

# International Tax Update

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TXCPA - October 24, 2024

# Agenda

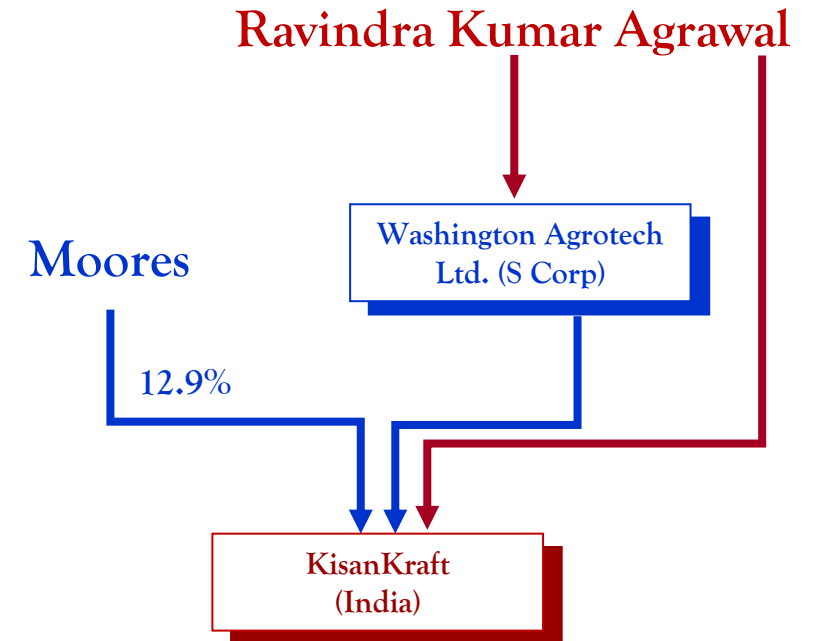
- Important Cases
  - Moore v. United States.
  - Aroeste v. United States
- Proposed regulations for Foreign Trusts
- International Tax Reporting and Compliance
- International Tax Penalties

# International Tax Caselaw Update

# Moore v. United States

# Background

- **Facts:** Individuals subject to mandatory repatriation tax of § 965 as a U.S. shareholder.
- **Taxpayer:** Claims that § 965 is unconstitutional based on *Macomber v. Eisner* because § 965 taxes unrealized income.
- **Government:** § 965 is within Congress' authority to enact under the 16th Amendment. Realization is not a constitutional requirement but a matter of administrative convenience.
- **9th Circuit:** Ruled in favor of the government. *Moore v. U.S.*, 36 F.4th 930 (9th Cir. 2022).



# Context

- I.R.C. Section 965 “Mandatory Deemed Repatriation” or “Transition Tax”
  - On December 22, 2017, President Trump signed the TCJA into law.
  - Of particular significance are the changes related to the enactment of a new participation exemption regime that effectively exempts from U.S. taxation dividends paid by foreign corporations to their U.S. corporate shareholders.
- In general, IRC 965 requires United States shareholders, as defined under IRC 951(b), to pay a transition tax on the untaxed foreign earnings of certain specified foreign corporations as if those earnings had been repatriated to the United States

# Context

- Who was affected?
  - The Mandatory Deemed Repatriation applied to U.S. persons (including individuals) who owned as of December 31, 2017, 10% or more of the shares of a specified foreign corporation (“SFC”), which include:
    - “controlled foreign corporations”; and
    - foreign corporations that have a U.S. corporate shareholder that owns 10% or more of the shares in the foreign corporation.
- Affected U.S. persons were required to include in income their share of the SFC’s undistributed earnings and profits “as if” the SFC had repatriated all of its earnings and profits as of December 31, 2017 through a dividend distribution.
- The big question for the SCOTUS is whether the 16<sup>th</sup> Amendment requires that income is realized.

# The Supreme Court narrowed the issue: Not realization anymore but attribution of realized income

- “the precise and narrow question that the Court addresses today is whether Congress may attribute an entity’s realized and undistributed income to the entity’s shareholders or partners.”
- “(...) the MRT does tax realized income—namely, the income realized by KisanKraft, which the MRT attributes to the shareholders (...) Congress may attribute an entity’s realized and undistributed income to the entity’s shareholders or partners and then tax the shareholders or partners on their portions of that income.”
- “The Court’s holding is narrow and limited to entities treated as pass-throughs. Nothing in this opinion should be read to authorize any hypothetical congressional effort to tax both an entity and its shareholders or partners on the same undistributed income realized by the entity. **Nor does this decision attempt to resolve the parties’ disagreement over whether realization is a constitutional requirement for an income tax.**”
- Holding: “The MRT—which attributes the realized and undistributed income of an American-controlled foreign corporation to the entity’s American shareholders, and then taxes the American shareholders on their portions of that income—does not exceed Congress’s constitutional authority.”



# Dissecting the Justices' stances on the realization requirement

## Majority Opinion



Justice Brett Kavanaugh



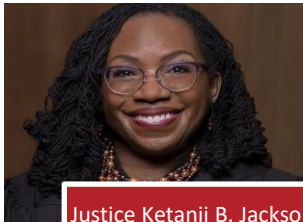
Justice John Roberts



Justice Sonia Sotomayor



Justice Elena Kagan



Justice Ketanji B. Jackson

## requirement

## Against the Realization Requirement



“[B]oth before and after the Sixteenth Amendment was adopted, the term ‘income’ was widely recognized as flexible enough to include both realized and unrealized gains.” “[T]here is no constitutional requirement, from *Macomber* or otherwise, that a taxpayer ‘be able to sever . . . the gain from his original capital’ in order to be taxed on it.”

# In favor of the realization requirement

## Concurring Opinion



Justice Amy  
C. Barrett



Justice  
Samuel A.  
Alito

“The question on which we granted review is ‘[w]hether the Sixteenth Amendment authorizes Congress to tax unrealized sums without apportionment among the states.’ (...) The answer is straightforward: No.”

## Dissenting Opinion



Justice  
Clarence  
Thomas



Justice Neil  
M. Gorsuch

“The Moores are correct. Sixteenth Amendment ‘incomes’ include only income realized by the taxpayer. The text and history of the Amendment make clear that it requires a distinction between ‘income’ and the ‘source’ from which that income is ‘derived.’ And, the only way to draw such a distinction is with a realization requirement.”

## Justice Thomas' Dissent:

- “The Court today upholds the MRT, but not because it endorses the Ninth Circuit’s erroneous view that ‘realization of income is not a constitutional requirement.’ 36 F. 4th, at 936. The majority acknowledges that the Sixteenth Amendment draws a distinction between income and its source (...) **And, it does not dispute that realization is what distinguishes income from property (...)** Those premises are sufficient to establish that realization is a constitutional requirement. Sixteenth Amendment ‘income’ is only realized income. We should not have hesitated to say so in this case.”

## **What are the next candidates for the SCOTUS to rule on the realization requirement?**

- Section 1256 (mark-to-market certain investment contracts).
- Section 1259 (constructive sale of appreciated financial positions).
- Section 877A (mark-to-market rule – exit tax – for covered expatriates).
  - Does not require a transfer of property. Thus, it is a tax imposed on the mere appreciation of the covered expatriate’s property.

# The Aroeste Case

# Aroeste v. United States - Background

- The Aroestes were lifelong citizens and residents of Mexico.
- They obtained green cards in the early 1980s.
- Estela Aroeste became a U.S. citizen in 2011.
- They originally filed joint Forms 1040 (U.S. Individual Income Tax Return) for several years. The years at issue in the case are 2012 and 2013.
  - The status “Married Filing Jointly” is only permitted if either (a) both spouses are U.S. citizens or residents or (b) one of the spouses is a U.S. citizen and the two elect to be treated as residents and waive treaty benefits (IRC section 6013(g)).
- They were advised to enter into Offshore Voluntary Compliance Program (OVDP) to correct compliance failures relating to non-U.S. income and assets.
- They later opted out of the OVDP. Mr. Aroeste filed a separate return as a nonresident under U.S.-Mexico Income Tax Treaty (filing Forms 1040NR and Forms 8833).

# Aroeste v. United States - Background

- Following their opting out of the OVDP, a Revenue Agent audited the taxpayers for several years.
- The agent “assessed” FBAR penalties on a per-account basis.
- The agent also assessed income tax deficiencies as well as penalties for failure to file international information returns that are required of U.S. persons.
- The case that has been decided at the District Court level concerns FBARs. The income tax case pending before the U.S. Tax Court has not yet been decided.

# The District Court Decides the Case

- On November 20, 2023, on motions for summary judgment by both parties, Judge Anthony Battaglia denied the government motion and mostly granted Mr. Aroeste's motion for a discharge of FBAR penalties and a refund of the penalties already paid. *Aroeste v. United States*, No. 3:22-CV-00682 (S.D. CA).
- The judge ordered Mr. Aroeste to pay a penalty of \$1,000 for each failure to file timely Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)) to report his position that he was not a U.S. resident because of the application of the Treaty.



