

## LR #7 **INTERNATIONAL PENALTIES: Provide Uniformity for the Reasonable Cause Exception to Initial and Continuation Penalties for the Failure to File Information Returns Under IRC §§ 6038, 6038A, 6038D, 6677, and 6679**

### TAXPAYER RIGHT(S) IMPACTED<sup>1</sup>

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

### PROBLEM

A taxpayer who fails to timely file certain international information returns using the required forms may be penalized pursuant to several Internal Revenue Code (IRC or the Code) provisions:

- § 6038 (penalty for failure to file information with respect to certain foreign corporations and partnerships);
- § 6038A (penalty for failure to file information with respect to certain foreign-owned corporations);
- § 6038D (penalty for failure to file information with respect to foreign financial assets);
- § 6677 (penalty for failure to file information with respect to certain foreign trusts); and
- § 6679 (penalty for failure to file returns with respect to foreign corporations or foreign partnerships).<sup>2</sup>

Each section generally imposes a \$10,000 initial penalty and additional continuation penalties, which generally accrue every thirty days if the taxpayer does not file the required return within ninety days after being notified by the IRS until the required return is filed, or until the penalties reach statutory maximum.<sup>3</sup>

1 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

2 Internal Revenue Code (IRC) §§ 6038(a)(1), 6038A(a), 6038D(a), 6677(a), and 6679(a). Further, IRC § 6038A(d) also assesses an additional \$10,000 penalty if the taxpayer does not maintain adequate records as required by IRC § 6038A.

3 A continuation penalty is generally \$10,000 each month after 90 days of being notified by the IRS. See IRC § 6038(b), IRC § 6038A(d), IRC § 6038D(d), IRC § 6677(a), and IRC § 6679(a). IRC §§ 6038, 6038D, and 6679 each provide for a maximum \$50,000 continuation penalty. IRC § 6677 provides for a maximum penalty equal to the gross amount that was reportable. IRC § 6038A, however, does not establish a statutory maximum for the penalty.

Despite the similarities in how these penalties are imposed, the following issues may cause confusion for taxpayers, practitioners, and IRS employees alike:

- Some Code provisions provide the reasonable cause exception for the initial penalty only, while others provide it for both the initial and the continuation penalties.<sup>4</sup>
- Reasonable cause language contained in the various Code sections imposing penalties for the failure to file information returns is inconsistent.<sup>5</sup>
- The reasonable cause exception language contained in the Code for some of these penalties does not specifically address facts and circumstances of taxpayers residing abroad and foreign taxpayers with tax filing obligations in the United States. These taxpayers may find it difficult to timely file U.S. information returns prior to determining their tax liability and filing taxes in their countries of residence which may have different tax years and filing deadlines.<sup>6</sup>

Providing uniformity to and simplifying the application of the reasonable cause exception for all international information return penalties will promote the taxpayers' *rights to pay no more than the correct amount of tax* and *to a fair and just tax system*, while improving the administration of the penalty regime by the IRS.<sup>7</sup>

### Example 1

Taxpayer A is a U.S. citizen, living in Malaysia,<sup>8</sup> who owns 100 percent of the stock of a foreign corporation. Under IRC § 6038 and the regulations thereunder, any American citizen who controls a foreign corporation generally must file Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*.<sup>9</sup> The foreign corporation owned by Taxpayer A manufactures custom automobile parts. The foreign corporation secured large contracts for the first time during tax year 2015 and Taxpayer A was not aware of the obligation to file Form 5471. On April 18, 2016, the IRS

4 Compare IRC §§ 6677(d) and 6038D(g) (providing that the reasonable cause exception applies to both the initial and continuation penalties), with IRC §§ 6038(c)(4)(B) and 6038A(d)(3) (providing for no reasonable cause abatement after the 90-day period, from the date of the IRS notice of failure to file to the taxpayers, starts to run), and IRC § 6679(a) (providing that only the initial penalty can be abated for reasonable cause). Under IRC §§ 6038 and 6038A, the start of the 90-day period after expiration of which continuation penalties are imposed is delayed until the last day on which reasonable cause existed for the initial penalty. However, after the 90-day period starts to run and the taxpayer does not furnish the required information return within ninety days, continuation penalties imposed under IRC §§ 6038 or 6038A *cannot* be abated due to reasonable cause.

5 The language of the reasonable cause exception under IRC §§ 6677(d) and 6038D(g) differs to the language found in IRC §§ 6038(c)(4)(B) and 6038A(d)(3), and IRC § 6679(a). This inconsistency in the statutory penalty provisions has caused confusion amongst taxpayers and private practitioners. See, e.g., Lisa O. Nelson & Jonathan T. Amitrano, *Amending and Aligning the IRS International Penalty Structure*, 157 *Tax Notes* 113 (Oct. 2, 2017).

