IRS Insights | A closer look

Recent Tax Court decision holds Form 5471 penalties are not immediately assessable by the IRS

In a recent United States Tax Court decision, the Tax Court ultimately held that the IRS cannot immediately assess section 6038(b) penalties and instead must collect the penalty through civil action.[1]

Background

Section 6038(b) imposes a $10,000 civil penalty against any taxpayer who fails to timely Form 5471, *Information Return of US Persons With Respect To Certain Foreign Corporations*. For years, the IRS has treated the section 6038(b) penalty, for the failure to file a Form 5471, as an automatically assessable penalty. That is, if the IRS determines that the penalty applies, it can send a notice to the taxpayer and seek to collect the penalty. For such penalties, the taxpayer does not have an opportunity to dispute the penalty in court without first paying the penalty.

Tax Court decision

In *Farhy*, the IRS automatically assessed the section 6038(b) penalty against a taxpayer for failure to timely file Forms 5471 for several years. The taxpayer asserted the penalties were invalid because the IRS did not have legal authority to assess section 6038 penalties.

In this edition

The Tax Court agreed with the taxpayer and held the penalties invalid. The Tax Court concluded that the Internal Revenue Code did not authorize the IRS to assess section 6038(b) penalties. Under the court's reading, the IRS can collect section 6038(b) penalties only through civil action.[2]

The Court said, "Congress has explicitly authorized assessment with respect to myriad of penalty provisions in the Code but not for section 6038(b) penalties." The court explained that for many penalties, the Internal Revenue Code provides whether they are automatically assessable or they are subject to deficiency procedures before being assessed. However, the Court said that Congress did not provide either procedure for assessing section 6038(b) penalties. Thus, the IRS's only option to assess the civil penalty is to collect under the federal government's general recovery statute (i.e., 28 U.S.C. 2461).

Implications

The potential ramifications of this significant decision are unclear. For example, it is unknown whether the Tax Court would apply this reasoning to other similarly situated penalties. Additionally, it is unknown whether the applicable US Court of Appeals will uphold the opinion (it is very likely that the IRS will appeal the case). Further, it is unclear whether the normal refund statute of limitations under section 6511 applies. Finally, given the likelihood that the IRS will appeal the case, if taxpayers file refund claims, it is unlikely that the IRS will process the refund claims at this time. Taxpayers that have been assessed and paid certain international information penalties should consult with their tax advisors on the appropriate course of action.

Chief Counsel memorandum discusses nominal refund claims

In PMTA 2023-01, a Chief Counsel memorandum discussed whether the IRS can accept and process refund claims for $1 or other nominal amounts ("nominal refund claims").

Background

Taxpayers have a limited a time to file refund claims.[3] If a taxpayer does not file a claim before the refund statute of limitation expires, the IRS cannot issue the refund. Occasionally, the time to file a refund claim may expire before the taxpayer's right to the refund claim is finalized and determinable (e.g., pending litigation). To preserve the right to claim a refund, the taxpayer must file a protective claim before the expiration of the refund statute.

In PMTA 2023-01, the Chief Counsel memorandum states that "a protective claim (1) must have a written component; (2) must identify and describe the contingencies affecting the claim; (3) must be sufficiently clear and definite to alert the Service as to the essential nature of the claim; and (4) must identify a specific year or years for which a refund is sought."[4] The Chief Counsel memorandum further states that "[a]lthough a valid 'protective' claim need not necessarily state a particular dollar amount or demand an immediate refund, taxpayers nonetheless should report an overpayment determination with as much accuracy as reasonably is possible."[5]

Memorandum

The Chief Counsel memorandum then discusses nominal refund claims. It acknowledges that there are circumstances in which the IRS has accepted refund claims for $1, including refund claims involving Alternative Fuel Mixing Credit, Ponzi-type scheme theft loss matters, and employment tax overpayments involving FICA litigation. However, the Chief Counsel memorandum says just because the IRS has accepted some $1 refund claims does not mean the IRS has to accept all $1 refund claims. The Chief Counsel memorandum states that the ability to accept and process $1 claims is "often a matter of process," and the IRS is "constrained by the legal framework." The Chief Counsel memorandum explains that nominal refund claims must still satisfy the requirements for a valid protective claim. Specifically, the nominal refund claim must involve an actual contingency. The taxpayer cannot be filing a $1 refund claim just so it can file a more detailed claim after the statute of limitations has expired. Instead, there must be some contingency that is preventing the taxpayer from filing a complete refund claim before the statute of limitations expires.