## Background to the Decision – the FBAR Requirement

- The Financial Crimes Enforcement Network (FinCEN) is a unit of the U.S. Treasury Department.
- Under the Bank Secrecy Act, Title 31 U.S. Code, FinCEN requires United States persons to file each year a Report of Foreign Bank and Financial Accounts (known to all as the FBAR) arises from Bank Secrecy Act, Title 31, if the aggregate value of all foreign accounts exceeded \$10,000 during the year
- In 2010, FinCEN promulgated a regulation that defined *who* is subject to the FBAR filing requirement that became effective in 2011. This regulation included United States citizens and residents and certain entities.
- Before 2011, the term “United States resident” was not defined. The new regulation adopted the tax law definition contained in Title 26 U.S. Code (*i.e.*, the U.S. Internal Revenue Code, or “IRC”) section 7701(b), but with a definition of “United States” that included U.S. territories.

## Aroeste v. United States – Court’s Analysis

The Court decided that the issue should be decided based on a five-step analysis:

1. Under 26 U.S.C. § 7701(b)(6), anyone allowed to permanently reside within the United States by virtue of US immigration laws is a “lawful permanent resident” for tax purposes *unless* an applicable tax treaty allows that person to be treated as a resident of a foreign country for tax purposes only;
2. Under 26 U.S.C. § 7701(b)(1)(A)(i), any “lawful permanent resident” is a “resident alien”;
3. Under 31 C.F.R. § 1010.350(b)(2), any “resident alien” is a “resident of the United States”;
4. Under 31 C.F.R. § 1010.350(b), any “resident of the United States” is a “United States person” required to file an FBAR;
5. Therefore, any person allowed to permanently reside in the United States by virtue of US immigration laws must file an FBAR unless that person is entitled to be treated as a resident of a foreign country under a tax treaty

## What Is the Effect of a Tax Treaty?

- Because FinCEN had adopted the definition of residence in the IRC, the question arose, what if an individual meets the statutory definition, as supplemented by Treasury Regulations, but is nevertheless treated as a resident of another country with which the United States has an income tax treaty and, under the tiebreaker provision of the treaty, the individual is treated as a resident of the other country.
- The FinCEN regulations, the FBAR and the instructions to the FBAR are all silent on this point. In the preamble to the regulations when they were issued in 2011, FinCEN stated “[a] legal permanent resident who elects under a tax treaty to be treated as a non-resident for tax purposes must still file the FBAR.” Judge Battaglia rejected the government’s reliance on this language given the plain language of the regulation itself, which makes no mention of any exception for individuals who are nonresidents under a treaty.

# Treaty Provisions on Residence

- The U.S.-Mexico Tax Treaty contains a “tie-breaker”, based on an OECD model. Almost identical provisions appear in numerous tax treaties. Article 4 provides a series of tests to be applied in order of priority:
  - “ 2. Where . . . an individual is a resident of both Contracting States, then his residence *shall* be determined as follows:
    - a) he *shall* be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both Contracting States, he *shall* be deemed to be a resident of the State which his personal and economic relations are closer (center of vital interests);
    - b) if the State in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he *shall* be deemed to be a resident of the State in which he has an habitual abode . . . .
    - c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;
    - d) in any other case, the competent authorities of the Contracting States shall settle the question by mutual agreement.”
- The Judge held (and the government conceded) that under Article 4, Mr. Aroeste was a resident of Mexico. See the Appendix for more detail about the underlined terms above.

# Other Issues in the Case – 1

- Section 6114 provides that each taxpayer who “takes the position that a treaty of the United States overrules (or otherwise modifies) an internal revenue law of the United States shall disclose” such position on a return or in the form prescribed. The form in question is Form 8833.
- Mr. Aroeste eventually filed this form after opting out of the OVDP but it was long past the date to be timely.
- The Government argued that Alberto “implicitly labeled himself as a resident alien” when he filed a joint Form 1040 with his wife rather than a Form 1040NR and that by doing so he “waived his ability to assert a treaty position.”
- The Judge decided that there was no waiver; the only consequence was a \$1,000 penalty for failure to file the form. The Judge noted that this was the only consequence provided by IRC section 6712 (“If a taxpayer fails to meet the requirements of section 6114, there is hereby imposed a penalty equal to \$1000 . . .”) and there was nothing in the regulations to the contrary.

## Other Issues in the Case – 2

- The Judge reviewed the flush language in IRC section 7701(b)(6).  
“An individual shall cease to be treated as a lawful permanent resident of the United States if [i] such individual commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country, [ii] does not waive the benefits of such treaty applicable to residents of the foreign country, and [iii] notifies the Secretary of the commencement of such treatment”. (Numbering added for clarity.)
- The Judge decided that Mr. Aroeste had met all three requirements and in particular that to satisfy item (iii) there was no timely filing requirement.
- The government argued that Mr. Aroeste had failed to file Form 8854 (Initial and Annual Expatriation Statement). The Judge held that this requirement was invalid, as it was required by Notice 2009-85, which had not been issued in compliance with the Administrative Procedures Act.

## Other Issues in the Case – 3

- At least in the FBAR case, issues relating to Treas. Reg. sec. 301.7701(b)-7(a)(3) remain unresolved.
  - “Generally, for purposes of the Internal Revenue Code other than the computation of the individual's United States income tax liability, the individual shall be treated as a United States resident.”
- Does this include international information returns and possibly FBARs? The Judge did not consider this point nor, so far as we can tell, did the government raise it.
  - For example, Form 8858 (Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs)) must be filed by “U.S. persons.”
  - What is a “U.S. person”? According to the instructions to Form 8858, it includes a citizen or resident alien of the U.S., and refers to Publication 519 “for guidance on determining resident alien status.”
  - Publication 519 provides that “[i]f you are treated as a resident of a foreign country under a tax treaty, you are treated as a nonresident alien in figuring your U.S. income tax. For purposes other than figuring your tax, you will be treated as a U.S. resident.”
  - How does this play a role with the proposed regulations regarding Foreign Trusts?

# Proposed Regulations regarding Foreign Trusts



# IRS statement on proposed regs that address foreign trust information reporting

**Topics in the news**

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**News releases**

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**Multimedia center**


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**Tax relief in disaster situations**

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**Inflation Reduction Act**

May 8, 2024

This week, the Treasury Department and the IRS released [proposed regulations](#)  for transactions with foreign trusts and information reporting on transactions with foreign trusts and large foreign gifts that are reported using Forms 3520 and 3520-A. Recent feedback from stakeholders has highlighted potential opportunities for improvement with respect to the IRS' penalty processes related to Forms 3520 and 3520-A. As such, the IRS has assembled a working group to further evaluate its penalty processes associated with Forms 3520 and 3520-A to identify opportunities for improvement, reduce burden and incentivize voluntary compliance. We plan to have further details on the group's recommendations in the near future.

# Context – Obligations for U.S. Persons relating to Foreign Trusts



Section 6048 generally requires U.S. persons to report transactions that involve foreign trusts.

- Section 6677 imposes penalties on U.S. persons for failing to comply with Section 6048.

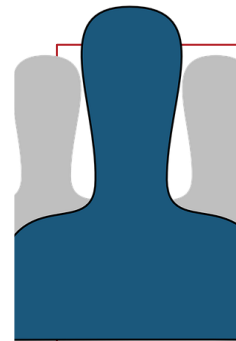


Section 6039F requires U.S. persons to report the receipt of large gifts or bequests from foreign persons, and in the event of a failure to provide this information, section 6039F(c) imposes penalties and allows the IRS to recharacterize the purported gift or bequest as income.

- U.S. Persons provide information required by the foreign trust and gift provisions on Form 3520 and Form 3520-A.



Section 643(i) generally provides that, if a foreign trust makes a loan of cash or marketable securities directly or indirectly to any grantor or beneficiary of the foreign trust who is a U.S. person, or to a U.S. person related to such a grantor or beneficiary, the amount of the loan is treated as a distribution by the trust to the grantor or beneficiary.



Section 679 treats a U.S. person who directly or indirectly transfers property to a foreign trust as the owner of the portion of the foreign trust attributable to the transferred property to the extent that, under the terms of the trust, the income or corpus of the trust may be paid to or accumulated for the benefit of a U.S. person during the taxable year, including if the trust were to be terminated during the taxable year.

# Who is a “U.S. person”?

- Reg. § 1.679-1(c)(2) provides a definition of “U.S. person” (for purposes of § 679):
  - A U.S. person as defined in § 7701(a)(30)
  - An NRA who elects under §6013(g) to be treated as a resident of the U.S., and
  - An individual who is a dual resident taxpayer within the meaning of § 301.7701(b)-7(a).
- The proposed regulations amend the definition of “U.S. person” for purposes of § 619 to exclude dual residents with respect to any taxable year for which such person computes U.S. tax liability as an NRA.
- The definition of “U.S. person” also does not include dual residents for purposes of § 643.