6 Although, in general, reasonable cause determinations are made based on “all the facts and circumstances,” IRC does not define what constitutes reasonable cause and not “willful neglect” in the context of international penalties, nor does it (or regulations) specifically address facts and circumstances of taxpayers residing abroad and foreign taxpayers with tax filing obligations in the U.S. See, e.g., IRC § 6038A; Treas. Reg. § 1.6038A-4(b)(1)(iii).

7 Per TBOR, taxpayers have the *right to a fair and just tax system*, which includes “the right to expect the tax system to consider facts and circumstances that might affect their underlying liabilities, ability to pay, or ability to provide information timely.” See TBOR, <https://taxpayeradvocate.irs.gov/taxpayer-rights>. Subjecting overseas taxpayers to a penalty without taking into account their unique facts and circumstances impairs this right. Taxpayers also have the *right to pay no more than the correct amount of tax*, which includes “the right to pay only the amount of tax legally due, including interest and penalties....”

8 *The U.S. currently does not have a tax treaty with Malaysia.* See [irs.gov, United States Income Tax Treaties - A to Z](https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z), <https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z> (last updated Aug. 17, 2017).

9 IRS Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*, <https://www.irs.gov/pub/irs-pdf/f5471.pdf> (Dec. 2015). See IRC § 6038(a).

mailed notice CP 215,<sup>10</sup> notifying Taxpayer A of the \$10,000 initial penalty and additional continuation penalties if Taxpayer A does not file the Form 5471 within 90 days of receipt of the CP 215. Because of a recent move, Taxpayer A did not receive any IRS notice and failed to file Form 5471 within the 90 days. In October 2017, while meeting with his accounting firm to prepare and file Malaysian taxes, Taxpayer A became aware of the obligation to file the Form 5471 in the U.S. Despite Taxpayer A's best efforts, it took about six months to gather business records, prepare, and file the required returns. By this time, the Form 5471 had been 12 months past due. Even though the IRS agreed to delay the start of the 90-day period upon expiration of which continuation penalties are imposed for six months (until the last day on which reasonable cause existed for the initial penalty), the penalties had compounded to \$40,000 (\$10,000 for the initial penalty and \$10,000 continuation penalty for every 30 days after the 90-day period started to run when Taxpayer A learned of the filing requirement). Taxpayer A consulted with his tax preparer who contacted the IRS to request the abatement of all penalties. The IRS abated the initial penalty but could not abate the continuation penalties because the law does not provide reasonable cause relief after the ninety day period starts to run and the taxpayer did not furnish the required information return within ninety days.<sup>11</sup> Thus, Taxpayer A was ultimately liable for \$30,000 in continuation penalties. Had Taxpayer A not filed the Form 5471 in April 2017, the penalty would continue to accrue in \$10,000 increments at least until the \$50,000 statutory maximum was reached for the continuation penalty under IRC § 6038.

### Example 2

Taxpayer B, a U.S. citizen living in India, owns more than a 50 percent interest in a small business (a foreign partnership) headquartered in India specializing in computer software manufacturing. Taxpayer B contributed property during the prior tax year to the partnership in exchange for a larger interest in the partnership to attain a more than 50 percent ownership. IRC § 6046A and the regulations thereunder generally require a filing of Form 8865 if the taxpayer is a U.S. person who contributed property during the tax year to a foreign partnership in exchange for an at least ten percent interest in the partnership.<sup>12</sup> Taxpayer B recently relocated to a more rural part of India to take part in a government development initiative and left a change of address notification with the local post office. The IRS mailed Taxpayer B a notice of failure to file as required under IRC § 6046A and the regulations thereunder, but Taxpayer B did not receive any notice from the IRS.

Taxpayer B found out about the obligation to file months later while meeting with his accountant in regards to his tax filing in India.<sup>13</sup> Taxpayer B immediately filed the Form 8865 arguing the reasonable cause exception applied because he had not received any IRS notice. While the IRS abated the initial penalty of \$10,000, it could not abate the continuation penalties (capped at \$50,000) because the law does not provide a reasonable cause exception to the continuation penalty.<sup>14</sup>

<sup>10</sup> IRS Letter CP 215, *Notice of Penalty Charge* (Sept. 12, 2017).

<sup>11</sup> The IRS referred his tax preparer to Internal Revenue Manual (IRM) 20.1.9.3.5(2) in interpreting the legal requirements for abatement. See IRM 20.1.9.3.5(2), *International Penalties, Reasonable Cause* (July 8, 2015) (stating "Continuation Penalty — There is no reasonable cause exception for this penalty.").

<sup>12</sup> IRC § 6046A(a); Treas. Reg. § 1.6046A-1(a). See also Schedule P of Form 8865, *Acquisitions, Dispositions, and Changes of Interests in a Foreign Partnership (under section 6046A)* (2017).

