

The Impact of the IRS's Clarification of the DIIRSP

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Recent clarifications to the Delinquent International Information Return Submission Procedures ("DIIRSP") remind taxpayers and their advisors of the need to understand the standards, case law, and administrative guidance that apply to requests to have late-filing penalties abated on the ground of reasonable cause.

In June 2014, the Internal Revenue Service's ("Service" or "IRS") established the DIIRSP for entities or individuals seeking to late-file delinquent international information returns and to avoid civil penalties based on reasonable cause. On November 5, 2020, the Service clarified the procedures that apply to the imposition of penalties for late-filed international information returns submitted under the DIIRSP. Prior to the IRS's clarification, the IRS's website instructed that taxpayers using the DIIRSP "should file the delinquent information returns with a statement of all facts establishing reasonable cause for the failure to file."¹ Per the same webpage, where a reasonable cause statement was not attached to the delinquent information return, the IRS reserved the right to assess (and typically did assess) late-filing penalties. The IRS's frequently asked question and answer concerning the DIIRSP ("FAQ") explained how the IRS would approach penalties where a reasonable cause statement was attached to the delinquent return. The FAQ provided:

...penalties may be imposed under the [DIIRSP] *if the Service does not accept the explanation of reasonable cause*. The longstanding authorities regarding what constitutes reasonable cause continue to apply, and existing procedures concerning establishing reasonable cause, including requirements to provide a statement of facts made under the penalties of perjury, continue to apply.^[2]

The DIIRSP, when available, was a more attractive option than the Offshore Voluntary Disclosure Program (until that program ended on September 28, 2018), the traditional voluntary disclosure practice, or the Streamlined Filing Compliance Procedures ("SFCP") because the DIIRSP allowed taxpayers to resolve historical noncompliance with respect to the reporting of foreign income and assets without penalties if reasonable cause existed. Of course, reasonable cause has been a defense to international tax penalties since the enactment of the applicable penalty provisions, but the establishment of the DIIRSP was perceived by taxpayers and their advisors, and touted by the IRS, as an established compliance path under which the IRS would review statements of reasonable cause in advance of assessing any penalties.

The DIIRSP was a popular path for bringing noncompliant taxpayers into compliance. Taxpayers worked with their advisors to prepare reasonable cause statements and file delinquent international information returns in accordance with the established procedures. Unfortunately, despite these efforts, the IRS frequently processed the returns and promptly assessed civil penalties, advising taxpayers of appeal rights *if reasonable cause existed*. It was clear from these

notices that the IRS was not reading the detailed submissions and penalties were being assessed automatically at the time the returns were processed. Of course, this led to confusion, frustration, and substantial time, effort and costs incurred as the taxpayers and practitioners navigated through the appeals process. In response, practitioners raised the issue with the IRS, with the National Taxpayer Advocate, and with national, state and local professional associations.³

On November 5, 2020, in response to the hue and cry, the IRS clarified the language of the DIIRSP on its website. The current guidance provides:

Taxpayers who have identified the need to file delinquent international information returns who are not under a civil examination or a criminal investigation by the IRS and have not already been contacted by the IRS about the delinquent information returns should file the delinquent information returns through normal filing procedures.

Penalties may be assessed in accordance with existing procedures.

...Taxpayers may attach a reasonable cause statement to each delinquent information return filed for which reasonable cause is being asserted. During processing of the delinquent information return, penalties may be assessed without considering the attached reasonable cause statement. It may be necessary for taxpayers to respond to specific correspondence and submit or resubmit reasonable cause information.^[4]

In other words, taxpayers are still advised to attach a reasonable cause statement to each late-filed delinquent information return for which reasonable cause is alleged to exist. However, even if a reasonable cause statement is attached to a late-filed return, taxpayers and their advisors are warned that an IRS employee may assess penalties without considering the attached reasonable cause statement.⁵ Moreover, the IRS clarified that taxpayers may need to respond to specific correspondence and submit or resubmit reasonable cause information.

A taxpayer who proceeds under the DIIRSP should expect that delinquent information return penalties will be asserted soon after filing, irrespective of the strength of the taxpayer's reasonable cause defense. In response to the initial assessments of the penalty, the IRS will typically afford the taxpayer an opportunity for an administrative appeal with the IRS Independent Office of Appeals. The taxpayer should exercise these administrative appeal rights.