# Proposed Regulations

- For purposes of § 6039F:
  - Treasury and IRS think that reporting on Form 3520 is not necessary for dual resident taxpayers who claim to be treated as a resident of a treaty partner.
  - “These rules are relevant both for purposes of determining whether a dual resident taxpayer or dual status taxpayer who receives a foreign gift is a U.S. person required to report the foreign gift on Form 3520 and for purposes of determining whether a gift or bequest from a dual resident taxpayer or dual status taxpayer is a gift from a foreign person.”
- For purposes of § 6048:
  - A dual resident taxpayer “who computes U.S. income tax liability as an NRA and complies with the filing requirements of § 301.7701(b)-7(b) and (c) is not treated as a U.S. person for purposes of the proposed regulations for the portion of the year that the dual resident taxpayer is treated as an NRA.”
    - Form 1040NR
    - Form 8833 (Treaty-Based Return Position Disclosure).
  - Effect of Aroeste?

# Inbound Migration of Foreign Trusts

## What is a Foreign Trust?

- A trust is considered a “United States person” if (i) a U.S. court can exercise primary supervision over the trust administration (the “Court Test”), and (ii) U.S. persons control all substantial trust decisions (the “Control Test”). IRC § 7701(a)(30)(E).
- If a trust is a United States person, such trust is considered a domestic trust. All other trusts are foreign trusts. Treas. Reg. § 301.7707-7(a)(2)

# Safe Harbor Test - Treas. Reg. § 301.7701-7(c)(1)

- A trust is considered to meet the court test if the following conditions are met:
  - The trust instrument does not direct that the trust be administered outside of the United States;
  - The trust, in fact, is administered exclusively in the United States, and
  - The trust is not subject to an “automatic migration provision,” meaning that the trust instrument provides that a United States court’s attempt to assert jurisdiction or otherwise supervise the administration of the trust directly or indirectly would cause the trust to migrate from the United States
- Thus, for example, a Mexican Fideicomiso that is exclusively administered in the United States (e.g., books and records are maintained in the U.S., and management and investment decisions are made by U.S. persons) could satisfy the Court Test even if the Trust Agreement does not provide for U.S. courts to exercise primary supervision over the Trust.

## Proposed Regs. under § 6048

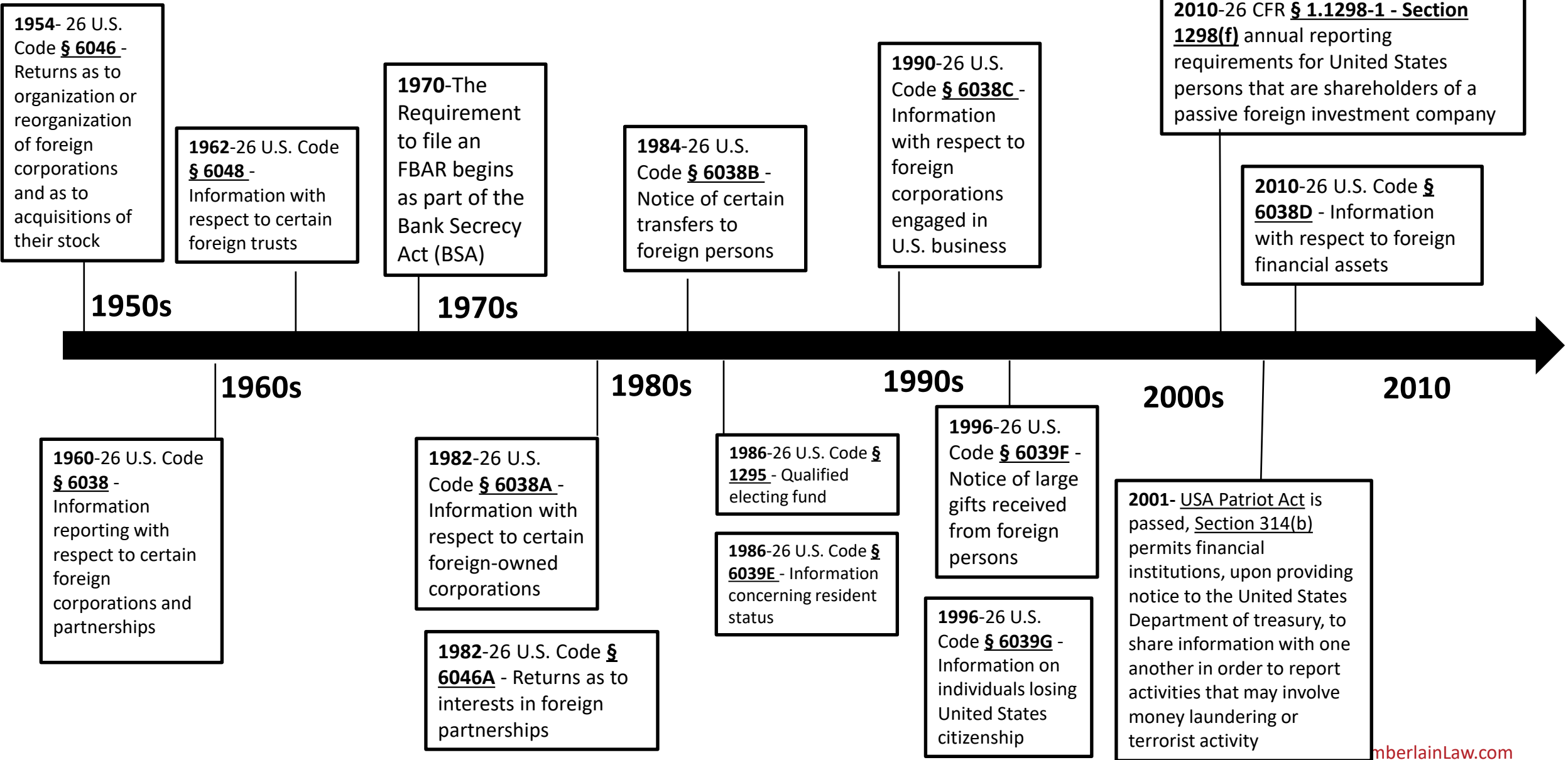
- The concept of “distribution” is amplified for purposes of the obligation to file Form 3520 for each taxable year in which a U.S. person receives any distribution from a foreign trust:
  - Transfer of property received by a U.S. person through an intermediary or agent.
  - Transfer of property from an entity owned by a foreign trust to a U.S. person related to the foreign trust.
  - **Migration** of a foreign trust to a domestic trust. “In such a case, the income and corpus of the foreign trust is treated as distributed to the domestic trust on the date the foreign trust becomes a domestic trust.”
  - Loan of cash or marketable securities.
  - The FMV of the direct or indirect use of trust property by a U.S. person

## Effective Date

- The proposed regulations provide that taxpayers can rely on them for tax years ending after May 8, 2024, and beginning on or before the date final regulations are published.



# International Tax Reporting and Compliance



# Tax planning compliance v. tax controversy

- Pre-Tax Return Filing
  - Compliance (Due Diligence)
- Post- Tax Return Filing
  - Factual Due Diligence
- Best practices-
- Administrative Review-
  - Audits and Appeals
- Judicial Review - & Forum

## International information reporting returns:

- [Form 3520](#): *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts* (IRC §§ 6039F, 6048(a), 6677);
- [Form 3520A](#): *Annual Report of Foreign Trust with a U.S. Owner* (IRC § 6048, 6677);
- [Form 5471](#): *Information Return of U.S. Persons With Respect to Certain Foreign Corporations* (IRC §§ 6038, 6046);
- [Form 5472](#): *Information Return of 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business* (IRC §§ 6048A, 6048C);
- [Form 8938](#): *Statement of Specified Foreign Financial Assets* (IRC § 6038D).
- [Form 8854](#): *Initial and Annual Expatriation Statement* (IRC §§ 877, 877A, 2801, et. seq.).
- Form 1040-C, *U.S. Departing Alien Income Tax Return* - [Departing Alien Clearance \(Sailing Permit\)](#)
- [Form 2063](#), *U.S. Departing Alien Income Tax Statement and Annual Certificate of Compliance*

## INTERNATIONAL INFORMATION REPORTING RETURNS:

- [Form 8865](#): *Return of U.S. Persons with Respect to Certain Foreign Partnerships* (IRC §§ 6038, 6038B, 6046A)
- [Form 8621](#): Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund (IRC §§ 1291-1298)
- [Form 2555](#): *Foreign Earned Income* (IRC § 911)
- [Form 1116](#): *Foreign Tax Credit* (IRC §§ 901-909)
- [Form 8833](#): *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)* (IRC §§ 6114 & 6712)
- [Form 926](#): *Return by a U.S. Transferor of Property to a Foreign Corporation* (IRC §§ 6038B(a)(1)(A), 367(d), or 367(e))
- [FinCen Form 114](#), *Report of Foreign Bank and Financial Accounts* (FBAR). (31 U.S. Code §§ 5314 & 5312)
- Corporate Transparency Act – [Beneficial Ownership Information](#) (31 U.S. Code §§ 5336)

## IRS “Programs” Not Created by Statute

- Voluntary Disclosure
- Streamlined Filing Compliance Procedures
- Delinquent International Information Return Submission Procedures (DIIRSP)
- Delinquent FBAR Submission Procedures
- “Made Up Monopoly Game” Rules-