<sup>13</sup> The corporate due date for filing taxes under section 139(1) of India's Income Tax Act, 1961 (ITA) is generally September 30 of the tax year. See § 139(1), Income Tax Act (ITA) (1961).

<sup>14</sup> IRC § 6679. See also IRM 20.1.9.15.5(3), *International Penalties, Reasonable Cause* (Mar. 21, 2013) (indicating that under IRC § 6679, "[r]easonable cause does not apply to the continuation penalty.").

Taxpayer B also received a distribution from a foreign trust in India and did not file Form 3520 as required under IRC § 6048 and the regulations thereunder.<sup>15</sup> The IRS assessed an initial penalty of \$10,000 pursuant to IRC § 6677(a) and additional continuation penalties of \$10,000 (capped not to exceed the gross reportable amount). Upon Taxpayer B demonstrating reasonable cause, the IRS abated all penalties since IRC § 6677(d) contains reasonable cause exception for both the initial and continuation penalties.

## RECOMMENDATIONS

To provide consistent and uniform rules for reasonable cause exception for both the initial and continuation penalties for failure to file certain information returns and to take into account taxpayers' facts and circumstances the National Taxpayer Advocate recommends that Congress amend:

- IRC §§ 6038(c)(4)(B), 6038A(d)(3), and IRC § 6679(a)(1) to insert the reasonable cause language contained in IRC §§ 6038D(g) and 6677(d), more specifically to state: “*no penalty shall be imposed by this section on any failure which is shown to be due to reasonable cause and not due to willful neglect*”;
- IRC §§ 6038(c)(4)(B), 6038A(d)(3), and IRC § 6679(a) to explicitly specify that the reasonable cause exception applies to both the initial and continuation penalties; and
- IRC §§ 6038, 6038A, 6038D, 6677, and 6679 to provide that the term “willful neglect” does not include a taxpayer’s first failure to file the required U.S. information returns if the filing deadline in the foreign country differs from that in the U.S.

## PRESENT LAW

IRC §§ 6038, 6038A, 6038D, 6677, and 6679 each penalize taxpayers that fail to timely file the required information returns with an initial penalty of \$10,000 and subsequent continuation penalties which are generally added every 30 days if the taxpayer fails to file the required forms within ninety days of receiving the IRS notice or letter.

### IRC § 6038 - Penalty for Failure to File Information with Respect to Certain Foreign Corporations and Partnerships

Under IRC § 6038 and the regulations thereunder, U.S. persons must in certain cases report information with respect to certain foreign corporations and partnerships.<sup>16</sup> For example, a U.S. person who controls a foreign corporation or foreign partnership generally has a reporting obligation under IRC § 6038 and the regulations thereunder. In general, a U.S. person satisfies a reporting obligation under IRC § 6038 by completing Form 5471 or Form 8865, as applicable, and attaching the Form to the U.S. person’s timely filed income tax return.<sup>17</sup>

<sup>15</sup> See IRS Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts* (2016).

<sup>16</sup> IRC § 6038 requires that a taxpayer file “information as the Secretary may prescribe” and the regulations specify which form is required to be filed. See IRC § 6038(a); Treas. Reg. §§ 1.6038-2.

<sup>17</sup> See IRS Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations* (Dec. 2015). See also IRS Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*. As explained in the Instructions to Form 8865, Form 8865 is used to satisfy reporting obligations under various Code sections: IRC §§ 6038, 6038B, and 6038A, and the related regulations. See *Instructions for Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships* (Oct. 6, 2017).

If the taxpayer fails to satisfy a reporting obligation under IRC 6038, IRC § 6038(b)(1) provides for a \$10,000 initial penalty and IRC § 6038(b)(2) provides for continuation penalties of \$10,000 for each 30-day period after the initial ninety days from the IRS notification to the taxpayer. IRC § 6038(b)(2) also caps the continuation penalty at \$60,000 (consisting of a \$10,000 initial penalty plus \$50,000 in continuation penalties). Treasury regulations provide a reasonable cause exception for abatement of the initial penalty for the failure to file the required forms.<sup>18</sup> However, neither IRC § 6038 nor the regulations thereunder provide for continuation penalty abatement for reasonable cause.<sup>19</sup>

### IRC § 6038A - Penalty for Failure to File Information with Respect to Certain Domestic Corporations

Under IRC § 6038A and the regulations thereunder, certain domestic corporations must report certain information with respect to certain related persons.<sup>20</sup> For example, a domestic corporation directly or indirectly owned at least 25 percent by a foreign person (individual or entity) generally has a reporting obligation under IRC § 6038A if certain transactions occur between the corporation and related persons.<sup>21</sup> In general, a domestic corporation satisfies a reporting obligation under IRC § 6038A by completing Form 5472 and attaching the Form to its timely filed income tax return.<sup>22</sup>

If a reporting corporation fails to satisfy a reporting obligation under IRC § 6038A, IRC § 6038A and the regulations thereunder impose an initial penalty of \$10,000, followed by continuation penalties of \$10,000 for each 30-day period starting 90 days after the IRS mails the notification to the taxpayer. The reasonable cause exception applies to both the initial penalty and continuation penalty,<sup>23</sup> and the maximum amount of the continuation penalties is not capped.<sup>24</sup>

<sup>18</sup> Treas. Reg. § 1.6038-2(k)(3).

