellate courts sustain the IRS's position. Other penalties, however, typically those determined without reference to the underlying return, are treated as assessable penalties.

70 See generally IRC §§ 6211-6213.

71 IRC § 7422.

72 Discussions with outside stakeholders (July 25, 2023).

73 See National Taxpayer Advocate 2024 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration (Expand the U.S. Tax Court's Jurisdiction to Hear Refund Cases)*; National Taxpayer Advocate 2024 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration (Provide That Assessable Penalties Are Subject to Deficiency Procedures)*.

The Farhy Decision Presents the IRS With Both Problems and Opportunities

In a recent decision in *Farhy v. Commissioner*, the U.S. Tax Court ruled that the IRS could not assess and collect IRC § 6038(b) penalties because Congress had failed to grant the statutory authority to do so.⁷⁴ The analysis of the *Farhy* opinion appears to make its holding applicable, by analogy, to most IIR penalties within Chapter 61, Subchapter A.⁷⁵ This outcome throws much of the IIR penalty regime and the IRS's ability to enforce it into disarray.⁷⁶

The government is appealing the *Farhy* opinion to the D.C. Circuit Court of Appeals and arguing that the Tax Court's decision should be reversed.⁷⁷ Regardless of how the D.C. Circuit ultimately rules, the IRS and Congress should treat *Farhy* as a golden opportunity to revisit the IIR penalty regime and make it more fair for taxpayers.

The IRS's reliance on systemic assessments also raises the legal issue of whether the IRS has met the requirements of IRC § 6751(b) by providing only a notation of penalty approval from the IRS reporting system, the Accounts Management System, as proof of supervisory approval.⁷⁸ This issue is currently being litigated in the U.S. Tax Court.⁷⁹

The IRS should work with Congress to make all IIR penalties subject to deficiency procedures. This would solve the IRS's immediate enforcement problem while representing a substantial benefit for taxpayers. Since taxpayers would be granted a forum in the U.S. Tax Court in which to seek prepayment judicial review, they would no longer face the potential inequity of being shut out of the court system on account of lack of sufficient financial resources. For the first time, lower- and middle-income taxpayers would have access to the same due process afforded wealthy taxpayers in the context of IIR penalties. The IRS would also have an incentive to proceed cautiously in asserting IIR penalties, as impacted taxpayers could cost-effectively challenge these penalties.

If IIR penalties were subject to deficiency procedures, the IRS would also immediately benefit. The IRS cannot effectively move forward before resolution of the issue raised in *Farhy*, and this approach would provide the IRS with much-needed certainty. It would also definitively clarify the issue in a way that is equitable for taxpayers and protects their due process rights. This matters because tax compliance is most effective when taxpayers feel they are being treated fairly.⁸⁰ Adopting deficiency procedures for IIR penalties would provide significant benefits for both taxpayers and tax administration.

74 *Farhy v. Commissioner*, 160 T.C. No. 6 (Apr. 3, 2023). See also Erin M. Collins, Chapter 61 Foreign Information Penalties: Part One: Taxpayers and Tax Administration Need a Legislation Fix, NATIONAL TAXPAYER ADVOCATE BLOG (Apr. 20, 2023) <https://www.taxpayeradvocate.irs.gov/news/nta-blog-chapter-61-foreign-information-penalties-part-one/>.

75 Andrew Velarde, *Official Says Info Return Penalty Suits Not Feasible After Farhy*, TAX NOTES, June 5, 2023, at 1409, <https://www.taxnotes.com/tax-notes-today-international/penalties/official-says-info-return-penalty-suits-not-feasible-after-farhy/2023/05/30/7qs0m>.

76 See, e.g., Nathan J. Richman, *Appeals Plans to Concede Unassessable Penalty CDP Cases*, TAX NOTES, June 9, 2023, at 1457, <https://www.taxnotes.com/tax-notes-today-international/information-reporting/appeals-plans-concede-unassessable-penalty-cdp-cases/2023/06/09/7qvhw>. Appeals has since treated this as a coordinated issue. IRS response to TAS fact check (Nov. 16, 2023).

77 Leslie Book, *Government Files Notice of Appeal in Farhy*, PROCEDURALLY TAXING (July 14, 2023), <https://www.taxnotes.com/procedurally-taxing/government-files-notice-appeal-farhy/2023/07/14/7h6r6>.

78 Andrew Velarde, *IRS Looks to Fight Informational Return Penalty Approval Case*, TAX NOTES, Sept. 1, 2023, at 1300, <https://www.taxnotes.com/tax-notes-today-international/penalties/irs-looks-fight-information-return-penalty-approval-case/2023/09/01/7h801>.

79 *Ching Tzu Lu a.k.a. Susan Lu, Petitioner v. Comm'r*, No. 10523-23L (T.C. filed July 1, 2023).

80 Marjorie E. Kornhauser, *A Tax Morale Approach to Compliance: Recommendations for the IRS*, 8 Fla. Tax Rev. 599 (2007), <https://journals.upress.ufl.edu/ft/article/view/388/367>; John Hasseldine and Peggy Hite, *Key Determinants of Compliance and Noncompliance*, TAX NOTES, Oct. 23, 2007, <https://www.taxnotes.com/tax-notes-today-federal/compliance/key-determinants-compliance-and-noncompliance/2007/10/23/xkzr>.

