Overview of the Penalty Reform Proposals

On April 21, 2009, the Section of Taxation of the American Bar Association distributed a Statement of Policy Favoring Reform of Federal Civil Tax Penalties. The general and specific recommendations we make below are guided by that Statement of Policy, which we have attached as an exhibit to this paper.

The Statement of Policy followed a study by the Civil Penalty Task Force of the Section that was presented to Congress in 1988 (“1988 Section Report”), and also drew upon the February 1989 report prepared by the task force created by the Commissioner of the Internal Revenue Service to study civil tax penalties (“1989 Task Force Report”). We applaud Congress for adopting many of the recommendations contained in the 1988 Section Report and the 1989 Task Force Report when it last reformed the civil tax penalty provisions in 1989 with the enactment of the Improved Penalty Administration and Compliance Tax Act (“IMPACT”).

In the two years leading up to IMPACT, both the House and Senate held hearings on penalty reform that revealed much discontent with the penalty system among taxpayers, tax practitioners, and the Service. Congress recognized that the “hodgepodge” of civil and criminal tax penalties had been added to the Internal Revenue Code (the “Code”)\(^1\) in “piecemeal” fashion, resulting in penalties that were “too complex to administer, too complex to understand, too numerous, and too harsh.”\(^2\) The Code’s collection at the time of more than one-hundred fifty civil penalties reflected a “morass of inconsistency and irrationality that often discourage[d], rather than encourage[d], compliance.”\(^3\) Through IMPACT Congress greatly simplified and harmonized the then-existing penalty provisions, making them more administrable and fair. The Section believes that we have come full circle. The Code once again contains a hodgepodge of approximately one-hundred fifty civil tax penalties that have been added in piecemeal fashion without any obvious design for coherent application. We therefore agree that the time is right for reform.

The Statement of Policy reiterated six guiding principles for the revision of civil tax penalty provisions:

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\(^1\) References herein to statutory “section(s)” or “subsection(s)” are with regard to the Internal Revenue Code of 1986, as amended, unless delineated otherwise.


Penalties are appropriate elements of an overall administrative effort to achieve voluntary compliance.

To be effective in achieving voluntary compliance, the penalty provisions must be understandable and consistent. This requires that the penalties be relatively simple and logical.

The total penalty imposition should be perceived to be fair and reasonable in relation to the particular misconduct.

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.

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.

Penalties should not be imposed to punish conduct which is proper, reasonable, appropriate, or not clearly prohibited.

The Statement of Policy, the 1988 Section Report, and the 1989 Task Force Report all explain why each of the six guiding principles is important to tax administration. We will not reiterate that explanation here. We continue to believe that penalty reform should be guided by these six principles.

The Statement of Policy also made eleven recommendations for reviewing the federal civil tax penalty regime:

1. Clearly define behavior to be penalized.
2. Ensure penalties are consistent.
3. Promote fairness by imposing penalties in proportion to misconduct and by penalizing a single act only once.
4. Retain the reasonable cause and good faith defense for all penalties.
5. Enhance compliance through greater disclosure and more enforcement rather than relying on the chilling effect of vague, overly broad, and confusing penalties.
6. Do not enact penalties merely to punish.
7. Do not use penalties for raising revenue or offsetting the costs of tax benefits.
8. Issue clear and detailed guidance on interpretation of penalties and their enforcement.
9. Do not penalize foot faults where substantial compliance is shown.
10. Increase transparency in administration of penalties.
11. Streamline procedures for resolving penalties imposed in partnership situations.

The Section continues to believe that the eleven recommendations made in the Statement of Policy are appropriate.
In addition to the recommendations made in the Statement of Policy, we make the following additional general recommendations and observations:

(1) Reform of the civil tax penalty regime should be coordinated with changes to the criminal tax provisions in the Code, applicable to the most egregious violators.
(2) Penalty reform should also take into consideration other tax compliance-related provisions, including the foreign bank account reporting and penalty regime under Title 31 and the rules relating to practice before the Treasury Department set forth in Circular 230.
(3) A penalty regime can only be effective if it is paired with a commitment to robust and long-term funding of the IRS to enforce both the substantive provisions of the tax law and the penalty rules.
(4) We believe that complexity in the substantive tax law is a (if not the) dominant factor in noncompliance, creating traps for the uninformed and providing cover for those who purposefully seek to avoid their obligations under the tax law. A penalty regime, no matter how well designed, cannot compensate for the compliance problems created by complexity in the underlying tax law.
(5) A comprehensive evaluation of the relationship between penalty rules and compliance should be conducted, including Congressional hearings on the issue.
(6) Penalties linked to targeted types of transactions (e.g., “listed,” “reportable,” “noneconomic substance” or transfer pricing transactions) should be generally avoided since these categories become quickly outdated and the added complexity that these rules add to the tax law outweighs any incremental benefit in compliance.

We also make the following specific recommendations, which we list here in an executive summary. Each of these specific recommendations is explained and described in more detail in the body of this paper:

**Accuracy Related Penalties**

- The penalty provisions should be rewritten to encourage taxpayers to disclose their transactions to the Service, by exempting from penalties most transactions that are disclosed in a manner of the Secretary’s choosing, if the tax position has a reasonable basis in the law. We also recommend that the maximum penalty under section 6662 be set at 20 percent for any transaction that is disclosed.
- The Code should be revised to allow taxpayers to assert a reasonable cause and good faith defense with respect to all accuracy-related penalties.
- Congress should repeal the “disqualified adviser” provisions in section 6664(d) that require taxpayers to obtain “second opinions” with respect to certain transactions.
- Congress should clarify the codified economic substance doctrine.
- Congress should make clear that the valuation misstatement penalties are intended to deter taxpayers from taking aggressive positions on factual questions of value.

**Burden of Proof with Respect to Penalties Under Chapter 68**

- The government should have the burden of proof with respect to the applicability of non-assessable penalties asserted against individual taxpayers when the taxpayers have been cooperative in the audit.
Statute of Limitations for Penalty Assessment

- Congress should enact a catch-all six-year statute of limitations for the assessment of those civil penalties not otherwise subject to a more specific statute of limitations.

International Disclosure Penalties

- Congress should provide a statutory proportionality defense to the application of the FBAR penalty
- Congress should revise the reasonable cause defense to international disclosure penalties to provide that, in assessing the reasonable cause and good faith of a taxpayer who makes an incomplete disclosure, the efforts made by the taxpayer to obtain complete information should be taken into account.
- Congress should limit the total amount of civil penalties for failures to disclose to 50 percent of the undisclosed foreign asset.
- Congress should provide taxpayers with an opportunity for pre-assessment judicial review of information return penalties regarding foreign assets and transactions

ACCURACY-RELATED PENALTIES

Overview:

The Internal Revenue Code contains several provisions that penalize taxpayers for inaccurate returns, that is, for the filing of a return, and the payment of the tax thereon, which shows an amount of tax due that is less than the amount of tax that is required to be shown on the return. These penalties are contained in sections 6662, 6662A, 6663 and 6664 of the Code. A related provision, section 6676, imposes a penalty on erroneous refund claims, that is, making a claim for refund or credit which exceeds the amount allowable as a refund or credit under the Code. These provisions penalize failures to maintain certain standards of conduct in the filing of returns and refund claims. While efforts have been made to standardize the application of these penalties in order to establish clear standards of conduct, specific provisions have been added to address particular abuses, leading to increased complexity and some confusion as to appropriate taxpayer behavior.

Description of Current Accuracy-Related Penalties:

Negligence (section 6662(c)). The basic standard for all returns is contained in the negligence “prong” of the accuracy-related penalty, defined in section 6662(c). A taxpayer is to make a reasonable attempt to comply with the provisions of the Code, including not carelessly, recklessly or intentionally disregarding rules and regulations. Under Treas. Reg. § 1.6662-3, a taxpayer has made a reasonable attempt as long as there is a “reasonable basis” for the position

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4 We have excluded the penalties for substantial overstatement of pension liabilities and substantial estate of gift tax valuation understatement, found in sections 6662(f) and (g), because we have not made any specific recommendation regarding those penalties.
he takes on his return. The “reasonable basis” standard is a relatively high standard of reporting, that is, significantly higher than not frivolous or not patently improper.\footnote{Treas. Reg § 1.6662-3(b)(3).}

\textit{Substantial Understatement (section 6662(d)).} A “substantial understatement” is an understatement which exceeds the greater of ten percent of the tax required to be shown on the return or $5,000. For a corporation that is not an S corporation or a personal holding company, the $5,000 floor is increased to $10,000, but any understatement in excess of $10,000,000 is considered a substantial understatement.\footnote{Section 6662(d)(1).} The amount of the understatement is reduced, however, by any portion that is attributable to (a) the tax treatment of an item if there is or was “substantial authority” for such treatment, or (b) any item if the relevant facts affecting the item’s tax treatment are adequately disclosed in the return and the taxpayer had a reasonable basis for such treatment.\footnote{Section 6662(d)(2)(B).} To be “adequate”, disclosure must be made using Form 8275 or Form 8275R.\footnote{Adequate disclosure of facts is not sufficient for a corporation with respect to any item attributable to a multiple-party financing transaction if the corporation’s tax treatment of the item does not clearly reflect income.} Thus, the taxpayer must either have “substantial authority” for the tax treatment, a level of authority that is higher than reasonable basis but lower than “more likely than not,” or a reasonable basis for the position if the relevant facts are adequately disclosed.