<sup>19</sup> In addition to the monetary penalty, IRC § 6038(c) also provides for a ten percent reduction of the foreign tax credit (FTC) available under IRC §§ 901, 902, and 960. IRC § 6038(a) - (c). Under IRC § 6038, the start of the 90-day period after expiration of which continuation penalties are imposed is delayed until the last day on which reasonable cause existed for the initial penalty. However, after the 90-day period starts to run and the taxpayer does not furnish the required information return within 90 days, continuation penalties imposed under IRC § 6038 cannot be abated due to reasonable cause.

<sup>20</sup> IRC § 6038A requires that a taxpayer file “at such time and in such manner as the Secretary shall by regulations prescribe” and the regulations specify which form is required to be filed. See IRC § 6038A(a); Treas. Reg. § 1.6038-2(k)(3).

<sup>21</sup> IRC § 6038A(a); Treas. Reg. §§ 1.6038A-1 through 1.6038A-7. The regulations contain two *de minimis* exceptions to the reporting requirement. See Treas. Reg. §§ 1.6038A-1(h) and 1.6038A-1(i). See also IRS Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code)*, <https://www.irs.gov/pub/irs-pdf/f5472.pdf> (Dec. 2012). Form 5472 must be filed with the reporting corporation’s income tax return for the taxable year by the due date (including extensions) of that return. Treas. Reg. § 1.6038A-2(d). See also IRS Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code)*, <https://www.irs.gov/pub/irs-pdf/f5472.pdf> (Dec. 2012). As explained in the instructions to Form 5472, the Form is used to satisfy reporting obligations under IRC §§ 6038A and 6038C. See *Instructions for Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business* (Dec. 2014), <https://www.irs.gov/pub/irs-pdf/i5472.pdf>.

<sup>22</sup> IRS Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code)*, <https://www.irs.gov/pub/irs-pdf/f5472.pdf> (Dec. 2012).

<sup>23</sup> Treas. Reg. § 1.6038A-4(b). See also IRM 20.1.9.5.5, *Reasonable Cause* (July 8, 2015).

<sup>24</sup> IRC § 6038A(d)(2); Treas. Reg. § 1.6038A-4(d)(4). Notably, the regulation states that the IRS will “apply the reasonable cause exception liberally in the case of a small corporation....” Treas. Reg. 1.6038A-4(b)(2)(ii). Under IRC § 6038A the start of the 90-day period after expiration of which continuation penalties are imposed is delayed until the last day on which reasonable cause existed for the initial penalty. However, after the 90-day period starts to run and the taxpayer does not furnish the required information return within 90 days, continuation penalties imposed under IRC § 6038A cannot be abated due to reasonable cause.

### IRC § 6038D - Penalty for Failure to File Information with Respect to Foreign Financial Assets

The *Foreign Account Tax Compliance Act*, added IRC § 6038D to the IRC.<sup>25</sup> Under IRC § 6038D and the regulations thereunder, certain persons must file information with respect to certain foreign financial assets.<sup>26</sup> In general, a person satisfies a reporting obligation under IRC § 6038D by completing Form 8938 and attaching the Form to its timely filed annual return.<sup>27</sup>

Under the statute and regulations thereunder, the failure to file Form 8938 results in an initial penalty of \$10,000 and continuation penalties of \$10,000 every 30 days if the form is not filed after ninety days of IRS notification. Similar to IRC § 6038, IRC § 6038D caps the continuation penalty so that the taxpayer may not be required to pay more than \$60,000 (consisting of a \$10,000 initial penalty plus \$50,000 in continuation penalties).<sup>28</sup> However, unlike IRC §§ 6038, 6038A and 6679, the language in IRC § 6038D allows reasonable cause abatement of *both* the initial and the continuation penalties.<sup>29</sup> The reasonable cause exception language is in the IRC, providing that “no penalty shall be imposed by this section on any failure which is shown to be due to reasonable cause and not due to willful neglect.”<sup>30</sup>

### IRC § 6677 - Penalty for Failure to File Information with Respect to Certain Foreign Trusts

Under IRC § 6048 and the regulations thereunder, certain persons must file information with respect to certain foreign trusts.<sup>31</sup> For example, a U.S. person who owns assets of a foreign trust and receives a distribution from the trust generally has a reporting obligation under IRC § 6048. In general, a U.S. person satisfies a reporting obligation under IRC § 6048 by completing Form 3520 and filing it by the 15th day of the 4th month following the end of the person’s tax year.<sup>32</sup>