## IRC § 6039F Penalty Aggregate data

- DURING THE YEARS 2018-2021 (FOR INDIVIDUALS AND BUSINESSES)
- Between 2018 and 2021, there were over 4000 penalties assessed against individuals and businesses for over \$1.7 billion
- The average penalty was approx. \$425,000, the median penalty was approx. \$58,000

Number of Penalties	Total Dollars Assessed	Average Penalty (Mean)	Median Penalty
4,038	\$1,718,381,301	\$425,553	\$57,714

Taxpayer Advocate Annual Report to Congress 2023 (pg.105) [https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2024/01/ARC23\\_MSP\\_08\\_International.pdf](https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2024/01/ARC23_MSP_08_International.pdf)

# IRC § 6039F Penalty Year-by-year data

- DURING THE YEARS 2018-2021 (FOR INDIVIDUALS **ONLY**)

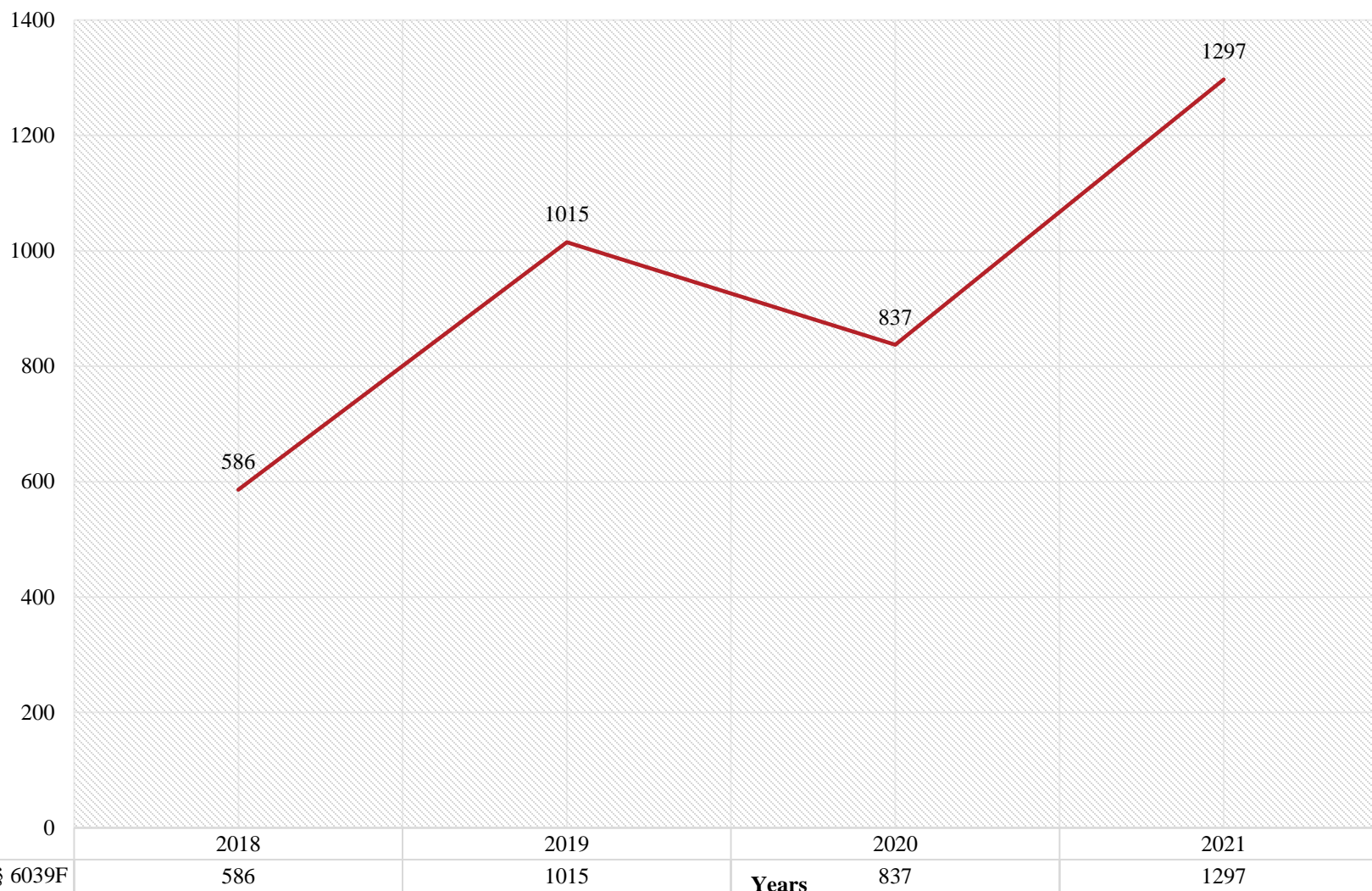
Year	Total Penalties Assessed	Total Dollars Assessed	Average Penalty (Mean)	Median Penalty
2018	586	\$77,274,037	\$131,867	\$39,160
2019	1,015	\$238,326,771	\$234,805	\$56,560
2020	837	\$282,289,168	\$337,263	\$60,000
2021	1,297	\$246,414,866	\$189,988	\$52,978

Taxpayer Advocate Annual Report to Congress 2023 (pg.105) [https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2024/01/ARC23\\_MSP\\_08\\_International.pdf](https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2024/01/ARC23_MSP_08_International.pdf)



## Manual Assessments of IRC § 6039F

Number of Penalties



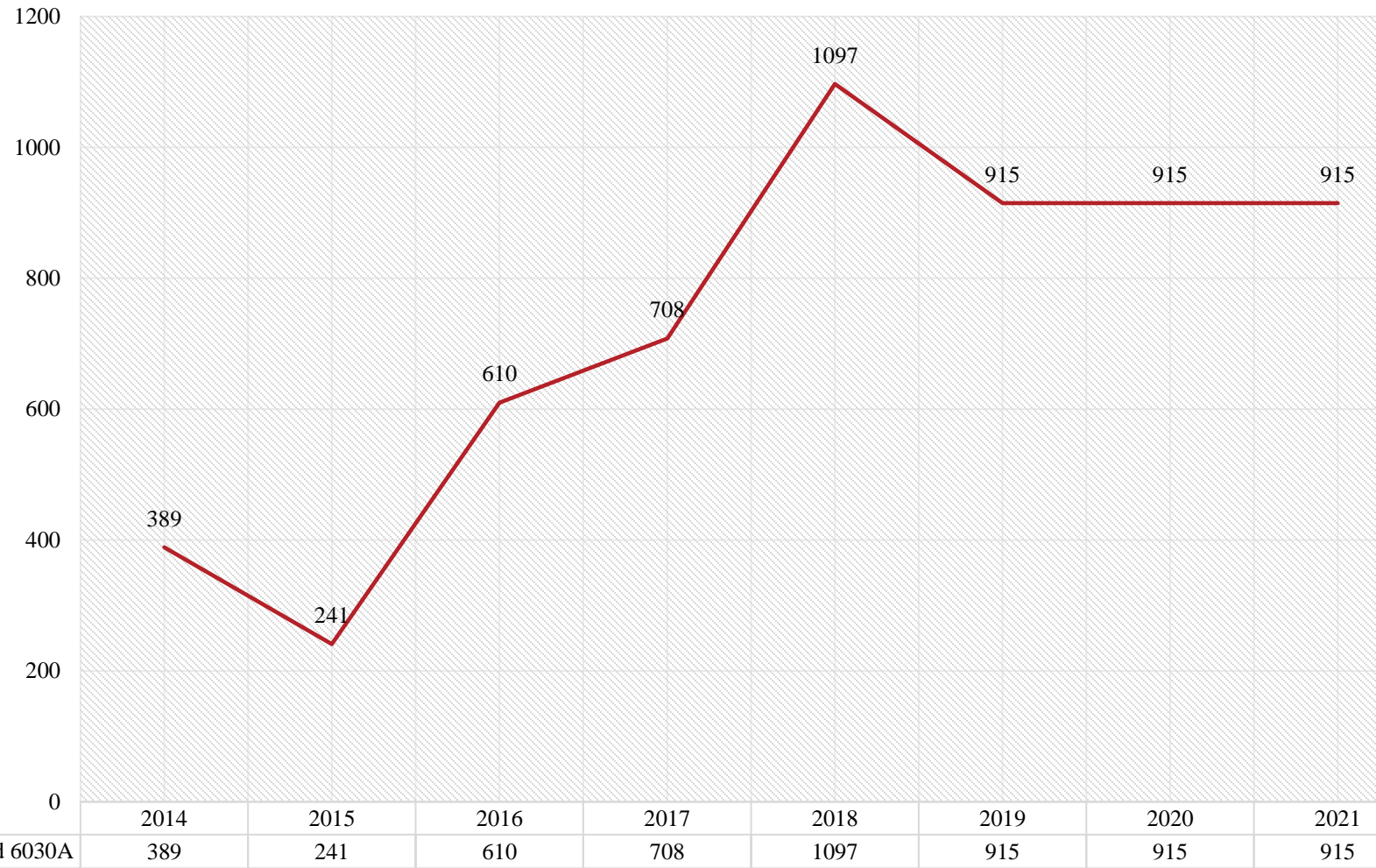
# IRC § 6039F Penalty Year-by-year data

Calendar Year Penalty Assessed	Number of Penalties Assessed	Dollar Amount Assessed	Number of Abatements	Dollars Abated	Abatement Percentage by Number	Abatement Percentage by Dollar
2014	389	\$33,268,121	150	\$21,875,043	39%	66%
2015	241	\$5,695,002	41	\$721,000	17%	13%
2016	610	\$45,148,635	180	\$4,571,000	30%	10%
2017	708	\$38,371,300	194	\$3,622,433	27%	9%
2018	1097	\$58,328,617	268	\$4,906,750	24%	8%