The reduction for positions that have substantial authority or that are disclosed and have a reasonable basis do not apply to any item attributable to a “tax shelter.” For this purpose, a “tax shelter” is a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a “significant purpose” of the partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.\footnote{Section 6662(d)(2)(C).} Thus, as a general matter, if a “significant purpose” of a substantial item on a taxpayer’s tax return is “the avoidance or evasion of Federal income tax,” there is no level of authority for a tax position to prevent the application of the penalty. A “significant purpose” of the avoidance or evasion of Federal income tax is not defined in section 6662 or the regulations thereunder.

\textit{Valuation Misstatements (section 6662(e), (h)).} The substantial valuation misstatement prong of the accuracy-related penalty applies to any underpayment “attributable to” any substantial valuation misstatement under chapter 1 of the Code. A “substantial valuation misstatement under chapter 1” is defined to exist when the value of any property, or the adjusted basis of any property, claimed on any return of tax imposed by chapter 1 is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis, as the case may be.\footnote{Section 6662(e)(1)(A).} No penalty is imposed unless the portion of the underpayment for the taxable year attributable to substantial valuation misstatements exceeds $5,000, or $10,000 in the case of a corporation other than an S corporation or a personal holding company.\footnote{Section 6662(e)(2).} The penalty cannot
be “stacked” with penalties under the other prongs of the accuracy-related penalty under section 6662, nor with the penalties under sections 6662A or 6663.

A substantial valuation misstatement can also be a “gross valuation misstatement,” if the value of any property, or the adjusted basis of any property, claimed on the return is 200 percent or more of the amount determined to be the correct amount of such value or adjusted basis. If there is an underpayment attributable to a gross valuation misstatement, the accuracy-related penalty is 40 percent of the underpayment. Again, this penalty cannot be “stacked” with other penalties under section 6662, 6662A or 6663.

Economic Substance (section 6662(b)(6) and (i)). If any tax benefits are disallowed by reason of a transaction lacking economic substance, or failing to meet the requirements of any similar rule or law, there is a separate prong of the 20 percent accuracy related penalty applied to the underpayment attributable to such disallowance. This penalty is increased to 40 percent if the relevant facts affecting the tax treatment of the item are not adequately disclosed in the return or a statement attached to the return.

Undisclosed Foreign Financial Asset Understatement (section 6662(j)). The portion of any understatement that is attributable to any transaction involving an “undisclosed foreign financial asset” is subject to a penalty without regard to the merit of the position. That is, a taxpayer must disclose the foreign financial asset by providing the information required by section 6038, 6038B, 6038D, 6046A or 6048. These sections variously require the filing of Forms 3520, 3520-A, 5471, 926, 8865 and the as-yet-to-be-issued Form 8938. Failure to disclose invokes the application of the penalty to any understatement attributable to the undisclosed transaction, without regard to the size of the understatement or the merit of the position. Further, the penalty rate is increased from 20 percent to 40 percent.

Reportable Transaction Understatements (section 6662A). There is a separate 20 percent penalty on “reportable transaction understatements,” which arise from items attributable to a listed transaction or to a reportable transaction (other than a listed transaction) if a significant purpose of such reportable transaction is the avoidance or evasion of Federal income tax. A reportable transaction understatement is the product of the highest tax rate under section 1 or section 11 (whichever the taxpayer is subject to) and the increase in taxable income resulting from the difference between the proper treatment of the item and the taxpayer’s treatment of the item, plus the decrease in credits resulting from the difference between the taxpayer’s treatment of the item and the proper treatment of the item. Reductions in the excess of deductions allowed over gross income and reductions in capital losses which would (without regard to the limitations of section 1211) be allowed are treated as increases in taxable income. Thus, the reportable

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12 Section 6662(h)(2)(A)(i).
13 Section 6662(h)(1).
14 Section 6662(i)(1).
15 Section 6662(j).
16 Section 6662A(b)(2).
17 Section 6662A(b)(1).
A transaction understatement penalty can be imposed for a year in which there is no underpayment of tax. There is no lower limit on the size of the reportable transaction understatement penalty, and there is no level of authority (such as having a reasonable basis or substantial authority for a reporting position) that prevent the application of the penalty. Further, if the taxpayer fails to adequately disclose the relevant facts affecting the tax treatment of the item by using Form 8886, the amount of the penalty is increased from 20 percent of the reportable transaction understatement to 30 percent.18

**Erroneous Claim for Refund (section 6676).**

Section 6676 imposes a 20 percent penalty on claims for refund that do not have a reasonable basis in the tax law. For this purpose, transactions lacking economic substance under section 6662(b)(6) shall not be treated as having a reasonable basis.

**Reasonable Cause and Good Faith (section 6664(c)).**

Section 6664(c)(1) provides an exception to the imposition of the accuracy-related penalty if the taxpayer establishes that there was reasonable cause for, and the taxpayer acted in good faith with respect to, the underpayment.19 The determination of whether the taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account the pertinent facts and circumstances.20 Generally, the most important factor is the extent of the taxpayer’s effort to assess the proper tax liability for such year.

The reasonable cause and good faith exception to penalties contains an exception if the underpayment is attributable to a substantial valuation overstatement with respect to charitable deduction property. In that case, the claimed value of the property must be based on a qualified appraisal made by a qualified appraiser, and the taxpayer must have made a good faith investigation of the value of the property. If the underpayment is attributable to a gross (as opposed to substantial) valuation overstatement with respect to charitable deduction property, there is no reasonable cause and good faith defense to the application of the penalty.21

The reasonable cause and good faith defense does not apply to any “disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o) or failing to meet the requirements of any similar rule of law.”22

It is not clear whether the reasonable cause and good faith standard applies to erroneous claims for refund.

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18 Section 6662A(c).
19 Treas. Reg. § 1.6664-4(a).
20 Treas. Reg. § 1.6664-4(b)(1).
21 Section 6664(c)(3) and (4).
22 Section 6664(c)(2); section 6662(b)(6).
Reasonable Cause and Good Faith for Reportable Transaction Understatements (section 6664(d)).

In order to show reasonable cause and good faith for a reportable transaction understatement under section 6662A: (1) the taxpayer must, in addition to the facts and circumstances ordinarily required, have adequately disclosed the relevant facts affecting the tax treatment of the item in accordance with the regulations under section 6011 (using Form 8886), (2) there must be or have been substantial authority for the taxpayer’s treatment and (3) the taxpayer must have reasonably believed that the tax treatment was more likely than not the proper treatment.23

In determining “reasonable belief,” taxpayers cannot rely on “disqualified tax advisors” to provide advice. A “disqualified tax advisor” is defined as a person who meets any of the following criteria:

(1) who is a material advisor who participated in the organization, management, promotion or sale of the transaction, or is related (within the meaning of § 267 or § 707(b)(1)) to any person who participates;

(2) who is compensated by a material advisor with respect to the transaction;

(3) who has a fee arrangement contingent on all or part of the tax benefits from the transaction being sustained; or

(4) who, pursuant to regulations promulgated by the Secretary, has a “disqualifying financial interest” with respect to the transaction.24

A person is a “material advisor” under section 6111 if he earns more than $50,000 in fees with respect to a reportable transaction in which substantially all of the tax benefits are reported by natural persons (or $250,000 in fees when some portion of the tax benefits are reported by other than natural persons).25

Penalty levels:

The accuracy-related penalty was initially set at 20 percent of the portion of the underpayment attributable to one or more of the section 6662 penalties, except in the case of a “gross valuation misstatement,” in which case the penalty was 40 percent of the portion of the underpayment attributable to the gross valuation understatement.26 The fraud penalty is 75 percent of the portion of the underpayment attributable to fraud.27 “Underpayment” was

