REFORM PENALTY AND INTEREST PROVISIONS

Legislative Recommendation #29

Convert the Estimated Tax Penalty Into an Interest Provision to Properly Reflect Its Substance

SUMMARY

- *Problem:* If a self-employed individual fails to pay sufficient estimated tax during the year, the IRS will impose an addition to tax that is calculated as an interest charge but classified as a penalty. The term "penalty" implies that the taxpayer has engaged in improper conduct, yet small business taxpayers often experience significant fluctuations in their incomes and expenses from year to year that make it difficult for them to accurately estimate their tax liabilities.
- *Solution:* Reclassify the addition to tax for underpaying estimated tax from a penalty to an interest charge.

PRESENT LAW

Through the combination of wage withholding and estimated tax payments, the tax code aims to ensure that federal income and payroll taxes are paid ratably throughout the year. IRC § 3402 generally requires employers to withhold tax on wages paid to employees. For many employees, wage withholding covers their tax liabilities in full. But taxpayers who are self-employed or who have investment income typically are not subject to withholding on this non-wage income and instead must make estimated tax payments.

IRC § 6654 generally requires individual taxpayers to pay at least the lesser of (i) 90 percent of the tax shown on a tax return for the current tax year or (ii) 100 percent of the tax shown on a tax return for the preceding tax year (reduced by the amount of wage withholding) in four installment payments due on April 15, June 15, September 15, and January 15 of the following tax year.[1] IRC § 6655 generally requires corporate taxpayers to pay at least 100 percent of the tax shown on a tax return for the current tax year or, in some cases, 100 percent of the tax shown on a tax return for the preceding tax year in four installment payments due on April 15, June 15, September 15, and December 15.

IRC §§ 6654(a) and 6655(a) provide that a taxpayer who fails to pay sufficient estimated tax will be liable for a penalty that is computed by applying (i) the underpayment rate established under IRC § 6621(ii) to the amount of the underpayment (iii) for the period of the underpayment. IRC § 6621 is an interest provision. Therefore, the additional amount a taxpayer owes for failing to pay sufficient estimated tax is calculated as an interest charge, even though it is classified as a penalty.

Unlike the failure-to-file and failure-to-pay penalties described in IRC § 6651(a)(1) and (2) and the accuracy-related penalty described in IRC § 6662, the penalty for failure to pay estimated tax generally is not subject to a "reasonable cause" exception. IRC § 6654(e)(3) allows the IRS to waive the estimated tax penalty for

1 If the adjusted gross income of a taxpayer for the preceding tax year exceeds $150,000, "110 percent" is substituted for "100 percent" in applying clause (ii). IRC § 6654(d)(1)(C).

individual taxpayers only in certain limited circumstances, including when the Secretary determines that imposing the penalty would be "against equity and good conscience" by reason of "casualty, disaster, or other unusual circumstances" or when a taxpayer retired after having attained the age of 62 or became disabled during the taxable year *and* the underpayment was due to reasonable cause.

REASONS FOR CHANGE

For a variety of reasons, taxpayers often have difficulty estimating how much tax they will owe. Self-employed taxpayers or taxpayers who own small businesses may experience significant fluctuations in their income and expenses from year to year. Taxpayers with sizable investment incomes may also experience significant fluctuations. Substantial changes in tax laws, such as those that took effect in 2018, may affect tax liabilities in ways that taxpayers do not fully anticipate. As a result, millions of taxpayers do not satisfy the requirements of IRC § 6654 and are liable for penalties each year, even though many have reasonably attempted to comply. Corporate taxpayers face similar challenges.

The term "penalty" carries negative connotations, and the National Taxpayer Advocate believes it should be reserved for circumstances in which a taxpayer has failed to make reasonable efforts to comply with the law. Her position aligns with the assessment of the House Committee on Ways and Means when it wrote during a previous Congress: "Because the penalties for failure to pay estimated tax are calculated as interest charges, the Committee believes that conforming their title to the substance of the provision will improve taxpayers' perceptions of the fairness of the estimated tax payment system."[2] TAS has conducted research studies that have found "tax morale" has an impact on tax compliance.[3] Conforming the estimated tax penalty's title to reflect its true substance as an interest provision should improve fairness and encourage voluntary compliance.[4]

RECOMMENDATIONS

- Reclassify the penalty for failure to pay sufficient estimated tax as an interest charge – which is the basis for the calculation of the addition to tax. Toward that end, relocate IRC §§ 6654 and 6655 from chapter 68 to chapter 67 and make conforming modifications to the headings and text.[5]
- If the failure to pay sufficient estimated tax continues to be treated as a penalty, consider expanding the reasonable cause exception in IRC § 6654(e)(3)(B) to apply to all individual taxpayers.[6]

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2 H.R. Rep. No. 108-61, at 23-24 (2003).

3 *See* National Taxpayer Advocate 2013 Annual Report to Congress vol. 2, at 1 (Research Study: *Do Accuracy-Related Penalties Improve Future Reporting Compliance by Schedule C Filers?*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/2013-ARC_VOL-2-1.pdf.

4 Interest provisions do not normally include waiver exceptions based on equitable considerations. *See* Internal Revenue Manual (IRM) 20.2.1.1.2(3), Authority (Jan. 25, 2021), https://www.irs.gov/irm/part20/irm_20-002-001r. Nonetheless, Congress may consider preserving the limited waiver exception for the individual estimated tax penalty, which allows the IRS to waive the charge when it would violate equity and good conscience to impose it. IRC § 6654(e)(3)(A).

5 For legislative language generally consistent with this recommendation, see Taxpayer Protection and IRS Accountability Act, H.R. 1528, 108th Cong. § 101 (2003).

6 Expanding the reasonable cause exception in IRC § 6654(e)(3)(B) to all individual taxpayers, not just newly retired or disabled individuals, would allow the IRS to base relief on what is reasonable, rather than the more difficult standard of "against equity and good conscience." *See* IRM 20.1.3.3.2.1.2, Waiver Criteria Under IRC 6654(e)(3)(A) (July 23, 2020), https://www.irs.gov/irm/part20/irm_20-001-003r (explaining that the "against equity and good conscience" standard is more limited than "reasonable cause"). For more details on a recommendation to expand the reasonable cause exception to all individual taxpayers who may be subject to the estimated tax payment regime for the first time, see National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, at 34 (Research Study: *A Framework for Reforming the Penalty Regime*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/08_tas_arc_vol2.pdf.

Legislative Recommendation #30

Apply a Single Interest Rate to Underpayments of Estimated Tax in the Periods Between Each Installment Due Date

SUMMARY

- *Problem:* The due dates for estimated tax payments do not align with the dates on which the interest rate for estimated tax underpayments is adjusted. As a result, more than one interest rate may apply to an underpayment during the period between each estimated tax installment due date, causing unnecessary complexity and burden for taxpayers.

