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A Tax Controversy and Tax Litigation Boutique

Gotcha! Challenging Tax Penalties on International Forms

**2022 IRS Representation Conference
November 18, 2022**



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- **Moderator:** Zhanna A. Ziering, Esq. *Moore Tax Law Group LLC*, New York, NY
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International Information Returns

- *FinCEN 114, FBAR – Report of Foreign Bank and Financial Accounts (Title 31)*
- *926- Return by a U.S. Transferor of Property to a Foreign Corporation*
- *1116/ 1118 – Foreign Tax Credits*
- *2555 – Foreign Earned Income Exclusion*
- *3520 -Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*
- *3520A- Annual Information Return of Foreign Trust With a U.S. Owner*
- *5471- Information Return of U.S. Persons With Respect To Certain Foreign Corporations*
- *5472 - Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*
- *8828 – U.S. Withholding Tax Return for Disposition by Foreign Persons of U.S. Real Property Interests*
- *W-8BEN – Certificate of Foreign Status of Beneficial Owner for U.S. Tax Withholding*
- *W-9 – Request for TIN*

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International Information Returns

- *8802 – Residency Certification*
- *8854 - Expatriation*
- *8621-Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*
- *8833- Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*
- *8858 - Information Return of U.S. Persons With Respect to Foreign Disregarded Entities*
- *8865 - Return of U.S. Persons With Respect to Certain Foreign Partnerships*
- *8938 -Statement of Foreign Financial Assets*
- *1042 – Annual Withholding Tax Return for U.S. Source Income of Foreign Person*
- *8805 – Foreign Partner’s Information Statement of Section 1146 Withholding Tax*

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Who is Subject?

- **U.S. citizens and residents** are taxed on their worldwide income, regardless of where it is earned.
 - A U.S. resident is an individual who has a green card or who meets the substantial presence test (i.e. days in the United States)
 - This includes people who may not know they are U.S. citizens.
 - U.S. citizens and residents have reporting obligations
 - It is not only taxes that are imposed, the U.S. also asserts penalties for failure to file or late filing.
 - Typically a \$10,000 USD minimum penalty for failure to file certain information returns (e.g., FBAR, Form 8938, etc.)

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Who is Subject? Accidental Americans

- Accidental Americans are U.S. citizens bearing U.S. tax filing obligations but unaware of such citizenship status and/or tax obligations. This includes:
 - Individuals born in the U.S. to foreign citizen parents and stayed for only a short period; or
 - People born outside of the U.S. to U.S. citizen parent(s) and rarely had any connection to the U.S. financially, socially, or physically.
 - One prominent example: Boris Johnson

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Civil Penalties for Failure to File

Form	Code Section	Penalties
926	§ 6038B § 6662(j)	\$10% of FMV of the property/transferred, max \$100,000 40% penalty may be imposed on any underpayment resulting from an undisclosed foreign financial asset understatement.
3520/3520A	§ 6677 § 6039F	Greater of \$10,000 OR : 35% of the gross value of any property transferred to a foreign trust 35% of the gross value of the distributions received from a foreign trust by a U.S. person and 5% of the gross value of all of a foreign trust's assets treated as owned by a U.S. person under the grantor trust rules (IRC sections 671–679) 5% of the amount of the foreign gift for each month, not to exceed 25%
3520A	§ 6677	Greater of \$10,000 or 5% of the gross value of the trust. \$10,000 per month continuation penalty
5471	§ 6038	\$10,000 per form; \$10,000 per month continuation penalty max \$50,000
5472	§ 6038A	\$25,000 per year \$25,000 continuation penalty per month

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Civil Penalties for Failure to File

Form	Code Section	Penalties
8621	§ 1298(f)	No Penalties
8833	§ 6712	\$1,000 per individual treaty based return (\$10,000 Corp)
8858	§ 6038, 6038B	\$10,000 per form, \$10,000 per month continuation penalty max \$50,000
8865	§ 6038	\$10,000 per foreign partnership, \$10,000 per month continuation penalty max \$50,000
8938	§ 6038D	\$10,000 per form; \$10,000 per month continuation penalty
FBAR	31 USC 5321(a)(5)	Nonwillful penalty - -\$10,000 per violation Willful penalty – the greater of \$100,000 or 50 percent of the balance of the account at the time of the violation (subject of litigation)

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Civil Penalties for Failure to File

Form	Code Section	Penalties
1116/1118	§ 901	Loss of FTC
2555	§ 911	Potential loss of exclusion
1042	§ 6651(a)(1)	Failure to file penalties under § 6651(a)(1)
8288	§ 1445/ 1461	Withholding agent liable for the tax

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Criminal Consequences for Failing to Report