Taxpayer Advocate Annual Report to Congress 2020 (pg.125) [https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2021/01/ARC20\\_FullReport.pdf](https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2021/01/ARC20_FullReport.pdf)

## Manual Assessments of IRC § 6038 and 6030A (2014-2021)

**Number of Penalties**



Manual Assessments of IRC § 6038 and 6030A

Years

## Systemic application of international information and Abatement statistics for 6038 and 6038A Data

- The IRS penalties are systematically assessed when the IRS processes late information returns from taxpayers who willingly come forward
  - This produces a high percentage of abatements
- **DURING THE YEARS 2018-2021**

Type of Assessment	Number of Penalties Assessed	Dollar Amount Assessed	Number of Abatements	Dollars Abated	Abatement Percentage by Number	Abatement Percentage by Dollar
Systemic	10,052	\$390.8 million	7,484	\$327.8 million	74%	84%
Manual (Individual Master File)	915	\$44.0 million	248	\$7.2 million	27%	16%

# Abatement of Penalties -

- **First time Abatement?**

- The First Time Abatement (FTA) administrative waiver is not applicable to International Penalties addressed in IRM 8.11.5. [International penalties include the IRC 6038 series located in Chapter 61 – Subchapter A –Part III of the IRC; and, the IRC 6677 and IRC 6679 series located in Chapter 68 – Subchapter B - Assessable Penalties.]

[Part 8. Appeals, Chapter 11. Penalties Worked in Appeals, Section 5. International Penalties](#)

- **Other Requests for Abatement - Remedies?**

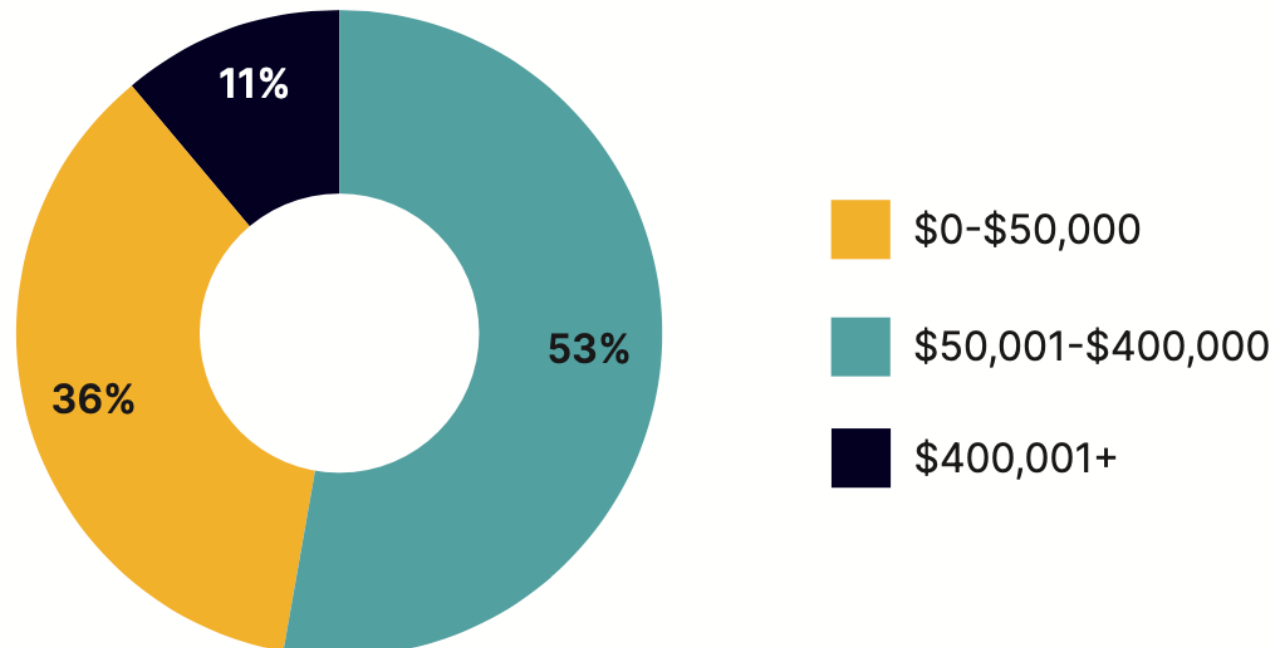
- **Form 843, Claim for Refund and Request for Abatement**
- **Form 656-L, Offer in Compromise (Doubt as to Liability)**
  - IRM - 5.19.24 Doubt as to Liability Offer in Compromise
  - **Audit reconsideration:**

- **Supervisory Approval - § 6751**

## IRC § 6039F Penalty data For individuals by total positive income

- DURING THE YEARS 2018-2021

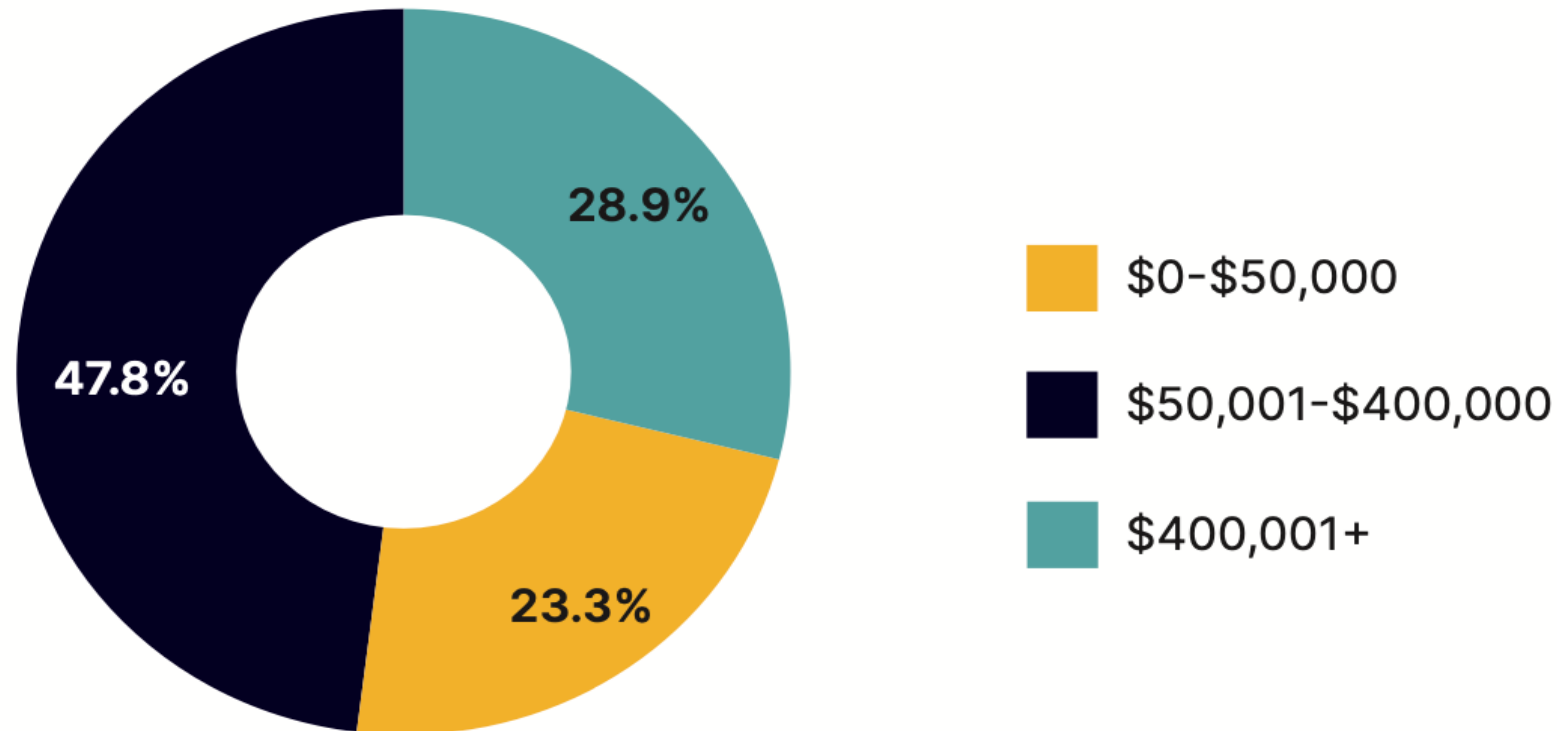
### IRC § 6039F Penalties by Total Positive Income, 2018-2021