- *Solution:* Apply the same interest rate to underpayments of estimated tax for the entire period between each installment due date.

PRESENT LAW

IRC § 6654(c) provides that individual taxpayers who make estimated tax payments must submit those payments on or before April 15, June 15, September 15, and January 15 of the following taxable year.[1] Similarly, IRC § 6655(c) provides that corporations required to make installment payments must submit those payments on or before April 15, June 15, September 15, and December 15.[2] Failure to make required estimated tax payments results in a penalty that is determined by the underpayment rate, the amount of the underpayment, and the period of the underpayment.

Under IRC § 6621(a)(2), the underpayment rate is equal to the federal short-term interest rate, plus three percentage points. Under IRC § 6621(b)(1), the federal short-term interest rate is determined quarterly by the Secretary of the Treasury. If the Secretary determines a change in the federal short-term interest rate, the change is effective on January 1, April 1, July 1, or October 1.[3] For individual estimated tax underpayments, IRC § 6621(b)(2)(B) delays the timing of the April 1 rate change to April 15, partially aligning the timing of the interest rate changes with the requirements of IRC § 6654.

REASONS FOR CHANGE

Under current law, more than one interest rate may apply to an underpayment in the period between each estimated tax installment due date. For example, if a taxpayer fails to make an estimated tax payment due June 15 and the Secretary determines a change in the federal short-term interest rate effective July 1, one interest rate would apply for the period from June 16 through June 30, and another rate would apply beginning July 1. A change in interest rate just 15 days after the estimated tax installment due date causes unnecessary complexity and burden for taxpayers. This complexity and burden would be reduced if the same interest rate applied to the entire period between required installments.

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1 To make compliance easier, the National Taxpayer Advocate separately recommends that Congress set the estimated tax payment deadlines 15 days after the end of each calendar quarter (April 15, July 15, October 15, and January 15). *See Adjust Individual Estimated Tax Payment Deadlines to Occur Quarterly*, *supra*.

2 The dates referenced in the text apply to calendar-year taxpayers. Fiscal-year taxpayers will have estimated tax due dates in different months at similar intervals. Thus, they face the same problem as calendar-year taxpayers with interest rate adjustments that do not align with estimated tax installment due dates. *See* IRC §§ 6654(k), 6655(i).

3 IRC § 6621(b)(2)(A) ("[T]he Federal short-term rate determined under [§ 6621(b)(1)] for any month shall apply during the first calendar quarter beginning after such month.").

RECOMMENDATION

- Amend IRC §§ 6654 and 6655 to provide that the rate applied to an estimated tax underpayment shall be set as of the due date for each required estimated tax installment and shall be the underpayment rate established by IRC § 6621 for the calendar quarter of the due date of that required installment.[4]

4 For legislative language generally consistent with this recommendation, see Taxpayer Bill of Rights Enhancement Act of 2017, S. 1793, 115th Cong. § 305 (2017). If this proposal is adopted, repeal of IRC § 6621(b)(2)(B) may be required. *See also* H.R. Rep. No. 108-61, at 25 (2003); Taxpayer Protection and IRS Accountability Act, H.R. 1528, 108th Cong. § 101 (2003).

Legislative Recommendation #31

Extend the Reasonable Cause Defense for the Failure-to-File Penalty to Taxpayers Who Rely on Return Preparers to E-File Their Returns

SUMMARY

- *Problem:* A taxpayer who fails to file a tax return by the deadline is subject to a late-filing penalty unless the taxpayer can demonstrate "reasonable cause" for the failure. In 1985, the Supreme Court held that reliance on a tax return preparer to file a return did not alone constitute reasonable cause for a late-filing penalty because the taxpayer had a responsibility to ensure the deadline was met. While that conclusion may be appropriate in the context of paper-filed returns where a taxpayer can mail the return themself, it is not appropriate in the context of e-filed returns, where the preparer typically submits the return and the taxpayer cannot easily verify whether a return has been filed and accepted.
- *Solution:* Allow taxpayers who rely on tax return preparers to e-file their returns to receive reasonable cause relief from the failure-to-file penalty.

PRESENT LAW

IRC § 6651(a)(1) imposes an addition to tax when a taxpayer fails to file a return by the due date unless the taxpayer can show the failure was due to reasonable cause and not due to willful neglect (the "failure-to-file penalty").[1] Reasonable cause exists when a taxpayer has exercised ordinary business care and prudence but was unable to file the return within the prescribed time.[2]

In *United States v. Boyle*, the Supreme Court held that a taxpayer's reliance on an agent to file a return did not constitute reasonable cause for late filing.[3] In *Boyle*, the tax return at issue was filed on paper. In 2023, the U.S. Court of Appeals for the Eleventh Circuit held that the *Boyle* decision also applies to e-filed returns.[4] This was the first time a federal appeals court had decided the issue. Several U.S. district courts have similarly held that *Boyle* applies to e-filing.[5]

In the IRS Restructuring and Reform Act of 1998, Congress adopted a policy that "paperless filing should be the preferred method and most convenient means of filing Federal tax and information returns" and gave the Secretary broad authority to incentivize taxpayers to file returns electronically.[6] IRC § 6011(e)(3) authorizes the Secretary to require tax return preparers to file returns electronically unless they reasonably expect to file ten or fewer individual income tax returns during a calendar year. Treasury Regulation § 301.6011-7 implements this requirement.

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1 The penalty amount is five percent of the tax due for each month or partial month the return is late, up to a maximum of 25 percent. The penalty increases to 15 percent per month up to a maximum of 75 percent if the failure to file is fraudulent. IRC § 6651(f).

2 Treas. Reg. § 301.6651-1(c)(1). *See also* Internal Revenue Manual (IRM) 20.1.1.3.2, Reasonable Cause (Nov. 21, 2017), https://www.irs.gov/irm/part20/irm_20-001-001r.

3 *Boyle*, 469 U.S. 241 (1985).

4 *Lee v. United States*, 84 F.4th 1271 (11th Cir. 2023).

5 *See, e.g.*, *Haynes v. United States*, 119 A.F.T.R.2d (RIA) 2202 (W.D. Tex. 2017), *vacated and remanded*, 760 F. App'x 324 (5th Cir. 2019); *Intress v. United States*, 404 F. Supp. 3d 1174 (M.D. Tenn. 2019); *Oosterwijk v. United States*, 129 A.F.T.R.2d (RIA) 512 (D. Md. Jan. 27, 2022).