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- 25 Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147, § 511, 124 Stat. 71 (2010). As the Joint Committee on Taxation’s Technical Explanation of the *Hiring Incentives to Restore Employment Act* explains, although the nature of the information required under IRC § 6038D is similar to the information disclosed on an Foreign Bank Account Report (FBAR), it is not identical and was not intended as a substitute for compliance with the FBAR reporting requirements. See J. COMM. ON TAX’N, JCX-4-10, *Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the “Hiring Incentives to Restore Employment Act,” under Consideration by the Senate* (Feb 23, 2010).
- 26 IRC § 6038D requires that a taxpayer “shall attach to such person’s return of tax imposed by subtitle A for such taxable year the information described in subsection (c) with respect to each such asset” and the regulations thereunder specify the forms required to be attached. See IRC § 6038D(a); Treas. Reg. § 1.6038D-2(a).
- 27 IRC § 6038D(a); Treas. Reg. § 1.6038D-2(a). See also IRS Form 8938, *Statement of Specified Foreign Financial Assets* (2016), <https://www.irs.gov/pub/irs-pdf/f8938.pdf>.
- 28 IRC § 6038D(d)(2); Treas. Reg. § 1.6038D-8(c).
- 29 IRC § 6038D(g); Treas. Reg. § 1.6038D-8(e). Treasury Regulation § 1.6038D-8(e)(3) further states that the reasonable cause exception determination for this section “is made on a case-by-case basis, taking into account all pertinent facts and circumstances.” This approach comports with the taxpayer’s *right to a fair and just tax system*, which requires the IRS “to consider facts and circumstances that might affect their underlying liabilities, ability to pay, or ability to provide information timely.” See TBOR, [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights).
- 30 IRC § 6038D(g); Treas. Reg. § 1.6038D-8(e). See also IRM 20.1.9.22.5, *Reasonable Cause* (Mar. 21, 2013).
- 31 IRC § 6677 provides that the information is to be filed as “determined by the Secretary” and refers to IRC § 6048 which authorizes the Secretary to prescribe the information required to be reported. The regulations thereunder specify the forms required to be attached. See IRC § 6677(a); IRC § 6048; Treas. Reg. § 404.6048-1. See also *Instructions for Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts* (Nov. 20, 2017), <https://www.irs.gov/pub/irs-pdf/i3520.pdf>; *Instructions for Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner* (Nov. 20, 2017), <https://www.irs.gov/pub/irs-pdf/i3520a.pdf>.
- 32 IRC § 6677; IRC § 6048. IRC § 6048 requires that U.S. persons who own assets of a foreign trust, or who received a distribution or loan from a foreign trust, to file Form 3520 (or to file Form 3520-A for a foreign trust with a U.S. owner). See IRS Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts* (2016), <https://www.irs.gov/pub/irs-pdf/f3520.pdf>. See also IRS Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner* (Under section 6048(b)) (2016), <https://www.irs.gov/pub/irs-pdf/f3520a.pdf>.

IRC § 6677 and the regulations thereunder impose an initial penalty of the greater of \$10,000 or 35 percent of the gross reportable amount if a taxpayer fails to file the forms required under IRC § 6048.<sup>33</sup> The continuation penalties of \$10,000 are imposed every thirty days after ninety days pass from the time of the IRS notice or letter informing the taxpayer of the initial penalty. However, continuation penalties cannot exceed the gross reportable amount on Form 3520 or Form 3520-A.<sup>34</sup> Similar to IRC § 6038D(g), there is a reasonable cause exception under IRC § 6677(d) which applies to both the initial and continuation penalties.<sup>35</sup> The reasonable cause language is codified and identical to the reasonable cause exception under IRC § 6038D(g) described above.<sup>36</sup>

### IRC § 6679 - Penalty for Failure to File Returns with Respect to Foreign Corporations or Foreign Partnerships

IRC § 6679 provides a penalty for a failure to comply with IRC §§ 6046 or 6046A reporting obligations. Under IRC §§ 6046 and 6046A and the regulations thereunder, taxpayers must file returns with respect to certain foreign corporations or foreign partnerships.<sup>37</sup> For example, a U.S. citizen who is an officer or director of a foreign corporation in which a U.S. person has acquired ten percent or more of the stock of the corporation generally has a reporting obligation under IRC § 6046.<sup>38</sup> In general, a U.S. person satisfies a reporting obligation under IRC § 6046 by completing Form 5471 and attaching the Form to the U.S. person's timely filed income tax return.

Under IRC § 6046A and the regulations thereunder, certain persons must file information with respect to certain interests in foreign partnerships. For example, a U.S. person who acquires an at least ten percent interest in a foreign partnership generally has a reporting obligation under IRC 6046A.<sup>39</sup> In general, a U.S. person satisfies a reporting obligation under IRC § 6046A by completing Form 8865 and attaching the Form the U.S. person's timely filed income tax return.

