



CIVIL PENALTY ADMINISTRATION

The IRS's Administration of Penalties Is Often Unfair, Is Inconsistently Deterring Improper Behavior, Is Not Promoting Efficient Administration, and Thus Is Discouraging Tax Compliance

WHY THIS IS A SERIOUS PROBLEM FOR TAXPAYERS

During fiscal year (FY) 2023, the IRS assessed almost 46 million civil penalties totaling almost \$66 billion against taxpayers.¹ Some of these penalties are immense, causing the total tax liability including penalties and interest to be life-changing and even insurmountable for some taxpayers. Taxpayers may not understand why the IRS penalized them or their right to invoke defenses such as reasonable cause to excuse their noncompliance. The IRS often does not timely consider their defenses. In the case of assessable penalties, the IRS does not provide taxpayers the right to have their defenses considered prior to assessment, causing harm and downstream consequences to both taxpayers and the IRS. These taxpayers must attempt to undo the penalty assessment that the IRS often should not have made. The use of penalties should encourage tax compliance while also discouraging intentional or reckless noncompliance. Though penalties are a necessary tool, the IRS does not always administer them according to its own policies or in a fair and consistent manner, which harms taxpayers and erodes their confidence in the U.S. tax system.

¹ IRS, 2023 Data Book, Table 28, Civil Penalties Assessed and Abated by Type of Tax and Type of Penalty, Fiscal Year 2023, at 62 (2024), <https://www.irs.gov/pub/irs-pdf/p55b.pdf>.

EXPLANATION OF THE PROBLEM

In 1955, the IRC contained approximately 14 penalty provisions.² The IRS is now responsible for administering almost 200 penalties, more than 14 times that number.³ Further, some tax provisions, while not technically penalties, are for all practical purposes considered penalties and function as such.⁴ While the penalties themselves are statutory and any underlying penalty reform lies with Congress, the administration of those penalties lies entirely with the IRS. With close to 200 penalties, the IRS recognizes it is essential that its administration of penalties is fair, comprehensive, and consistently applied to all taxpayers.⁵ However, the IRS's procedures regarding penalties are not always consistent with its own penalty policies, it does not always strictly follow the law, and it does not always administer civil penalties in a consistent, fair, and effective manner.

The IRS's current procedures regarding penalties often do not encourage compliance and, in some instances, actually do the opposite:

- The IRS's failure to follow certain procedural penalty laws violates taxpayer rights, is unfair to taxpayers, and enhances the perception of an uneven playing field; and
- The IRS's "assess first, ask questions later" culture and approach to many penalties are unfair and serve to deter compliance.⁶

ANALYSIS

Background and Brief History

Penalties have long been part of the U.S. tax system, with the instructions for the first Form 1040 for tax year (TY) 1913 including both civil and criminal penalties.⁷ Encouraging compliance is essential to the tax system as taxpayers self-report and timely pay approximately 85 percent of all taxes due.⁸

The penalties in the IRC have grown substantially in both number and severity.⁹ By the 1980s, a great deal of controversy and concern about civil tax penalties prompted studies by Congress, the IRS, and outside stakeholders including practitioner and taxpayer groups.¹⁰ In November 1987, the IRS Commissioner

2 Internal Revenue Manual (IRM) 20.1.1.1(1), Background (Nov. 25, 2011), https://www.irs.gov/irm/part20/irm_20-001-001r.

3 IRS response to TAS information request (Oct. 10, 2024). These include penalties for failures to file, pay, and deposit timely; estimated taxes; accuracy-related penalties and penalties on preparers, promoters, material advisors, and appraisers involved in tax schemes; information returns, including international information returns (IIRs); and specialty areas such as employee plans, exempt organizations, excise taxes, and estate and gift. *Id.*

4 For example, the early withdrawal penalty under IRC § 72(t) is actually a ten percent additional tax for taking an early distribution from a qualified retirement plan. See IRC § 72(t).

5 IRM 20.1.1.1(1), Background (Nov. 25, 2011), https://www.irs.gov/irm/part20/irm_20-001-001r.

6 While there are numerous issues and considerations regarding penalty administration, this is not an exhaustive discussion of all issues. Rather, we highlight the IRS's administration of penalties in certain areas with a focus on the ultimate goal of enhancing compliance.

7 The instructions for the TY 1913 Form 1040 state 50 percent shall be added to the tax as penalty for failure to timely file a return, and 100 percent shall be added to the tax for filing a false or fraudulent return. Additionally, any person who makes any false or fraudulent return or statement with intent to defeat or evade the assessment of tax "shall be guilty of a misdemeanor, and shall be fined not exceeding \$2,000 or be imprisoned not exceeding one year, or both." Instructions for 1040, Annual Return by Individuals (1040), #7 (1914), reprinted in Jim Martin, *The First Form 1040*, In CUSTODIA LEGIS LAW LIBRARIANS OF CONGRESS BLOG (Apr. 18, 2017), <https://blogs.loc.gov/law/2017/04/the-first-form-1040>.

8 The IRS recently measured compliance for TY 2022 and determined that the voluntarily compliance rate (VCR) was about 85 percent for all federal taxes due each year. The VCR is defined as the amount of tax paid voluntarily and timely divided by total true tax, expressed as a percentage. For TY 2022, this translates to just over \$3.9 trillion collected through compliance. See IRS, Pub. 5869, Tax Gap Projections for Tax Year 2022 (Oct. 2024), <https://www.irs.gov/pub/irs-pdf/p5869.pdf>.

9 Executive Task Force for Internal Revenue Commissioner's Penalty Study, *A Philosophy of Civil Tax Penalties* (Discussion Draft) (1988), reprinted in DAILY TAX REP. (BNA) Issue No. 111, at L-2 (June 9, 1988).

10 *Id.*

implemented a task force consisting of employees from the IRS and the Department of Treasury to study civil tax penalties.¹¹ The task force also received input from key stakeholders, some of whom completed studies or reports with recommendations regarding penalty reform of their own.

In June 1988, the Executive Task Force for Internal Revenue Commissioner's Penalty Study released a discussion draft of its study.¹² It looked not only at the rationales behind penalties but also the purposes that penalties should serve.¹³ The task force determined four criteria for evaluating penalties:

1. Fairness – “A penalty should be perceived as fair both by the taxpayer upon whom the penalty is imposed and by compliant taxpayers;”
2. Simplicity – “Penalties need to be both understandable and understood, as do the standards of conduct contravention of which result in the imposition of a penalty;”
3. Administrability – “Penalties should be administrable...;” and
4. Effectiveness – “A penalty should be effective in achieving both specific and general deterrence.”¹⁴

In further articulating the goals for administering penalties, it provided that the IRS should administer penalties in a way that is responsive, reasonable, and reproducible.¹⁵ The conclusion of the task force was that “the sole purpose of civil tax penalties should be to enhance voluntary compliance.”¹⁶

Outside stakeholder studies were consistent with the findings of the IRS Task Force. For example, the Civil Penalty Task Force of the American Bar Association's (ABA) Section on Taxation prepared a study on penalty reform that it presented to Congress in July 1988.¹⁷ In conjunction with the report, the ABA's Section on Taxation adopted a resolution identifying six guiding principles for civil tax penalty reform, which also focused on compliance, simplicity, and fairness, among other things.¹⁸ In February 1989, the IRS's task force published its final report.¹⁹ The ultimate conclusion was that “[c]ivil tax penalties should exist for the purpose

11 Letter from Stuart M. Lewis, Chair-Elect, American Bar Ass'n Tax Section, to S. Comm. on Finance and H. Comm. on Ways & Means (Apr. 21, 2009) (on file with TAS).

12 Executive Task Force for Internal Revenue Commissioner's Penalty Study, *A Philosophy of Civil Tax Penalties* (Discussion Draft) (1988), reprinted in DAILY TAX REP. (BNA) Issue No. 111 (June 9, 1988).

13 In doing so, it noted that “confusion as to the purposes that penalties should serve has led to confused administration, as IRS employees attempt to implement a confused and confusing system to achieve conflicting and sometimes unknown policies.” Executive Task Force for Internal Revenue Commissioner's Penalty Study, *A Philosophy of Civil Tax Penalties* (Discussion Draft) (1988), reprinted in DAILY TAX REP. (BNA) Issue No. 111, at L-2 (June 9, 1988).

14 Executive Task Force for Internal Revenue Commissioner's Penalty Study, *A Philosophy of Civil Tax Penalties* (Discussion Draft) (1988), reprinted in DAILY TAX REP. (BNA) Issue No. 111, at L5-L6 (June 9, 1988).