6 Pub. L. No. 105-206, § 2001, 112 Stat. 685, 723 (1998); IRC § 6011(f).

REASONS FOR CHANGE

At the time *Boyle* was decided, all tax returns were filed on paper. Taxpayers generally could fulfill the basic responsibility of mailing returns to the IRS themselves, even when they engaged tax professionals to prepare them. In ruling that the taxpayer in *Boyle* was not entitled to reasonable cause abatement as a matter of law, the Supreme Court stated that "[i]t requires no special training or effort to ascertain a deadline and make sure that it is met."[7]

In effect, the *Boyle* decision concluded that the duty to file a return is non-delegable. While that rule might make sense in a paper-filing context, it is not reasonable to apply it in the e-filing context. Today, most taxpayers effectively delegate the electronic filing of their returns to preparers or use software providers. Particularly when a taxpayer uses a preparer, the taxpayer is generally several steps removed from the filing process. When a preparer e-files a tax return, he or she must transmit it through an electronic return originator (typically, a software company) to the IRS. Thus, there are four parties sequentially involved in this chain: (i) the taxpayer; (ii) the preparer; (iii) the software company; and (iv) the IRS. If the IRS rejects an e-filed tax return, it generally sends a notification back through the software company to the preparer, but it will not notify the taxpayer directly.[8] In these circumstances, a taxpayer cannot easily ensure his or her return has been properly submitted by the preparer and accepted by the IRS. In addition, the IRS rejects e-filed returns before processing them for a variety of reasons, and unlike with paper filing, a return that is e-filed with the IRS but rejected before processing is not treated as timely filed.

While Treasury regulations generally require tax return preparers to e-file client returns, the regulations exempt preparers from the e-filing requirement if a taxpayer provides the preparer with "a hand-signed and dated statement" that says the taxpayer chooses to file a paper return.[9] Because taxpayers can mail paper returns themselves, this "opt-out" may reduce a taxpayer's risk of incurring a failure-to-file penalty. In light of the congressional directive to incentivize e-filing, it makes little sense to increase the penalty risk for taxpayers who e-file.[10]

The Eleventh Circuit's decision, *Lee v. United States*, highlights the unfairness of applying the *Boyle* rule in the context of e-filing. In many ways, the taxpayer in *Lee* was a model taxpayer. A surgeon with significant earnings, he hired a certified public accountant (CPA) to prepare and file his complicated returns for 2014-2016. During each of those years, he ensured the returns were timely prepared and verified, and he sent a signed Form 8879, *IRS e-file Signature Authorization*, to the CPA before the filing deadline. Additionally, he made significant overpayments of tax each year to avoid an underpayment penalty, choosing to apply the overpayments to the following year's liability. However, his CPA never filed the returns, apparently because they were too complex for the filing software, and he did not tell the taxpayer. The CPA also did not provide the IRS with the taxpayer's correct mailing address, so the taxpayer did not receive any notices. The taxpayer was completely unaware that his returns had not been filed until the IRS visited his office in 2018. Because the CPA had not filed the returns, the IRS did not apply the 2014 overpayment to subsequent years, leaving the taxpayer with tax liabilities for 2015 and 2016 and approximately $70,000 in penalties.[11]

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7 *Boyle*, 469 U.S. at 252.

8 IRM 3.42.5.7.2(1), Form 1040 Online Filing (Nov. 22, 2023), https://www.irs.gov/irm/part3/irm_03-042-005r.

9 Treas. Reg. § 301.6011-7(a)(4)(ii).

10 For context, over half of all individual income tax returns filed during 2024 were prepared by professionals and e-filed (more than 84 million returns). *See* IRS, 2024 Filing Season Statistics (week ending Oct. 18, 2024), https://www.irs.gov/newsroom/filing-season-statistics-for-week-ending-oct-18-2024.

11 The penalties were for failure to file a return under IRC § 6651(a)(1) and failure to pay tax under IRC § 6651(a)(2). The Eleventh Circuit noted that it and other courts have held that *Boyle* also applies to the failure-to-pay penalty. *Lee v. United States*, 84 F.4th 1271, 1275 (11th Cir. 2023).

After filing a refund claim with the IRS, which was denied, the taxpayer brought suit in U.S. district court, arguing there was reasonable cause for the failure to file due to his reliance on the CPA. The district court held that the *Boyle* rule applied to e-filed returns[12] and the Eleventh Circuit agreed. The taxpayer made several arguments as to why the penalties should be abated, including that once he had sent the Form 8879 to the CPA the burden was on the CPA to file the returns and the failure to do so was beyond the taxpayer's control. However, the Eleventh Circuit rejected the taxpayer's arguments, concluding there was no basis to treat e-filed returns differently from paper-filed returns under the Supreme Court's *Boyle* decision.

One judge wrote a concurring opinion "to highlight the risks facing taxpayers" due to *Boyle*'s application in the e-filing context, noting the fact that the taxpayer owed taxes and penalties to the IRS despite his otherwise prudent actions "is reflective of the current e-filing system and the precarious situation in which it places taxpayers who rely on" preparers.[13] The judge added: "[U]nder Boyle's bright line rule, it is not clear whether Lee would be excused from penalties *even if his accountant [had] affirmatively misrepresented to him that his returns were filed on time*."[14]

Prior to the Eleventh Circuit's decision in *Lee*, several U.S. district courts had similarly held that *Boyle* applied in the e-filing context.[15] As in *Lee*, the facts of these cases illustrate the unfairness of *Boyle*'s application. In *Haynes v. United States*, a married couple employed a CPA to prepare and file their joint tax return.[16] The preparer timely e-filed the return, but the IRS did not accept it for processing because a taxpayer identification number was listed on the wrong line. The preparer did not receive a rejection notice from the IRS. The preparer notified the taxpayers that their return had been timely filed. Ten months later, the IRS notified the taxpayers that their return had not been received and asserted the failure-to-file penalty. The taxpayers requested penalty abatement for reasonable cause, asserting they had sought to file their return timely, their preparer had transmitted the return timely, and both the preparer and the taxpayers believed the return had been received. The taxpayers filed suit in district court, arguing that *Boyle* should not apply in the context of electronic filing because the complexities of e-filing vastly exceed the comparatively simple and verifiable task of mailing a return. The district court concluded that the holding in *Boyle* applies to e-filed returns to the same extent as paper-filed returns and ruled in the government's favor as a matter of law.[17]

The issue in these cases is not whether the failure-to-file penalty is applicable in the first instance. Based on the wording of the statute, there is no doubt the penalty is applicable if the return is filed late. Rather, the issue is whether taxpayers are entitled to request abatement of the penalty on reasonable cause grounds. Because the *Boyle* decision used relatively sweeping language, lower courts have seemingly felt bound to apply its holding in the context of e-filed returns, notwithstanding the significant differences between paper filing and electronic filing.

While the bright-line rule embodied in *Boyle* is convenient for the IRS to administer, the nearly automatic assessment of the failure-to-file penalty for e-filed returns deemed late (often where the return was submitted timely by the taxpayer or preparer but rejected by the IRS before processing) is grossly unfair and undermines

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12 *Lee v. United States*, 129 A.F.T.R.2d (RIA) 667 (M.D. Fla. Feb. 8, 2022).

