



**SOUTHERN FEDERAL  
TAX INSTITUTE**

**INTERNATIONAL INFORMATION  
RETURN PENALTIES:  
CURRENT DEVELOPMENTS AND  
EFFECTIVE STRATEGIES**

By

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**SESSION S**



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**The “Joys” of Preparing International Information Returns**



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Throughout this outline, I provide practice tips to highlight practical points using red bold italics “*Practice tip.*”

Hyperlinked Resources: This outline contains hyperlinked resources for your convenience. If you notice that a hyperlink no longer works, please email [info@pricetaxlaw.com](mailto:info@pricetaxlaw.com).

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## 1. Theory Underlying Penalties - IRS Penalty Policy

IRS penalty policy focuses on using penalties to encourage voluntary compliance and to raise revenue for the Treasury. Voluntary compliance is a bedrock to the tax system of the United States. “The Government has millions of taxpayers to monitor, and our system of self-assessment in the initial calculation of a tax simply cannot work on any basis other than one of strict filing standards. Any less rigid standard would risk encouraging a lax attitude toward filing dates.” *United States v. Boyle*, 469 U.S. 241, 249 (1985).

The Internal Revenue Manual attempts to harmonize the two-fold goal of penalties this way:

- (1) Taxpayers in the United States assess their tax liabilities against themselves and pay them voluntarily. This system of self-assessment and payment is based on the principle of voluntary compliance. Voluntary compliance exists when taxpayers conform to the law without compulsion or threat. ...
- (4) Although penalties support and encourage voluntary compliance, they also serve to bring additional revenues into the Treasury and indirectly fund enforcement costs. However, these results are not reasons for creating or imposing penalties.
- (5) Penalties advance the mission of the IRS when they encourage voluntary compliance. The IRS has formalized this obligation to the public in its mission statement.
- (6) Voluntary compliance is achieved when a taxpayer makes a good faith effort to meet the tax obligations defined by the Internal Revenue Code. ...

(10) Penalties should relate to the standards of behavior they encourage. Penalties best aid voluntary compliance if they support belief in the fairness and effectiveness of the tax system. This belief encourages compliance in areas that cannot be reached through audits or other programs. ...

I.R.M. 20.1.1.2.1 Encouraging Voluntary Compliance.

As a practical observation, the IRS has strayed from its stated penalty policy. In many areas of tax administration, IRS asserts penalties completely disconnected from underlying taxpayer conduct and intent. This leads to the conclusion that IRS penalty policy focuses more on penalties as a source of revenue than to encourage voluntary compliance.

**Practice point:** In writing persuasive penalty abatement requests, include reasoning on how the IRS’ assertion of a specific penalty may run contrary to the IRS’ penalty policy.

**2. Typical IRS Civil Penalties**

The IRS may administer more than 150 separate civil penalties (estimates of the number of civil penalties vary). Some common examples include:

- [Information Return](#)
- [Failure to File](#)
- [Failure to Pay](#)
- [Accuracy-Related](#)
- [Civil Fraud](#)
- [Erroneous Claim for Refund or Credit Penalty](#)
- [Failure to Deposit](#)
- [Tax Preparer Penalties](#)
- [Dishonored Checks](#)
- [Underpayment of Estimated Tax by Corporations](#)
- [Underpayment of Estimated Tax by Individuals](#)
- [International Information Return](#)

Beyond those common penalties, the IRS has been delegated enforcement authority for certain penalties originally administered by the Financial Crimes Enforcement Network or FinCEN. Those penalties relate to reports of foreign bank accounts or [FBARs](#), recordkeeping relating to foreign bank accounts, and similar matters.

- a. The following table summarizes some of the most common international information return penalties.

Form	Code §	Potential Penalties
<b>Form 926</b> (Return by a U.S. Transferor of Property to a Foreign Corporation)	6038B(c)	10% of the FMV of property transferred to foreign corporation (max. \$100,000)
<b>Form 3520-A</b> (Annual Information Return of Foreign Trust with a U.S. owner)	6677(b)	The greater of \$10,000 or 5% of the gross value of U.S. person’s portion of foreign trust assets (measured as of the close of the U.S. person’s tax year)