15 To be responsive, the “IRS should hear the taxpayer's case (and make the taxpayer aware of this hearing), give proper weight to the taxpayer's point of view, and resolve penalty cases, all without unnecessary effort on the taxpayer's part;” to be reasonable, “written rules should be applied to reach the substantively correct result in light of their purpose and the scope of administrative discretion granted;” and to be reproducible, “a particular set of facts should give rise to the same outcome, regardless of what office or individual makes the final decision.” Executive Task Force for Internal Revenue Commissioner's Penalty Study, *A Philosophy of Civil Tax Penalties* (Discussion Draft) (1988), reprinted in DAILY TAX REP. (BNA) Issue No. 111, at L-7 (June 9, 1988).

16 Executive Task Force for Internal Revenue Commissioner's Penalty Study, *A Philosophy of Civil Tax Penalties* (Discussion Draft) (1988), reprinted in DAILY TAX REP. (BNA) Issue No. 111, at L-4 (June 9, 1988).

17 Letter from Stuart M. Lewis, Chair-Elect, American Bar Ass'n Tax Section, to S. Comm. on Finance and H. Comm. on Ways & Means (Apr. 21, 2009) (on file with TAS).

18 Letter from Stuart M. Lewis, Chair-Elect, American Bar Ass'n Tax Section, to S. Comm. on Finance and H. Comm. on Ways & Means (Apr. 21, 2009) (on file with TAS). The Section identified the following guiding principles:

(1) Penalties are appropriate elements of an overall administrative effort to achieve voluntary compliance. (2) To be effective in achieving voluntary compliance, the penalty provisions must be understandable and consistent. This requires that penalties be relatively simple and logical. (3) The total penalty imposition should be perceived to be fair and reasonable in relation to the particular misconduct. (4) To contribute to a sense of fairness, penalties should be applied, and perceived to be applied, for the purpose of deterring and punishing specifically and clearly defined misconduct. Accordingly, penalties should not be imposed to serve as an independent source of revenue. (5) Since it is not fair to punish acts that may reasonably be believed to be permitted prior to specifying the identified misconduct, nor acts deterred by penalties not even in existence when the conduct occurred, penalties should not be adopted retroactively. (6) Penalties should not be imposed to punish conduct which is proper, reasonable, appropriate, or not clearly prohibited.

19 Executive Task Force for Internal Revenue Commissioner's Penalty Study, *Report on Civil Tax Penalties* (Feb. 22, 1989), reprinted in *IRS Task Force Releases Penalty Reform Proposals*, TAX NOTES, Doc. 89-1586 (Feb. 27, 1989).

of encouraging voluntary compliance and not for other purposes, such as raising revenue.”²⁰ The task force made various administrative recommendations consistent with this conclusion, including for the IRS to develop both a penalty policy statement and a penalty handbook.²¹

In 1989, Congress passed the Improved Penalty Administration and Compliance Tax (IMPACT) Act of 1989 to revise the then-current civil penalty regime and reform information reporting penalties, accuracy-related penalties, preparer penalties, promoter penalties, protester penalties, and penalties for failure to file, pay, withhold, and make timely tax deposits.²² In 1998, in connection with the IRS Restructuring and Reform Act of 1998 (RRA 98), Congress required both the Secretary of the Treasury and the Joint Commission on Taxation to conduct studies reviewing the IRS’s administration and implementation of the penalty and interest provisions of the 1986 IRC to “examine whether the current penalty and interest provisions encourage voluntary compliance” and make recommendations to simplify administration and ease taxpayer burden.²³ The studies reiterated many of the same principles of the prior task force reports.²⁴ While Congress held hearings to discuss the recommendations, it did not enact sweeping civil penalty reform. Thus, the last major reform of the civil tax penalty regime was 35 years ago with IMPACT. Since that time, Congress has enacted even more penalties, some of which do not focus solely on compliance.²⁵ Clearly, penalty reform is needed. To this end, the IRS should initiate a task force consisting of IRS and Treasury Department employees and stakeholders to conduct a comprehensive review and study of the Title 26 penalty regime as well as provide administrative and legislative recommendations for sound legal and administrative policies that promote fairness and effective administration.

The IRS’s Policy Statement – “Penalties Are Used to Enhance Voluntary Compliance”

Consistent with recommendations of the IRS Task Force, the IRS developed a penalty policy statement and a penalty handbook, which are included in the Internal Revenue Manual (IRM).²⁶ The IRS’s penalty policy set forth in Policy Statement P-1-18 was consistent with the findings of the studies and stated: “Penalties support the [IRS’s] mission **only if** penalties enhance voluntary compliance.” The IRS amended its penalty policy statement in 2004. The IRS’s current penalty policy is set forth in Policy Statement 20-1, which states:

20 Executive Task Force for Internal Revenue Commissioner’s Penalty Study, *Report on Civil Tax Penalties* (Feb. 22, 1989), reprinted in *IRS Task Force Releases Penalty Reform Proposals*, TAX NOTES, Doc. 89-1586 at 15 (Feb. 27, 1989).

21 Executive Task Force for Internal Revenue Commissioner’s Penalty Study, *Report on Civil Tax Penalties* 1 (Feb. 22, 1989), reprinted in *IRS Task Force Releases Penalty Reform Proposals*, TAX NOTES, Doc. 89-1586, at 214-215 (Feb. 27, 1989). See also H.R. Rep. No. 101-386, at 661 (1989) (Conf. Rep.) (“The IRS should develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance.”).

22 See Omnibus Budget Reconciliation Act of 1989, Pub. Law No. 101-239, Title VII, Subtitle G, §§ 7701-7743, 103 Stat. 2106, 2388-2406 (1989). Subtitle G is known as the Improved Penalty Administration and Compliance Tax (IMPACT) Act.

23 RRA 98, Pub. L. No. 105-206, § 3801, 112 Stat. 685, 782 (1998); H.R. Rep. No. 105-599, at 323 (1998) (Conf. Rep.).

24 See, e.g., DEP’T OF THE TREASURY, REPORT TO THE CONGRESS ON PENALTY AND INTEREST PROVISIONS OF THE INTERNAL REVENUE CODE 18 (1999), <https://home.treasury.gov/system/files/131/Report-Penalty-Interest-Provisions-1999.pdf> (stating that the fundamental objective “should be to foster and enhance the high degree of voluntary compliance that presently exists... without undue burden or complexity”); STAFF OF J. COMM. ON TAX’N, 106TH CONG., STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY SECTION 3801 OF THE IRS RESTRUCTURING AND REFORM ACT OF 1998 (INCLUDING PROVISIONS RELATING TO CORPORATE TAX SHELTERS) vol. 1, at 31, JCS-3-99 (J. Comm. Print 1999), <https://www.jct.gov/getattachment/9cae8146-a598-490b-a522-6852fd32dfb2/jcs-3-99-vol1-2896.pdf> (stating that tax penalties should “(1) encourage voluntary compliance, (2) operate fairly, (3) deter undesired behavior, and (4) be designed in a manner that promotes efficient and effective administration of the provisions by the IRS”).

25 See, e.g., AM’N INST. OF CPAs, REPORT ON CIVIL TAX PENALTIES: THE NEED FOR REFORM 1, 2013, <https://us.aicpa.org/content/dam/aicpa/advocacy/tax/taxlegislationpolicy/downloadabledocuments/aicpa-report-civil-tax-penalty-reform-2013.pdf> (noting that since IMPACT, “numerous penalty provisions have been enacted that are not directed toward, and do not achieve, the core goal of encouraging voluntary compliance. In part, this likely is due to the government’s understandable interest in combating tax shelters. However, this loss of direction has resulted from ad hoc efforts to craft penalties and an increase in the use of penalties, rather than substantive tax laws, to drive taxpayer behavior. The use of penalties to ‘raise revenues’ contributes to this loss of direction.”).

26 See IRM 20.1.1.1(2), Background (Nov. 25, 2011), https://www.irs.gov/irm/part20/irm_20-001-001r; IRM 20.1, Penalty Handbook (Mar. 29, 2023), https://www.irs.gov/irm/part20/irm_20-001-001r; IRM 1.2.1.12.1(1), Policy Statement 20-1 (Formerly P-1-18), Penalties Are Used to Enhance Voluntary Compliance (June 29, 2004), https://www.irs.gov/irm/part1/irm_01-002-001.