13 *Lee v. United States*, 84 F.4th 1271, 1281 (11th Cir. 2023) (Lagoa, J., concurring).

14 *Id.* at 1282 (emphasis added).

15 *See, e.g.*, *Haynes v. United States*, 119 A.F.T.R.2d (RIA) 2202 (W.D. Tex. 2017), *vacated and remanded*, 760 F. App'x 324 (5th Cir. 2019); *Intress v. United States*, 404 F. Supp. 3d 1174 (M.D. Tenn. 2019); *Oosterwijk v. United States*, 129 A.F.T.R.2d (RIA) 512 (D. Md. Jan. 27, 2022).

16 119 A.F.T.R.2d (RIA) 2202 (W.D. Tex. 2017).

17 On appeal, the U.S. Court of Appeals for the Fifth Circuit vacated and remanded the district court's decision on different grounds and did not take a position on the *Boyle* issue. *Haynes v. United States*, 760 F. App'x 324 (5th Cir. 2019). *See also* Keith Fogg, *Reliance on Preparer Does Not Excuse Late E-Filing of Return*, Procedurally Taxing (Sept. 4, 2019), https://www.taxnotes.com/procedurally-taxing/reliance-preparer-does-not-excuse-late-e-filing-return/2019/09/04/7h5vr.

the congressional policy that e-filing be encouraged. The American College of Tax Counsel shares this view and submitted a compelling *amicus curiae* brief in the appeal of the *Haynes* decision.[18]

RECOMMENDATION

- Amend IRC § 6651 to specify that reasonable cause relief may be available to taxpayers that use return preparers to submit their returns electronically and direct the Secretary to issue regulations specifying what constitutes ordinary business care and prudence for e-filed returns.

18 *See* Brief of American College of Tax Counsel (Nov. 27, 2017), https://www.actconline.org/wp-content/uploads/2018/02/ACTC_Amicus_Brief_Haynes.pdf.

Legislative Recommendation #32

Authorize a Penalty for Tax Return Preparers Who Engage in Fraud or Misconduct by Altering a Taxpayer's Tax Return

SUMMARY

- *Problem:* When a corrupt tax return preparer steals from a client or from the public fisc, the government's enforcement options are limited. The Department of Justice (DOJ) may bring criminal charges, but it lacks the resources to do so except in cases of widespread, high-dollar schemes. The alternative is civil penalties, but the law currently does not authorize meaningful civil penalties.
- *Solution:* Authorize the IRS to impose larger civil penalties in a wider range of cases.

PRESENT LAW

IRC § 6694(b) authorizes the IRS to impose a penalty when a tax return preparer has understated a taxpayer's liability on a return or claim for refund and the understatement is due to willful or reckless conduct.[1] IRC § 6695(f) imposes a $500 penalty (adjusted for inflation) on a preparer who negotiates (*e.g.*, endorses) a taxpayer's refund check.[2]

REASONS FOR CHANGE

TAS has handled hundreds of cases involving return preparer fraud or misconduct. In the most common scenario, a taxpayer visits a preparer to get a tax return prepared, the preparer completes the return while the taxpayer is present, and the preparer alters the return after the taxpayer leaves before submitting it to the IRS. In some cases, the items of income, deduction, and credit are accurate, but the preparer alters the direct deposit routing information so that the entire refund is directed to the preparer's account instead of the taxpayer's account. In other cases, the preparer increases the refund amount by altering items of income, deduction, or credit and then elects a split refund[3] so the taxpayer receives the refund amount he expects, and the additional amount goes to the preparer.

The DOJ may bring criminal charges against preparers who alter tax returns, but resource constraints generally preclude criminal charges except in cases of widespread schemes. In addition, the dollar amount of a refund obtained by a preparer in these cases often will determine whether DOJ pursues an erroneous refund suit under IRC § 7405, also due to resource constraints.[4] Therefore, it is important that the IRS have the authority to impose sizeable civil penalties against preparers who alter tax returns without the knowledge or consent of the taxpayers who hired them.

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1 The amount of the penalty is per return or claim for refund, equal to the greater of $5,000 or 75 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim. IRC § 6694(b)(1)(A), (B).

2 The penalty is assessed on a per-check basis and adjusted annually for inflation, as provided by IRC § 6695(h).

3 Taxpayers can split their refunds among up to three accounts at a bank or other financial institution. *See* IRS, Form 8888, Allocation of Refund (Including Savings Bond Purchases) (Nov. 2022), https://www.irs.gov/pub/irs-pdf/f8888.pdf. The instructions to Form 8888 specifically advise taxpayers not to deposit their refunds into their tax return preparer's account.

4 *See* Internal Revenue Manual (IRM) 21.4.5.15(6), Collection Methods for Category D Erroneous Refunds (Oct. 1, 2007), https://www.irs.gov/irm/part21/irm_21-004-005r ("The erroneous refund suit is limited to amounts that exceed the litigating threshold established by the Department of Justice.").

Under current law, the IRS has very limited authority to impose civil penalties in instances of preparer fraud or misconduct. The IRC § 6694 penalty generally will not apply to either of the scenarios described above for the following reasons:

- When a preparer has altered only the direct deposit information on the return and has not changed the tax liability, there is no understatement of tax.
- When a preparer has altered items of income, deduction, or credit to increase a taxpayer's refund after the taxpayer has reviewed and approved the return for filing, the IRS Office of Chief Counsel has concluded that the resulting document is not a valid tax return.[5]

In addition, it is unclear whether the IRC § 6695(f) penalty applies. Treasury regulations have interpreted the IRC § 6695(f) penalty as applicable to a preparer who negotiates "a check (including an electronic version of a check)."[6] Although the IRS's internal procedures currently treat direct deposits as subject to the IRC § 6695(f) penalty, the tax code and regulations do not make clear whether a direct deposit is legally identical to an electronic version of a check.[7] Moreover, even if the penalty is applicable, the penalty amount for calendar year 2024 of $635[8] is small in relation to the size of refunds that some preparers misappropriate and therefore is unlikely to serve as a deterrent.

The National Taxpayer Advocate recommends the IRS be given the authority to assess and collect civil penalties against tax return preparers who engage in fraud or misconduct by altering the return of a taxpayer for personal financial gain.

RECOMMENDATIONS

- Amend IRC § 6694(b) so the penalty the IRS may assess against a tax return preparer for understating a taxpayer's liability is broadened beyond tax returns and claims for refund by adding the words "and other submissions purporting to be returns."
- Amend IRC § 6695 to (i) explicitly cover a preparer who misappropriates a taxpayer's refund by changing the direct deposit information and (ii) increase the dollar amount of the penalty to deter preparers from engaging in this type of fraud or misconduct. To make the public fisc whole, the penalty should be equal to 100 percent of the amount a preparer has improperly converted to his own use by altering a taxpayer's return or direct deposit information.