<b>Form 3520</b> (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts)	6677, 6039F	Up to four penalties may apply. For trust contributions, ownership, or distributions, a separate penalty applies for failure to timely report each transaction. Each penalty is equal to the greater of \$10,000 or (1) 35% of the trust contribution, (2) 5% of the gross value of U.S. person's portion trust assets (at close of U.S. person's tax year), or (3) 35% of the trust distribution For failure to timely report a foreign gift/bequest, a maximum penalty equal to 25% of the FMV of the foreign gift/bequest may apply	
<b>Form 5471</b> (Information Return of U.S. Persons with Respect to Certain Foreign Corporations)	6038	\$10,000 per form	
<b>Form 5472</b> (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in U.S. Trade or Business)	6038A	\$25,000 per form	
<b>Form 5713</b> (International Boycott Report)	999	\$25,000, maximum 1 year imprisonment, or both for willful failure to report	
<b>Form 8621</b> (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund)	6501(c)(8)	Statute of limitations for tax year remains open until 3 years after form is filed	
<b>Form 8854</b> (Initial Expatriation Statement)	877A, 6039G	\$10,000 per failure and potential treatment as "covered expatriate" subject to U.S. exit tax	
<b>Form 8858</b> (Information Return of U.S. Persons with respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs))	6038(b)	Form 5471, Category 4/5 filers Form 8865, Category 1/2 filers	\$10,000 per failure
<b>Form 8865</b> (Return of U.S. Persons with Respect to Certain Foreign Partnerships)	6038(b), 6038B(c), 6046A, 6679	Multiple penalties may apply: \$10,000 per failure Category 1, 2, and 4  10% of FMV of property transferred (capped at \$100,000) per Category 3 failure	
<b>Form 8938</b> (Statement of Specified Foreign Financial Assets)	6038D(d)	\$10,000 per form	

<b>Form 8992</b> (U.S. Shareholder Calculation of Global Intangible Low-Taxed Income)	6038(b); Treas. Reg. 1.6038-5	\$10,000 per form
<b>FBAR, FinCEN Form 114</b>	31 USC § 5321	Up to \$14,489 (after 1/24/2022) for “non-willful” violations  Up to the greater of \$144,886 (after 1/24/2022) or 50% of account balances, plus potential criminal penalties, for “willful” violations
§ 6662(j): Penalty of 40% of underpayment attributable to transaction involving undisclosed asset under § 6038, 6038B, 6038D, 6046A, or 6048		

b. Index of international forms by IRS form number

<b>IRS Form</b>	<b>Outline Pages</b>
Form 1120-F	16
Form 3520/3520-A	12, 22, 23, 27, 30
Form 5471	11, 12, 13, 19, 34
Form 5472	11, 12, 13
Form 8288	12
FBAR	12, 18, 23, 32

### 3. Administrative Relief

#### a. Administrative Waivers

The IRS may administratively waive penalties connected to certain events or conditions. The IRS waived certain penalties in [IRS Notice 2022-36](#) citing the COVID-19 pandemic as a key reason for offering penalty relief. *See generally* IRM 20.1.1.3.3.2. For a more recent example, in October 2024, Commissioner Werfel publicly announced an end to systemic Form 3520 Part IV penalties for late reporting of foreign gifts and inheritances. <https://www.taxpayeradvocate.irs.gov/news/nta-blog/irs-hears-concerns-from-tas-and-practitioners-makes-favorable-changes-to-foreign-gifts-and-inheritance-filing-penalties/2024/10/> *See also*, Andrew Velarde and Benjamin Valdez, *IRS Signals Major Internal Changes for Foreign Gift Penalties*, TAX NOTES (Oct. 25, 2024)

#### b. First Time Abate

The IRM and IRS.gov provide guidance on First Time Abate (FTA). The essence of FTA is offering taxpayers a “mulligan” if they have been fully compliant for the most recent three tax years. The IRS focuses on threshold criteria of past compliance as follows:

- Filed the same return type, if required, for the past three tax years before the tax year you received the penalty.
- Didn’t receive any penalties during the prior three years, or any penalty was removed for an acceptable reason other than First Time Abate

<https://www.irs.gov/payments/penalty-relief-due-to-first-time-abate-or-other-administrative-waiver>

I.R.M. 20.1.1.3.3.2.1 (03-29-2023) provides additional FTA criteria.