23 Section 6664(d)(3).
24 Section 6664(d)(4)(B)(ii).
25 Section 6111(b)(1)(B).
26 Section 6662(a) and (h).
27 Section 6663(a).
uniformly defined as the amount by which the tax imposed exceeds the excess of (1) the sum of the amount shown as the tax by the taxpayer on his return, plus any amounts not shown on the return but previously assessed or collected without assessment, over (2) the amount of “rebates”. The term “rebate” means so much of an abatement, credit, refund or other repayment as was made on the ground that the tax imposed was less than the amount described in (1) above, less any rebates previously made.28

In 2004, new penalty levels were added with section 6662A. As noted above, the initial 20 percent penalty was not applied to the underpayment attributable to a reportable transaction understatement, but to the reportable transaction understatement itself. Because “reportable transaction understatement” is defined as an amount determined using the highest tax rate, and because that rate is applied to the difference between the proper taxable income and the reported taxable income, even if that difference is a reduction in net loss, the measurement of the section 6662A penalty is different from that of the section 6662 accuracy-related penalty. Further, for reportable transaction understatements with respect to which the taxpayer did not make the appropriate disclosure under the reportable transaction regulations, the penalty is increased to 30 percent.

As also noted above, tax legislation in 2010 added two additional penalties for which a penalty equal to 40 percent of the corresponding underpayment is imposed: a undisclosed noneconomic substance transaction and an undisclosed foreign financial asset understatement.

Recommendations:

1) The Penalty Provisions Should Encourage Full Disclosure

Congress has enacted many provisions over the past decade that encourage taxpayers to disclose certain tax positions in various manners that are intended to bring them to the full attention of the Service. We agree that sunshine is often the best disinfectant, and we believe that the penalty provisions should also be designed to encourage voluntary disclosure.

The current penalty provisions do not always encourage disclosure. For example, taxpayers can generally avoid the substantial understatement penalty by “adequately” disclosing transactions that have a reasonable basis for the reporting position. In order to adequately disclose the transaction, a taxpayer must complete Form 8275 or 8275R, which requires detailed factual information about the transaction. Yet, the reasonable basis/disclosure exception to the penalty does not apply to “tax shelters”, which is precisely the type of transaction that calls for disclosure.

Similarly, the recently enacted penalty for transactions that lack economic substance encourages disclosure on the one hand by increasing the penalty from 20 percent to 40 percent for transactions that are not disclosed, but on the other hand discourages disclosure by asserting a strict liability penalty.

28 Section 6664(a).
Given the appropriate emphasis by Congress and the Service over the past decade toward disclosure, we recommend that Congress: (1) delete section 6662(d)(2)(C) (the tax shelter carve out to the reasonable basis/disclosure provision) and (2) delete the exception in section 6662(d)(2)(B)(i) to the substantial understatement penalties for reporting positions that had substantial authority, thus leaving only adequate disclosure and a reasonable basis as a means to avoid the substantial understatement penalty (short of showing that the taxpayer acted reasonably and in good faith). Moreover, we recommend that the revised section 6662(d)(2) be made applicable to all penalties described in section 6662. Thus, none of the penalties included in section 6662 would apply to any understatement for which the taxpayer adequately discloses the relevant facts in the manner prescribed by the Secretary (now on Form 8275 or Form 8275R) provided there is a reasonable basis for the reporting position. We believe that this change would greatly simplify the accuracy-related penalties, making them more understandable and easier to administer, would encourage taxpayers to disclose transactions in a manner of the Secretary’s choosing, and would result in fairer application of the penalties. We do not recommend that any corresponding change be made to section 6662A, which allows the Secretary to impose the 20-percent penalty on certain high-risk transactions even with disclosure regardless whether there is a reasonable basis in the law for such transactions. Section 6662A encourages disclosure by capping the penalty for these high-risk transactions at 20 percent if they are disclosed but increasing it to 30 percent if they are not.

We further recommend that the maximum penalty under section 6662 for any disclosed transaction be 20 percent, again with the intent of emphasizing disclosure. We note that this change would make section 6662 more consistent with section 6662A which imposes a penalty of 20 percent for disclosed transactions.

2) The Penalty Provisions Should Allow Taxpayers to Show That They Acted Reasonably and in Good Faith

The Section believes that civil tax penalties should apply only to negligent, reckless, or intentional conduct. The Section therefore strongly believes that all civil tax penalties should be subject to a reasonable cause and good faith defense and no penalty should be imposed without affording an opportunity to the taxpayer who may be sanctioned to defend his conduct. Fundamental fairness requires that taxpayers be permitted an opportunity to contest penalties, and to demonstrate why penalties are not appropriate in a particular situation. In some cases, precluding taxpayers from raising a reasonable cause defense may encourage taxpayers not to disclose their participation in certain transactions and to instead play the “audit lottery.”

We specifically recommend that:

a) Congress repeal section 6664(c)(2), which makes the reasonable cause defense inapplicable to the penalty imposed by section 6662(b)(6) for transactions lacking economic substance as defined in section 7701(o);

b) Enact a new section 6676(e) to provide that the penalty for erroneous claims for refund or credit will not apply if the taxpayer acted reasonably and in good faith. In particular, it has been unclear since this penalty was enacted whether taxpayers will be subject to the penalty for filing “protective refund claims.” Taxpayers often file such protective claims in cases
involving industry-wide issues prior to the expiration of the statute of limitations to preserve their interests should the issue be favorably decided by the courts. We believe that allowing taxpayers to assert a reasonable cause defense in such cases will provide for a fair resolution of these concerns.

c) Repeal section 6664(d)(3)(A), which requires disclosure in order for taxpayers to rely on the reasonable cause defense to a reportable transaction understatement. As noted above, we applaud the recent emphasis on disclosure. Yet, we view this provision which precludes taxpayers from raising a reasonable cause defense to be too harsh. For example, the taxpayer may have acted reasonably in failing to make the disclosure itself, and we believe that such a taxpayer should be given an opportunity to demonstrate why the penalty should not apply. To preclude taxpayers from showing they acted reasonably calls the fairness of our tax system into question.

d) Rewrite section 6664(c)(3) to allow taxpayers to raise a reasonable cause defense in cases of a gross valuation overstatement under chapter 1 with respect to charitable deduction property.

3) Taxpayers Should Not Be Required to Obtain Second Opinions to Show Reasonable Cause and Good Faith

The Section is concerned that the restriction in section 6664(d) against taxpayers relying on “disqualified tax advisers” is too burdensome on taxpayers and is not well-designed to achieve its purpose. It is common for taxpayers to pay their advisers fees in excess of the materiality thresholds for advice in connection with more complicated transactions. Obviously, it is with respect to these more complicated transactions that taxpayers are most in need of advice. Taxpayers often seek to rely on their long-time advisers who understand their business to assist them throughout the structuring of the transactions to ensure that they are appropriately completed. We do not agree with the policy in section 6664(d) that encourages taxpayers who have engaged in any transaction that could plausibly be a reportable transaction subject to section 6662A to retain a second adviser who was not materially involved in structuring the transaction, to provide advise on its tax consequences. We note that any transaction that creates a loss in excess of $10,000,000 for a corporation or $2,000,000 for an individual is a reportable transaction, thus disqualifying a tax advisor who has worked structuring the transaction. The application of these interrelated rules effectively requires taxpayers to seek second opinions at significant cost. It can also have a detrimental effect on the relationship between the taxpayer and his tax advisors. Moreover, we do not believe that taxpayers face any real impediment to obtaining a “second opinion” aside from cost. Thus, we believe that the provision offers little protection for the fisc and only burdens taxpayers to retain a second adviser at incremental cost.

Having special rules disqualifying advisors in cases involving reportable transactions is also unnecessary. Subsequent to the adoption of the “disqualified tax advisor” rules of section 6664(d), the courts have demonstrated that they are adept at determining when reliance on a tax professional is not warranted, without relying on the rules set out in section 6664(d).

29 Treas. Reg. § 1.6011-4(b)(5).
For example, in January 2011, the Tax Court released *106 Ltd v. Comm’r*, 136 T.C. No. 3, addressing when one can have good faith reliance on a tax professional. The *106 Ltd* opinion defined a “promoter” as “an advisor who participated in structuring the transaction or is otherwise related to, has an interest in, or profits from the transaction.” The Tax Court noted that some care must be given in applying this definition to some types of transactions (e.g., a tax lawyer is asked by a businessman on how to sell the family business through a tax favored stock sale might be said to have “participated in structuring the transaction”), but noted that “when the transaction involved is the same tax shelter offered to numerous parties, the definition is workable.”