5 IRS, Program Manager Technical Advice (PMTA) 2011-20, Tax Return Preparer's Alteration of a Return (June 27, 2011), https://www.irs.gov/pub/lanoa/pmta_2011-20.pdf; PMTA 2011-13, Horse's Tax Service (May 12, 2003), https://www.irs.gov/pub/lanoa/pmta-2011-013.pdf.

6 Treas. Reg. § 1.6695-1(f)(1).

7 *See* IRM 20.1.6.5.6, Negotiation of Check – IRC 6695(f) (Oct. 13, 2021), https://www.irs.gov/irm/part20/irm_20-001-006.

8 Rev. Proc. 2023-34, 2023-48 I.R.B. 1296, https://www.irs.gov/pub/irs-irbs/irb23-48.pdf.

Legislative Recommendation #33

Clarify That Supervisory Approval Is Required Under IRC § 6751(b) Before Proposing Penalties

SUMMARY

- *Problem:* By law, some penalties require supervisory approval. However, due to an apparent drafting error, the statute leaves the timing of the required approval unclear. This ambiguity has generated conflicting decisions among the courts, creating confusion for taxpayers and the IRS alike and seemingly undermining the purpose of the supervisory approval requirement.
- *Solution:* Clarify that supervisory approval is required before a proposed penalty is communicated in written form to a taxpayer.

PRESENT LAW

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."

IRC § 6751(b)(2) carves out two categories of exceptions from this supervisory approval requirement:

- The additions to tax for failure to file a tax return or pay the tax due (IRC § 6651), the additions to tax for failure to pay sufficient estimated tax (IRC §§ 6654 and 6655), and the penalty for the overstatement or disallowance of certain charitable contribution deductions (IRC § 6662(b)(9) and (10)), and
- Any other penalty that is "automatically calculated through electronic means."[1]

REASONS FOR CHANGE[2]

IRC § 6751(b) protects the taxpayer *right to a fair and just tax system*[3] by ensuring that penalties are only imposed in appropriate circumstances and are not used as a bargaining chip to encourage settlement.[4] However, the statutory phrase "initial determination of [an] assessment" is unclear. A "determination" is made based on the IRS's investigation of the taxpayer's liability and an application of the penalty statutes. An "assessment" is merely the entry of a decision on IRS records. Therefore, while a penalty can be determined and a penalty can be assessed, the IRS cannot "determine" an "assessment."[5] Due to this apparent drafting error and consequent ambiguity in the statute, an increasing number of courts have had to grapple with

1 Generally, a penalty is considered automatically calculated through electronic means if the penalty is proposed by an IRS computer program without human involvement. *See, e.g.*, *Walquist v. Comm'r*, 152 T.C. 61 (2019).

2 *See also* Erin M. Collins, Treasury FY 2025 Green Book Proposes to Abolish a Taxpayer Right by Essentially Eliminating Written Supervisory Approval for Penalties Enacted by Congress, 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.

3 *See* Taxpayer Bill of Rights (TBOR), https://www.taxpayeradvocate.irs.gov/taxpayer-rights (last visited Sept. 18, 2024). The rights contained in TBOR are also codified in IRC § 7803(a)(3).

4 *See* S. Rep. No. 105-174, at 65 (1998).

5 *See Chai v. Comm'r*, 851 F.3d 190, 218-19 (2d Cir. 2017); *Graev v. Comm'r*, 147 T.C. 460 (2016) (Gustafson, J., dissenting).

the question of when written supervisory approval must be provided.[6] In recent years, courts have come to conflicting conclusions about when the supervisory approval must occur:

- In 2016, the Tax Court held in *Graev v. Commissioner* (which was later vacated) that supervisory approval for penalties subject to deficiency procedures could take place at any point before the assessment was made.[7]
- In 2017, the U.S. Court of Appeals for the Second Circuit held in *Chai v. Commissioner* that supervisory approval was required for penalties subject to deficiency procedures no later than the date on which the IRS issued the notice of deficiency or, if the penalty was asserted through an answer or amended answer, the time of that filing.[8]
- In 2019, the Tax Court held in *Clay v. Commissioner* that supervisory approval for penalties subject to deficiency procedures was required prior to sending the taxpayer a formal communication that included the right to go to the IRS Independent Office of Appeals.[9]
- In 2020, the Tax Court followed *Clay* and held in *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner* that the same timing rule applied to assessable penalties. However, the U.S. Court of Appeals for the Ninth Circuit overruled the Tax Court decision in 2022.[10] The Ninth Circuit held that approval must be obtained before assessment of the penalty or, if earlier, before the relevant supervisor loses discretion to approve the penalty assessment.

In *Belair Woods, LLC v. Commissioner,* the Tax Court found the IRS did not have to obtain supervisory approval before sending the taxpayer a Letter 1807, TEFRA Partnership Cover Letter for Summary Report, which invited the taxpayer to a closing conference to discuss proposed adjustments.[11] Instead, the court found that Letter 1807 only advised the taxpayer of the possibility that penalties could be proposed, and the pivotal moment requiring supervisory approval was when the IRS sent the 60-day letter formally communicating its definite decision to assert the penalties.

In September 2020, the IRS issued interim guidance that instructs employees to obtain written supervisory approval before sending a written communication that offers the taxpayer an opportunity to sign an agreement or consent to assessment or proposal of a penalty.[12] The interim guidance specifies that prior to obtaining written supervisory approval, employees can share written communications with the taxpayer that reflect proposed adjustments as long as they do not offer the opportunity to sign an agreement or consent to assessment or proposal of the penalty.

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6 *See* National Taxpayer Advocate 2020 Annual Report to Congress 194 (Most Litigated Issue: *Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2021/01/ARC20_MLI_03_Accuracy.pdf; National Taxpayer Advocate 2019 Annual Report to Congress 149 (Most Litigated Issue: *Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/ARC19_Volume1_MLI_03_Accuracy.pdf; National Taxpayer Advocate 2018 Annual Report to Congress 447 (Most Litigated Issue: *Accuracy-Related Penalty Under IRC § 6662(b)(1) and (2)*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/07/ARC18_Volume1_MLI_01_AccuracyRelatedPenalty.pdf.

7 147 T.C. at 460, *superseded by*, *in part*, *modified by*, *in part*, 149 T.C. 485 (2017).

8 851 F.3d 190 (2d Cir. 2017). In *Minemyer v. Comm'r*, 131 A.F.T.R.2d 2023-364 (10th Cir. 2023), the Tenth Circuit agreed with *Chai* that supervisory approval for a civil fraud penalty must be obtained by the date of the notice of deficiency.

9 152 T.C. 223 (2019), *aff'd on other grounds,* 990 F.3d 1296 (11th Cir. 2021).