Conclusion

Taxpayers filing protective refund claims should give careful consideration to the amount claimed and ensure the protective claim identifies the contingency that prevented the taxpayer from timely filing a complete refund claim.

IRS proposes regulations for supervisory approval of penalties

In the last several years, there has been significant litigation regarding section 6751(b)'s requirement for a supervisor to approve certain penalties. In response, the IRS has issued proposed regulations providing new rules for timing of approval and definitions for terms used in section 6751(b).

Background

In 1998, Congress added section 6751(b) to the Internal Revenue Code. That section provides that the IRS cannot assess a penalty unless the "initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination...."[6] This rule does apply to additions to tax under section 6651 (failure to file or pay penalties), section 6654 (individual estimated payment penalty), section 6655 (corporate estimated payment penalty), or "penalties automatically calculated through electronic means."

In legislative history, the Senate Finance Committee stated that the IRS should not use penalties as a "bargaining chip."[7]

In 2017, the United States Court of Appeals for the Second Circuit ruled that section 6751(b)(1) requires written approval of the of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer asserting such penalty).[8] Since then, there has been extensive litigation on section 6751(b) with inconsistent results. For example, the Tax Court has required the supervisory approval be obtained before the exam formally communicates to the taxpayer the decision to assert a penalty.[9] However, three circuit courts of appeals have rejected the Tax Court's "formal communication" timing rule.[10]

Proposed regulations

In April 2023, the IRS issued proposed regulations regarding the section 6751(b) supervisory approval requirement.[11]

The proposed regulations propose three rules:

- Penalties subject to pre-assessment review in the Tax Court: Supervisory approval may be obtained at any time before the IRS issues the notice of deficiency.[12]
- Penalties raised in Tax Court after a petition: Supervisory approval may be obtained at any time before the IRS requests the court determine the penalty.[13]
- Penalties not subject to pre-assessment review in the Tax Court: Supervisory approval may be obtained at any time before assessment.[14]

The proposed regulations also include definitions, such as the following:

- Immediate supervisor—any individual with responsibility to approve another individual's proposal of penalties without the proposal being subject to an intermediary's approval[15]
- Personally approved in writing—any writing, including in electronic form, made by the writer to signify the writer's assent; no signature or particular words are required so long as the circumstances of the writing reflect that it was intended as approval[16]
- Automatically calculated through electronic means—if an IRS computer program automatically generates a notice to the taxpayer that proposes the penalty; if a taxpayer challenges the notice and an IRS employee considers the response before assessment, then the penalty is no longer considered "automatically calculated through electronic means"[17]

Conclusion

In the preamble, the IRS states it proposed these regulations to resolve the litigation and inconsistent caselaw. It is unclear if the proposed regulations, if finalized, will achieve those goals. In the meantime, taxpayers should continue to confirm the IRS has received supervisory approval of the applicable penalties.

Ninth Circuit requires "meticulous compliance" to start assessment statute of limitations

In *Seaview Trading LLC. v. Commissioner*,[18] the Ninth Circuit recently ruled that a taxpayer did not file its tax return when it provided the return to IRS employees; thus, the assessment statute of limitation was open.

Background

In July 2005, an IRS revenue agent informed Seaview Trading LLC that the IRS did not have any record of its 2001 tax return. In September 2005, Seaview faxed a copy of its 2001 Form 1065 along with a certified mail receipt for an envelope that had been mailed to the Ogden Service Center in July 2002. Two years later, as part of the IRS examination, Seaview mailed a copy of the same return to an IRS attorney. Neither the revenue agent nor IRS attorney forwarded the return to Ogden Service Center for processing.