“Penalties are used to enhance voluntary compliance.”²⁷ Thus, the IRS changed the focus of penalty policy away from only enhancing voluntary compliance. While the IRS can encourage compliance in different ways including assessing and enforcing penalties or mitigating penalties through voluntary disclosure programs, it does not always administer penalties consistent with its policy.²⁸

The IRS Does Not Always Follow the Law on Penalties

The IRS Does Not Always Provide the Requisite Penalty Information in Penalty Notices

One of the fundamental ways penalties encourage tax compliance is by “demonstrating the fairness of the tax system.”²⁹ Implicit in the concept of “fairness” is the expectation that all parties play by the rules. However, the IRS does not always follow the rules for the procedural protections regarding penalties provided to taxpayers under IRC § 6751, which Congress enacted as part of RRA 98.³⁰ Congress was concerned the IRS had no requirements to show how it was computing penalties, and in some cases, imposing penalties without supervisory approval.³¹ IRC § 6751 created two procedural requirements the IRS must follow with respect to certain penalties: (a) the notice and computation requirement and (b) the supervisory approval requirement.

The IRC § 6751 notice provision requires the IRS to include certain specific information with each notice of penalty including the name of the penalty, the IRC section under which it is imposed, and a computation of the penalty.³² Because Congress believed that “taxpayers are entitled to an explanation of the penalties imposed on them,”³³ the goal of IRC § 6751(a) was to provide taxpayers with the information critical to understanding the penalties the IRS assessed against them. Practitioners note, however, that the IRS frequently fails to include a penalty computation in penalty notices it issues to taxpayers, especially in the case of immediately assessable penalties.³⁴ These penalty amounts can be substantial,³⁵ and the computations can be complex. The requirement of the statute is clear – the IRS “shall” include the penalty information with “*each notice of penalty* under this title.”³⁶ According to the IRS, it provides the required notice information for all penalties when

27 IRM 1.2.1.12.1(1), Policy Statement 20-1 (Formerly P-1-18), Penalties Are Used to Enhance Voluntary Compliance (June 29, 2004) (emphasis in the original), https://www.irs.gov/irm/part1/irm_01-002-001. Thus, the focus of penalties is no longer “only” to enhance voluntary compliance. For a comparison of former Policy Statement P-1-18 and current Policy Statement 20-1, along with a discussion regarding the shift away from solely encouraging voluntary compliance, see National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, at 11 (*A Framework for Reforming the Penalty Regime*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/08_tas_arc_vol2.pdf.

28 While there are numerous issues and considerations regarding penalty administration as evidenced by the various studies, our discussion is not an exhaustive discussion of all issues. Rather, we focus on the IRS’s administration of penalties in certain areas with a focus on the ultimate goal of enhancing voluntary compliance. One way of enhancing voluntary compliance is through programs aimed at noncompliant taxpayers. For a discussion on the IRS’s Criminal Voluntary Disclosure Practice (VDP), including recommendations to enhance compliance through the VDP, see Most Serious Problem: *Criminal Voluntary Disclosure: Changes to the IRS’s Criminal Voluntary Disclosure Practice Requirements May Be Reducing Voluntary Compliance and Negatively Impacting the Tax Gap*, *infra*. However, the IRS can and should consider civil disclosure programs similar to the VDP to encourage voluntary and future compliance for emerging issues such as digital assets.

29 IRM 1.2.1.12.1(3), Policy Statement 20-1 (Formerly P-1-18), Penalties Are Used to Enhance Voluntary Compliance (June 29, 2004), https://www.irs.gov/irm/part1/irm_01-002-001.

30 RRA 98, Pub. L. No. 105-206, § 3306, 112 Stat. 685, 744 (1998).

31 S. REP. NO. 105-174, at 65 (1998).

32 IRC § 6751(a). This requirement is incorporated into the IRM at 20.1.5.2.3(1), Supervisory Approval of Penalties – IRC 6751 Procedural Requirements (Aug. 31, 2021), https://www.irs.gov/irm/part20/irm_20-001-005.

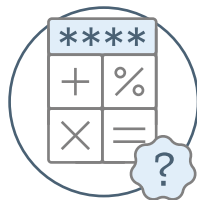
33 S. REP. NO. 105-174, at 65 (1998).

34 Conversations with outside stakeholders (Aug. 21, 22, and 28, 2024). See also Andrew Velarde, *Lack of Penalty Computation Issue Lurking in Litigation Again*, TAX NOTES (July 1, 2024), <https://www.taxnotes.com/tax-notes-today-international/penalties/lack-penalty-computation-issue-lurking-litigation-again/2024/07/01/7kdzy> (“Attorneys have argued that the lack of computation notices is a pervasive problem for several Ogden-campus-issued penalties, including for foreign trust reporting penalties.”).

35 In *Groves v. Comm’r*, Docket No. 9974-22L, a case currently pending in the U.S. Tax Court, the IRS assessed a penalty against the petitioner totaling \$4,351,138 under IRC § 6707, Failure to Furnish Information Regarding Reportable Transactions, and issued several notices to the taxpayer but did not include a computation of the penalty in any of the notices. See Brief of the Center for Taxpayer Rights as Amicus Curiae in Support of Petitioner, *Groves v. Comm’r*, Docket No. 9974-22L (T.C. May 2, 2024), <https://kostelanetz.com/wp-content/uploads/2024/05/Groves-Amicus-Brief.pdf>.

36 IRC § 6751(a) (emphasis added). This “title” is Title 26, the Internal Revenue Code of 1986.

available.³⁷ However, it acknowledges that it does not include the information when IRS systems “are unable to provide a computation of the penalty assessment.”³⁸



Taxpayers need to see the IRS’s penalty computation so they understand why the IRS is penalizing them. Otherwise, how can they effectively challenge the amounts? And how can IRS employees help verify the calculation?

The IRS’s failure to provide the required penalty computation and other information is fundamentally unfair to taxpayers, infringes on due process, and violates the taxpayer *rights to be informed, to pay no more than the correct amount of tax, and to a fair and just tax system*.³⁹ Taxpayers need this information to understand why the IRS is penalizing them. If taxpayers cannot see how the IRS computed the penalties, how can they effectively challenge the amounts? And how can the IRS verify its calculation and ensure that it has correctly computed the penalty?⁴⁰ Further compounding the problem for taxpayers is that IRC § 6751(a) does not provide any consequences if the IRS fails to comply. Without consequences, the law has no “bite;” thus, the IRS has no real incentive to comply.

IRC § 6751(a) is a significant procedural safeguard that the IRS should not be able to ignore or selectively apply. It should conduct a thorough review of its penalty notices to determine which ones do not comply with IRC § 6751(a) and develop procedures to ensure that all penalty notices comply, along with remedial procedures for those that do not.

The IRS’s Approach to the Supervisory Approval of Penalty Requirements of IRC § 6751(b) Harms Taxpayers

The supervisory approval provision of IRC § 6751(b)(1) provides: “No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate.” The IRC excepts two types of penalties from this requirement: (i) additions to tax for failure to file, pay, and make estimates under IRC §§ 6651, 6654, and 6655 and penalties for the overstatement or disallowance of certain contribution deductions, and (ii) any other penalty that is “automatically calculated through electronic means.”⁴¹ Congress enacted IRC § 6751(b) because it believed that “penalties should only be imposed where appropriate and not as a bargaining chip,”⁴² thus preventing the IRS “from threatening unjustified penalties to encourage taxpayers to settle.”⁴³ Unfortunately, the “initial determination of such

37 IRS response to TAS information request (Oct. 10, 2024).

38 *Id.*

39 See Taxpayer Bill of Rights (TBOR), <https://www.taxpayeradvocate.irs.gov/taxpayer-rights> (last visited Nov. 15, 2024). The rights contained in TBOR are also codified in IRC § 7803(a)(3).

40 “It is crucial that the IRS inform taxpayers regarding the computation of the penalties it imposes so taxpayers can evaluate their accuracy and decide whether to challenge them. Equally important is that the IRS ‘show its work’ to catch common, yet avoidable, errors that can have significant detrimental effects on taxpayers.” Brief of the Center for Taxpayer Rights as Amicus Curiae in Support of Petitioner 1, *Groves v. Comm’r*, Docket No. 9974-22L (T.C. May 2, 2024), <https://kostelanetz.com/wp-content/uploads/2024/05/Groves-Amicus-Brief.pdf>.

41 IRC § 6751(b)(2). A penalty is generally considered as automatically calculated through electronic means if an IRS computer program proposes it without human involvement. See, e.g., *Walquist v. Comm’r*, 152 T.C. 61 (2019).