- Criminal prosecution (if failure to report was Willful):
- Attempting to evade or defeat tax I.R.C. § 7201 – Willful failure to file a return I.R.C. § 7203
- Filing a false return, statement, or other document I.R.C. § 7206(1)
- Assisting in preparation of a false return I.R.C. § 7206 (2)
- Attempting to interfere with administration of Internal Revenue laws I.R.C. § 7212

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Statute of Limitation for Assessment

- **Title 26**

- Under I.R.C. § 6501(c)(8)(A), the period of limitations for assessment does not expire until three years from the date on which the IRS is furnished the information required under I.R.C. § 6038, 6038A, 6038B, 6046, 6046A, or 6048
- Applies to entire tax return (however, there is a reasonable cause exception that limits application of the rule to items for which there was a failure to furnish the information referred to in I.R.C. § 6501(c)(8)(A))

- **Title 31**

- Under 31 U.S.C. § 5321(b)(1), the penalty must be assessed within 6 years from the date of violation

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Section 6751(b): Supervisory Approval

- Written supervisory approval of penalty assessments is required, and notice letters are required prior to assertion of certain penalties. IRM 20.1.9.1.5. (01-29-2021)
- The written approval should be obtained in a timely manner... . The Immediate Supervisor must approve the case control, sign the notice letters, and approve the penalty assessment by signing Form 8278. IRM 20.1.9.2.(20) (01-29-2021)

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Penalty Mitigation

- FBAR Penalties
 - May 12, 2015 Guidance – Suggested limitation on penalties
 - Nonwillful – one penalty per FBAR and capped at 50% of the aggregate balance (currently before Supreme Court)
 - Willful – generally one 50% penalty, but capped to 100% of the highest aggregate balance
 - Mitigation Guidelines -- IRM 4.26.16.6.6.1. (11-06-2015)
 - Examiner Discretion -- IRM 4.26.16.5.2.1. (06-24-2021)
 - Be mindful of the double-counting issues but there is no statutory relief

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Penalty Mitigation

- International Title 26 Penalties
 - Stacking Penalties
 - Forms 5471 and Forms 8938;
 - Form 3520, Part II and III and Form 3520-A
 - Although there is general policy against stacking foreign trust penalties, now a frequent occurrence IRM 20.1.9.13.4(3) (01-29-2021)
 - Multiple year penalties (reasonable cause for some but not all years)

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IRS Documents Received in Response to FOIA

taxnotes
DOCUMENT SERVICE
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Partial Penalty Abatement Based on a Penalty Policy and Mitigation

(4) Although penalties support and encourage voluntary compliance, they also serve to bring additional revenues into the Treasury and indirectly fund enforcement costs. However, these results are not reasons for creating or imposing penalties.

(5) Penalties advance the mission of the IRS when they encourage voluntary compliance. The IRS has formalized this obligation to the public in its mission statement.

(6) **Voluntary compliance is achieved when a taxpayer makes a good faith effort to meet the tax obligations defined by the Internal Revenue Code.**

(7) Penalties support voluntary compliance by assuring compliant taxpayers that tax offenders are identified and penalized.

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

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

Penalty policy is not encouraging voluntary compliance when tax professionals are reconsidering whether they should advise their clients to file delinquent returns when it will result in what they believe to be excessively large penalties.

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Defenses: Reasonable Cause

- Reasonable Cause defense applies to most Title 26 international penalties when *“failure is due to reasonable cause and not to willful neglect”*
- IRS’s position: Taxpayers who conduct business or transactions offshore or in foreign countries *have a responsibility to exercise ordinary business care and prudence in determining their filing obligations and other requirements. It is not reasonable or prudent for taxpayers to have no knowledge of, or to solely rely on others for, the tax treatment of international transactions.* IRM 20.1.9.1.5.(4) (01-29-2021);
- Taxpayer must be in compliance with all open reporting years before a reasonable cause defense may be considered. IRM 20.1.9.2.(15) (01-29-2021)

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Defenses: Reasonable Cause

- Based on “facts and circumstances” of the case, including:
 - Experience, knowledge and education of the taxpayer;
 - Extent of efforts to comply;
 - Honest, reasonable misunderstanding of fact or law;
 - Reliance on advisors, etc.
- That a foreign jurisdiction would impose penalties on a person disclosing the information required by U.S. law is not reasonable cause. IRM 20.1.9.2.(15)(d) (01-29-2021)

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Reasonable Cause Defense

Treas. Reg. 301.6651-1(c)(1):

- “If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause.”
- “A failure to pay will be considered to be due to reasonable cause to the extent the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship... if he paid on the due date.”