In October 2010, the IRS issued Seaview a notice of final partnership administrative adjustment for its 2001 tax year; the notice disallowed a $35.5 million loss. Seaview petitioned the US Tax Court and asserted that the notice of deficiency was untimely because it was issued more than three years after Seaview filed its tax return. The IRS asserted that the assessment statute of limitations was open because the taxpayer never filed a tax return.

The Tax Court agreed that Seaview never filed its return because Seaview did not send the return to the designated place for filing under Treasury regulations. Seaview appealed to the US Ninth Circuit Court of Appeals. In May 2022, a three-judge panel

reversed the IRS's win and remanded to the Tax Court. When the case was appealed the second time, the full Ninth Circuit heard the case and ruled for the IRS.

Ninth Circuit decision

The Ninth Circuit began its analysis by noting that the assessment statute of limitation is strictly construed in favor of the government, and if a taxpayer wants to invoke the assessment statute of limitations, there must be "meticulous compliance by the taxpayer with all named conditions...."[19]

As part of those named conditions, Congress mandated that the taxpayers must file their returns "at such place as prescribed in the regulations."[20] The relevant regulations provided that the return must be filed with service center as provided by IRS guidance;[21] the 2021 Instructions for Form 1065 stated that taxpayers must file the return with the Ogden Service Center.

The Ninth Circuit concluded that the Seaview did not "meticulously" comply with the filing requirements because its return was not filed with the Ogden Service Center. The court also rejected the argument that the regulations applied only to timely filed returns because the regulation makes no distinction between returns that are timely filed and those that are filed late.

One judge dissented because she agreed with the taxpayer that the IRS has a history of allowing taxpayers to file late or untimely with IRS officials.

Conclusion

Taxpayers should ensure they "meticulously" comply with filing requirements in order to start the IRS's three-year assessment statute of limitations.

Failure to comply with international information return reporting obligations keeps statute of limitations open

In *Leigh C. Fairbank and Barbara J. Fairbank v. Commissioner*,[22] the Tax Court ruled that a failure to file Forms 3520-A, *Annual Information Return of Foreign Trust with a US Owner*, and Forms 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*, as required by IRC section 6048, extends the time in which the IRS can assess tax deficiencies under section 6501. Here, the taxpayers' failure to file certain international information returns allowed the IRS to assess tax deficiencies going back to 2003.

Facts

The taxpayers timely filed their original Forms 1040, *US Individual Income Tax Return*, for the 2003 through 2011 tax years. However, they failed to disclose Mrs. Fairbank's beneficial ownership interest in a Liechtenstein Anstalt, Xavana Establishment, for the 2003 through 2009 tax years, or her position as the sole shareholder of a BVI corporation, Xong Services, Inc., for the 2009 through 2011 tax years. They also failed to report any income associated with either entity. Both Xavana Establishment and Xong Services held Swiss bank accounts, and Mrs. Fairbank was the beneficial owner of both accounts.

In 2010, the IRS opened an examination of the taxpayers' tax returns following receipt of Mrs. Fairbank's name from UBS.[23] The IRS used the information received from UBS along with information provided by the taxpayers during the examination to make the proposed adjustments. The taxpayers eventually filed Forms 5471, *Information Return of US Persons with Respect to Certain Foreign Corporations*, for Xong Services for the 2009 and 2010 tax years, but they never filed any information returns related to Xavana Establishment.

The IRS issued a notice of deficiency dated April 12, 2018, and determined income tax deficiencies for the taxpayers' 2003, 2004, 2005, 2006, 2007, 2008, 2009, and 2011 tax years. The taxpayers challenged the deficiency notice as untimely.