As the courts have proven themselves up to the task of determining when reliance on a tax professional is unwarranted, we believe the special rule governing “disqualified tax advisors” should be repealed. In the alternative, the definition of “disqualified tax advisor” could be amended by adding the following sentence to the end of section 6664(d)(4)(B)(ii)(I): “If the transaction is a reportable transaction solely because of the size of any loss, deduction or credit arising out of the transaction, any person who is a material advisor solely by reason of providing tax advice with respect to the structuring of the transaction shall not be treated as a material advisor for purposes of this section.”

4) Congress Should Clarify the Codified Economic Substance Doctrine

No recent enactment of tax law has drawn as much criticism from taxpayers and the tax practitioner community as section 7701(o), the codified economic substance doctrine. It is unclear when the codified doctrine applies because it is triggered – circularly – when the doctrine is “relevant.” The statute does not offer any definition of “relevant” or any principle to determine when the doctrine is “relevant.” Nor does the statute define the “transaction” to which the new doctrine is to be applied. Moreover, if one assumes that the new doctrine applies, the “test” to be applied is vague because many key terms also are undefined. For example, the statute does not explain what is meant by a “meaningful” change in economic position, “a substantial purpose (apart from Federal income tax effects)”, or how large must the “present value of the reasonably expected pre-tax profit” be in order to be “substantial in relation to the present value of the expected net tax benefits.” We note that the Commissioner, Large Business and International Division, has issued two directives limiting the imposition of the economic substance penalty. First, the imposition of the penalty must be reviewed and approved by the appropriate Director of Field Operations. LMSB-20-0910-024 (September 14, 2010). Second, it will not rely on the doctrine and hence the penalty will not be imposed if any other judicial doctrine may support the adjustment. LB&I-4-0711-015 (July 15, 2011). We believe that these directives reflect the Service’s understanding that the codified doctrine is too vague to justify assertion of the penalty in most cases.

The codified doctrine is designed (since it imposes a strict liability penalty) to deter taxpayers from entering into tax avoidance transactions, rather than to insure the correct reporting of these transactions. The breadth (if not vagueness) of their definitions is part of their deterrent effect. However, the Section believes that the statute is so vague that it is having an *interrorem* effect on transactions that have not generally been considered abusive. Moreover, even for transactions that proceed, taxpayers are incurring unwarranted additional cost in their efforts to apply to the new statute.
As discussed above, the Section recommends that Congress amend the Code to allow taxpayers to avoid the section 6662(b)(6) penalty for transactions lacking economic substance if they can show that they acted reasonably and in good faith. That recommendation, if accepted, will go a long way to alleviating taxpayer concerns about the fairness of such a vague provision. We further recommend that Congress also clarify the key terms noted above to provide certainty. This is particularly true if Congress opts not to allow for a reasonable cause defense, as no taxpayer should be subject to a strict liability penalty for violating a standard that is vague and ambiguous in several respects.

5) The Valuation Misstatement Penalties Should be Clarified

Congress enacted the first penalty specifically applicable to valuation misstatements, section 6659, in 1981.\(^{30}\) The reason for the addition of the penalty was the proliferation of tax disputes involving property valuation, estimated to be 500,000 in number at the time of enactment. Congress understood that these disputes involved difficult questions of fact, which were often resolved by “splitting the difference.” The valuation overstatement penalty was enacted to discourage taxpayers from overstating the value of property, particularly where valuation issues are difficult and time consuming.\(^{31}\) In 1989, the valuation overstatement penalty, together with other valuation misstatement penalties, was included as part of the accuracy-related penalty of section 6662.

This penalty on a factual overstatement of the value of property owned by the taxpayer was soon extended to cases in which the benefits of the claimed value were denied because the taxpayer was determined not to own the property at all. \textit{Zirker v. Commissioner}, 87 T.C. 970 (1986); \textit{Massengill v. Commissioner}, 876 F.2d 616 (8th Cir.1989). The taxpayer was reasoned to have a basis of zero in property which he does not own; as a result, the basis for the property claimed on the return (any amount greater than zero) would be more than 150 percent of the “correct” basis.

The Second Circuit, in \textit{Gilman v. Commissioner}, 933 F.2d 143, 150-151 (2\textsuperscript{nd} Cir 1991), noted the problems with this analysis, pointing out that “these were not cases of taxpayers selecting an unduly high value; rather, the taxpayers were rebuffed in their claims that any purchase at all had occurred.” Despite the overvaluation in a case in which the taxpayer is determined not to own the property in question “arguably [being] different in kind, not merely degree,” the court went on to note that the application of the penalty “reenforces the Congressional objective of lessening tax shelter abuse.” The court also reasoned that Congress left the penalty unchanged when it reenacted the substantial valuation overstatement penalty in IMPACT after \textit{Zirker} and \textit{Massengill}, and so adopted the analysis of those decisions. As a result, the gross valuation overstatement penalty is now a standard tool in the Service’s attack on abusive tax avoidance transactions. \textit{See, e.g.}, \textit{New Phoenix Sunrise Corp. v. Commissioner}, 132 T.C. 161, 187-189 (2009); \textit{Palm Canyon X Investments, LLC v. Commissioner}, T.C. Memo. 2009-288.

\(^{30}\) Section 722(a) of the Economic Recovery Tax Act, Pub. L. 97-34.

The 40-percent penalty rate is to apply “to the extent that a portion of the underpayment … is attributable to one or more gross valuation misstatements.” Taxpayers have been successful in the Fifth and Ninth Circuit in arguing that an underpayment resulting from a total disallowance of a deduction or credit is not “attributable to” the valuation misstatement. Todd v. Commissioner, 862 F.2d 540 (5th Cir. 1988); Heasley v. Commissioner, 902 F.2d 380 (5th Cir. 1990); Gainer v. Commissioner, 893 F.2d 225 (9th Cir. 1990); Keller v. Commissioner, 556 F.3d 1056 (9th Cir. 2009). Other circuits have not agreed, and have held that, at least in cases where deductions are disallowed due to a lack of economic substance, the basis of the property giving rise to the deduction is zero, so that there is automatically a gross valuation overstatement and therefore a 40-percent penalty. Massengill and Gilman, supra; Illes v Commissioner, 982 F.2d 163 (6th Cir. 1992); Zfass v Commissioner, 118 F.3d 184 (4th Cir. 1997); Merino v Commissioner, 196 F.3d 147 (3rd Cir 1999).

While the use of the 40-percent gross valuation misstatement penalty undoubtedly has a deterrent effect on abusive tax avoidance transactions, its main effect may be distinguishing abusive transactions that rely on creating a carryover or substituted basis from abusive transactions that rely on other maneuvers, such as shifting partnership allocations, to create the desired tax benefits. In neither case is a misstatement of the objective value of property required. Creating income in one year and loss in the next, with the gain allocated to a tax indifferent party (as in ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir 1998)) is subject to a lesser penalty than increasing basis in excess of value by claiming a “short” option position is not a liability under section 752. The Section believes that the same level of accuracy-related penalty should apply equally to each, without regard to the legal mechanism used to generate the disallowed tax benefit. Further, there is now a 40-percent accuracy-related penalty for underpayments for undisclosed noneconomic substance transactions, which appears to be better tailored to the abuses to which the gross valuation misstatement penalty has been applied.

Because the gross valuation misstatement penalty is intended to discourage taxpayers from overvaluing property in situations where difficult valuation questions require substantial time and resources of the Service and the courts, the gross valuation misstatement penalty should only apply to the extent that there would be no understatement but for the valuation misstatement. Otherwise, the courts will be required to rule on the very questions regarding value to determine whether the penalty applies that the penalty was meant to alleviate the courts from having to decided. Thus, for example, in cases in which the taxpayer concedes an adjustment or deficiency on grounds independent of the valuation misstatement, the gross valuation misstatement penalty should not apply.

We therefore recommend that section 6662(e)(1)(A) be re-written as follows:

“There is a substantial valuation misstatement under chapter 1 if—

“(A) the value of any property claimed on any return of tax imposed by chapter 1 (including the value of any property used to determine the adjusted basis of such property or any other property on any such return) is 150 percent or more of the amount determined to be the correct amount of such valuation.”
To resolve the conflict in the circuit courts of appeals, we further recommend that section 6662(e) be amended to clarify that the portion of a tax underpayment that is attributable to a valuation misstatement be determined after taking into account any other proper adjustments to tax liability. Thus, the underpayment resulting from a valuation misstatement would be determined by comparing the taxpayer’s (1) actual tax liability (that is, the tax liability that results from a proper valuation and which takes into account any other proper adjustments) with (2) actual tax liability as reduced by taking into account the valuation misstatement. This clarification would adopt the Joint Committee on Taxation’s analysis in its General Explanation of the Economic Recovery Tax Act of 1981.