10 *Laidlaw's Harley Davidson Sales, Inc. v. Comm'r*, 29 F.4th 1066 (9th Cir. 2022), *rev'g* 154 T.C. 68 (2020). *See also Kroner v. Comm'r*, 48 F.4th 1272 (11th Cir. 2022), *rev'g* T.C. Memo. 2020-73, in which the Eleventh Circuit agreed with the Ninth Circuit's *Laidlaw's* decision. In *Carter v. Comm'r*, 130 A.F.T.R.2d 2022-5978 (11th Cir. 2022), *rev'g* T.C. Memo. 2020-21, the Eleventh Circuit followed its decision in *Kroner*.

11 154 T.C. 1 (2020).

12 Interim Guidance Memorandum (IGM) SBSE-04-0920-0054, Timing of Supervisory Approval of Penalties Subject to IRC 6751(b) (Sept. 24, 2020), *reissued by* IGM SBSE-04-0922-0075, Reissue Interim Guidance (IG) for Timing of Supervisory Approval of Penalties Subject to IRC 6751(b) (Sept. 28, 2022), *reissued by* IGM SBSE-04-1223-0062, Interim Guidance (IG) for Timing of Supervisory Approval of Penalties Subject to IRC 6751(b) (Dec. 15, 2023), https://www.irs.gov/pub/foia/ig/sbse/sbse-04-0922-0075.pdf.

In 2023, the Treasury Department issued proposed regulations under IRC § 6751.[13] For pre-assessment penalties subject to Tax Court review, the proposed regulations would allow supervisory approval to be obtained any time before issuance of the statutory notice of deficiency. Penalties not subject to pre-assessment Tax Court review could be approved up until the time of the assessment itself. That same year and again in 2024, the Treasury Department asked Congress to amend IRC § 6751 to achieve the same result.[14] Thus, the proposed regulations and legislation would establish the broadest possible window and allow the requisite supervisory approval to occur at the latest possible moment. In this way, the proposed regulations and legislative proposal would bring relative certainty to this area, but they would do so by seriously eroding the taxpayer protections provided by IRC § 6751 and in opposition to the views expressed by a range of stakeholders and commentators, including the National Taxpayer Advocate.[15]

Both *Belair Woods* and the Treasury Department's position leave open the possibility that IRS employees could use penalties as a bargaining chip – precisely what Congress sought to prevent by enacting IRC § 6751(b). Under *Belair Woods*, IRS employees can propose penalties to induce a resolution without first obtaining written supervisory approval, so long as the communication is deemed a proposal and not a definite decision. This approach undermines the statutory intent because, as explained in the dissent in *Belair Woods*, "[e]very communication from the Commissioner proposing a deficiency and a related penalty – whether it is a preliminary report, a 30- or 60-day letter, or a notice of deficiency – sets forth proposed adjustments, which do not become final until a decision is entered, or an assessment is properly recorded."[16]

The IRS's interim guidance, the proposed regulations, and the Treasury Department's legislative proposal seek to resolve the question of what is merely a proposal as opposed to a definite decision by drawing the line at written communications that offer a chance to agree to assessment or consent to proposal of a penalty. However, employees could still use penalties as a bargaining chip because some taxpayers may feel pressured to resolve their cases when penalties are first put on the table as proposed adjustments.

In addition to the timing issue, the statutory language of IRC § 6751(b)(1) is also problematic because of its focus on "assessment(s)." In *Wells Fargo & Company v. Commissioner*, the U.S. Court of Appeals for the Eighth Circuit found that supervisory approval under IRC § 6751(b) was not required because there was no assessment.[17] The IRS asserted the accuracy-related penalty in a refund suit to offset any refund granted to the taxpayer. Because the penalty, if upheld by the court, would only lead to a reduced refund and not a balance to be assessed, the court found there would be no assessment and thus no requirement for supervisory approval.

13 Rules for Supervisory Approval of Penalties, 88 Fed. Reg. 21,564, 21,570-72 (proposed Apr. 11, 2023) (to be codified at Treas. Reg. § 301.6751(b)-1), https://www.federalregister.gov/d/2023-07232.

14 U.S. Dep't. of the Treasury, General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals 175 (Mar. 11, 2024), https://home.treasury.gov/system/files/131/General-Explanations-FY2025.pdf; U.S. Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals 161-162 (Mar. 2023), https://home.treasury.gov/policy-issues/tax-policy/revenue-proposals. Like the proposed regulations, Treasury's legislative proposal would expand the definition of supervisors permitted to provide the required approval. We note it is extremely unusual for the Treasury Department to simultaneously propose legislation and regulations that are substantially identical. Presumably, the General Counsel's office is uncertain whether it has the legal authority to impose a timing rule by regulation, so it is asking for a legislative change in case the courts invalidate the regulation.

15 For a more detailed discussion of the problems arising under the IRS's interpretation of IRC § 6751, see Erin M. Collins, Reconsidering the IRS's Approach to Supervisory Review, National Taxpayer Advocate Blog (Aug. 29, 2023), https://www.taxpayeradvocate.irs.gov/news/nta-blog-reconsidering-the-irs-approach-to-supervisory-review. Stakeholder comments regarding the proposed regulations can be viewed at IRS, Notice of Proposed Rulemaking, Notice of Hearing, Rules for Supervisory Approval of Penalties: Hearing, IRS-002023-0016, 88 Fed. Reg. 49,397 (July 31, 2023), https://www.regulations.gov/document/IRS-2023-0016-0010/comment.

16 *Belair Woods, LLC v. Comm'r*, 154 T.C. 1, 11 (Jan. 6, 2020) (Marvel, J., dissenting).

17 957 F.3d 840 (8th Cir. 2020), *aff'g* 260 F. Supp. 3d 1140 (D. Minn. 2017).

In practice, the overwhelming majority of penalties imposed by the IRS are excluded from the supervisory approval requirement through one of the exceptions in IRC § 6751(b)(1).[18] But where written supervisory approval is required, the National Taxpayer Advocate believes it should be required early enough in the process to ensure it is meaningful and is not merely an after-the-fact rubber stamp applied in the cases in which a taxpayer challenges a proposed penalty.

RECOMMENDATION

- 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.

18 In fiscal year 2023, the IRS imposed 38.2 million penalties on individuals, estates, and trusts in connection with income tax liabilities. The following penalties, generally imposed by electronic means, accounted for over 98 percent of the total: failure-to-pay (18.6 million), failure-to-pay estimated tax (14.2 million), failure-to-file (3.3 million), and bad checks (1.4 million). IRS, Pub. 55-B, 2023 IRS 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.