Under these requirements, an initial penalty of \$10,000 is imposed on any taxpayer who fails to comply with IRC §§ 6046 and 6046A, unless the taxpayer can show reasonable cause.<sup>40</sup> If any failure to comply with a reporting obligation under IRC §§ 6046 or 6046A continues for more than ninety days after the IRS mails a notice of such failure to the taxpayer, IRC § 6679 and the regulations thereunder impose continuation penalties of \$10,000 for every 30 days thereafter (capped at \$60,000 in total for both initial and continuation penalties).<sup>41</sup> The statute does not define "reasonable cause," and while the

33 This penalty is imposed in addition to any criminal penalty provided by other laws. IRC § 6677(a)-(a)(2), as amended by the Foreign Account Tax Compliance Act, part of the Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147, IRC § 535(a), 124 Stat. 71 (2010).

34 IRC § 6677(a)(2).

35 IRC § 6677(d). See also IRM 20.1.9.22.5, *Reasonable Cause* (Mar. 21, 2013).

36 Compare IRC § 6038D(g) with IRC § 6677(d).

37 IRC § 6679 refers to requirements under IRC §§ 6046 and 6046A which state that the filing must done "as the Secretary prescribes" (IRC § 6046) and as "the Secretary shall by regulations prescribe" (IRC § 6046A). IRC §§ 6679(a), 6046(b), and 6046A(b). The regulations thereunder specify the forms required to be attached. See Treas. Reg. §§ Treas. Reg. 1.6046-1 and 1.6046A-1.

38 IRC § 6046(a); Treas. Reg. 1.6046-1. See IRS Schedule O of Form 5471, *Organization or Reorganization of Foreign Corporation, and Acquisitions and Dispositions of its Stock*, <https://www.irs.gov/pub/irs-pdf/f5471so.pdf> (Dec. 2012).

39 IRC § 6046A(a); Treas. Reg. § 1.6046A-1(a). See Schedule P of Form 8865, *Acquisitions, Dispositions, and Changes of Interests in a Foreign Partnership (under section 6046A)*, <https://www.irs.gov/pub/irs-pdf/f8865sp.pdf> (2017).

40 IRC § 6679(a)(1); Treas. Reg. § 301.6679-1.

41 *Id.*

statute and the Treasury regulation provide for a reasonable cause exception for the initial penalty, the exception does not apply for the continuation penalties.<sup>42</sup>

## REASONS FOR CHANGE

The IRS increasingly collects more revenue from penalties than it did in the past. The IRS assessed about 39.6 million civil penalties (or \$27.3 billion in aggregate) in Fiscal Year (FY) 2016, up from about 15 million (or \$1.3 billion in aggregate) in FY 1978.<sup>43</sup> In adjusted for inflation dollars, the IRS assessed 4.7 times more civil penalties in FY 2016 than in FY 1978. It also abated about 5.2 million civil penalties (or \$9 billion in aggregate) in FY 2016, up from 1.4 million (or \$338 million in aggregate) in FY 1978.<sup>44</sup> As demonstrated by Figure 2.7.1., the IRS imposes an increasing number of penalties for the failure to file various international information returns.

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42 IRC § 6679(a)(1); Treas. Reg. § 301.6679-1(a)(3) (providing that “[i]f the taxpayer exercises ordinary business care and prudence and is nevertheless unable to furnish any item of information required under section 6035, 6046, or 6046A and the regulations thereunder, such failure shall be considered due to a reasonable cause”). IRC § 6679, does not provide for a reasonable cause abatement of the continuation penalty. See also IRM 20.1.9.15.5, *International Penalties, Reasonable Cause* (Mar. 21, 2013). This is because the continuation penalty is found in section 6679(a)(2), and the only reference to reasonable cause is found in section 6679(a)(1), which refers only to the initial penalty and not the continuation penalty.

43 The earliest year comparable information was found in an IRS Data Book. IRS Data Book (FY 2016) (Table 17); IRS Data Book (FY 1978) (Table 13).