BURDEN OF PROOF WITH RESPECT TO PENALTIES UNDER CHAPTER 68

Prior to 1998, taxpayers generally had the “burden of proof” in civil tax cases not involving fraud. The term “burden of proof” refers to the obligation to prove a disputed matter by a preponderance of the evidence. In a hypothetical world where the taxpayer and the government produced exactly equal evidence at trial, the party with the burden of proof would lose.

In certain cases, Congress has specified that the IRS bears the burden of proof with respect to penalties. In this regard, section 7454 provides that the IRS has the burden of proof with respect to fraud, as well as certain penalties applicable to foundation managers which require “knowing” conduct on the part of the penalized individual. Also, section 6703(a) provides that the IRS has the burden of proof with respect to the penalties under sections 6700 (tax shelter promotion), 6701 (aiding and abetting understatement) and 6702 (frivolous submissions).

In 1998, as part of the Taxpayer Bill of Rights 3, Congress enacted section 7491, which shifts the burden of proof in certain types of cases. Section 7491(a) shifts the burden of proof to the IRS for any tax imposed by Subtitle A (income taxes) or Subtitle B (estate and gift taxes) where the taxpayer has produced credible evidence and cooperated with the IRS during the course of the audit.

Section 7491(c) provides the government shall have the “burden of production” in any court proceeding with respect to the liability of any individual for any penalty or addition to tax. The term “burden of production” refers to the obligation on a party to produce enough evidence on an issue in its case in chief (without considering any contrary evidence produced by the opposing party), for the matter to go to the finder of fact (jury or judge), as opposed to being decided by the judge on summary judgment or on a directed verdict. Section 7491 does not specify who has the burden of proof with respect to penalties.

In Higbee v. Comm’r, 116 T.C. 438, 446-447 (2001), the Tax Court held that, once the Commissioner meets his burden of production, the burden of proof regarding the applicability of the penalty is placed with the taxpayer, reasoning that most penalties are contained in Subtitle F, which is not subject to the burden of proof shifting provisions of section 7491(a). Taking a position contrary to Higbee, one Judge for the Court of Federal Claims has indicated that section 7491(a) places the burden of proof on the Commissioner in a case involving penalties.
arising in an income, estate or gift tax case.\textsuperscript{32} \textit{Allison v. United States}, 80 Fed. Cl. 568, 582 n.32 and associated text (2008).

This conflict should be resolved. As discussed in the introduction to this report, as a policy matter, we believe that penalties should generally be applied in cases where there is fault on the part of the taxpayer. Accordingly, the government should have the burden of proof with respect to the applicability of penalties asserted against individual taxpayers when the taxpayers have been cooperative in the audit.

We therefore recommend that Congress amend section 7491(a) to provide that, if the taxpayer “introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B (or penalties and additions to such tax under Chapter 68), the Secretary shall have the burden of proof with respect to such issue.” (Proposed addition to the statute in italics.)

\textbf{STATUTE OF LIMITATIONS FOR ASSESSABLE PENALTIES}

Statutes of limitations “protect interests in reliance and repose,” \textit{Am. Trucking Assoc., Inc. v. Smith}, 496 U.S. 167, 214 (1990), and guard “against stale demands,” \textit{Bell v. Morrison}, 26 U.S. (1 Pet.) 351, 360, 7 L. Ed. 174 (1828). As a practical matter, it can be very difficult for taxpayers to litigate a matter that is many years old: memories fade and fact witnesses die or disappear.

Section 6501(a), the general statute of limitations for assessments, provides that assessments must be made within three years after a return was filed. This three year statute also governs penalties that are based on errors on the return, such as the accuracy penalty set out in section 6662.\textsuperscript{33} Some penalties have their own specific statutes of limitations. \textit{See, e.g.}, section 6696(d) (providing a three year statute of limitations on assessments with respect to the return preparer penalties of sections 6694, 6695 and 6695A).

Certain penalties in the Internal Revenue Code do not relate to errors on tax returns and do not have their own specific statute of limitations. The IRS takes the position that there is no applicable statute of limitations governing these penalties, and they may be assessed at any time.

In cases where there is no Internal Revenue Code statute of limitations with respect to the assessment of penalties, some taxpayers have argued that the general federal five-year statute of limitations governing “proceedings for the enforcement” of all federal penalties in section 2642 is applicable. The courts in \textit{Mullikin v. United States}, 952 F.2d 920 (6th Cir. 1991), \textit{Lamb v.}

\textsuperscript{32} Section 6665(a)(2) provides that references to the term “tax” includes return-based penalties of sections 6651–6664. Thus, the “tax imposed by subtitle A” (or subtitle B) may be read to include penalties related to the tax imposed by Subtitle A (or subtitle B).

\textsuperscript{33} Once an assessment is made, the IRS has 10 years to administratively collect any assessment. Section 6502(a). If the tax cannot be collected in that period, the IRS can ask the Department of Justice to bring suit against the taxpayer, and can collect during the period that a judgment remains enforceable – usually 20 years after the judgment is entered.
United States, 977 F.2d 1296 (8th Cir. 1992), and United States v. Capozzi, 980 F.2d 872 (2d Cir. 1992), have ruled that the general federal “catchall” five-year statute of limitations for penalties was not applicable to tax penalties on the grounds that the act of the “assessment” of such penalties by the Internal Revenue Service was not part of “proceedings for the enforcement” of such penalties. However, the logic of these opinions was questioned by a spirited dissent in Mullikin, 952 F.2d at 933 n.1 (“It would seem quite odd to say that the very act that initiates the actions leading to the collection of the penalty, a stream of events that must at some point be a proceeding, is not itself part of the proceeding.”). Moreover, the logic of Mullikin, Lamb, and Capozzi was rejected in FEC v. Williams, 104 F.3d 237 (9th Cir. 1996) (“for purposes of [28 U.S.C.] § 2462 ‘enforcement’ comprises ‘assessment.’”) and 3M Company v. Browner, 17 F.3d 1453, 1458-60 (D.C. Cir. 1994). But see Hargrove & Constanzo v. Comm’r, 240 F.R.D. 652 (E.D. Cal. 2006) (purporting to harmonize 3M Company and Mullikin/Capozzi).

In some cases, there is substantial uncertainty as to whether certain penalties relate to a tax return and therefore whether the general statute of limitations applies. For example, in ILM 201047022, released on November 26, 2010, the IRS Chief Counsel’s Office took the position that the pre-American Jobs Creation Act (AJCA) version of the section 6707(a)(1) penalty for failing to register a tax shelter had no applicable statute of limitations, while the revised AJCA-version of that penalty is subject to a three year statute of limitations. The IRS’s rationale for the differing treatment is that the pre-AJCA statute governing the registration of tax shelters provided that “any tax shelter organizer shall register the tax shelter with the Secretary (in such form and in such manner as the Secretary shall prescribe)” and the post-AJCA version of the statute provides that the “material advisor” shall make “a return (in such form as the Secretary prescribes).” The information required to be submitted by the Secretary under both the pre- and post-AJCA version of the statute is virtually identical; the IRS’s differing treatment of the two statutes is based solely on the fact that the Code used the word “return” in the post-AJCA version of the statute, but not in the pre-AJCA version. Thus, the IRS reasoned that the post-AJCA version had a statute of limitations, but the pre-AJCA version did not.

Another example of this uncertainty can be found in the application of the statute of limitations to the new penalty under section 6676 for excessive claims for refund. The IRS takes the position that the new penalty applies to “informal claims” (claims which may not be made on a tax return) as well as formal claims made on an amended tax return. In an internal FAQ for IRS agents, the IRS has indicated that, while the statute is silent as to a statute of limitations, “best practice” is to assess the section 6676 penalty within three years of the date of the claim for refund. It leaves open the possibility that the IRS will chose to assess such penalty long after the three year period has elapsed.