Legislative Recommendation #34

Require an Employee to Determine and a Supervisor to Approve All Negligence Penalties Under IRC § 6662(b)(1)

SUMMARY

- *Problem:* The tax code generally requires supervisory approval before the IRS may assess a penalty, but it provides an exception for penalties that may be automatically calculated and do not require employee judgment. The IRS currently takes the position that the negligence penalty can sometimes be automatically calculated and applied, but whether a taxpayer acted negligently requires an assessment of the taxpayer's conduct and state of mind, which a computer cannot make. As a result, the IRS is imposing the negligence penalty in cases where the taxpayer was not negligent.
- *Solution:* Do not allow the IRS to impose the negligence penalty by automation, absent employee review and supervisory approval.

PRESENT LAW

IRC § 6662(b)(1) imposes a penalty equal to 20 percent of any underpayment of tax required to be shown on a tax return that is attributable to negligence or disregard of rules or 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."

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."[1] IRC § 6751(b)(2) carves out two categories of exceptions from this supervisory approval requirement:

- The additions to tax for failure to file a tax return or pay the tax due (IRC § 6651), the additions to tax for failure to pay sufficient estimated tax (IRC §§ 6654 and 6655), and the penalty for the overstatement or disallowance of certain charitable contribution deductions (IRC § 6662(b)(9) and (10)); and
- Any other penalty that is "automatically calculated through electronic means."[2]

REASONS FOR CHANGE

IRC § 6751 states that the initial determination of penalties must be personally approved (in writing) by the immediate supervisor of the individual making the initial determination, subject to the exceptions described above. In the significant majority of cases, the IRS imposes penalties by electronic means because it is easier

1 The meaning of "initial determination of such assessment" and the timing required for approval have been the subject of litigation. *See, e.g.*, *Belair Woods v. Comm'r*, 154 T.C. 1 (2020). For a recommendation to clarify the timing, see *Clarify That Supervisory Approval Is Required Under IRC § 6751(b) Before Proposing Penalties*, *supra*.

2 Generally, a penalty is considered automatically calculated through electronic means if the penalty is proposed by an IRS computer program without human involvement. *See, e.g.*, *Walquist v. Comm'r*, 152 T.C. 61 (2019).

and cheaper to do so.[3] Where the imposition of a penalty is mechanical, such as the penalties for failure to file, failure to pay, or failure to pay estimated tax, that approach is justifiable.

However, imposition of a penalty for "negligence or disregard of rules or regulations" is different. To determine whether a taxpayer made a reasonable attempt to comply with the law, an employee must analyze the taxpayer's state of mind, the actions the taxpayer took to comply, and the taxpayer's motivations for taking those actions. A computer cannot perform this analysis.

Nevertheless, Treas. Reg. § 1.6662-3(b)(1)(i) states that negligence is strongly indicated when a taxpayer omits income reported on an information return from his or her income tax return. In reliance on this regulation, the IRS has programmed its computers to calculate certain negligence penalties automatically as part of its Automated Underreporter (AUR) program. For example, the AUR system proposes the negligence penalty where IRS data suggests the taxpayer failed to report income reflected on a third-party information return for a second tax year in a row.[4]

Legal advice from the Office of Chief Counsel goes further, concluding that "in the absence of any other evidence suggesting the failure was not negligent, it is appropriate to propose and subsequently assess an accuracy-related penalty for negligence when a taxpayer does not include on an income tax return an amount of income shown on an information return."[5]

However, the AUR system in this scenario solely checks for the presence of information returns and unreported income. It cannot determine there is no other evidence that would rebut the negligence finding, such as whether the information return was mailed to a different address than the one used by the taxpayer when filing the return or whether the information return contained an error. Before the IRS can reasonably conclude that a taxpayer acted negligently, an employee must review the case to consider facts and circumstances that may suggest the taxpayer did not act negligently.

Although the AUR program and proposed regulations do require supervisory approval for the negligence penalty if the taxpayer submits a response to the notice issued through the AUR program,[6] there are many reasons a taxpayer may not respond. A taxpayer may have moved and not received the notice. A taxpayer may have put the notice aside and not replied before the response deadline. Or a taxpayer may have accepted the proposed tax adjustment without realizing that he or she must respond to avoid the penalty assessment.

In these and other circumstances, taxpayers may face a penalty for negligence without any analysis into their reasonable attempts to comply with the tax laws. Allowing a computer to determine negligence without employee involvement harms taxpayers and undermines the protections afforded by IRC § 6751(b). The Treasury Department has made a legislative proposal that would perpetuate this harm by definitively

3 In fiscal year 2023, the IRS imposed 38.2 million penalties on individuals, estates, and trusts in connection with income tax liabilities. The following penalties, generally imposed by electronic means, accounted for over 98 percent of the total: failure to pay (18.6 million), failure to pay estimated tax (14.2 million), failure to file (3.3 million), and bad checks (1.5 million). IRS, Pub. 55-B, 2023 IRS 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.

4 Internal Revenue Manual (IRM) 4.19.3.22.1.4, Accuracy-Related Penalties (Sept. 21, 2020), https://www.irs.gov/irm/part4/irm_04-019-003r.

5 IRS, Program Manager Technical Advice 2008-01249, Accuracy Related Penalties and Automated Underreporter Program (Oct. 22, 2007), https://www.irs.gov/pub/lanoa/pmta01249_7337.pdf.

6 IRM 4.19.3.22.1.4, Accuracy-Related Penalties (Sept. 21, 2020), https://www.irs.gov/irm/part4/irm_04-019-003r; Rules for Supervisory Approval of Penalties, 88 Fed. Reg. 21,564, 21,570 (to be codified at Treas. Reg. § 301.6751(b)-1(a)(3)(vi) (proposed Apr. 11, 2023), https://www.federalregister.gov/d/2023-07232.

removing all IRC § 6662 penalties, including negligence penalties, from the supervisory review and approval requirement.[7]

RECOMMENDATION

- 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).

7 U.S. Dep't. of the Treasury, General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals 175 (Mar. 11, 2024), https://home.treasury.gov/system/files/131/General-Explanations-FY2025.pdf; U.S. Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals 161-162 (2023), https://home.treasury.gov/policy-issues/tax-policy/revenue-proposals.

Legislative Recommendation #35

Modify the Definition of "Willful" for Purposes of Determining Report of Foreign Bank and Financial Accounts Violations and Reduce the Maximum Penalty Amounts

SUMMARY

- *Problem:* Penalties for failure to disclose foreign assets on a Report of Foreign Bank and Financial Accounts (FBAR) are steep and grow even steeper when the IRS determines a taxpayer's failure was "willful." The IRS has become increasingly aggressive in asserting that taxpayers' failures to file are willful, which can lead to draconian penalties for good-faith errors.
- *Solution:* Increase the burden of proof on the IRS for declaring a failure "willful" and reduce the maximum penalty for willful violations involving small accounts.