42 See S. REP. NO. 105-174, at 65 (1998).

43 *Chai v. Comm’r*, 851 F.3d 190, 219 (2d Cir. 2017).

assessment” language of IRC § 6751(b)(1) is unclear.⁴⁴ This ambiguity led to much litigation regarding what constitutes a determination along with when and who must make written approval, with courts coming to differing conclusions.⁴⁵

The IRS has interpreted IRC § 6751(b)(1) broadly to require supervisory approval late in the process.⁴⁶ After significant litigation, the IRS changed its policy to require written supervisory approval prior to the IRS issuing taxpayers any written communication of penalties that offers the opportunity to sign an agreement or consent to assessment or proposal of the penalty.⁴⁷ Thus, an IRS agent can share written communication of proposed penalties *before* obtaining a supervisor’s approval as long as the employee does not include a letter that allows the taxpayer to agree.⁴⁸

The law is still unclear regarding when the IRS must obtain written supervisory approval, and taxpayers have successfully litigated and challenged the IRS’s position on supervisory signature in several instances.⁴⁹ All concerned parties need clarification of the law. On March 11, 2024, the Treasury Department released its Fiscal Year 2025 Green Book of revenue proposals.⁵⁰ One of the proposals essentially erodes almost all taxpayer protections provided in IRC § 6751(b)(1). Most detrimentally, it eliminates the written supervisory approval requirement for penalties for underpayments of tax under IRC § 6662, understatements with respect to reportable transactions under IRC § 6662A, and fraud under IRC § 6663.⁵¹ It is important to note that the IRC already exempts approximately 98 percent of penalties assessed against individuals, estates, and trusts in connection with income tax liabilities from supervisory approval, and this proposal would essentially eliminate almost all remaining requirements to obtain supervisory approval for these penalties.⁵²

44 The IRS makes a “determination” when it investigates a taxpayer’s tax liability and applies the penalty statutes thereto, while an “assessment” is merely when the IRS enters a penalty on its books. Thus, it is not possible to “determine” an “assessment.”

45 See, e.g., *Graev v. Comm’r*, 147 T.C. 460, 477-478 (2016), superseded by 149 T.C. 485 (2017); *Chai v. Comm’r*, 851 F.3d 190, 221 (2d Cir. 2017); *Clay v. Comm’r*, 152 T.C. 223, 248-249 (2019), *aff’d on other grounds*, 990 F.3d 1296 (11th Cir. 2021); *Belair Woods v. Comm’r*, 154 T.C. 1 (2020).

46 Previously, the IRS’s policy was to obtain written supervisory approval prior to the issuance of a notice of deficiency. See IRS, Interim Guidance Memorandum (IGM) SBSE-04-0922-0075, Reissue Interim Guidance (IG) for Timing of Supervisory Approval of Penalties Subject to IRC 6751(b) (Sept. 28, 2022), <https://www.irs.gov/pub/foia/ig/sbse/sbse-04-0922-0075.pdf>. The IRS issues a notice of deficiency at the end of an examination if it did not reach an agreement and notifies the taxpayer that the IRS has determined a deficiency.

47 IRM 20.1.1.2.3.1(1), Timing of Supervisory Approval (Oct. 19, 2020), https://www.irs.gov/irm/part20/irm_20-001-001r.

48 See IRS, IGM SBSE-04-0922-0075, Reissue Interim Guidance (IG) for Timing of Supervisory Approval of Penalties Subject to IRC 6751(b) (Sept. 28, 2022), <https://www.irs.gov/pub/foia/ig/sbse/sbse-04-0922-0075.pdf>, which provides the following guidance: “Example: At the conclusion of the fact-finding phase of the examination (during a face-to-face appointment), the examiner determines an accuracy-related penalty applies. Supervisory approval of the penalty has not yet been obtained, so to facilitate discussion of the proposed adjustments and penalty, the examiner prepares Form 5278 [Statement – Income Tax Changes] and shares it with the taxpayer.”

49 In one notable case, *LakePoint Land II, LLC v. Comm’r*, T.C. Memo. 2023-111, the Tax Court imposed sanctions against the IRS with respect to filings that included a false declaration with a backdated supervisory approval document and IRS Counsel’s failures to notify the Court of the backdated document and timely correct the error.

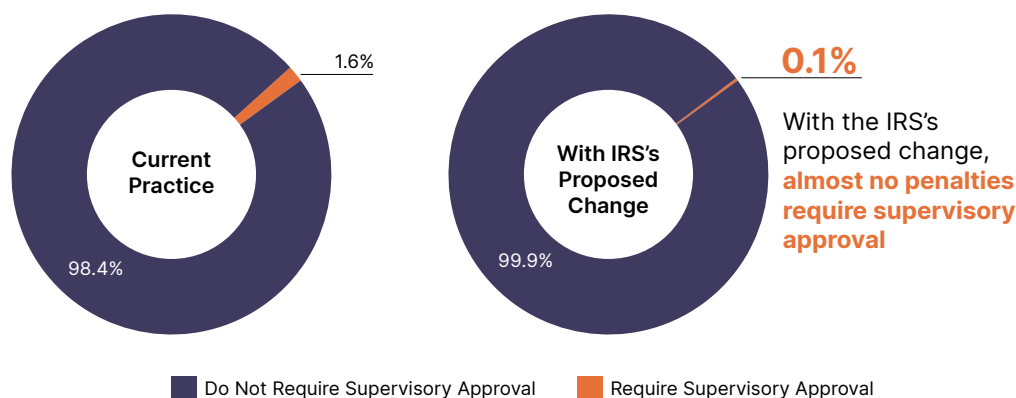
50 Dep’t of the Treasury, *General Explanations of the Administration’s Fiscal Year 2025 Revenue Proposals* (Mar. 2024), <https://home.treasury.gov/system/files/131/General-Explanations-FY2025.pdf>.

51 *Id.* at 176. For an in-depth look at how Treasury’s Green Book proposal would harm taxpayers, see Erin M. Collins, Treasury FY 2025 Green Book Proposes to Essentially Eliminate Written Supervisory Approval for Penalties, NATIONAL TAXPAYER ADVOCATE BLOG (May 2, 2024), <https://www.taxpayeradvocate.irs.gov/news/nta-blog/treasury-fy-2025-green-book-proposes-to-essentially-eliminate-written-supervisory-approval-for-penalties/2024/05/>.

52 For FY 2023, more than 98 percent of the penalties the IRS assessed against individuals, estates, and trusts in connection with income tax liabilities were exempt from supervisory approval requirements. For a discussion of the particular types and numbers of penalties subject to supervisory approval in FY 2022, see Erin M. Collins, Treasury FY 2025 Green Book Proposes to Essentially Eliminate Written Supervisory Approval for Penalties, NATIONAL TAXPAYER ADVOCATE BLOG (May 2, 2024), <https://www.taxpayeradvocate.irs.gov/news/nta-blog/treasury-fy-2025-green-book-proposes-to-essentially-eliminate-written-supervisory-approval-for-penalties/2024/05/>.

FIGURE 2.9.1⁵³

Individual, Estate, and Trust Income Tax Liability Penalties Requiring Supervisory Approval, CY 2023 – Now and Under IRS's Proposed Change



The proposal would allow the IRS to obtain written supervisory approval of penalties at the latest possible time in the penalty process.⁵⁴ Also, it would allow *any supervisor* to approve the penalty as opposed to an immediate supervisor or higher level official. The Green Book proposals are consistent with the proposed regulations under IRC § 6751(b), which the Treasury Department published on April 11, 2023.⁵⁵

The IRS's policy and procedures regarding the written supervisory approval of penalties, including the proposed regulations, harm taxpayers and are inconsistent with the statute and its legislative history. It is almost inconceivable that Congress intended supervisory approval to apply to only one-tenth of one percent of all civil penalties assessed against individuals, estates, and trusts. Allowing an IRS agent to communicate proposed penalties to taxpayers prior to any review and approval by a supervisor leaves open the possibility of the very conduct which Congress meant to prohibit – *i.e.*, the possible use of penalties as a bargaining chip. Taxpayers, especially unrepresented ones, may not understand that the penalties are not yet officially approved and feel pressure to resolve their case to avoid the penalties. Further, requiring approval at the latest possible time does not allow taxpayers sufficient opportunity to challenge the penalties, especially those not subject to deficiency procedures. Finally, allowing a supervisor who is unfamiliar with the case to approve the penalty would arguably defeat the purpose of the statute to ensure that the IRS only impose penalties where

53 IRS, 2023 Data Book, Table 28, Civil Penalties Assessed and Abated by Type of Tax and Type of Penalty, Fiscal Year 2023, at 62 (2023), <https://www.irs.gov/pub/irs-pdf/p55b.pdf>.