The question naturally arises as to whether the DIIRSP is a viable option to cure historical noncompliance with respect to the reporting of foreign financial assets. A taxpayer with unfiled delinquent international information returns should file all required returns, but with the advice of counsel familiar with the various paths to compliance, grounds for defending against proposed civil penalties, and the taxpayer's potential exposure to criminal investigation and prosecution. For a taxpayer who has reasonable cause for late-filing the information return, the DIIRSP is one option for correcting the historical noncompliance. But, any taxpayer who opts to use the DIIRSP

must understand that it is possible (indeed, likely) that (1) the IRS will assess delinquent international information return penalties, and (2) the taxpayer may not be able to challenge the imposition of that penalty in a judicial forum without first prepaying the liability and filing a lawsuit to recover the amount paid.

A second option is for an eligible taxpayer to forego the DIIRSP and instead avail herself of the SFCP. The SFCP are available to a taxpayer who certifies that her failure to report foreign financial assets and pay all tax due in respect of those assets did not result from willful conduct on her part. In general, the SFCP requires a taxpayer to file an amended tax return and all required international information forms for the most recent three years, pay tax and interest due for those three years, and pay a miscellaneous offshore penalty equal to 5% of the highest aggregate balance or value of the taxpayer's foreign financial assets that are subject to the penalty. The taxpayer may avoid this penalty if she meets the definition of a nonresident. The availability of the SFCP is limited to individuals and estates, so entities seeking to address noncompliance with international information returns are not eligible under the SFCP.

For those taxpayers who engaged in willful noncompliance, and are therefore ineligible for the DIIRSP, the IRS offers the voluntary disclosure practice, which is designed for taxpayers who have true exposure to a criminal investigation and prosecution. The IRS has made it clear that its voluntary disclosure practice is not intended to be a solution for those who acted with reasonable cause.

Finally, taxpayers may always simply file delinquent or amended returns, frequently referred to as a "quiet disclosure," to come into compliance. The IRS has a well-established, general policy set forth in the Internal Revenue Manual advising taxpayers to utilize a six-year look-back period.⁶ While this policy does not offer finality for years prior to the look-back period, and does not start the statute of limitations on assessment for unfiled returns, the approach remains a viable method of addressing a taxpayer's noncompliance.

A submission under the DIIRSP requires a legal determination with respect to, among other things, whether the taxpayer had reasonable cause for not timely filing the international information return. The standard of reasonable cause that applies in the context of a failure to file required international information returns is nuanced and evolving. Taxpayers should consult a lawyer with respect to the existence of reasonable cause and whether the DIIRSP is a viable option for remedying historical noncompliance.

¹ IRS, *Delinquent International Information Return Submission Procedures*, <https://web.archive.org/web/20201028094724/https://www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures> (last updated Oct. 2, 2020).

² IRS, *Delinquent International Information Return Submission Procedures Frequently Asked Questions and Answers, Q&A-1*, <https://www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures-frequently-asked-questions-and-answers> (last updated Apr. 17, 2020) (emphasis added).

³ See, e.g., Letter from Tom Callahan, Chair, Section of Taxation to the Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury, the Hon. Charles P. Rettig, Commissioner of the IRS, and the Hon. Michael

Desmond, Chief Counsel to the IRS, *Recommendations for 2020-2021 Priority Guidance Plan* (July 22, 2020), available at <https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/2020/072220comments.pdf>.

⁴ IRS, *Delinquent International Information Return Submission Procedures*, <https://www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures> (last updated Nov. 5, 2020).

⁵ This procedure is in tension with the IRS's practice requiring employees to "carefully analyze the taxpayer's [statement of reasonable cause] to determine if penalty relief can be considered and is warranted." See I.R.M., pt. 20.1.1.3.5(2) (Oct. 19, 2020).

⁶ See I.R.M., pt. 1.2.1.6.18 (Aug. 4, 2006) (Policy Statement 5-133) (providing the policy that enforcement beyond the six-year period will normally not be undertaken, and only will be undertaken with managerial approval).