Law

As a general rule, section 6501(a) provides that the IRS must assess a tax liability "within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed)." But, as with many statutory rules, there are a number of exceptions to the general rule. Here, section 6501(c)(8), addresses the "[f]ailure to notify Secretary of certain foreign transfers." As relevant to the taxpayers, section 6501(c)(8) provides:

> "[i]n the case of any information which is required to be reported to the Secretary ... under section ... 6048, the time for assessment of any tax imposed by this title with respect to any tax return, event, or period to which such information relates shall not expire before the date which is 3 years after the date on which the Secretary is furnished the information required to be reported under such section."

Section 6048 addresses the information reporting requirements for certain foreign trusts. Specifically, for taxpayers who are owners of a foreign trust, section 6048(b) requires them to "ensure" that the foreign trust files an information return (i.e., Form 3520-A, *Annual Information Return of Foreign Trust with a US Owner*) reporting its activities and the names of any US person who received a distribution during the year. Additionally, for taxpayers who are foreign trust beneficiaries or who received a distribution from said trust, section 6048(c) requires them to file an information return (i.e., Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*) reporting the name of the trust, the aggregate amount distributed that year, and "such other information as the Secretary may prescribe."

For section 6048 to apply, Mrs. Fairbank must have been an owner and/or beneficiary of a "trust." If the entity in question was not a trust, the section 6048 reporting requirements would not apply. Other reporting requirements covered in section 6501(c)(8)[24] may still have applied, but because the Tax Court ultimately determined that Xavana Establishment was a trust, they didn't need to look beyond section 6048.

Classification of Xavana Establishment as a trust

Treas. Reg. Sec. 301.7701-1(a)(1) states that "[w]hether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." Treas. Reg. Sec. 301.7701-4 confirms that whether an entity is deemed a trust will be determined by function, and trusts generally have the following four elements: (1) a grantor, (2) a trustee who takes title to property for the purpose of conserving or protecting it, (3) property, and (4) designated beneficiaries. The Tax Court "applies a facts and circumstances analysis when determining whether an arrangement should be treated as a trust or business entity by determining whether the arrangement includes (1) associates and (2) an objective to carry on a business and divide the gains therefrom. The absence of either of these essential characteristics will cause an entity to be classified as a trust."[25]

To support their position that Xavana Establishment was a business entity and not a trust, the taxpayers cited IRS Chief Counsel Attorney Memorandum 2009-012 ("the CCA Memo"). The CCA Memo indicates that, generally speaking, a Liechtenstein Stiftung would be classified as a trust for US tax purposes, whereas a Liechtenstein Anstalt would not. However, the CCA Memo cautions that the specific facts and circumstances of each entity will "determine whether a particular Anstalt was established primarily to conduct a trade or business or to protect and conserve assets for the designated beneficiaries of the Anstalt."

Xavana Establishment's organizing documents showed that it was to operate "on a trust basis," its purpose was for the "investment and management of assets," and its "capital and its results as well as any clear profits … shall be due to the beneficiaries." The Tax Court noted that it was irrefutable that Mrs. Fairbank was the beneficial owner of Xavana Establishment and that there was no record that Xavana Establishment was involved in any business or joint enterprise. As such, the Tax Court determined that Xavana Establishment was properly classified as a trust for federal tax purposes. It then determined that Xavana Establishment was a foreign trust under section 7701(a)(30)(E) and Treas. Reg. Sec. 301.7701-7(a)(2), which gave rise to the taxpayers' reporting obligations under section 6048.

Section 6048 reporting obligations

As noted above, section 6048 requires owners and beneficiaries of foreign trusts to annually file Forms 3520-A and 3520, respectively. There was no dispute as to whether the taxpayers filed Forms 3520-A or 3520. The taxpayers, however, argued that section 6501(c)(8) does not require a specific form to be filed, only that the required information be "furnished" to the IRS, which they contended they did during the audit. The Tax Court was not persuaded by this argument and looked to the language of sections 6048(b) and (c) as required by section 6501(c)(8). And because the taxpayers did not "provide any written return to [the IRS] setting forth a full and complete accounting of Xavana Establishment's activities for the years at issue" or "any return that includes the name Xavana Establishment and which outlines the aggregate amount of distributions [Mrs. Fairbank] received during each of the tax years at issue,"[26] they did not comply with sections 6048(b) or (c). Further, because the taxpayers did not comply with section 6048, the Tax Court held that the statute of limitations had not expired under section 6501(c)(8). In fact, it hadn't even begun to run, making the notice of deficiency timely.