54 Under the proposal: 1) The IRS can approve penalties up until the time it issues a notice of deficiency; 2) if the taxpayer petitions the court, the IRS may raise a penalty at any time as long as a supervisor approves it; and 3) the IRS can approve a penalty any time prior to assessment if the penalty is not subject to deficiency procedures. Penalties not subject to deficiency procedures include all IIR penalties.

55 Rules for Supervisory Approval of Penalties, 88 Fed. Reg. 21,564 (Apr. 11, 2023) (to be codified at Treas. Reg. § 301.6751(b)-1), <https://www.federalregister.gov/documents/2023/04/11/2023-07232/rules-for-supervisory-approval-of-penalties>. According to Treasury, the regulations are “intended to clarify the application of section 6751(b) in a manner that is *consistent with the statute and its legislative history*, has nationwide uniformity, is administrable for the IRS, and is easily understood by taxpayers.” *Id.* at 21, 566 (emphasis added). It is difficult to see how the proposed elimination of taxpayer rights is consistent with the statute and its legislative history.

appropriate.⁵⁶ To ensure that the IRS follows the spirit of the law and only applies penalties when warranted, Congress should amend IRC § 6751(b)(1) to require that the IRS obtain written supervisory approval prior to the first time that the IRS sends a written communication to the taxpayer proposing the penalty.⁵⁷

The IRS also takes the position that it can assess accuracy-related penalties, including the negligence penalty under IRC § 6662(b)(1), without supervisory approval if it calculates them through electronic means.⁵⁸ While some penalties calculated through electronic means are purely computational (*e.g.*, failure-to-file and failure-to-pay), the imposition of a negligence penalty is different. It requires an employee to analyze the taxpayer's state of mind, the actions the taxpayer took to comply, and why the taxpayer took those actions. A person must conduct this analysis, not a computer.⁵⁹ Requiring supervisory review of such a subjective penalty would help ensure that the IRS assesses the penalty only if warranted, consistent with Congress's intent when enacting the statute. Therefore, Congress should amend IRC § 6751(b)(2)(B) to clarify that the exception for "other penalties automatically calculated through electronic means" does not apply to the penalty for "negligence or disregard of rules or regulations" under IRC § 6662(b)(1).⁶⁰

The IRS's Culture of "Assess First, Ask Questions Later" Is Unfair and Inefficient and Does Not Encourage Compliance

When the IRS changed its policy statement in 2004, it changed the focus of the penalty policy away from *only* enhancing voluntary compliance⁶¹ to ensuring that it always developed and applied penalties,⁶² especially in the tax shelter area.⁶³ However, "[p]enalties should apply only to negligent, reckless or intentional conduct ... should be subject to a reasonable cause and good faith defense and no penalty should be imposed without affording an opportunity to the party who may be sanctioned to defend the conduct."⁶⁴ While adopting a more aggressive penalty approach, the policy also states that the IRS will demonstrate the

56 It is important to note that while IRM 4.10.9.8.6.2(1) provides that a group manager "must perform a meaningful review of the penalty determination," the IRS has argued, and courts have agreed, that the only requirement is the timely written approval or signature of a supervisor and that the IRS does not need to establish extent or comprehensiveness of the review. IRM 4.10.9.8.6.2(1), Penalties: Supervisory Approval (Apr. 22, 2024), https://www.irs.gov/irm/part4/irm_04-010-009; see, *e.g.*, *Raifman v. Comm'r*, T.C. Memo 2018-101; *Belair Woods, LLC v. Comm'r*, 154 T.C. 1 (2020); *Estate of Glassman v. Comm'r*, T.C. Memo. 2024-51. See also Stephen J. Olsen, *Is Rubber-Stamping All That's Required For Supervisory Approval?*, *PROCEDURALLY TAXING* (July 26, 2024), <https://www.taxnotes.com/procedurally-taxing/rubber-stamping-all-thats-required-supervisory-approval/2024/07/26/7khsc?highlight=rubber-stamping>.

57 See National Taxpayer Advocate 2025 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration (Clarify That Supervisory Approval Is Required Under IRC § 6751(b) Before Proposing Penalties)*.

58 IRC § 6662(b)(1) imposes a penalty equal to 20 percent of any underpayment of tax the IRC requires a tax return to show that is attributable to negligence or disregard of the rules and regulations. IRC § 6662(c) defines negligence to include "any failure to make a reasonable attempt to comply with the provisions of this title" and "disregard" to include "any careless, reckless, or intentional disregard."

59 Both the IRS Automated Underreporter and Correspondence Examination Automation Support programs calculate negligence penalties through electronic means. See IRM 20.1.1.2.3.2, Automated Underreporter and Correspondence Automation Support Programs (Oct. 19, 2020), https://www.irs.gov/irm/part20/irm_20-001-001r.

60 See National Taxpayer Advocate 2025 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration (Require an Employee to Determine and a Supervisor to Approve All Negligence Penalties Under IRC § 6662(b)(1))*.

61 For a history of penalty reform and the IRS's penalty policy, including the shift away from solely enhancing voluntary compliance, see National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, at 1 (*A Framework for Reforming the Penalty Regime*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/08_tas_arc_vol2.pdf. While the recommendations are old, there has been no sweeping penalty reform since then, and many of the penalty problems still exist today.

62 See, *e.g.*, IRM 1.2.1.12.1(4), Policy Statement 20-1 (Formerly P-1-18), Penalties Are Used to Enhance Voluntary Compliance (June 29, 2004), https://www.irs.gov/irm/part1/irm_01-002-001 ("[E]xaminers and their managers must consider the applicability of penalties in each case, and fully develop the penalty issue, when the initial consideration indicates that penalties should apply. That is, [they] must consider the elements of each applicable penalty and then fully develop the facts to support the application of the penalty. ... Full development of the penalty issue is important for Appeals to sustain a penalty and for Counsel to successfully defend that penalty in litigation.").

63 National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, at 11 (*A Framework for Reforming the Penalty Regime*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/08_tas_arc_vol2.pdf. See also IRM 1.2.1.12.1(5) and (6), Policy Statement 20-1 (Formerly P-1-18), Penalties Are Used to Enhance Voluntary Compliance (June 29, 2004), https://www.irs.gov/irm/part1/irm_01-002-001 (addressing specifically abusive transactions and listed transactions).

64 Letter from Stuart M. Lewis, Chair-Elect, American Bar Ass'n Tax Section, to S. Comm. on Finance and H. Comm. on Ways & Means (Apr. 21, 2009) (on file with TAS).

fairness of the tax system by providing “every taxpayer against whom the Service proposes to assess penalties with a reasonable opportunity to provide evidence that the penalty should not apply” and giving “full and fair consideration to evidence in favor of not imposing the penalty.”⁶⁵

Although these statements are part of the IRS’s policy, it does not follow this policy with many penalties. According to practitioners, the current culture in the IRS is that penalties apply unless taxpayers establish otherwise – a guilty until proven innocent philosophy.⁶⁶ This policy is clear from the “assess first, ask questions later” tactics the IRS uses with various penalties. Only an extremely small number of penalties are subject to the supervisory approval requirements leaving approximately 98 percent of penalties assessed against individuals, estates, and trusts in connection with income tax liabilities exempt from the requirement that a manager review and approve the penalty.⁶⁷ These exempt penalties include penalties that the IRS automatically assesses either systemically or manually without any substantive analysis.⁶⁸

The IRS’s Automatic Assessment of International Information Return Penalties Causes Undue Hardship, Creates Unnecessary Work, and Discourages Compliance

The “assess first, ask questions later” procedures employed by the IRS, both through the automated matching systems and automatic assessments on delinquently filed returns, harm taxpayers and reflect the IRS’s current culture that penalties apply until taxpayers prove otherwise. These procedures do not provide a mechanism for the IRS to first determine whether the taxpayer’s error resulted from particular conduct that warrants a penalty, whether reasonable cause exists to excuse the penalty, or whether the penalty is proportional to the misconduct the IRS is penalizing. This is especially evident in the international information returns (IIRs) area.⁶⁹

U.S. persons who receive money from abroad or who have cross-border activities or foreign financial interests may potentially be subject to a wide range of U.S. reporting requirements for IIRs. The IRS may assess significant penalties against taxpayers for failing to timely file or for filing incomplete or inaccurate IIRs. Often taxpayers do not know they are subject to IIR requirements. 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

65 IRM 1.2.1.12.1(9), Policy Statement 20-1 (Formerly P-1-18), Penalties Are Used to Enhance Voluntary Compliance (June 29, 2004), https://www.irs.gov/irm/part1/irm_01-002-001.