I.R.M 20.1.1.3.2.2(1)(02-22-2008):

- Ordinary business care and prudence includes making provisions for business obligations to be met when reasonably foreseeable events occur. A taxpayer may establish reasonable cause by providing facts and circumstances showing that he or she exercised ordinary business care and prudence (taking that degree of care that a reasonably prudent person would exercise), but nevertheless were unable to comply with the law.

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Reasonable Cause Defense

I.R.M. 20.1.1.3.2.2:

- The taxpayer's explanation, compliance history, the length of time between the noncompliance and subsequent compliance, and any circumstances beyond the taxpayer's control
- If the taxpayer was unable to obtain records necessary to comply with a tax obligation, taxpayer may or may not be able to establish reasonable cause. Reasonable cause may be established if taxpayer exercised ordinary business care and prudence, but due to circumstances beyond taxpayer's control, he or she was unable to comply.

I.R.M. 20.1.9.1.5(4):

- For failure to file foreign information returns, the IRS warns that not having access to records or information is not reasonable cause: "[i]t is not reasonable or prudent for taxpayers to have no knowledge of, or to solely rely on others for, international transactions."

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Reasonable Cause Defense

I.R.M 20.1.1.3.2.2.6:

- Reasonable cause may be established if taxpayer shows ignorance of the law in conjunction with other facts and circumstances:
 - Taxpayer's education.
 - If taxpayer has previously been subject to the tax.
 - If taxpayer has been penalized before.
 - If there were recent changes in the tax forms or law which a taxpayer could not reasonably be expected to know.
 - The level of complexity of a tax or compliance issue.
- Reasonable cause due to ignorance of the law if:
 - A reasonable, good faith effort was made to comply with the law, or
 - The taxpayer was unaware of a requirement and could not reasonably be expected to know of the requirement.

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Reasonable Cause Defense: Reliance

- ▶ *U.S. v. Boyle*, 469 U.S. 241 (1985) – Executor of estate hired a lawyer to handle the estate and file Form 706. Executor had no experience with estate tax. Executor called lawyer several times to determine if return was filed. Despite assuring the executor that it would be taken care of, the lawyer failed to file on time. Court states in *dicta*:
 - ▶ “When an accountant or an attorney *advises* a taxpayer on a matter of law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice or an accountant or attorney. To require the taxpayer to challenge the attorney, to see a ‘second opinion, or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. . . . ‘Ordinary business care and prudence’ do not demand such actions.”
 - ▶ “By contrast, one does not have to be a tax expert to know that returns have fixed filing deadlines and that taxes must be paid when they are due. In short, tax returns imply deadlines. Reliance by a lay person on a lawyer is of course common but that reliance cannot function as a substitute for compliance with an unambiguous statute. . . such reliance is not reasonable cause for a late filing penalty under 6651(a)(1).”
- ▶ *But see Kelly v. Commissioner*, T.C. Memo 2021-76 (2021)

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Reasonable Cause Defense: Reliance

- ▶ *Neonatology Associates, P.A. v. Commissioner*, 229 F.3d 221 (3d Cir. 2002) – Advisor was a competent professional with sufficient expertise to justify reliance. Taxpayer provided necessary and accurate information and relied in good faith on advisor’s judgement.
 - Advice must take into account all relevant facts and circumstances, including taxpayer’s sophistication. Treas. Reg. §1.6664-4(c)(1)(i).
 - Advice must relate the law to facts and circumstances, taking into account, among other things, taxpayer’s motives for entering the transaction. Treas. Reg. §1.6664-4(c)(1)(ii).
 - Advice must not be based on unreasonable factual or legal assumptions and must not unreasonably rely on taxpayer’s or any other person’s representations, statements, findings, or agreements. Treas. Reg. § 1.6664-4(c)(1)(iii).
 - Advice must not rely upon invalidity of a regulation without disclosing such position. Treas. Reg. §1.6664-4(c)(1)(iv)

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Other Potential Defenses

- Compliance with section 6751(b)
- Compliance with Administrative Procedure Act

Not a lot of options because had not been litigated

- Tax Court only has jurisdiction if the case went through CDP hearing
- Most likely option is refund litigation is CFC or district court, which require prepayment
- But see *Wrzesinski v. United States*, No. 2:22-cv-03568 (E.D. Pa. 2022) (son of Polish lottery winner assessed a penalty for failure to file Form 3520 reporting receipt of gift from his mother).

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Voluntary Disclosure Programs

- There are several options available for U.S. taxpayers who are not compliant with their U.S. tax filing obligations or otherwise have undisclosed foreign financial assets:
 - Voluntary Disclosure Program;
 - Streamlined Filing Compliance Procedures;
 - Delinquent International Information Return Submission Procedures
 - Delinquent FBAR Submission Procedures

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Voluntary Disclosure Program

- Until November 2018, there was the Offshore Voluntary Disclosure Program (OVDP) which was specifically tailored to disclosure of foreign assets.
- Now replaced by IRS Criminal Investigation Voluntary Disclosure Practice. See <https://www.irs.gov/compliance/criminal-investigation/irs-criminal-investigation-voluntary-disclosure-practice>
 - The OVDP provided protection from criminal prosecution in exchange for a standardized monetary penalty schedule.
 - The current VDP still provides protection from criminal prosecution but generally imposes statutory penalties with a lot of discretion granted to the examining IRS agent.