44 IRS Data Book (FY 2016) (Table 17); IRS Data Book (FY 1978) (Table 13).



**FIGURE 2.7.1, International Penalties Assessed and Abated in the Aggregate in FYs 2013 and 2016<sup>45</sup>**

Fiscal Year Assessed	Penalty Type	Penalty Assessed	Penalty Abated	Net Penalty	Percent Abated
2013	Initial Penalty - IRC § 6038 (Penalty Codes 599 and 623)	\$40,478,250	\$32,891,099	\$7,587,151	81.3 %
2013	Continuation Penalty - IRC § 6038 (Penalty Code 619)	\$5,193,983	\$1,617,567	\$3,576,416	31.1 %
2013	Initial Penalty - IRC § 6038A (Penalty Code 625)	\$350,000	\$56,500	\$293,500	16.1 %
2013	Continuation Penalty - IRC § 6038A (Penalty Code 711)	\$150,336,000	\$123,754,528	\$26,581,472	82.3 %
2013	Initial Penalty - IRC § 6677 (Penalty Codes 659 and 660)	\$111,697,966	\$80,897,639	\$30,800,327	72.4 %
2013	Initial Penalty - IRC § 6679 (Penalty Code 613)	\$30,000	\$0	\$30,000	0 %
2016	Initial Penalty - IRC § 6038 (Penalty Codes 599 and 623)	\$55,993,300	\$35,629,000	\$20,364,300	63.6 %
2016	Continuation Penalty - IRC § 6038 (Penalty Codes 619 and 712)	\$49,761,336	\$13,770,000	\$35,991,336	27.7 %
2016	Initial Penalty - IRC § 6038A (Penalty Code 625)	\$610,000	\$0	\$610,000	0 %
2016	Continuation Penalty - IRC § 6038A (Penalty Codes 701 and 711)	\$309,732,100	\$226,218,100	\$83,514,000	73.0 %
2016	Initial Penalty - IRC § 6038D (Penalty Code 700)	\$60,000	\$0	\$60,000	0 %
2016	Initial Penalty - IRC § 6677 (Penalty Codes 659 and 660)	\$709,187,004	\$7,000,000	\$702,187,004	0.98 %
2016	Continuation Penalty - IRC § 6677 (Penalty Codes 702 and 703)	\$6,645,580	\$0	\$6,645,580	0 %
2016	Initial Penalty - IRC § 6679 (Penalty Code 613)	\$60,000	\$0	\$60,000	0 %
2016	Continuation Penalty - IRC § 6679 (Penalty Code 704)	\$2,687,250	\$15,315	\$2,671,935	0.6 %

Almost 30 years ago, Congress recommended the IRS “develop better information concerning the administration and effects of penalties” to ensure they promote voluntary tax compliance.<sup>46</sup> It is

45 This data was obtained from TAS Research (from the January 2017 Enforcement Revenue Information System database on the IRS Compliance Data Warehouse).

46 See H.R. REP. No. 101-386, at 661 (1989) (Conf. Rep).

the IRS's longstanding policy to do so,<sup>47</sup> and many of the IRS's stakeholders, including the National Taxpayer Advocate, have recommended changes to the penalty regime.<sup>48</sup>

Currently, as they are written, IRC §§ 6038, 6038A, 6038D, 6677, and 6679 may be confusing for taxpayers, practitioners and IRS employees because they do not contain uniform language regarding the reasonable cause exception.<sup>49</sup> IRC §§ 6038D and 6677 explicitly allow for a reasonable cause as an exception to both the initial penalty and the continuation penalties, whereas, IRC § 6679 *only* allows reasonable cause as an exception for the initial penalty, even if affected taxpayers can show reasonable cause for failing to file both the initial and continuation penalties. At the same time, IRC §§ 6038 and 6038A provide that the start of the ninety day period after expiration of which continuation penalties are imposed is delayed until the last day on which reasonable cause existed for the initial penalty. However, after the 90-day period starts to run and the taxpayer does not furnish the required information return within ninety days, continuation penalties imposed under IRC §§ 6038 or 6038A cannot be abated due to reasonable cause.

In addition, reasonable cause language contained in the various Code sections imposing penalties for the failure to file information returns is inconsistent. IRC §§ 6038D(g) and 6677(d), contain the following reasonable cause language: “*no penalty shall be imposed by this section on any failure which is shown to be due to reasonable cause and not due to willful neglect.*” (emphasis added).<sup>50</sup> Unlike §§ 6038D(g) and 6677(d), IRC §§ 6038 and 6038A do not contain a separate subsection describing reasonable cause. Instead IRC §§ 6038(c)(4)(B) and 6038A(d)(3) include language delaying “the beginning of the 90-day period after notice” by the IRS until “the last day on which... reasonable cause existed...”<sup>51</sup> Moreover, as stated above, IRC § 6679(a)(1) imposes the initial \$10,000 penalty “unless it is shown that such failure is due to reasonable cause,” but does not provide reasonable cause relief for the increase in penalty where failure continues after notification (*i.e.*, continuation penalties) at all.<sup>52</sup>

Finally, the reasonable cause exception language does not specifically take into consideration whether there is a mismatch in filing requirements or filing deadlines between foreign jurisdictions and the U.S., and does not consider such mismatch as a factor negating “willful neglect.” Although, in general, reasonable cause determinations are made based on “all the facts and circumstances,” current law does not define what constitutes reasonable cause and not “willful neglect” in the context of international penalties, nor does it specifically address facts and circumstances of taxpayers residing abroad and foreign taxpayers with tax filing obligations in the U.S. Thus, U.S. taxpayers residing abroad and foreign taxpayers with U.S. filing obligations may find it difficult to timely file U.S. information returns

47 Policy Statement 20-1 (Formerly P-1-18), reprinted at IRM 1.2.20.1.1(1)-(2) (June 29, 2004). See also IRM 20.1.1, Introduction and Penalty Relief (Aug. 5, 2014).