66 Conversations with outside stakeholders (Aug. 5, 8, 21, 22, and 28, 2024).

67 For FY 2023, more than 98 percent of the penalties the IRS assessed against individuals, estates, and trusts in connection with income tax liabilities were exempt from supervisory approval requirements. For a discussion of the particular types and numbers of penalties subject to supervisory approval in FY 2022, see Erin M. Collins, Treasury FY 2025 Green Book Proposes to Essentially Eliminate Written Supervisory Approval for Penalties, NATIONAL TAXPAYER ADVOCATE BLOG (May 2, 2024), <https://www.taxpayeradvocate.irs.gov/news/nta-blog/treasury-fy-2025-green-book-proposes-to-essentially-eliminate-written-supervisory-approval-for-penalties/2024/05>.

68 Systemically assessed penalties are those the IRS automatically assessed electronically without initial review or action from IRS personnel. Assessments that IRS personnel take actions to make are referred to as “manual assessments.” The IRS makes many manual assessments automatically without reviewing whether the penalties should apply. Hereinafter, “automatically” will include both systemic and manual assessments made without any substantive review of the applicability of the penalty.

69 The National Taxpayer Advocate has highlighted the serious problems with IIRs many times. For in-depth discussions of the IRS’s harmful approach to assessment and collection of IIRs, see National Taxpayer Advocate 2023 Annual Report to Congress 101 (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; 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; Erin M. Collins, Foreign Information Penalties: Provide Taxpayers Their Rights Before Assessment, NATIONAL TAXPAYER ADVOCATE BLOG (May 21, 2024), <https://www.taxpayeradvocate.irs.gov/news/nta-blog/foreign-information-penalties-provide-taxpayers-their-rights-before-assessment/2024/05/>; Erin M. Collins, Chapter 61 Foreign Information Penalties: Part One: Taxpayers and Tax Administration Need a Legislation Fix, NATIONAL TAXPAYER ADVOCATE BLOG (Apr. 17, 2023), <https://www.taxpayeradvocate.irs.gov/news/nta-blog/nta-blog-chapter-61-foreign-information-penalties-part-one/2023/04/>; Erin M. Collins, Chapter 61 Foreign Information Penalties: Part Two: Taxpayers and Tax Administration Need Finality, Which Requires Legislation, NATIONAL TAXPAYER ADVOCATE BLOG (Apr. 20, 2023), <https://www.taxpayeradvocate.irs.gov/news/nta-blog/nta-blog-chapter-61-foreign-information-penalties-part-two/2023/04/>; Erin M. Collins, Foreign Information Penalties: Part Three: Keeping a Watchful Eye on the FBAR Guard Dog, NATIONAL TAXPAYER ADVOCATE BLOG (Apr. 20, 2023), <https://www.taxpayeradvocate.irs.gov/news/nta-blog/nta-blog-chapter-61-foreign-information-penalties-part-three/2023/05/>.

and IIR penalties, even though they never thought of themselves as U.S. citizens.⁷⁰ A U.S. person holding a controlling interest in a foreign partnership can face significant penalties, even though the partnership generates no taxable income.⁷¹ Similarly, a taxpayer receiving a tax-free gift or inheritance can lose a substantial portion of it to penalties simply because they had no idea that they had to report it.⁷²

Typically, when taxpayers learn of the IIR requirements, they voluntarily file the forms late, only to have the IRS reward their compliance with harsh penalties, even if they have attached a reasonable cause statement asking for the IRS not to assess the penalty. This is because the IRS's policy is to automatically assess many of the IIR penalties upon receipt of the late IIR return.⁷³

Congress established the IIR penalty regime primarily to combat tax avoidance and discourage U.S. taxpayers from hiding income and assets abroad. While these objectives are commendable, the penalties often do not affect high net worth individuals and large companies; they have sophisticated advisors and generally avoid these penalties or successfully obtain abatements. Rather, lower-income individuals, immigrants, and small businesses who generally lack advisors with the same expertise are the ones to inadvertently trigger the penalty. The IRS imposes a substantial number of IIR penalties on the non-wealthy. For instance, for calendar years (CYs) 2018-2022, the IRS assessed 70 percent of individual IRC § 6038 penalties against lower- to middle-income taxpayers (those reporting under \$400,000 in income).⁷⁴ Likewise, the IRS assessed 84 percent of systemic business IRC §§ 6038 and 6038A penalties against small and midsize businesses (those with assets under \$10 million) over this same period.⁷⁵

One area of particular concern regarding IIR penalties is with gifts and inheritances subject to IRC § 6039F reporting. IRC § 6039F generally requires U.S. persons who receive large foreign gifts or inheritances to submit information returns (Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, Part IV) to the IRS. Because gifts and inheritances are excludable from income, taxpayers may not realize they have to report them. There are many examples of taxpayers who received a once-in-a-lifetime tax-free gift or inheritance and were unaware of their reporting requirement. When they learned of the filing requirement, these taxpayers did the right thing and filed a late information return only to find that the IRS greets them with substantial penalties it automatically assessed upon the late filing of Form 3520. Depending on how late the taxpayer filed, they face penalties of up to 25 percent of their gift or inheritance despite owing no actual tax.

In the foreign gift context, the penalties can be huge; over 2018-2021, even taxpayers who reported \$400,000 or less in income received an average penalty of over \$235,000.⁷⁶ However, as shown in Figure 2.9.2, over this same four-year period, the IRS abated 68 percent of the individual IRC § 6039F penalties assessed with respect to Form 3520, Part IV, averaging almost \$181 million (79 percent of the dollars assessed).⁷⁷

70 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>.

71 IRC § 6038(a).

72 IRC § 6039F.

73 See National Taxpayer Advocate 2023 Annual Report to Congress 101, 110-111 (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.

74 IRS, Compliance Data Warehouse (CDW), Individual Master File (IMF) and Individual Return Transaction File (IRTF), Calendar Years 2018-2022 (Oct. 30, 2024). 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 data from four years.

75 IRS, CDW, Business Master File (BMF) and Business Return Transaction File (BRTF) (Oct. 30, 2024).

76 IRS, CDW, IMF/BMF, IRTF/BRTF (Oct. 30, 2024). Penalty statistics associated with total assets/income stratification reflect data from the most common income tax returns, representing about 94 percent of businesses filing Forms 1120, 1120F, or 1065 and at least 77 percent of individuals filing Form 1040 for which the IRS assessed IIR penalties.

77 IRS, CDW, IMF (Oct. 28, 2024).

FIGURE 2.9.2, Average Assessment and Abatement Rates for Individual IRC § 6039F Penalties, CYs 2018-2021⁷⁸

Form 3529 Part IV	Average for CYs 2018-2021
Penalties Assessed	1,016
Dollars Assessed	\$229 mil
Abatements	688
Dollars Abated	\$181 mil
Abatement Percent by Number	68%
Abatement Percent by Dollars	79%

The automatic assessment of IIR penalties for late filed Parts I-III of Forms 3520 and 3520-A is also concerning. IRC § 6048 requires taxpayers to report information about certain reportable events of foreign trust, which they report on Forms 3520, Parts I-III, and 3520-A. IRC § 6677 imposes a penalty for failure to timely file these forms. When taxpayers delinquent file Forms 3520 and 3520-A, the IRS automatically assesses the IRC § 6677 penalty, generally assessing the maximum penalty amount.⁷⁹ Again, these penalties can be substantial.⁸⁰ To add insult to injury, while the IRS can waive the IRC § 6677 penalty if taxpayers show that they had reasonable cause⁸¹ for filing the returns late, the IRS does not consider any reasonable cause statements or other information provided by taxpayers prior to assessing the penalties, even when attached to the returns.⁸² After assessment, these taxpayers must either challenge the penalties with the IRS Independent Office of Appeals (Appeals) or pay the penalties in full and challenge them in court. Once taxpayers show reasonable cause, the IRS abates the penalty.