# IRC § 6038 Penalty data For individuals by total positive income

- DURING THE YEARS 2018-2021

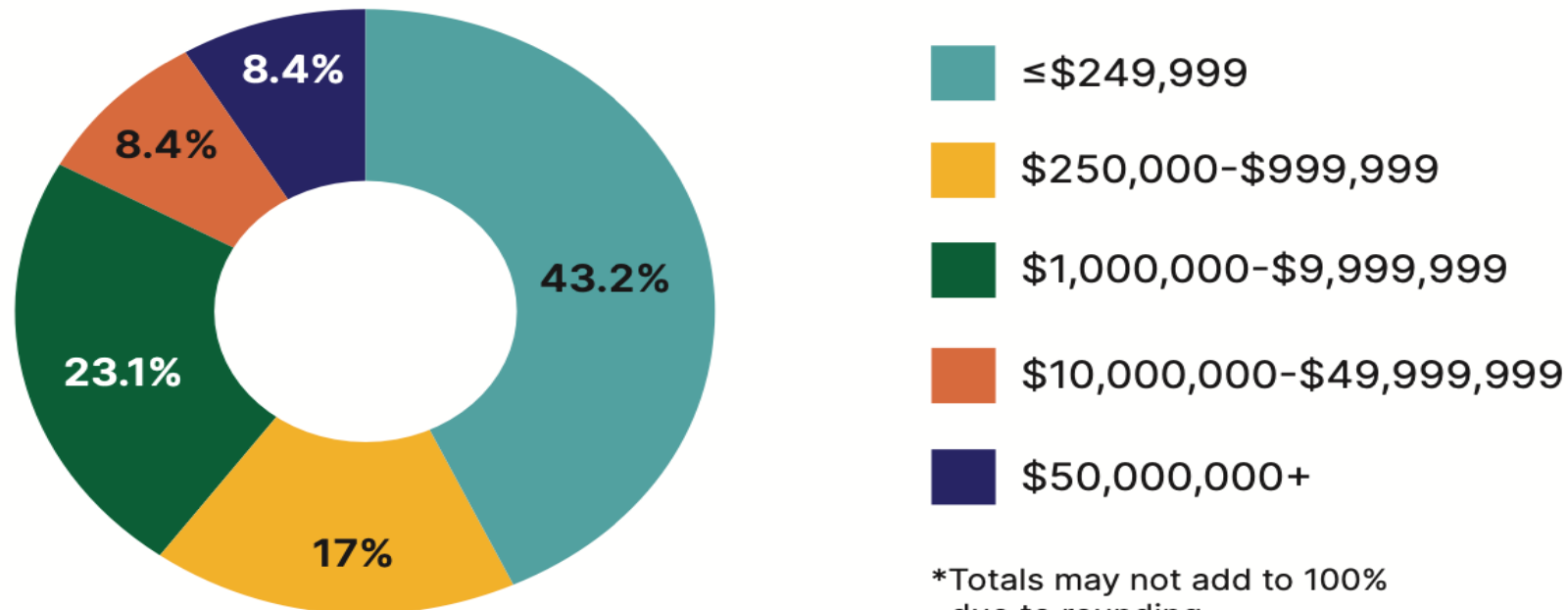
## Individual IRC § 6038 Penalties by Total Positive Income, 2018-2021



# IRC § 6038 and 6038A Penalties for businesses by total assets

- **DURING THE YEARS 2018-2021**
- Small and midsize businesses, like individuals, bear a disproportionate burden of these penalties: Small and midsize businesses comprise 83% of IRC 6038 and 6038A penalties: In dollar terms, small and midsize businesses are subject to 64% of the aggregate business penalties imposed under IRC 6038 and 6038A

## Systemic Business IRC §§ 6038 and 6038A Penalties by Total Assets, 2018-2021



\*Totals may not add to 100%  
due to rounding.



# New Developments

THREE PRECEDENT SETTING CASES IN INTERNATIONAL INFORMATION REPORTING (“IIR”) IN 6 WEEKS: \* AROESTE, \* BITTNER, AND \* FARHY: ALL INTERCONNECTED VIA TITLE 26, TITLE 31 AND U.S. INCOME TAX TREATIES

- Six Weeks, Three International Information Reporting Decisions (Tax Notes: Martin, Villegas & Chain)
- These IIR decisions relate to –
  - Title 31 penalties for Foreign Bank Account Reports (“FBARs”),
  - Title 26 IIR penalties specific to reporting of ownership interests in foreign companies [and “reportable events” with foreign trusts[1]], and
  - How these two federal statutory regimes of Title 31 and 26 crossover into international law as set forth in U.S. income tax treaties negotiated with different countries around the world.

“Each of these three cases are interconnected and have significant impact to individuals with global lives, global assets, multi-national family members and those who have businesses or accounts in different parts of the world.” – Patrick W. Martin

# International Penalties –More Details

## International Information Reporting

Code Section	International Information Reporting
<a href="#"><u>§ 1295(b)</u></a>	Qualified Electing Fund Election
<a href="#"><u>§1298(f)</u></a>	Reporting requirement of a PFIC
<a href="#"><u>§6038</u></a>	Information reporting with respect to certain foreign corporations and partnerships
<a href="#"><u>§6038A</u></a>	Information with respect to certain foreign-owned corporations
<a href="#"><u>§6038B</u></a>	Notice of certain transfers to foreign persons
<a href="#"><u>§6038D</u></a>	Information with respect to foreign financial assets
<a href="#"><u>§6038C</u></a>	Information with respect to foreign corporations engaged in U.S. business
<a href="#"><u>§6039C</u></a>	Returns with respect to foreign persons holding direct investments in U.S. real property interests
<a href="#"><u>§6039E</u></a>	Information concerning resident status
<a href="#"><u>§6039F</u></a>	Notice of large gifts received from foreign persons
<a href="#"><u>§6039G</u></a>	Information on individuals losing United States citizenship
<a href="#"><u>§6046</u></a>	Returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock
<a href="#"><u>§6046A</u></a>	Returns as to interests in foreign partnerships
<a href="#"><u>§6048</u></a>	Information with respect to certain foreign trusts

**§6501(c)(8) - Statute of Limitations -  
International Information Reporting**

<b>Code Section</b>	<b>International Information Reporting</b>
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<a href="#"><u>§6048</u></a>	Information with respect to certain foreign trusts

**Noticeably Absent Code Section**

<a href="#"><u>§6038C</u></a>	Information with respect to foreign corporations engaged in U.S. business
<a href="#"><u>§6039C</u></a>	Returns with respect to foreign persons holding direct investments in U.S. real property interests
<a href="#"><u>§6039E</u></a>	Information concerning resident status
<a href="#"><u>§6039F</u></a>	Notice of large gifts received from foreign persons
<a href="#"><u>§6039G</u></a>	Information on individuals losing United States citizenship

**"Assessable Penalties" International information reporting under Chapter 68**

**Chapter 61, International Information Penalties - Not referenced as "Assessable Penalties"**



Code Section	Ch. 68 "Assessable Penalties"
<a href="#"><u>§6048</u></a>	Information with respect to certain foreign trusts
<a href="#"><u>§6677</u></a>	Failure to file information with respect to certain foreign trusts (Penalties)
<a href="#"><u>§6046A</u></a>	Returns as to interests in foreign partnerships
<a href="#"><u>§6679</u></a>	Failure to file returns, etc., with respect to foreign corporations or foreign partnerships (Penalties)

Code Section	Ch. 61 Not referenced as "Assessable Penalties"
<a href="#"><u>§ 1295(b)</u></a>	Qualified Electing Fund Election
<a href="#"><u>§1298(f)</u></a>	Reporting requirement of a PFIC
<a href="#"><u>§6038</u></a>	Information reporting with respect to certain foreign corporations and partnerships
<a href="#"><u>§6038A</u></a>	Information with respect to certain foreign-owned corporations
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<a href="#"><u>§6046</u></a>	Returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock

# The IRS's Procedure to Assess Penalties

- Many Foreign Information Return penalties are being systematically asserted, meaning that a penalty is automatically issued whenever there is a late-filed form or a form is missing information, without regard to the individual circumstances of the taxpayer.
- In many cases, the penalties are wildly disproportionate to the taxpayer's mistake, and serve no purpose other than to discourage taxpayers from voluntary compliance.

- The government appears to view this foreign information return penalties as assessable penalties treating them as “paid upon notice and demand” and not subject to the deficiency procedures, and thus assuming they cannot be challenged in Tax Court.
- For example, §6671(a) specifically falls within Subchapter B of chapter 68 assessable penalties. This sections determines that a penalty within Subchapter 68B should be assessed and collected in the same manner as a tax.
- Finally, as with all penalties, the IRS is supposed to obtain proper managerial approval before a determination.