PRESENT LAW

The Bank Secrecy Act requires U.S. citizens, residents, and entities to report foreign accounts to the Treasury Department's Financial Criminal Enforcement Network (FinCEN) when the combined value of those accounts exceeds $10,000 at any time during the calendar year.[1] They must do so on FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR).

31 U.S.C. § 5321(a)(5) imposes civil penalties for failing to report the accounts. The penalty amount depends on whether the failure was non-willful or willful. For a non-willful violation, the maximum civil penalty is $10,000 (adjusted for inflation), subject to a reasonable cause exception.[2] Under 31 U.S.C. § 5321(a)(5)(C)(i), the maximum civil penalty for a willful violation is the greater of $100,000 (adjusted for inflation) or 50 percent of the account balance at the time of the violation. For violations occurring over multiple years, the IRS has adopted a policy, set forth in the Internal Revenue Manual (IRM), that limits the total amount of penalties to 50 percent of the highest aggregate balance of all unreported foreign accounts for all years under examination, which can be increased to 100 percent for willful violations.[3]

REASONS FOR CHANGE

The maximum FBAR penalty is among the harshest civil penalties the government may impose.

FBAR penalties are so steep there is debate about whether they violate the prohibition against excessive fines in the Eighth Amendment to the U.S. Constitution.[4] In August 2024, the U.S. Court of Appeals for the Eleventh Circuit held that the Eighth Amendment's prohibition against excessive fines applies to FBAR penalties and partially reduced the taxpayer's penalty after finding it was "grossly disproportionate" to the offense of failing to disclose the foreign account.[5] This decision creates a split among the circuits, as the U.S.

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1 31 U.S.C. § 5314; 31 C.F.R. § 1010.350.

2 31 U.S.C. § 5321(a)(5)(B)(i); *see also Bittner v. United States*, 598 U.S. 85 (2023) (holding that the $10,000 cap applies on a per-FBAR report, not per-account, basis).

3 IRM 4.26.16.5.4.1, Penalty for Non-willful Violations – Calculation (June 24, 2021), https://www.irs.gov/irm/part4/irm_04-026-016; IRM 4.26.16.5.5.3, Penalty for Willful FBAR Violations – Calculation (June 24, 2021), https://www.irs.gov/irm/part4/irm_04-026-016.

4 *See, e.g.*, Matthew A. Melone, *Penalties for the Failure to Report Foreign Financial Accounts and the Excessive Fines Clause of the Eighth Amendment*, 22 Geo. Mason L. Rev. 337 (2015).

5 *United States v. Schwarzbaum*, 114 F.4th 1319 (11th Cir. 2024).

Court of Appeals for the First Circuit held in 2022 that the Eighth Amendment does not apply to FBAR penalties.[6]

An example illustrates the potential severity of the FBAR penalties, particularly for smaller accounts. Assume an account holder maintains a balance of $25,000 in a foreign account that they willfully fail to report. The IRS may, under the statute, impose a penalty of over $100,000 per year (the exact amount depends on the year since the $100,000 is adjusted for inflation) and may go back six years, producing an aggregate statutory maximum penalty of over $600,000. While the IRS should not impose such a severe penalty under the IRM, the IRM is simply a set of instructions to help IRS employees do their jobs. It is not binding and can be changed at any time.

In this example, the penalty exceeds the account balance because the statute provides that the maximum penalty is the *greater of* $100,000 (adjusted for inflation) or 50 percent of the account balance. The $100,000 cap only applies to accounts with balances below $200,000 like the one in the example; for higher balance accounts, the maximum statutory penalty is limited to 50 percent of the account balance. The National Taxpayer Advocate recommends Congress address this disparity by limiting the maximum statutory penalty for a willful FBAR violation to 50 percent of the account balance for all accounts.

While the distinction between willful and non-willful violations makes sense in concept, its application can lead to unduly harsh results. If the IRS chooses to assert a violation was willful, it is very difficult for a taxpayer to prevail. One reason is because Form 1040, U.S. Individual Income Tax Return, includes Schedule B, which is titled "Interest and Ordinary Dividends" and is used by taxpayers to report such income. Schedule B contains a question at the bottom that asks whether the taxpayer has a foreign account and references the FBAR filing requirement. The IRS has argued, and some courts have agreed, that since taxpayers are presumed to know the contents of their return when they sign it under penalty of perjury, a failure to file an FBAR form is willful where a taxpayer filed a tax return that includes Schedule B (because it mentions the FBAR filing requirement).[7] Further making it difficult for taxpayers to prevail is that courts generally have allowed the government to prove willfulness in FBAR cases by a "preponderance of the evidence," rather than requiring the government to meet the higher standard of "clear and convincing" evidence, which is typically the standard in tax fraud cases.[8]

These practices are unfair to taxpayers. Tax forms and instructions contain a lot of verbiage, and few if any taxpayers have a complete understanding of all lines, questions, and instructions on a return or schedule – or even read them all. Additionally, it is common for individuals who have lived in foreign countries or have immigrated to the United States to maintain foreign bank accounts, and they may overlook the reporting requirement for benign reasons.

Account holders who do not file FBAR forms due to negligence, inadvertence, or similar causes are appropriately subject to penalties for non-willful violations, which have a reasonable cause exception. But they should not face uncertainty regarding possible application of the harsh penalties for willful violations. The National Taxpayer Advocate recommends Congress clarify that the IRS must prove a violation was willful without relying on the Schedule B or its instructions and must do so by clear and convincing evidence.

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6 *United States v. Toth*, 33 F.4th 1, 15-19 (1st Cir. 2022), *cert. denied*, 143 S.Ct. 552 (2023).

7 Not all courts have accepted the IRS's argument. For two recent examples discussing key cases in this area, see *United States v. Saydam*, No. 22-cv-07371-DMR, 2024, WL 3407677 (N.D. Cal. July 12, 2024) and *United States v. Niksich*, No. 1:22-CV-02411-SCJ2024, WL 3915240 (N.D. Ga. July 8, 2024).

8 *See, e.g.*, *United States v. Vettel*, No, 4:21CV3099, 2024 WL 2012352 (D. Neb. Apr. 11, 2024); *United States v. Reyes*, 133 A.F.T.R.2d 2024-468 (E.D.N.Y. 2024); *United States v. Garrity*, 304 F. Supp. 3d 267 (D. Conn. 2018); *United States v. Bohanec*, 263 F. Supp. 3d 881 (C.D. Cal. 2016); *United States v. McBride*, 908 F. Supp. 2d 1186 (D. Utah 2012).

RECOMMENDATIONS

- Clarify that the government has the burden to establish willfulness by clear and convincing evidence before asserting a civil willful FBAR penalty and that the government cannot meet this burden by relying on the Schedule B attached to a return.
- Remove subsection (I) in 31 U.S.C. § 5321(a)(5)(C)(i) so that the maximum statutory civil penalty for a willful FBAR violation is 50 percent of the account balance at the time of the violation.