Conclusion

The failure to comply—even during the audit—with the specific reporting obligations identified in section 6048 resulted in the taxpayers' assessment statute of limitations remaining open under section 6501(c)(8).

Endnotes

1. *Farhy v. Commissioner*, 160 T.C. No. 6 (April 23, 2023)..

2. See 28 U.S.C. § 2461(a) ("Whenever a civil fine, penalty or pecuniary forfeiture is prescribed for the violation of an Act of Congress without specifying the mode of recovery or enforcement thereof, it may be recovered in a civil action").

3. IRC § 6511(b).

4. PMTA 2023-01, p. 4.

5. PMTA 2023-01, p. 4.

6. IRC § 6751(b).

7. S. Rep. No. 105-714, at 65 (1998).

8. *See Chai v. Commissioner*, 851 F.3d 190, 221 (2d Cir. 2017).

9. *Belair Woods LLC v. Commissioner*, 154 T.C. 1, 13 (2020).

10. *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, 29 F.4th 1066 (9th Cir. 2022), *reh'g en banc denied*, No. 20-73420 (9th Cir. July 14, 2022); *Minemyer v. Commissioner*, 2023 WL 314832 (10th Cir. Jan. 19, 2023); *Kroner v. Commissioner*, 48 F. 4th 1272 (11th Cir. 2022).

11. REG-121709-19.

12. Prop. Treas. Reg. § 301.6751(b)-1(c).

13. Prop. Treas. Reg. § 301.6751(b)-1(d).

14. Prop. Treas. Reg. § 301.6751(b)-1(b).

15. Prop. Treas. Reg. § 301.6751(b)-1(a)(3)(iii).

16. Prop. Treas. Reg. § 301.6751(b)-1(a)(3)(v).

17. Prop. Treas. Reg. § 301.6751(b)-1(a)(3)(vi).

18. 62 F.4th 1131 (9th Cir. 2023).

19. *Id*. (quoting *Lucas v. Pilliod Lumber Co.*, 281 U.S. 245, 249 (1930)).

20. 26 U.S.C. § 6230(i) (2000).

21. Treas. Reg. § 1.6031-(a)-1(e)(1) (2001).

22. T.C. Memo. 2023-19 (Feb. 23, 2023).

23. Mrs. Fairbank's name and the Xavana Establishment account information were provided to the IRS by UBS in connection with the 2009 deferred prosecution agreement between the Department of Justice and UBS.

24. In addition to section 6048, applicable to certain foreign trusts, the section 6501(c)(8) exception also applies to information required to be reported under (a) section 6038, applicable to foreign corporations and partnerships; (b) section 6038A, applicable to foreign-owned corporations; (c) section 6038B, applicable to transfers to foreign persons; (d) section 6046, applicable to organization or reorganization of foreign corporations and acquisitions of their stock; and (e) section 6046A, applicable to interests in foreign partnerships.

25. T.C. Memo. 2023-19.

26. *Id*.

Contact us

Matt Cooper
Tax Managing Director| Tax WNT
Deloitte Tax LLP
mattcooper@deloitte.com

Howard Berman
Tax Managing Director| Tax WNT
Deloitte Tax LLP
hberman@deloitte.com

Colleen Harkins
Tax Senior Manager | Tax WNT
Deloitte Tax LLP
charkins@deloitte.com

Teresa Abney
Tax Senior Manager | Tax WNT
Deloitte Tax LLP
tabney@deloitte.com

Jennifer O'Brien
Tax Senior Manager | Tax WNT
Deloitte Tax LLP
jenobrien@deloitte.com