At times, IRS guidance on FTA is contradictory. Search for guidance focusing on the specific penalty. For example, the IRM lists an exception to FTA at IRM 20.1.1.3.3.2.1(8) for various international information returns for business filers. That list is not accurate and directly conflicts with I.R.M. 21.8.2.21.2 concerning systemically assessed Form 5471/5472 penalties. I.R.M. 21.8.2.21.2 incorporates by reference FTA relief for Form 5471/5472 penalties based on FTA for related Form 1120 penalties. See also [December 7, 2022, memo by John E. Hinding](#), Director, Specialized Examination Programs & Referrals (relating to FTA for Forms 5471 and 5472 for business filers).

***Practice points:***

- If the IRM specifically excepts a penalty from FTA, look for an exception to the exception. Do not expect all IRS personnel to be aware of exceptions to exceptions.
- Even if the IRM does not provide FTA for a specific penalty, raise FTA as a possible form of relief in penalty abatement requests.

**c. Other Avenues for Administrative Relief**

The IRS sometimes offers very specific paths offering penalty relief for certain taxpayers. For example, the IRS continues to offer a specific path to avoid various penalties for taxpayers with non-willful reporting failures relating to FBARs and international information returns by means of the [Streamlined Filing Compliance Procedures](#). For the Streamlined Filing Compliance Procedures, when late information returns, including Forms 3520, 3520-A, 5471, 8938 are submitted and delinquent/amended FBARs are e-filed, the IRS offers either a reduced penalty (Streamlined Domestic Offshore) or no penalties at all (Streamlined Foreign Offshore). Additionally, the [VCAP-ET](#) process may reduce employment tax penalties in certain cases. The IRS has also provided for specialized relief procedures through Revenue Procedures. *See, e.g.*, Rev. Proc. 2008-27 (providing specific reasonable cause procedures for certain international withholding penalties including FIRPTA Form 8288 withholding).

***Practice point:*** Search for specific IRS paths that may offer full or partial penalty relief for the specific penalty you are handling.

**4. Reasonable Cause – General Concept**

Many penalty statutes include an exception for reasonable cause. The general gist of reasonable cause is a legally justifiable excuse. For example, Treasury Reg. § 301.6651-1(c)(1) states in part: “If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause.” The Treasury Regulations under § 6664 provide useful interpretation and guidance on reasonable cause in general directing us to consider the general facts and circumstances of each case. Treas. Reg. § 1.6664-4(b)(1) notes the following:

Generally, the most important factor is the extent of the taxpayer’s effort to assess the taxpayer’s proper tax liability. Circumstances that may indicate reasonable cause and

good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. ... Reliance on an information return, professional advice, or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. ...

Also, pay attention to the specific construction of any reasonable cause exception and address all elements of the exception. For example, the failure to file penalty under I.R.C. § 6651(e) will not apply if “it is shown that such failure is due to reasonable cause and not due to willful neglect... .” Some penalty exceptions focus solely on reasonable cause without the “willful neglect” component. *See, e.g.*, I.R.C. § 6038A(d)(3) (providing for a reasonable cause exception without a “willful neglect” component for Form 5472). Others include a “good faith” component such as I.R.C. § 6664(c)(1) (“No penalty shall be imposed under section 6662 or 6663 with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion”).

***Practice Points:***

- Dig into the regulations for the specific penalty you are handling. For example, at least one reasonable cause provision requires the Service to liberally construe reasonable cause when specific criteria are met. *See, e.g.*, Treas. Reg. § 1.6038A-4(b)(2)(ii) (providing for liberal application of reasonable cause for “small corporations” that failed to timely file Forms 5472).
- The body of caselaw relating to reasonable cause for various penalties often overlap given the “reasonable cause” wording in various penalty provisions. For example, I.R.C. § 6664 and its regulations have been applied in the context of taxpayers failing to file various information returns. *See generally, Kelly v. Commissioner*, T.C. Memo. 2021-76 (analyzing reasonable cause under § 6664 for a penalty under § 6038(b) for the failure to file a Form 5471). If you find a great reasonable cause case dealing with a penalty different from the one you are handling, determine whether courts have applied the logic of the case to other penalties, and, at a minimum cite it as persuasive authority.

## **5. Reasonable Cause Based on Reasonable Reliance on Professional**

### **a. *Boyle* and Nonfiling / Late Filing**

The starting point for non-filed or late filed returns and reasonable cause is *United States v. Boyle*, 469 U.S. 241 (1985). IRS personnel cite and rely on *Boyle* in many penalty cases. In *Boyle*, the taxpayer relied on his attorney to file an estate tax return. The return was filed late. The Supreme Court held that the timely filing of a tax return is not excused by the taxpayer’s reliance on an agent. *Id.* at 251-52. Although the IRS paints *Boyle* with a broad brush, the case distinguishes a general tax return filing obligation and whether a return must be filed. The following passage from *Boyle* emphasizes this distinction:

When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a “second opinion,” or

to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place.