Accordingly, we recommend that Congress enact a catch-all statute of limitations for the assessment of civil penalties not otherwise subject to a more specific statute of limitations. We recommend the adoption of a new six year statute of limitations for penalties not otherwise subject to a more specific statute of limitations:

New 6501(m) – Limitations on the Assessment of Penalties

The amount of any penalty not otherwise subject to a more specific limitation period with respect to assessment pursuant to this
section or any other provision of this title shall be assessed within six years of the conduct subject to penalty, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

INTERNATIONAL DISCLOSURE PENALTIES

Both the Internal Revenue Code (Title 26) and Title 31 contain penalties related to the failure to disclose information to the IRS and Treasury related to offshore assets and transactions. The penalties have taken on new importance with the IRS’s voluntary disclosure initiatives in 2009 and 2011 with respect to foreign accounts and the 2010 enactment of FATCA as part of the HIRE Act.

A. Background Regarding Penalties Related To Foreign Accounts and Assets.

1. FBAR penalties.

Background. A United States person who transfers assets to and holds interests in foreign bank accounts or foreign entities may be subject to self-reporting requirements under both Title 26 (the Internal Revenue Code) and Title 31 (the Bank Secrecy Act) of the United States Code. Under the law, Form TD F 90-22.1, “Report of Foreign Bank and Financial Accounts,” (the FBAR) must be filed by June 30th of the year following the year in which the $10,000 filing threshold is met.34

FBAR filing requirement. An FBAR must be filed if the following conditions are met: (i) the filer is a U.S. person with a financial account(s) in a foreign country; (ii) the filer has a financial interest in the account or signature authority over the account; and (iii) the aggregate amounts in all foreign accounts valued in dollars must exceed $10,000 at any time during the calendar year.35 A financial interest includes an account held by an entity where a U.S. person directly or indirectly owns more than 50 percent of the corporation or partnership, or has a beneficial interest in over 50 percent of the assets or income of a trust that owns a non-U.S. account.

Summary of Title 31 FBAR penalties. Table 1 is from the IRS Web site36 and highlights the civil and criminal tax penalties that may be asserted for not complying with the

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34 31 C.F.R. § 103.27(c). The $10,000 threshold is the aggregate value of all of foreign financial accounts in which a U.S. person has a financial interest over which the U.S. person has signature or other authority.

35 IRM Section 4.26.16.3.2(1)(A–D).

FBAR reporting and associated recordkeeping requirements.\textsuperscript{37} Under the penalty provisions found in 31 U.S.C § 5314(a)(5) it is possible to assert civil penalties for FBAR violations in amounts that exceed the balance in the foreign financial account.\textsuperscript{38}

<table>
<thead>
<tr>
<th>Violation</th>
<th>Civil Penalties</th>
<th>Criminal Penalties</th>
<th>Citation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Negligent Violation</td>
<td>Up to $500</td>
<td>N/A</td>
<td>31 U.S.C. § 5321(a)(6)(A) 31 C.F.R. 103.57(h)</td>
</tr>
<tr>
<td>Non-Willful Violation</td>
<td>Up to $10,000 for each negligent violation</td>
<td>N/A</td>
<td>31 U.S.C. § 5321(a)(5)(B)</td>
</tr>
<tr>
<td>Pattern of Negligent Activity</td>
<td>In addition to penalty under § 5321(a)(6)(A) with respect to any such violation, not more than $50,000</td>
<td>N/A</td>
<td>31 U.S.C.§ 5321(a)(6)(B)</td>
</tr>
<tr>
<td>Willful - Failure to File FBAR or retain records of account</td>
<td>Up to the greater of $100,000, or 50 percent of the amount in the account at the time of the violation up to $250,000 or 5 years, or both</td>
<td>31 U.S.C. § 5321(a)(5)(C) 31 U.S.C. § 5322(a) and 31 C.F.R. § 103.59(b) for criminal. The penalty applies to all U.S. persons.</td>
<td></td>
</tr>
<tr>
<td>Willful - Failure to File FBAR or retain records of account while violating certain other laws</td>
<td>Up to the greater of $100,000, or 50 percent of the amount in the account at the time of the violation up to $500,000 or 10 years, or both</td>
<td>31 U.S.C. § 5322(b) and 31 C.F.R. § 103.59(c) for criminal.</td>
<td></td>
</tr>
<tr>
<td>Knowingly and Willfully Filing False FBAR</td>
<td>Up to the greater of $100,000, or 50 percent of the amount in the account at the time of the violation up to $10,000 or 5 years, or both</td>
<td>18 U.S.C. §1001, and 31 C.F.R. § 103.59(d) for criminal.</td>
<td></td>
</tr>
</tbody>
</table>

Civil Tax Penalties and Criminal Tax Penalties may be imposed together. 31 U.S.C. § 5321(d).

2. **Problems with the FBAR Willful Penalty: Proportionality**

The Excessive Fines Clause of the Eighth Amendment to the Constitution requires that any fine—including the FBAR penalty—be “proportionate” to the conduct it seeks to punish.

\textsuperscript{37} Id. The citations are to the BSA and the Code of Federal Regulations and not the Internal Revenue Code.

\textsuperscript{38} See FAQs Regarding Report of Foreign Bank and Financial Accounts (FBAR)—Filing Requirements, Q&A #14 (last revised June 29, 2009).
The Constitutional proportionality inquiry requires that the amount of the forfeiture bear some relationship to the gravity of the offense that it is designed to punish.³⁹

The proportionality requirement under the Excessive Fines Clause was analyzed by the Supreme Court in United States v. Bajakajian, 524 U.S. 321 (1998), a forfeiture case. The Court held that forfeiture of $357,144, under 18 U.S.C. § 982(a)(1), in connection with a criminal conviction for willfully failing to report that he was transporting more than $10,000 out of the United States in violation of 31 U.S.C. § 5316(a)(1)(A), violated the Excessive Fines Clause.⁴⁰ The Court explained that, while the Government asserted a loss of information as to the amount of currency leaving the country, such loss would not be remedied by the Government’s confiscation of the full $357,144 that he was transporting and that the forfeiture would be grossly disproportional to the gravity of the offense.⁴¹ The Bajakajian Court also held that, in making a proportionality determination, the culpability of the offender should be examined specifically, rather than examining the gravity of the crime in the abstract. 524 U.S. at 337-38.

Following the Supreme Court's decision in Bajakajian, as part of the Civil Asset Forfeiture Reform Act of 2000 (“CAFRA”), Congress added a proportionality requirement to govern civil forfeiture proceedings, as follows:

Proportionality [18 U.S.C. § 983(g)].

(1) The claimant under subsection (a)(4) may petition the court to determine whether the forfeiture was constitutionally excessive.

(2) In making this determination, the court shall compare the forfeiture to the gravity of the offense giving rise to the forfeiture.

(3) The claimant shall have the burden of establishing that the forfeiture is grossly disproportional by a preponderance of the evidence at a hearing conducted by the court without a jury.

(4) If the court finds that the forfeiture is grossly disproportional to the offense it shall reduce or eliminate the forfeiture as necessary to avoid a violation of the Excessive Fines Clause of the Eighth Amendment of the Constitution.

The failure to file an FBAR (or the filing of an incorrect FBAR) is also a reporting violation analogous to the currency transporting violation at issue in Bajakajian. Just as it is lawful to transport currency out of or into the United States, it is also lawful to maintain an offshore bank account, so long as the transportation or existence of the account is properly disclosed to the Government.⁴² The violation is in the failure to report (or failure to accurately

⁴⁰ Bajakajian, 524 U.S. at 324.
⁴¹ Bajakajian, 524 U.S. at 324.
⁴² In the currency reporting cases, courts have routinely found forfeiture of the entire amount of currency excessive when the only offense was failing to report currency that would have otherwise been lawful to possess and transport. See, e.g., Bajakajian, 524 U.S. at 337; $100,348 in U.S. Currency, 354 F.3d 1110, 1122 (9th Cir. 2004) (the crime
in Bajakajian, should be equally applicable to the imposition of civil FBAR penalties, as well as other conduct subject to civil penalties under 31 U.S.C. § 5321.

In many cases, the application of the 50-percent willful FBAR penalty set out in 31 U.S.C. § 5321(a)(5)(C) would be grossly disproportionate to the conduct sought to be punished. For example, assume an individual willfully failed to report the existence of a foreign bank account with a balance of $2,000,000 and for which there was legally earned unreported interest income of $100,000. The IRS could assert a penalty of up to 50 percent of the account balance for each year in which there was a willful failure to report. The harm to the government is loss of information about the source of $100,000 in income, which would result in additional tax liability of less than $40,000 at today’s marginal rates. Despite this low amount of harm, under the statute, the IRS could assert a $1 million penalty for each of six years (in connection with the Offshore Voluntary Disclosure Program, in FAQs, the IRS has indicated that the maximum penalties could be 50 percent of the balance in each year). This amounts to a $6 million penalty for failing to report a $2 million bank account. The penalty appears grossly disproportionate to the conduct sought to be punished.