## What is an assessment?

The U.S. Tax Court in *Farhy*, cited case law that defines an assessment as “the formal recording of a taxpayer’s tax liability” by the Service. The SCOTUS has noted it is “essentially a bookkeeping notation.”

*See, Baltic v. Commissioner*, 129 T.C. 178, 183 (2007). *See, Hibbs v. Winn*, 542 U.S. 88, 100 (2004) (“An assessment is made 'by recording the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the Secretary.'” (quoting section 6203)); Treas. Reg. § 301.6203-1.

*See, Laing v. United States*, 423 U.S. 161, 170 n.13 (1976) (“The 'assessment,' essentially a bookkeeping notation, is made when the Secretary or his delegate establishes an account against the taxpayer on the tax rolls.”).



## What is an assessable penalty?

The U.S. Tax Court in *Farhy* explains what “assessable penalties” are as used in section 6201(a), which includes certain penalties (but not all penalties in the Code). These are those that “must be paid upon notice and demand and assessed and collected in the same manner as taxes.” The Court went on to say that, “the term ‘assessable penalties’ used in section 6201 does not automatically apply to all penalties in the Code not subject to deficiency procedures.” The Tax Court concluded that penalties under section 6038(b) (i.e. failure to file IRS Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*) are not “assessable penalties.”

Citing - *Smith v. Commissioner*, 133 T.C. 424, 428 (2009). IIs.”).

## What is an assessable penalty?

The U.S. Tax Court cited to *Ruesch* that held that section 6038(b) penalties are not subject to deficiency procedures. In its decision, the Tax Court in *Farhy* noted:

After the IRS mails a taxpayer a timely notice of deficiency, this Court has jurisdiction to re determine deficiencies in income, estate, and gift taxes ‘imposed by subtitle A or B’ and deficiencies in certain excise taxes imposed by ‘chapter 41, 42, 43, or 44.’ Secs. 6212(a), 6213(a). The section 6038 penalties assessed against [the taxpayer] are imposed by subtitle F, chapter 61, and thus lie outside our deficiency jurisdiction.<sup>[13]</sup>

*Ruesch v. Commissioner*, 154 T.C. 289, 297 (2020), *aff’d in part, vacated in part, remanded*, 25 F.4th 67 (2d Cir. 2022).

## What is an assessable penalty?

The Tax Court separately in an Order in the case of *Alberto Aroeste & Estela Aroeste vs. Commissioner* concluded it had no jurisdiction over IIR penalties under Sections 6038(b) and 6677:

By negative implication, any other taxes — even if imposed in Title 26 — fall outside this Court’s deficiency jurisdiction. *Williams v. Commissioner*, 131 T.C. 54, 58 (2008). Penalties under section 6038(b) are imposed by respondent under subtitle F, chapter 61, and are thus outside the Court’s deficiency jurisdiction. *Ruesch*, 154 T.C. at 297. Penalties under section 6677 are imposed by respondent under subtitle F, chapter 68, subchapter B, and are explicitly exempt from the deficiency procedures for income, estate, gift, and certain excise taxes. § 6677(e); see also *Smith v. Commissioner*, 133 T.C. 424, 428–29, n.3, 4 (2009).

Docket Nos. 13024-20, 15372-20; Order dated May 13, 2022.

## What is an assessable penalty?

This raises the question of what other IIR penalties are not “assessable penalties”? The Order in *Alberto Aroeste & Estela Aroeste vs. Commissioner* distinguishes between (i) section 6038(b) penalties (Chapter 61 of Subtitle F) and (ii) section 6677 penalties (Chapter 68 of Subtitle F). Section 6677 are clearly ones that can be assessed. The problem individuals’ face is the inability to obtain judicial review by the taxpayer if she does not agree with the Service’s determination of the IIR penalties. The Tax Court in *Farhy* means those facing 6038(b) penalties will obtain such review in a federal district court or court of federal claims, once the DOJ pursues its civil lawsuit for enforcement within the time required by the statute.

A previous report by one of the authors provided the following summary of IIR statutory penalties; in two categories, Chapter 68 and Chapter 61. The statute as reflected in these charts designates Subchapter B of Chapter 68 of Subtitle F as “assessable penalties”.

# Farhy

- [D.C Circuit Reverses Farhy on Close Examination of Statute](#) (Tax Notes, Velarde)
- The D.C. Circuit handed the IRS a significant win, leaning on context clues in reversing a Tax Court decision holding that the agency couldn't assess international information return penalties.
- The D.C. Circuit reversed and remanded the Tax Court in its May 3 decision in *Farhy v. Commissioner*. It held that the text, structure, and function of section 6038 support the IRS's assessment authority for those penalties. [Tax Notes- Farhy](#)
- “We hold that the text, structure, and function of section 6038 demonstrate that Congress authorized assessment of penalties imposed under subsection (b), and so reverse and remand to the Tax Court with instructions to enter decision in favor of the Commissioner.”

***Farhy v. Comm'r of Internal Revenue***, 100 F.4th 223, 225 (D.C. Cir. 2024)

***Golsen v. Commissioner of Internal Revenue***, 54 T.C. 742 (1970), *cert. denied*, 404 U.S. 940 (1971)

## *Farhy v. Commissioner, -- F.4th -- (D.C. Cir. 2024)*

- Reversed the Tax Court. “Read in light of its text, structure, and function, section 6038 itself is best interpreted to render assessable the fixed-dollar monetary penalties subsection (b) authorizes. As a result, the Commissioner's authority to assess all “assessable penalties” encompasses the authority to assess penalties imposed under section 6038(b).”
- I.R.C. § 6038(c) is not subject to deficiency procedures.
  - All agree the IRS may assess subsection (c) penalties, and those two objectives of the amendment—that recovery of subsection (b) penalties be more streamlined than recovery of subsection (c) penalties, and that any subsection (c) penalty be reduced by the amount of the subsection (b) penalty—make plain that subsection (b) penalties must also be assessable.”
  - Compare with IRM.
- Putting the IRS in charge of determining whether a taxpayer has demonstrated reasonable cause only makes sense in circumstances in which it is the IRS that assesses the penalty. Where Congress requires the government to file a civil action to enforce a violation of the tax code, the court rather than the Service would decide whether the taxpayer proved that the defense excuses his or her violation.
- ***Golsen Rule:***

## The Assessment Process

Penalties will be determined (sometimes automatically) and approved on the Form 8278;

Then a CP Notice (either CP15 or CP215) will be generated and sent to taxpayer;

- Taxpayer may protest the CP Notice.

After the initial notice, the collection notices will be sent (typically Notices CP501-504) to taxpayer.

- Can submit a Collection Appeal Request, Form 9423.

Final step of the collections process is for the Service to issue either (or both) a final notice of intent to levy or a notice of federal tax lien.

- These notices allow taxpayer to request a collection due process hearing, which results in a notice of determination that can be reviewed by the U.S. Tax Court.

## Assessments

- I.R.C. § 6201(a): Assessment Authority
  - The Secretary is authorized and required to make the inquiries, determinations, and assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by this title, or accruing under any former internal revenue law, which have not been duly paid by stamp at the time and in the manner provided by law. Such authority shall extend to and include the following:  
**(1) TAXES SHOWN ON RETURN** The Secretary shall assess all taxes determined by the taxpayer or by the Secretary as to which returns or lists (or payments under section 6225(c)(2)(B)(i)) are made under this title.
- I.R.C. § 6202: Mode or time of assessment
  - If the mode or time for the assessment of any internal revenue tax (including interest, additional amounts, additions to the tax, and assessable penalties) is not otherwise provided for, the Secretary may establish the same by regulations.
- I.R.C. § 6203: Method of assessment
  - The assessment shall be made by recording the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the Secretary. Upon request of the taxpayer, the Secretary shall furnish the taxpayer a copy of the record of the assessment.



## Assessments v. Deficiencies

- Assessment:
  - A tax assessment is simply “the formal recording of a taxpayer's tax liability.” *See Our Country Home Enters., Inc. v. Comm'r of Internal Revenue*, 855 F.3d 773, 778 (7th Cir. 2017) (citing I.R.C. § 6203); *see also Hibbs v. Winn*, 542 U.S. 88, 89 (2004) (“[A]n assessment is closely tied to the collection of a tax, *i.e.*, the assessment is the official recording of liability that triggers levy and collection efforts.”). Importantly, “ ‘[t]he assessment is given the force of a judgment,’ authorizing the IRS to collect the tax.” *See Our Country Home*, 855 F.3d at 778 (quoting *Bull*, 295 U.S. at 260). *United States v. Sadig*, 2022 WL 2356625, at \*6 (N.D. Ill. June 30, 2022).
- Deficiency:
  - For purposes of this title in the case of income, estate, and gift taxes imposed by subtitles A and B and excise taxes imposed by chapters 41, 42, 43, and 44 the term “deficiency” means the amount by which the tax imposed by subtitle A or B, or chapter 41, 42, 43, or 44 exceeds the excess of
    - **(1)**the sum of - **(A)**the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus
    - **(B)**the amounts previously assessed (or collected without assessment) as a deficiency, over—
    - **(2)**the amount of rebates, as defined in subsection (b)(2), made.