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Voluntary Disclosure Program: Requirements

- A voluntary disclosure is made when the communication is truthful, timely, and complete. The practice also requires taxpayers to:
 - Cooperate with the IRS in determining their tax liability and compliance reporting requirements,
 - Cooperate with the IRS in investigating any professional enablers who aided in the noncompliance,
 - Submit all required returns, information returns, and reports for the disclosure period, and
 - Make good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.

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Voluntary Disclosure Program: Requirements

- Intended only for taxpayers with criminal exposure
 - Returns must be corrected for last 6 years
 - Agree to penalties, e.g.:
 - A 75% civil fraud penalty on the highest balance year;
 - Willful FBAR penalties of 50% are the norm (see IRM 4.26.16);
 - Information return penalties are not automatic – case-by-case.
 - Use IRS Form 14457
 - Part I for pre-clearance,
 - Part II for disclosure once cleared within 45 days
- See IRM 9.5.11.9 (revised 9-17-20); Instructions to IRS Form 14457.

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Streamlined Filing Compliance Procedures

- The IRS developed the new streamlined filing compliance procedures in 2014 with the purpose of bringing taxpayers into U.S. tax and reporting compliance
- Specifically, it is designed to bring non-willful applicants with foreign income, assets, accounts and investments into compliance (while designed for foreign income, unreported U.S. income can be included as well)
- Generally, if the non-compliance is not willful, taxpayers will have all penalties waived (foreign) or reduced to a 5% miscellaneous Title 26 offshore penalty (domestic)

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Streamlined Filing Compliance Procedures

- Requirements for domestic and foreign submissions
 - Non-compliance must be non-willful
 - Taxpayers cannot be under civil or criminal investigation by the IRS.
 - Taxpayers must have a valid social security number or valid individual taxpayer identification number (ITIN).
 - Three years of tax returns are required (six years of FBARs)
 - Certification Form 14653 or 14654 required
 - More information can be found at <https://www.irs.gov/individuals/international-taxpayers/streamlined-filing-compliance-procedures>

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Streamlined Filing Compliance Procedures

- Streamlined Foreign Offshore Procedures (SFOP)
 - Must meet non-residency requirements in at least one out of the last three years – did not have a U.S. abode and were physically outside of US for at least 330 full days
 - Can file delinquent or amended returns
 - NO PENALTY only tax and interest
- Streamlined Domestic Offshore Procedures (SDOP)
 - To be used for taxpayers who do not qualify for the SFOP
 - Only accepts amended tax returns; non-filers not eligible
 - Tax and interest
 - 5% miscellaneous Title 26 penalty imposed on the highest aggregate value of previously unreported assets.

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Delinquent International Information Return Submission Procedures

- Taxpayers whose only failure was to file information returns use this procedure.
- Taxpayer should file the delinquent information returns through normal filing procedures (by attaching the necessary forms to amended tax returns)
- Penalties may be assessed in accordance with existing procedures.
- However, taxpayers may attach a reasonable cause statement to each delinquent information return filed for which reasonable cause is being asserted. The reasonable cause statements generally set forth the reasons why penalties should be forgiven
- Information returns filed with amended returns will not be automatically subject to audit but may be selected for audit through the existing audit selection processes that are in place for any tax or information returns

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Delinquent International Information Return Submission Procedures

- Requirements:
 - Taxpayer has identified the need to file delinquent international information returns
 - Taxpayer is not under a civil examination or a criminal investigation by the IRS
 - Taxpayer has not already been contacted by the IRS about the delinquent information returns
 - More information can be found at <https://www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures>

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Delinquent FBAR Submission Procedures

- Taxpayers who do not need to use VDP or SFCP to file amended returns to report and pay additional tax but who:
 - Have not filed FBARs
 - Are not under criminal investigation by the IRS, and
 - Have not been contacted by the IRS about the delinquent FBARsmay use this procedure.
- Taxpayer should file the FBARs electronically and select the reason for late filing
- The IRS will not impose a penalty if the foreign account was reported on the return and tax was paid.
- Will not be automatically subject to audit but may be selected for audit through the existing audit selection processes that are in place for any tax or information returns
- <https://www.irs.gov/individuals/international-taxpayers/delinquent-fbar-submission-procedures>

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Questions?

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