For foreign trust reporting penalties, the IRS abates a significant number of penalties it automatically assessed but should not have. As shown in Figure 2.9.3, over CYs 2018-2021, the IRS abated IRC § 6677 penalties assessed against individuals with respect to Forms 3520 and 3520-A, averaging almost \$225 million.⁸³ The abatement rate was 68 percent of the penalties assessed and 54 percent of the dollars assessed.

78 IRS, CDW, IMF (Oct. 28, 2024).

79 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.

80 The penalty for failing to file Form 3520, Parts I-III, is generally the greater of \$10,000 or 35 percent of the amount transferred to, or distributed from, the foreign trust. The IRS assesses additional penalties of \$10,000 each 30 days if the taxpayer fails to comply more than 90 days after the IRS mails a notice of failure to comply. The penalty for failing to file Form 3520-A is the greater of \$10,000 or five percent of the gross value of the foreign trust's assets held as of the end of the year. IRC § 6677.

81 IRC § 6677(d) provides that "[n]o penalty shall be imposed ... on any failure which is shown to be due to reasonable cause and not willful neglect."

82 See National Taxpayer Advocate 2023 Annual Report to Congress 101, 110-111 (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. See also Andrew Velarde, *Ex-Official Confirms IRS Ignores Some Reasonable Cause Statements*, TAX NOTES, Feb. 14, 2022, <https://www.taxnotes.com/taxpractice/penalties/ex-official-confirms-irs-ignores-some-reasonable-cause-statements/2022/02/14/7d5fm> (quoting a former IRS employee confirming "[t]he IRS is not analyzing reasonable cause when it is attached to a late filing. No IRS person at Ogden [Utah] reviews reasonable cause on the front end."); 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.

83 IRS, CDW, IMF (Oct. 28, 2024).

FIGURE 2.9.3, Average Assessment and Abatement Rates for Individual IRC § 6677 Penalties, CYs 2018-2021⁸⁴

Form 3520 Parts I-III and Form 3520-A	Average for CYs 2018-2021
Penalties Assessed	3,573
Dollars Assessed	\$415 mil
Abatements	2,416
Dollars Abated	\$225 mil
Abatement Percent by Number	68%
Abatement Percent by Dollars	54%

The significant abatement rates for IRC §§ 6039F and 6677 penalties relating to Forms 3520 and 3520-A illustrate how often the IRS erroneously assesses these penalties. The automatic assessment of the penalties causes undue hardship, burdens taxpayers, and creates unnecessary work for the IRS.

But there is good news for taxpayers with respect to some international penalties. After hearing concerns raised by the National Taxpayer Advocate and practitioners, the IRS is making favorable changes to the foreign gifts and inheritance filing penalties.⁸⁵ On October 24, 2024, IRS Commissioner Danny Werfel announced that the IRS has ended its practice of automatically assessing penalties at the time of late filing for reporting foreign gifts and bequests on Form 3520, Part IV.⁸⁶ Also, by the end of 2024, the IRS will begin reviewing any reasonable cause statements taxpayers attach to late filed Form 3520, Parts I-III, and Form 3520-A (*i.e.*, for the trust portion of the form) before assessing any IRC § 6677 penalty.⁸⁷ TAS has recommended these changes for years, and the IRS listened. These are favorable changes for taxpayers that will reduce unwarranted assessments and relieve burden by giving them the opportunity to explain their situation before the IRS assesses a penalty.

While the IRS is heading in the right direction on penalties related to Forms 3520 and 3520-A, it has not made changes in its administration of other IIR penalties. The IRS's automatic assessment of penalties when taxpayers willingly come forward and file their late returns, without any consideration of reasonable cause, is unfair to taxpayers, violates their *right to pay no more than the correct amount of tax*, and discourages compliance. When taxpayers know that voluntarily filing returns leads to the IRS automatically assessing crushing penalties that may be impossible to challenge and may even bankrupt them, how many of them will decide not to file and simply hope the IRS does not find them? The IRS needs to stop its automatic assessment of penalties prior to considering the taxpayer's specific facts and circumstances and provide taxpayers their rights to a conference with Appeals. Additionally, the IRS should develop procedures to review reasonable cause relief requests prior to assessment, including exploring an option to check a box on the return if the taxpayer attached a reasonable cause statement.

Not only does the IRS automatically assess IIR penalties without reviewing reasonable cause, it often erroneously classifies these penalties as assessable. Therefore, taxpayers must first pay the penalties in full and then incur the costs of filing suit in a U.S. district court or the Court of Federal Claims to recover the payments.⁸⁸ Full payment many times is impossible as some of these penalties are huge and have no bearing on the underlying tax liabilities. This deprives taxpayers of preassessment review in the U.S. Tax Court and

⁸⁴ IRS, CDW, IMF (Oct. 28, 2024).

⁸⁵ See Erin M. Collins, IRS Hears Concerns From TAS and Practitioners, Makes Favorable Changes to Foreign Gifts and Inheritance Filing Penalties, NATIONAL TAXPAYER ADVOCATE BLOG (Oct. 24, 2024), <https://www.taxpayeradvocate.irs.gov/news/nta-blog/irs-hears-concerns-from-tas-and-practitioners-makes-favorable-changes-to-foreign-gifts-and-inheritance-filing-penalties/2024/10>.

⁸⁶ See *id.*

⁸⁷ See *id.*

⁸⁸ See IRC § 7422 for requirements relating to refund suits.

impairs the taxpayer *right to challenge the IRS's position and be heard*.⁸⁹ As Title 26, Subtitle F, Chapter 61, Subchapter A, Part III penalties are not subject to deficiency procedures the IRS has taken the position that these penalties are assessable. The IRS's assessment of these penalties rests on a questionable legal foundation.⁹⁰ The National Taxpayer Advocate's position, consistent with the U.S. Tax Court's holding in *Farhy v. Commissioner*, *Mukhi v. Commissioner*, and *Mukhi v. Commissioner* ("*Mukhi II*"), 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.⁹¹

Although the U.S. Court of Appeals for the D.C. Circuit reversed the Tax Court's decision in *Farhy* and held that the penalties are assessable,⁹² the Tax Court is only required to follow that decision in cases appealable to the D.C. Circuit.⁹³ In a case appealable to the U.S. Court of Appeals for the Eighth Circuit, the Tax Court, in a full court opinion, reaffirmed its position that the IRS lacks authority to assess the IRC § 6038(b)(1) penalties, which could result in a split opinion between the circuits.⁹⁴ In the meantime, it appears, the IRS is not changing its litigation position leaving taxpayers in a quandary on how to proceed while the IRS continues to assess these penalties.

Putting aside the litigation, 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. To protect taxpayer rights, the National Taxpayer Advocate recommends Congress clarify that the IRS cannot assess these penalties before it issues a notice giving taxpayers the right to a prepayment judicial review in the U.S. Tax Court.⁹⁵ This would help ensure that the IRS only imposes penalties where appropriate rather than automatically applying them in every situation.

The IRS's Penalty Culture Harms Taxpayers

According to practitioners, the current IRS culture that penalties automatically apply is pervasive even in examinations.⁹⁶ They report that in the majority of cases, IRS examiners propose and IRS managers approve penalties at the end of the examination, and to get fair consideration of the penalties, taxpayers need to request a hearing with Appeals.⁹⁷ They note that IRS Revenue Agents appear to have less discretion and seem to act in accordance with a policy that penalties should apply by default.⁹⁸ This assertion is borne out in data regarding accuracy-related penalties proposed by Examination. From CYs 2018 to 2022, there were 6,432 cases in which the IRS recommended the IRC § 6662 accuracy-related penalty at examination and the taxpayers appealed. Of these, the IRS ultimately did not assess 50.6 percent, and of those assessed, it abated 10.6 percent.⁹⁹ While the numbers include only accuracy-related penalties, a reversal or abatement rate of over

89 See TBOR, <https://www.taxpayeradvocate.irs.gov/taxpayer-rights> (last visited Nov. 15, 2024). The rights contained in TBOR are also codified in IRC § 7803(a)(3).

90 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.

91 See *Farhy v. Comm'r*, 160 T.C. 399 (2023), *rev'd and remanded*, 100 F.4th 223 (D.C. Cir. 2024); *Mukhi v. Comm'r*, 162 T.C. No. 8 (Apr. 8, 2024), *adhered to on recons.*, 163 T.C. No. 8 (Nov. 18, 2024); *Mukhi v. Comm'r* ("*Mukhi II*"), 163 T.C. No. 8 (Nov. 18, 2024), *adhering to on recons.*, 162 T.C. No. 8 (Apr. 8, 2024).

92 *Farhy*, 100 F.4th at 236 (D.C. Cir. 2024).

