

## Legislative Recommendation #14

## Provide That Assessable Penalties Are Subject to Deficiency Procedures

### SUMMARY

- *Problem:* To judicially challenge an “assessable penalty,” 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 to recover the payment. The inability of taxpayers to obtain judicial review prior to assessment and the requirement they pay the penalties in full to obtain judicial review after assessment can effectively deprive taxpayers of the right to judicial review.
- *Solution:* Give taxpayers an opportunity to challenge assessable penalties in the U.S. Tax Court before assessment by making these penalties subject to 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.

IRC § 6671(a) authorizes the IRS to assess some penalties without first issuing a notice of deficiency.<sup>1</sup> 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.<sup>2</sup> These courts generally impose higher filing fees than the U.S. Tax Court, and due to the complexities of their rules and formalities of their procedures, 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*,<sup>3</sup> the U.S. Supreme Court held that, with limited exceptions, a taxpayer must fully pay an assessment before filing suit in a U.S. district court or the Court of Federal Claims to obtain judicial review of an adverse IRS determination.<sup>4</sup> Penalties requiring full payment have historically included foreign information reporting penalties under IRC §§ 6038, 6038A, 6038B, 6038C, and 6038D, and penalties relating to reportable transactions under IRC §§ 6707 and 6707A.<sup>5</sup>

Although IRC § 6671(a) authorizes the IRS to immediately assess “assessable” penalties and 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 return (IIR) penalties contained in Chapter 61, Subchapter A, Part III, Subpart A of the tax code 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

1 These “assessable” penalties are generally ones 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(2), Common Terms and Acronyms (Jan. 29, 2021), [https://www.irs.gov/irm/part20/irm\\_20-001-009](https://www.irs.gov/irm/part20/irm_20-001-009).

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

3 362 U.S. 145 (1960).

4 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).

5 Courts ruled that full payment was required prior to a judicial challenge of the IRC § 6707 penalty in *Pfaff v. United States*, 117 A.F.T.R.2d 2016-981 (D. Colo. 2016), and *Diversified Grp., Inc. v. United States*, 841 F.3d 975 (Fed. Cir. 2016).

Return of U.S. Persons With Respect to Certain Foreign Corporations. When applicable, penalties under these sections can be substantial.<sup>6</sup>

## REASONS FOR CHANGE

The IRS's systemic assessment of these assessable penalties creates hardships for taxpayers, causes substantial inequities and inefficiencies in tax administration, and rests on a questionable legal foundation.<sup>7</sup> The IRS's position is that the penalties in Title 26, Subtitle F, Chapter 61, Subchapter A, Part III are not subject to deficiency procedures. The National Taxpayer Advocate's position, consistent with the U.S. Tax Court's holding in *Farhy v. Commissioner*, is that the tax code does not contain or cross-reference language authorizing the IRS to treat these penalties as assessable, and therefore the Department of Justice must institute a civil suit to recover the penalties.<sup>8</sup>

The U.S. Court of Appeals for the D.C. Circuit reversed the Tax Court's decision in *Farhy*, holding that "the statute's text, structure, and function" indicate the penalties are assessable.<sup>9</sup> But the Tax Court is only required to follow that decision in cases appealable to the D.C. Circuit.<sup>10</sup> In a case appealable to the U.S. Court of Appeals for the Eighth Circuit, the Tax Court maintained its position that the IIR penalties at issue are not assessable, which could result in a split opinion between circuits.<sup>11</sup> In the meantime, it appears the IRS is not changing its litigation position, leaving taxpayers in a quandary on how to proceed while it continues to assess these penalties. It remains to be seen how the Tax Court will rule, and if it denies the IRS's motion, whether the IRS will appeal to the Eighth Circuit, which could result in a split opinion between circuits.