3. Penalty for failure to report transfers to or distributions from a foreign trust.

Background. Section 6048 imposes various reporting obligations on foreign trusts and persons creating, making transfers to, or receiving distributions from such trusts. If a U.S. person creates a foreign trust or transfers property to a foreign trust, the U.S. person generally must report this event and certain other information by the due date for the U.S. person's tax return, including extensions, for the tax year in which the creation of the trust or the transfer occurs. Similar rules apply in the case of the death of a U.S. citizen or resident if the decedent was treated as the owner of any portion of a foreign trust under the grantor trust rules or if any portion of a foreign trust was included in the decedent’s gross estate.

If a U.S. person directly or indirectly receives a distribution from a foreign trust, the U.S. person generally must report the distribution by the due date for the U.S. person's tax return, including extensions, for the tax year during which the distribution is received. If a U.S. person is the owner of any portion of a foreign grantor trust at any time during the year, the

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was “solely a reporting offense” because the money would have been lawful to take out of the country “so long as he reported it”); United States v. $120,856 in U.S. Currency, 394 F.Supp.2d 687, 694 (D.V.I. 2005); United States v. $293,316 in U.S. Currency, 349 F.Supp.2d 638 (E.D. N.Y 2004).

43 For purposes of this hypothetical, assume that the government can establish that the failure to file an FBAR was willful and therefore potentially subject to the 50% penalty.

44 Section 6048(a). The required information is reported on a Form 3520.

45 Section 6048(c). This information is also reported on a Form 3520.
person is responsible for causing an information return to be filed for the trust, which must, among other things, give the name of a U.S. agent for the trust.\textsuperscript{46}

**Section 6677 penalty.** If a notice or return required under the rules just described is not filed when due or is filed without all required information, the person required to file is generally subject to a penalty based on the “gross reportable amount.”\textsuperscript{47} The gross reportable amount is: (i) the value of the property transferred to the foreign trust if the delinquency is failure to file notice of the creation of or a transfer to a foreign trust; (ii) the value (on the last day of the year) of the portion of a grantor trust owned by a U.S. person who fails to cause an annual return to be filed for the trust; and (iii) the amount distributed to a distributee who fails to report distributions.\textsuperscript{48}

The initial penalty is 35 percent of the gross reportable amount in cases (i) and (iii), and five percent in case (ii).\textsuperscript{49} If the return is more than 90 days late, additional penalties are imposed at a rate of $10,000 for every 30 days the delinquency continues.\textsuperscript{50} The HIRE Act provided a new minimum penalty of $10,000 if 35 percent of the reportable amount is less than $10,000.

**4. Penalty for Failure to Report Receipt of Foreign Gift.**

Taxpayers are required to report the receipt of gifts in excess of $100,000 from foreign persons or entities under section 6039F on an annual basis.\textsuperscript{51} The penalty for failing to file this information return, or for filing an incomplete return, is five percent of the gift per month, up to a maximum penalty of 25 percent of the gift. Section 6039F(c). There is an exception if the failure is due to reasonable cause, and not to willful neglect. Section 6039F(c)(2)

**5. Penalty for Failure File To Information Return Regarding Foreign Corporation**

Certain United States persons who are officers, directors or shareholders in certain foreign corporations are required to report information under sections 6035, 6038 and 6046.\textsuperscript{52} The penalty for failing to file each one of these information returns is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return. Section 6679.

\textsuperscript{46} Section 6048(b). This information is reported on a Form 3520-A.

\textsuperscript{47} Section 6677(a).

\textsuperscript{48} Section 6677(c).

\textsuperscript{49} Section 6677(b).

\textsuperscript{50} Section 6677(a).

\textsuperscript{51} Gifts from foreign persons, like distributions from foreign trusts, are reported on Form 3520.

\textsuperscript{52} This information is reported on a Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations. The IRS now automatically asserts the $10,000 base penalty with respect to any return filed late.
6. **New Penalty for failure to disclose foreign financial assets—section 6038D.**

**Background.** Under new section 6038D (enacted in 2010), if an individual holds any interest in a “specified foreign financial asset,” or “SFFA” he will be required to attach to his tax return an annual disclosure statement declaring the asset and certain other information if the aggregate value of all such assets exceeds $50,000 (or any higher amount prescribed by the Service) at any time during his taxable year.\(^{53}\) The term “specified foreign financial asset” or “SFFA” means:\(^ {54}\)

- any “financial account” maintained by a foreign financial institution (including any non-publicly traded equity and debt of a foreign financial institution), and
- any of the following assets which are not held in an account maintained by a foreign financial institution\(^ {55}\) including: (i) any stock or security issued by a person other than a U.S. person; (ii) any financial instrument or contract held for investment that has an issuer or counterparty which is other than a U.S. person; and (iii) any interest in a foreign entity.

At present, it is not clear how or when a taxpayer is supposed to calculate the “aggregate value.”

**Information to be reported.** The information to be included on the statement includes identifying information on each asset and its maximum value during the taxable year. In the case of an account the information to be attached to an individual’s tax return with respect to any such asset is the name and address of the financial institution in which such account is maintained and the account number of such account. In the case of any stock or security, the name and address of the issuer and such information as is necessary to identify the terms and class or issue of which such stock or security is a part. In the case of any other instrument, contract or interest, such information as is necessary to identify the instrument, contract or interest, the nature or terms of such instrument, contract or interest, the names and addresses of all issuers and counterparties with respect to such instrument, contract or interest. In all cases, the maximum value of the asset during the year must be disclosed.\(^ {56}\)

Although the nature of the information required is similar to the information disclosed on an FBAR, it is not identical. For example, a beneficiary of a foreign trust who is not within the scope of the FBAR reporting requirements (as recently revised by Treasury) because his interest in the trust is less than 50 percent may nonetheless be required to disclose the interest in the trust with his tax return under this provision if the value threshold is met.

\(^{53}\) Section 6038D(a).
\(^{54}\) Section 6038D(b).
\(^{55}\) An individual is not now required under these new rules to disclose foreign interests which are held through a U.S. financial institution.
\(^{56}\) Section 6038D(c).
New section 6038D penalty. If a person fails to furnish the required information on his
tax return, such person will pay a penalty of $10,000 for the taxable year. In addition, if any
failure continues for more than 90 days after the day on which the Service mails notice of such
failure, such individual will be subject to an additional penalty of $10,000 for each 30-day period
(or part thereof) during which such failure continues with such penalty not to exceed $50,000 for
one taxable period.

If the Service determines that an individual has an interest in an SFFA and such
individual does not provide enough information to enable the Secretary to determine the
aggregate value of such assets, then the aggregate value of such identified foreign financial
assets will be presumed to have exceeded $50,000 or such higher amount as the Service shall
prescribe for purposes of determining the penalty.

Reasonable cause exception—However, no penalty will be imposed on any failure
which is shown to be due to reasonable cause and not due to willful neglect. Foreign law
prohibitions such as the fact that a foreign jurisdiction would impose a civil or criminal penalty
on the taxpayer for disclosing the required information is not reasonable cause.

7. New penalty under section 6662(j) for underpayments attributable to
undisclosed foreign financial asset—accuracy-related (negligence)
penalty.

New 6662(j) imposes a 40-percent penalty on any understatement of income attributable
to an “undisclosed foreign financial asset,” subject to the same defenses as are otherwise
applicable under section 6662.

Under the new law, an asset is an “undisclosed foreign financial asset” if it is an asset
subject to certain information reporting requirements, and the required information was not
provided by the taxpayer during the relevant taxable year. The relevant information reporting
includes information reporting related to:

- FATCA’s requirement for an individual to furnish the “6038D required
  information” on his tax return in the time and manner as required;
- controlled foreign corporations and partnerships;
- transfers to foreign corporations and partnerships;

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57 Section 6038D(d).
58 Id. The computation of the penalty is similar to that applicable to failures to file Forms 5471 with respect to
certain foreign corporations under section 6038 discussed above.
59 Section 6038D(e).
60 Section 6038D(g).
61 The information reporting requirements identified under Sections 6038, 6038A, 6038D, 6046A, and 6048.
62 Section 6038D(d).
63 Section 6038.
• certain organizations, reorganizations and acquisitions of stock in foreign corporations;\textsuperscript{65}
• certain acquisitions, dispositions of and substantial changes to interests in foreign partnerships;\textsuperscript{66} and
• certain transactions involving foreign trusts.\textsuperscript{67}

An understatement is attributable to an undisclosed foreign financial asset if it is attributable to any transaction involving such asset. Thus, a U.S. person who fails to comply with the various self-reporting requirements for a foreign financial asset and engages in a transaction with respect to that asset incurs a penalty on any resulting underpayment that is double the otherwise applicable penalty for substantial understatements or negligence. For example, if a taxpayer fails to disclose amounts held in a foreign financial account, any underpayment of tax related to the transaction that gave rise to the income would be subject to the new penalty provision, as would any underpayment related to interest, dividends or other returns accrued on such undisclosed amounts.