CONCLUSION AND RECOMMENDATIONS

When a taxpayer voluntarily corrects the failure to file an IIR, their good-faith action has the unexpected effect of causing the IRS to automatically assess a penalty. Furthermore, in light of the *Farhy* opinion, the IRS's ability to assess and collect most IIR penalties may be jeopardized. If the IRS does not administratively abate the assessed penalty, taxpayers will need to pay the penalty in full before seeking judicial review.

The IIR penalty regime is characterized by attributes that impose significant hardships on taxpayers, especially for lower- to middle-income taxpayers and small and midsize businesses. The penalties themselves are often disproportionate and extraordinarily harsh when considered in light of the underlying tax liabilities involved. Rather than being imposed on taxpayers who are voluntarily filing late information returns correcting an honest mistake or curing past noncompliance, they should be reserved for bad actors. To make matters worse, the majority of IIR penalties are systemically assessed, which leads to the broad imposition of these penalties, even when they may be inappropriate under the circumstances. Because the IRS has treated IIR penalties as assessable penalties, taxpayers are also deprived of a prepayment forum in the U.S. Tax Court and can only obtain review of IRS administrative actions by first paying the penalties and then taking the case to a federal district court or the Court of Federal Claims.

These factors have historically placed taxpayers subject to IIR penalties in a difficult position and may have caused extreme financial hardship for many. Given the U.S. Tax Court's recent decision in *Farhy v. Commissioner*, however, the IRS has problems of its own. Nevertheless, the IRS continues to systemically assess and collect these penalties. The solution for taxpayers and the IRS is a comprehensive administrative and statutory reform of the IIR penalty regime in which the IRS enforces penalties in a way that is more educational than punitive and imposes them via a system similar to deficiency procedures. Taxpayers have the *right to a fair and just tax system*,⁸¹ and the IRS's procedural approach to IIR penalties continues to cause hardship and inequities for many. Protection of taxpayer rights is a bedrock aspect of quality tax administration.

ADMINISTRATIVE RECOMMENDATIONS TO THE IRS

The National Taxpayer Advocate recommends that the IRS:

1. Stop automatic assessment and collection of Chapter 61 IIR penalties prior to considering the taxpayer's specific facts and circumstances, including providing the taxpayer their appeal rights with the Independent Office of Appeals.
2. Update the Internal Revenue Manual to require review of any reasonable cause relief requests before assessing penalties when these requests are submitted in conjunction with IIRs potentially giving rise to penalties.
3. Extend eligibility for FTA to all IIR penalties regardless of whether the underlying return was filed late.
4. Revise Notice 97-34 or issue guidance to make the administrative \$100,000 threshold subject to the same inflation adjustments as the \$10,000 threshold set forth in IRC § 6039F.
5. Update Schedule B and the related instructions to include foreign gifts as potentially reportable transfers.

⁸¹ See IRC § 7803(a)(3)(J).

LEGISLATIVE RECOMMENDATIONS TO CONGRESS

The National Taxpayer Advocate recommends that Congress:

1. Amend IRC § 6212 to require the Secretary to establish procedures to send a notice of IIR penalties to the taxpayer by certified mail or registered mail for adjudication with the U.S. Tax Court prior to assessing any “assessable penalty” or other IIR penalty listed in Chapter 61, Subchapter A, Part III, Subpart A.⁸²
2. Clarify that the government has the burden to establish willfulness by clear and convincing evidence before asserting a civil willful FBAR penalty and that the government cannot meet this burden by relying on the Schedule B attached to a return.⁸³
3. Eliminate 31 U.S.C. § 5321(a)(5)(C)(i)(I), which would have the effect of narrowing the statutory maximum civil penalty for a willful FBAR violation to no greater than 50 percent of the balance in the account at the time of the violation so that a \$100,000 penalty is not imposed with respect to low-balance accounts.⁸⁴
4. Amend IRC § 6038D and 31 U.S.C. § 5314 to eliminate duplicative reporting of assets on Form 8938 where a foreign financial account is correctly reported or reflected on an FBAR while ensuring continued IRS access to foreign financial asset data for both tax compliance and financial crime enforcement purposes.⁸⁵

RESPONSIBLE OFFICIALS

Amalia Colbert, Commissioner, Small Business/Self-Employed Division

Holly Paz, Commissioner, Large Business and International Division

Kenneth Corbin, Commissioner, Wage and Investment Division

⁸² See National Taxpayer Advocate 2024 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration (Provide That Assessable Penalties Are Subject to Deficiency Procedures)*.

⁸³ National Taxpayer Advocate 2024 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration (Modify the Definition of “Willful” for Purposes of Determining Report of Foreign Bank and Financial Accounts Violations and Reduce the Maximum Penalty Amounts)*.

⁸⁴ *Id.*

⁸⁵ National Taxpayer Advocate 2024 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration (Eliminate Duplicative Reporting Requirements Imposed by the Bank Secrecy Act and the Foreign Account Tax Compliance Act)*.