*Id.* at 251.

The Supreme Court decided against the taxpayer in *Boyle* by contrasting a mere filing deadline with substantive advice: “By contrast, one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due.” *Id.* The Supreme Court further stated: “It requires no special training or effort to ascertain a deadline and make sure that it is met.” *Id.* at 252.

A case that presents an excellent contrast with *Boyle* is *Sanderling Inc. v. Commissioner*, 571 F.2d 174 (3rd Cir. 1978). Although it is a pre-*Boyle* case, some IRS Appeals Officers have specifically referred to *Sanderling* in training material on reasonable cause. In *Sanderling*, the taxpayer relied on a CPA to calculate the due date of a final corporate return. *Id.* at 175. The IRS asserted the corporation’s return was late and applied a late filing penalty. *Id.* at 177-78. Under *Boyle*, taxpayers are held to the bright-line rule that they cannot rely on their professional for a late-filed return; and that is true in general when everyone knows or should know the due date. But in *Sanderling*, the Third Circuit found that reliance on the CPA was reasonable and excused the late filing penalty because the due date was difficult to compute. The court stated:

Rather, the issue is whether the correct due date was so uncertain that the taxpayer was reasonable in relying on professional advice. This case does not involve the delegation of a purely ministerial task and is thus distinguishable from those decisions which allow the imposition of a penalty where the accountant was late in filing the return but the taxpayer was aware of the due date.

*Id.* at 178-79. In other words, the filing deadline for the terminated corporation’s tax return was complicated and required a professional to compute. The corporate officers delegated the computation of the deadline to the CPA and reasonably relied on the CPA to interpret that deadline for them. The logic of *Sanderling* can be extended to other esoteric filings where a taxpayer relies on the professional to determine what to file and when.

Pursuant to a Freedom of Information Act request, the IRS released certain slides from training provided to the Independent Office of Appeals (Appeals) about reasonable cause. The training slides provide a glimpse into the IRS’ thinking on this topic including its perspective on *Boyle* and some favorite cases of IRS personnel on the topic of reasonable cause. If you are interested in these slides, you can download relevant excerpts from [Dan’s website](#).

***Practice Points:***

- Anticipate the IRS raising *Boyle* and address it in your penalty abatement request.
- Review the [Appeals’ training slides on reasonable cause](#) to optimize your presentation to Appeals and to prepare for Appeals conferences.

**b. Arguing Against *Boyle* in E-Filing Age – An Uphill Battle**

In the age of e-filing, taxpayers often rely on their CPAs or return preparers to e-file automatic extensions of time to file their returns. At times return preparers drop the ball and fail to file the extension

requests. Are we left without an argument? No. But arguing against *Boyle* in this context is an uphill battle.

The National Taxpayer Advocate's [2022 Purple Book](#) addresses reasonable cause in the age of e-filing. A penalty abatement request can incorporate the logic in the NTA's recommendation as a basis to urge reasonable cause in the age of e-filing. *See generally, Haynes v. United States*, 760 Fed. Appx. 324 (5th Cir. 2019) (declining to rule that *Boyle* is no longer applicable in an e-filing world but reversing the lower court's ruling in favor of the IRS solely relying on *Boyle*). *But see Lee v. United States*, No. 22-10793 (11th Cir. 10/24/2023) (strictly applying *Boyle* in an e-filing case rejecting taxpayer's reliance on his CPA for e-filing).

**Practice Point:** If nothing else, argue the logic used by the NTA in the 2022 Purple Book and perhaps that will increase the odds for a slightly more favorable hazards or mitigation settlement. *See infra* section 10.c.

### c. *Neonatology* Factors

Address the *Neonatology* factors in every case involving reasonable cause based on reliance on a professional. *Neonatology Assocs., P.A. v. Commissioner*, 115 T.C. 43, 98–99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002). *Neonatology* presents a three prong test to determine whether a taxpayer reasonably relied on a professional considering whether: (i) the advisor is competent, (ii) the taxpayer provided necessary and accurate information to the advisor, and (iii) the taxpayer relied in good faith on the advisor. The IRS expects to apply *Neonatology*, and you should analyze it for the IRS revenue agent or Appeals Officer. In high dollar cases, expect the IRS to attack all three elements.