93 See *Golsen v. Comm'r*, 54 T.C. 742 (1970); *Mukhi v. Comm'r* ("*Mukhi II*"), 163 T.C. No. 8 (Nov. 18, 2024), *adhering to on recons.*, 162 T.C. No. 8 (Apr. 8, 2024).

94 *Mukhi v. Comm'r* ("*Mukhi II*"), 163 T.C. No. 8 (Nov. 18, 2024), *adhering to on recons.*, 162 T.C. No. 8 (Apr. 8, 2024). See also orders in *Safdieh v. Comm'r*, Docket No. 11680-20L (T.C. Dec. 5, 2024) and *Cauchon v. Comm'r*, Docket No. 23863-22L (T.C. Dec. 5, 2024).

95 See National Taxpayer Advocate 2025 Purple Book, *Compilation of Legislative Recommendations to Strengthen Taxpayer Rights and Improve Tax Administration (Provide That Assessable Penalties Are Subject to Deficiency Procedures)*.

96 Conversations with outside stakeholders (Aug. 5, 8, 21, 22, and 28, 2024).

97 *Id.*

98 Conversations with outside stakeholders (Aug. 21, 22, and 28, 2024).

99 IRS, CDW, Examination Operational Automation Database and IMF Transaction History (Oct. 28, 2024).

50 percent suggests that the IRS is often applying unwarranted penalties. For taxpayers, having to challenge penalties at the Appeals level is stressful, time-consuming, and expensive, and it is inefficient for the IRS and a drain on its resources.

If taxpayers do not challenge the penalties, however, the IRS assesses them. Once assessed, taxpayers are left with no option but to get the IRS to abate an assessment, which is much more difficult and expensive than challenging penalties on the front end.¹⁰⁰ If the taxpayer is successful in convincing the IRS to abate the penalty, it leaves taxpayers wondering why the IRS assessed it in the first place.¹⁰¹ This culture is unfair to taxpayers and can detrimentally impact the perception of fairness and proportionality, which does little to promote compliance. Taxpayers must expend significant resources either challenging the penalties in Appeals or in court. To challenge them judicially, they will need to pay many of these penalties first and then file suit in a district court or the Court of Claims. This is especially unfair to lower-income taxpayers or small businesses who either are unrepresented or where it just does not make economic sense to hire an attorney to challenge the penalties in a district court or the Court of Claims.

The IRS needs to change its penalty policy and culture from the top down, according to external stakeholders, and the National Taxpayer Advocate is in full agreement.¹⁰² To do this, the IRS should return to the policy that penalties exist *only* for encouraging compliance and give meaning to the provisions that allow taxpayers a reasonable opportunity to provide evidence that the penalty should not apply by giving “full and fair consideration to evidence in favor of not imposing the penalty.”¹⁰³

CONCLUSION AND RECOMMENDATIONS

Penalties are a necessary component of tax compliance. While penalties themselves are statutory and any underlying penalty reform lies with Congress, the administration of those penalties lies entirely with the IRS. It is therefore essential that the IRS’s administration of penalties be fair, comprehensive, and consistently applied to all taxpayers.

To encourage compliance, the IRS should show that the tax system is fair through its penalty administration. It should be beyond reproach when it comes to following the law. How can taxpayers see the system as fair if the IRS penalizes them for failing to follow the law while not strictly following the law itself? Further, how can taxpayers feel it is fair when the IRS assesses penalties against them automatically without even considering their facts and circumstances in defense of the penalty? The IRS needs to change its current culture of assuming penalties apply unless taxpayers prove otherwise. It needs to stop its “assess first, ask questions later” approach by stopping the automatic assessment of penalties prior to considering taxpayers’ defenses. This is unfair and erodes taxpayers’ confidence in the federal tax system, which arguably affects compliance. Finally, the IRS needs to refocus its policy on administering penalties in a manner *solely* for the purpose of encouraging compliance.

100 The IRS has some penalty relief programs, including first-time abatement (FTA). IRS, Administrative Penalty Relief, <https://www.irs.gov/payments/penalty-relief-due-to-first-time-abate-or-other-administrative-waiver> (last updated Dec. 17, 2024). FTA is an administrative program under which the IRS will abate certain penalties if a taxpayer shows they did not have to file a return, or if required to file, had no penalties assessed against them in the prior three years (or the IRS removed any penalty for an acceptable reason other than FTA, for example, due to reasonable cause); have timely filed all required returns (or filed a valid extension); and have paid or have a valid payment plan to pay all taxes due for years other than the year for which the taxpayer requests relief. However, FTA applies only to certain penalties (failure-to-file, failure-to-pay, failure-to-deposit). The IRS should extend this program to include other penalties including estimated tax penalties under IRC §§ 6654 and 6655 and penalties the IRS automatically calculated through electronic means.

101 “In the application of penalties, the IRS should make a correct substantive decision in the first instance rather than mechanically assert penalties with the idea that they will be corrected later.” H.R. REP. NO. 101-386, at 661 (1989) (Conf. Rep.).

102 Conversations with outside stakeholders (Aug. 21, 22, and 28, 2024). Relatedly, the IRS Advisory Council in its 2024 report recommends the IRS take several actions to improve penalty administration, including that the IRS increase transparency by publishing more specific details in the IRS Data Book about assessment and abatement of penalties that are commonly asserted or are an IRS enforcement priority, among others, and that the IRS create a Director of Civil Penalties position whose duties include commissioning an advisory task force to study ways to make IRS policies and procedures regarding penalties more consistent. See IRS, Pub. 5316, Internal Revenue Service Advisory Council Public Report 177-78 (Nov. 2024), <https://www.irs.gov/pub/irs-pdf/p5316.pdf>.

103 IRM 1.2.1.12.1(9), Policy Statement 20-1 (Formerly P-1-18), Penalties Are Used to Enhance Voluntary Compliance (June 29, 2004), https://www.irs.gov/irm/part1/irm_01-002-001.

It has been 35 years since the last comprehensive overhaul of federal tax penalties. Congress has enacted more penalties and amendments to penalties, and the IRS has implemented regulations interpreting the penalties. Some regulations, like the ones proposed regarding supervisory approval of penalties, aim to decrease statutory protections for taxpayers that Congress intended. Despite the studies, collaboration, and work that resulted in the 1989 penalty reform in IMPACT, subsequent civil penalty legislation and administration of the penalties by the IRS has veered from the policies and principles outlined by the studies. The focus of the federal civil tax penalty regime has shifted away from utilizing civil penalties only to enhance compliance. The National Taxpayer Advocate believes it is time to reconsider the existing penalty regime and develop better information concerning the administration and impact of penalties to effectively promote compliance.

Administrative Recommendations to the IRS

The National Taxpayer Advocate recommends that the IRS:

1. Create a task force consisting of IRS, other Treasury Department personnel, and stakeholders to study the current tax penalties regime and make administrative and legislative recommendations to ensure penalties are applied more fairly and consistently for the purpose of improving tax compliance.
2. Consider establishing civil voluntary disclosure programs to encourage voluntary and future compliance for emerging issues such as digital assets.
3. Conduct a thorough review of all penalty notices issued to taxpayers to determine whether they comply with IRC § 6751(a) and develop procedures to ensure that all penalty notices comply with IRC § 6751(a) along with remedial procedures for those that do not.
4. Stop the automatic assessment of all IIR penalties prior to considering the taxpayer's specific facts and circumstances, including providing taxpayers their appeal rights with Appeals.
5. Update the IRM to require review of any reasonable cause relief requests before assessing penalties including exploring an option to check a box on the return if the taxpayer attaches a reasonable cause statement.
6. Extend eligibility for first-time abatement administrative relief to estimated tax penalties under IRC §§ 6654 and 6655 and to any other penalties automatically assessed through electronic means.

Legislative Recommendations to Congress

The National Taxpayer Advocate recommends that Congress:

1. Amend IRC § 6751(b)(1) to clarify that no penalty under Title 26 shall be assessed or entered in a final judicial decision unless the penalty is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate, prior to the first time the IRS sends a written communication to the taxpayer proposing the penalty as an adjustment.
2. Amend IRC § 6751(b)(2)(B) to clarify that the exception for "other penalties automatically calculated through electronic means" does not apply to the penalty for negligence or disregard of rules of regulations under IRC § 6662(b)(1).
3. 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.

RESPONSIBLE OFFICIALS

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

Holly Paz, Commissioner, Large Business and International Division

Heather Maloy, Chief Tax Compliance Officer