B. Problems Arising With Multiple Overlapping Penalties

The Internal Revenue Manual correctly notes, “Some returns have dual filing requirements and the penalty can apply for failure to file either return.”\textsuperscript{68} In addition, the Internal Revenue Manual recognizes that U.S. persons frequently have multiple obligations for each year and multiple penalty assessments and penalties apply to each information return that was required to be filed each year.\textsuperscript{69} For example, as noted above, the information requested under new section 6038D is similar although not identical to the information requested to be disclosed on an FBAR. The same base conduct can be subject to several of the above discussed penalties.

Example 1. The failure to report income which passes through a foreign account of $50,000 or more can be subject to a 40-percent penalty on the tax with respect to the income (section 6662(j)), a $10,000 penalty (section 6038D), and a FBAR penalty equal to 50 percent of the balance of the account. If the account is held in the name of a corporation, there may be an additional $10,000 penalty for failing to file a Form 5471.

Example 2. If a taxpayer fails to report a distribution from a foreign trust and fails to provide the required records (section 6048(c)(2)), the distribution is treated entirely as income including any accumulation distribution. Thus, it is possible to have the resulting tax liability be

\textsuperscript{64} Section 6038B.
\textsuperscript{65} Section 6046.
\textsuperscript{66} Section 6046A.
\textsuperscript{67} Section 6048.
\textsuperscript{68} IRM Manual Section 20.1.9.2.8.B.
\textsuperscript{69} IRM Manual Section 20.1.9.1.G.
subject to the 40-percent penalty under section 6662(j) since the taxpayer has undisclosed income, plus a penalty equal to 35 percent of the distribution (section 6677). In addition, if the taxpayer is a greater than 50 percent beneficiary of the trust, he or she may also be subject to FBAR penalties.

If a taxpayer has multiple disclosure obligations each year, failure to be compliant may result in multiple penalty assessments related to failures to provide similar information, which in the aggregate may be several orders of magnitude higher than the harm actually suffered by the government, i.e. the tax that was not reported.\(^70\)

The penalty amounts vastly exceed other penalties with respect to information returns. For example, the failure to file a Form 1099 reporting income paid to a taxpayer is ordinarily subject to a minor penalty under section 6721 ($100), which can be reduced if corrected promptly. If there is intentional disregard of the reporting requirement in certain cases, there is a penalty of 10 percent of the income amount that should have been reported. Section 6721(e). This pales in comparison to 25 percent, 30 percent or 50 percent of the asset (which may generate little or no income).

C. **Recommendations For International Disclosure Penalty Reform**

1. **Provide A Statutory Proportionality Defense to the FBAR Penalty.**
   
   We recommend that § 5321 be amended to add new subparagraph § 5321(b)(3), containing substantive rules identical to the proportionality rule of CAFRA:

   
   (A) The defendant in any action brought by Secretary under subsection (2) may petition the court to determine whether the fine was Constitutionally excessive.
   (B) In making this determination, the court shall compare the amount of the fine to the gravity of the offense giving rise to the fine.
   (C) The defendant shall have the burden of establishing that the fine is grossly disproportional by a preponderance of the evidence at a hearing conducted by the court without a jury.
   (D) If the court finds that the fine is grossly disproportional to the offense it shall reduce or eliminate the fine as necessary to avoid a violation of the Excessive Fines Clause of the Eighth Amendment of the Constitution.

2. **Incomplete Disclosures Made in Good Faith Should Be Entitled To Relief From Penalties.** With respect to what constitutes reasonable cause for purposes of

\(^70\) If a taxpayer is earning an 8% per year return on an offshore investment, the evaded marginal tax at today’s rates is less than 3% of the asset. Given the fact that the statute of limitations is extended in situations where the taxpayer has failed to report interests in foreign assets, section 6501(b)(8), the government will likely be able to collect the full amount of tax due (with interest), as well as an accuracy penalty. On top of this, disclosure penalties based on 25%, 35% and 50% of the asset value per year create a situation where the penalty could be more than 10x the harm suffered by the government when the taxpayer fails to provide the required information.
avoiding penalties under the international disclosure penalties discussed above, the Code should be amended to provide that, when considering whether a penalty should be applied with respect to incomplete disclosures, whether or not the taxpayer disclosed all the information known to him and steps taken by the taxpayer to obtain information not available to him should be taken into account. We recognize that a taxpayer will not have reasonable cause merely because a foreign country would impose a civil or criminal penalty on the trustee or other person for disclosing the required information; however, a taxpayer who attempts (but fails) to obtain the required information should not be penalized for a third party’s intransigence.

3. The Total Amount of Penalties For Failures to Disclose Should Be Limited To 50 percent of The Foreign Asset. We recommend an overall cap or limit to the penalties attributable to failure to disclose a single foreign financial asset. We suggest that Congress provide the aggregate amount of penalties which can be imposed on the failure to provide information on a single foreign financial asset under Subpart A of Part III of Subchapter 61A, sections 6046, 6046A, 6048, 6677 and 6679, and 31 U.S.C. § 5321 be limited to 50 percent of the asset value in the case of funds which were not the proceeds of illegal activities, or which were not untaxed (skimmed) funds. In taking pleas in criminal cases involving foreign bank accounts, the Department of Justice Tax Division has ordinarily insisted on a penalty of 50 percent of the highest balance in the account, even if the conduct continued over the course of several years. Given that the Department of Justice prosecutions generally target the most flagrant tax evaders, we suggest that a 50 percent of asset value limit on the amount of aggregate failure to disclose penalties is a fair and reasonable upper limit for the appropriate civil sanction. This would not relieve taxpayers of the obligation to pay tax, interest and (if applicable) an accuracy or fraud penalty with respect to any tax evaded.

4. Congress Should Put In Place The Opportunity For Pre-Assessment Judicial Review Of Information Return Penalties Regarding Foreign Assets and Transactions. Because they are not related to the calculation of tax on a tax return, the penalties for failing to disclose international assets/transactions are not currently covered by deficiency procedures under section 6211 et seq, and, unlike income and estate and gift taxes, currently may be assessed and collected by the IRS prior to any judicial determination. The penalty can be contested only after full payment of the tax. The amounts of these penalties can vastly exceed any tax due with respect to a foreign asset, placing a significant burden on a taxpayer who wishes to seek judicial review of these penalties.

71 IRM Section 20.1.9.13.1.2.B.
72 Sections 6211-6213 require that the IRS issue a Notice of Deficiency to taxpayer and allow the affected taxpayer to litigate the merits of the proposed deficiency—without first paying the tax—in the Tax Court.
73 With respect to the FBAR penalty, the IRS cannot enforce civil penalties under Title 31 in the same manner it enforces penalty assessments under Title 26. Instead, the Department of Justice has to bring suit in District Court to collect the penalty.
74 The taxpayer can challenge liability for the penalty in a collection due process appeal. Section 6330(c)(2)(B). However, if the taxpayer previously received pre-assessment administrative appeal rights with respect to a penalty, the issue may be not presented to appeals or to a reviewing court as part of the collection due process appeal. Section 6330(c)(4)(A)(i) (“An issue may not be raised at the hearing if the issue was raised and considered … in any other previous administrative or judicial proceeding.”)
We recommend that Congress enact provisions consistent with deficiency type penalties, providing that the IRS be required to propose penalties pursuant to a Notice of Deficiency, and that the Tax Court should be given jurisdiction to review these penalty determinations prepayment. In the alternative, that taxpayer should be able to pay a portion of the asserted penalty and litigate the matter in the Tax Court or district court.\footnote{Section 6703 provides a mechanism for post assessment review penalties under sections 6700-6702 (including the tax shelter promotion penalty under section 6700). The taxpayer is allowed to pay 15\% of the asserted amount and litigate the balance in the district court. This statute could serve as a model for a “partial payment” judicial review.}