48 In the past, the National Taxpayer Advocate has written extensively about penalties, touching on topics of fairness, equity, and whether penalties are effective in promoting taxpayer compliance. See National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2, 24 (*A Framework for Reforming the Penalty Regime*) (recommending legislation to make the penalty proportional to the decrease in tax, establish a “reasonable cause” exception, and to eliminate the potential for stacking). See also National Taxpayer Advocate 2014 Annual Report to Congress 94-101 (Most Serious Problem: *Penalty Studies: The IRS Does Not Ensure Penalties Promote Voluntary Compliance, as Recommended by Congress and Others*); National Taxpayer Advocate 2014 Annual Report to Congress 351-356 (Legislative Recommendation: *Erroneous Refund Penalty: Amend Section 6676 to Permit “Reasonable Cause” Relief*).

49 See, e.g., Lisa O. Nelson & Jonathan T. Amitrano, *Amending and Aligning the IRS International Penalty Structure*, 157 TAX NOTES 113 (Oct. 2, 2017).

50 IRC § 6038D(g); IRC § 6677(d).

51 See IRC §§ 6038(c)(4)(B) and 6038A(d)(3). See also Treas. Reg. § 1.6038-2(k)(3) & (4), Treas. Reg. § 1.6038A-4(b).

52 IRC § 6679(a)(1) & (2); Treas. Reg. § 301.6679-1(a)(3).

prior to determining their tax liability and filing taxes in their countries of residence which may have different tax years and filing deadlines.

Providing uniformity to and simplifying the application of the reasonable cause exception will promote the taxpayers' *right to pay no more than the correct amount of tax* and their *right to a fair and just tax system*, and improve the administration of the penalty regime by the IRS.

## EXPLANATION OF RECOMMENDATION

The proposed legislative changes would promote voluntary compliance by simplifying and streamlining the reasonable cause exception making these penalties more simple and fair.<sup>53</sup> Complicated tax laws make it more likely that taxpayers who have acted reasonably in trying to comply will, nonetheless, fail and be subjected to penalties, thus eroding future voluntary compliance. Additionally, penalizing taxpayers who acted reasonably in trying to comply, especially taxpayers abroad who may have to file in multiple jurisdictions, will alienate them further.<sup>54</sup>

The proposed legislative changes will achieve consistency, simplicity, and uniformity in the application of reasonable cause exception to various international information return penalties. This could be achieved by inserting the uniform reasonable cause language currently contained in IRC § 6038D and IRC § 6677:

“No penalty shall be imposed by this section on any failure which is shown to be due to reasonable cause and not due to willful neglect.”<sup>55</sup>

In addition, providing that the reasonable cause exception is available for both initial and continuation penalties will eliminate inconsistency and associated unfairness, *i.e.*, when the facts that may lead to abatement of the initial penalty, become irrelevant for continuation penalties for which reasonable cause does not apply.

Finally, specifying that the term “willful neglect” does not include a taxpayer’s first-time failure to file certain information by the due date if the delay is caused by different tax filing deadlines in foreign jurisdictions will allow the IRS to consider all relevant facts and circumstances of overseas taxpayers.<sup>56</sup>

53 The IRM states that “[t]he Internal Revenue Service has a responsibility to collect the proper amount of tax revenue in the most efficient manner. Penalties provide the Service with an important tool to achieve that goal because they enhance voluntary compliance by taxpayers.” IRM 1.2.20.1.1, *Policy Statement 20-1* (Formerly P-1-18) (June 29, 2004).

54 See National Taxpayer Advocate 2008 Annual Report to Congress vol. 2 (*A Framework for Reforming the Penalty Regime*).

55 IRC § 6038D(g); § 6677(d).

56 Additionally, the National Taxpayer Advocate has expressed concerns in the past about notices not reaching taxpayers and about the IRS failure to mail notices to taxpayers last known addresses. See, e.g., National Taxpayer Advocate 2012 Annual Report to Congress 526-36 (Legislative Recommendation: *Amend IRC § 7701 to Provide a Definition of “Last Known Address,” and Require the IRS to Mail Duplicate Notices to Credible Alternate Addresses*); National Taxpayer Advocate 2010 Annual Report to Congress 221-34 (Most Serious Problem: *The IRS Has Not Studied or Addressed the Impact of the Large Volume of Undelivered Mail on Taxpayers*); National Taxpayer Advocate 2008 Annual Report to Congress 449-51 (Legislative Recommendation: *Mailing Duplicate Notices to Credible Alternate Addresses*).