I.R.C. § 6211(a).

# Notices of deficiency

- Notice of deficiency (90-day letter):
  - “If the Secretary determines that there is a deficiency in respect of any tax imposed by subtitles A or B or chapter 41, 42, 43, or 44 he is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail. Such notice shall include a notice to the taxpayer of the taxpayer’s right to contact a local office of the taxpayer advocate and the location and phone number of the appropriate office.” I.R.C. § 6212(a).
  - 90 days to seek a redetermination in the U.S. Tax Court (150 days if taxpayer is not within U.S.).
- “A notice of deficiency, also called a "statutory notice of deficiency" (SNOD) or, "90-day letter" , is a legal notice in which the Commissioner determines the taxpayer's tax deficiency. IRC 6212 and IRC 6213 require that the IRS issue a notice of deficiency before assessing additional income tax, estate tax, gift tax, generation-skipping transfer tax and certain excise taxes unless the taxpayer agrees to the additional assessment. The notice of deficiency is a legal determination that is presumptively correct and consists of the following:
  - A letter explaining the purpose of the notice, the amount of the deficiency, and the taxpayer's options.
  - A waiver to allow the taxpayer to agree to the additional tax liability.
  - A statement showing how the deficiency was computed.
  - An explanation of the adjustments.” I.R.M., pt. 4.8.9.2(1) (08-11-2016).

## The Collection Process

- A CP Notice (either CP15 or CP215) will be generated and sent to taxpayer;
  - Taxpayer may protest the CP Notice.
- After the initial notice, the collection notices will be sent (typically Notices CP501-504) to taxpayer.
  - Can submit a Form 9423, *Collection Appeal Request*.
- Final step of the collections process is for the Service to issue either (or both) a final notice of intent to levy or a notice of federal tax lien.
  - These notices allow taxpayer to request a collection due process hearing, which results in a notice of determination that can be reviewed by the U.S. Tax Court.
  - Must file a Form 12153, *Request for a Collection Due Process or Equivalent Hearing*.

## International Penalties Requiring NOD?

- Notice of deficiency is generally required for:
  - I.R.C. § 6038(c) – Penalty of Reducing Foreign Tax Credit Plus Continuation Penalty
  - I.R.C. § 6038A(e) – Noncompliance Penalty for Failure to Authorize an Agent or Failure to Produce Records
  - I.R.C. § 6038C(d) – Noncompliance Penalty for Foreign Related Party Failing to Authorize the Reporting Corporation to Act as its Limited Agent
  - I.R.C. § 6039F(c) – Taxability of Gift from Foreign Persons
  - I.R.C. § 6686 – Information Returns for Former FSCs
  - I.R.C. § 6688 – Reporting for Residents of U.S. Possessions
- I.R.M., pt. 8.11.5.1(4) (12-18-2015).

## Appeals

- “Proceedings before Appeals are informal. Testimony under oath is not taken, although matters alleged as facts may be required to be submitted in the form of affidavits, or declared to be true under the penalties of perjury. Taxpayers may represent themselves or designate a qualified representative to act for them.” Treas. Reg. § 601.106(c).
- Collection Appeal Rights (CAP) request: CAP requests are submitted on Form 9423, *Collection Appeal Request*. CAP requests can be submitted:
  - Before or after the IRS files a Notice of Federal Tax Lien
  - Before or after the IRS levies or seizes your property
  - Termination, or proposed termination, of an installment agreement
  - Rejection of an installment agreement
  - Modification, or proposed modification, of an installment agreement. See IRS Publication 1660 (Rev. 1-2020).

# Procedure for requesting abatement and appealing penalty assessment

- The Internal Manual states that the taxpayer is entitled to post-assessment, but pre- payment, Appeals review of the penalty. See [Internal Revenue Manual 8.11.5.1](#).
- The IRS does not automatically suspend collection activity in order to provide taxpayers with this pre-payment right to appeal, and routinely fails to respond to taxpayers' requests to suspend collection during their appeals.
- If the appeal is unsuccessful, many tax advisors believe the taxpayer's only option for judicial review is to pay the penalty in full and file a refund claim, there is no clear case law as to what is the procedural path for judicial review.

## Collection Due Process Hearing

- IRS Collections will typically end with one of two notices: Final Notice of Intent to Levy or Notice of Federal Tax Lien. These notices are governed by I.R.C. §§ 6320 and 6330. In response to these notices, Taxpayer can request a CDP hearing.
- The following is considered during a CDP hearing:
  - “Verification from the Secretary that the requirements of an applicable law or administrative procedure have been met.” I.R.C. § 6330(c)(1).
  - Appropriate spousal defenses (i.e., innocent spouse relief); I.R.C. § 6330(c)(2)(A)(i).
  - Challenges to the appropriateness of the collection action; I.R.C. § 6330(c)(2)(A)(ii) and
  - Collection alternatives (i.e., offer-in-compromise, installment agreement, currently-not-collectible status). I.R.C. § 6330(c)(2)(A)(iii).
  - Underlying liability (so long as there was no prior opportunity, or a NOD was issued). I.R.C. § 6330(c)(2)(B).

## Collection Due Process Hearing

- Appeals issues a notice of determination with its findings upon the conclusion of the CDP hearing, this notice gives the taxpayer the right to challenge Appeals' determinations in the Tax Court.
  - Petition must be filed within 30 days of the determination. As of recently, this is subject to equitable tolling. *See Boechler v. Commissioner*, 596 U.S. 199 (2022).



## CDP hearing (cont'd)

- Appeals' determination must include:
  - Verification;
  - Issues raised by Taxpayer; and
  - “Whether any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary.” I.R.C. § 6330(c)(3).
- Appeals cannot consider the following issues:
  - Issues previously raised and considered in another CDP hearing or a judicial proceeding;
  - “the issue meets the requirement of clause (i) or (ii) of section 6702(b)(2)(A); or
  - a final determination has been made with respect to such issue in a proceeding brought under subchapter C of chapter 63. I.R.C. § 6330(c)(4).

- Offers in Compromise
  - IRC 7122 authorizes the IRS to compromise a taxpayer's tax liability on the basis of 1) doubt as to collectability, 2) doubt as to liability, or 3) the promotion of effective tax administration.
  - IRS will accept an offer where it is unlikely to collect the liability in full and the amount offered reflects the reasonable collection potential
- Installment Agreements
  - IRC 6159 authorizes the IRS to enter into written agreements which allow taxpayers to pay their tax due in installments over a period of months or years, where it is demonstrated that doing so will facilitate full or partial collection of such liability
- Currently Not Collectable
  - The IRS will place an account in currently not collectable status where a taxpayer has insufficient leivable income and assets.
- Bankruptcy
  - 11USC 727 / 11USC 523(a) Taxes discharged in bankruptcy are reported as currently not collectable by the IRS.
- Audit Reconsideration
  - Process IRS uses to reevaluate the results of a prior audit if the taxpayer disagrees with the original assessment and there is now new information that was not previously considered. Typically granted where, 1) the taxpayer did not appear for the audit, 2) the taxpayer moved or did not receive IRS correspondence, or 3) the taxpayer has new documentation that is pertinent to the audit issues.

# Best Practices During Appeals & CDP Hearings

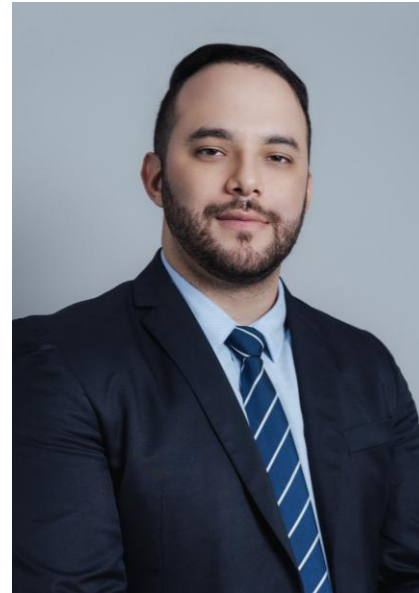
- Written protest should be written like a legal brief, including a legal analysis that contains the IRAC method (Issue, Rule, Application, Conclusion);
- Hazards of litigation should be used during Appeals (hazards of litigation is only considered during Appeals and in litigation, it is not otherwise considered by the Service);
- Face-to-face hearing may be the best method, it may make sense to prepare a PowerPoint or bring some type of demonstrative exhibit during the meeting;
- Request a copy of the administrative record (either through the Freedom of Information Act department or the Appeals officer) and review the Service's file prior to the hearing;
- Raise every possible issue, often an issue will be considered waived if not raised;
- Always make sure that Appeals maintains its independence (there is a preclusion on ex parte communication, and this should be abided); and
- If any additional issues or raised or supplemental arguments made, ensure that they are faxed to the Appeals officer (with a request that the document be included in the administrative record).

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