To protect taxpayer rights, the National Taxpayer Advocate recommends Congress clarify that these penalties cannot be assessed before the IRS issues a notice giving taxpayers the right to judicial review. Taxpayers who are savvy enough to request an abatement based on reasonable cause or 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). For the most frequently assessed IIR penalties (IRC §§ 6038 and 6038A), TAS has found that across calendar years 2018-2021 the abatement percentage of those systemically assessed as measured by number of penalties was 74 percent and as measured by dollar value was 84 percent, averaged.<sup>12</sup>

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- 6 The amount of 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. 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 amount of the penalty under IRC § 6707 for failure to furnish information regarding reportable transactions, other than listed transactions, is \$50,000. IRC § 6707(b)(1). If the penalty is with respect to a listed transaction, the amount of the penalty is the greater of (i) \$200,000 or (ii) 50 percent of the gross income derived by the material advisor with respect to aid, assistance, or advice provided before the date the information return is filed under IRC § 6111. IRC § 6707(b)(2). In *Diversified Group*, the penalties assessed under IRC § 6707 for failure to register its tax shelter totaled \$24.9 million. *Diversified Grp., Inc. v. United States*, 123 Fed. Cl. 442, 445 (Fed. Cl. 2015), *aff'd*, 841 F.3d 975 (Fed. Cir. 2016).
  - 7 See National Taxpayer Advocate 2020 Annual Report to Congress 119 (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](https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2021/01/ARC20_MSP_08_International.pdf).
  - 8 See *Farhy v. Comm'r*, 160 T.C. 399 (2023), *rev'd and remanded*, 100 F.4th 223 (D.C. Cir. 2024).
  - 9 *Farhy*, 100 F.4th at 236 (D.C. Cir. 2024).
  - 10 See *Golsen v. Comm'r*, 54 T.C. 742 (1970).
  - 11 *Mukhi v. Comm'r*, 162 T.C. No. 8, (Apr. 8, 2024), *adhered to on recons.*, 163 T.C. No. 8 (Nov. 18, 2024).
  - 12 IRS, Compliance Data Warehouse (CDW), Business Master File. 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. See also National Taxpayer Advocate 2023 Annual Report to Congress 101, 111 (Most Serious Problem: *International: The IRS's Approach to International Information Return Penalties is Draconian and Inefficient*), [https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2024/01/ARC23\\_MSP\\_08\\_International.pdf](https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2024/01/ARC23_MSP_08_International.pdf). The abatement percentage of those penalties manually assessed as measured by number of penalties was 27 percent and as measured by dollar value was 16 percent. IRS, CDW, Individual Master File (Sept. 2023).

Specifying that deficiency procedures apply would prevent the systemic assessments the IRS often abates, a process that imposes undue burdens on taxpayers and unnecessarily consumes resources for the IRS. Additionally, requiring full payment puts judicial review out of reach for many if not most taxpayers. It is simply wrong to require taxpayers to pay penalties that can be disproportionate to the tax owed without first giving them an opportunity to obtain independent judicial review of the IRS's determination. This is particularly important for taxpayers who face large penalties but have limited resources.

Making assessable penalties subject to deficiency procedures would put pre-assessment judicial review of penalties in the hands of the Tax Court, which has several benefits. Due to the tax expertise of its judges, the Tax Court is generally better equipped to consider tax controversies than other courts. The Tax Court is 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. Taxpayers litigating in Tax Court are generally offered the option to receive free legal assistance from a Low Income Taxpayer Clinic or *pro bono* representative. Thus, the Tax Court in most instances is the least expensive and easiest-to-navigate judicial forum for low-income taxpayers.

As noted above, *Farhy* was reversed by the D.C. Circuit but remains applicable to cases appealable to other circuits, thus leaving considerable uncertainty regarding the legal status of Chapter 61, Subchapter A, Part III, Subpart A IIR penalties and resulting in the potential for taxpayers to be treated differently depending on the circuit in which they reside. Congressional action would resolve ambiguity in this area and provide important due process protections for taxpayers.

## RECOMMENDATION

- 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 IIR penalty or other IIR penalty listed in Chapter 61, Subchapter A, Part III, Subpart A of the IRC.