#### i. Advisor is Competent

The IRS often inappropriately argues that an advisor is not competent using 20-20 hindsight to point out an advisor's mistakes. But the standard for competence is not professional perfection. As a best practice, secure advertising material including the advisor's website and LinkedIn profiles highlighting education, experience, and professional accomplishments.

Also, is the appropriate standard the subjective perspective of competence from the taxpayer's perspective or an objective standard of competence that the IRS often asserts? I argue that competence should be viewed through the eyes of the taxpayer when the advisor was originally selected. Also, at times the IRS seems to rely on mistakes of professionals to assert a lack of competence. But perfection and competence cannot be equated.

*Grecian Magnesite Mining, Industrial & Shipping Co. v Commissioner*, 149 T.C. 63 (2017) provides an excellent analysis and evaluates two of the three *Neonatology* prongs in the context of the failure to file a Form 1120-F: competence of an advisor and good faith reliance (considered *infra*). The case also highlights the general unreasonableness of the IRS when it comes to evaluating reasonable cause.

Grecian Magnesite Mining, Industrial & Shipping Co. (GMM) was a privately held foreign corporation organized in Greece. *Id.* at 6. Other than an ownership in a U.S. partnership, "GMM had no office, employees, or business operation in the United States." *Id.* As a result of a redemption of GMM's interest in the U.S. partnership in 2009, GMM realized taxable gain. *Id.* at 8-9. The following facts relate to GMM's tax advisor:

In 2001 GMM hired attorney John Phufas to handle all of its legal business and tax obligations in the United States, including its investment in Premier. Mr. Phufas later referred GMM to Elihu Rose for tax return preparation. Mr. Rose was a certified public accountant with numerous partnership clients whose returns he regularly prepared, but GMM was his first non-U.S. client. Mr. Rose thereafter prepared GMM's U.S. income tax returns for 2003 through 2008.

Relating to 2009, the year of the redemption of the partnership interest:

With its 2009 Form 1065, Premier included a Schedule K-1 for GMM that reported a zero balance in GMM's capital account and, consistent with the agreement between GMM and Premier that the redemption of GMM's entire interest was effective as of December 31, 2008, did not attribute to GMM any income, gain, loss, deductions, or credits for 2009.

Pursuant to Mr. Rose's advice, GMM did not file a return for 2009.

*Grecian Magnesite*, at 10.

The IRS determined that GMM failed to report \$5.2 million for 2009 from the redemption of its interest in the U.S. partnership and failure to file and failure to pay penalties relating to the non-filing of Form 1120-F for tax year 2009. *Id.* at 11. Focusing on the failure to file and failure to pay penalties, GMM asserted reasonable reliance on its tax professional, Mr. Rose, for its failure to file and pay in 2009. In analyzing the issue, Judge Gustafson soundly rejected the IRS' contention that GMM should have done more than rely on Mr. Rose's advice.

In analyzing reasonable reliance, the Court noted that Mr. Rose was referred to GMM by GMM's attorney. *Id.* at 53. Mr. Rose was an attorney and CPA who "had been preparing U.S. income tax returns for 40 years." *Id.* Mr. Rose believed he was qualified for the engagement. *Id.* "GMM relied completely on Mr. Rose to prepare its tax returns." *Id.* at 54. Interestingly, the IRS asserted Mr. Rose was not competent because he was not an "expert who specialized in international tax law or an attorney with an LL.M. degree." *Id.*

At trial, the IRS attorney asserted that a foreign taxpayer could not rely on a recommendation of a tax return preparer and should have investigated the return preparer's experience. The trial transcript includes some humorous back and forth on this point showing the complete lack of common sense underlying the IRS's position:

THE COURT: But -- and I'm saying -- you suggest that in order to use the reasonable cause defense, a foreign taxpayer cannot simply take the recommendation that they hire and use a lawyer CPA, but must instead pursue to determine the actual expertise of the preparer?

MS. KINDEL [IRS attorney]: Well, that's -- in this situation, we do not know the relationship between Mr. Phufas and Grecian Magnesite. We do not know what services Mr. Phufas provided for Grecian Magnesite. We do not know the level of trust that was established there. We do not know that. That's not part of the record of this case.

THE COURT: Okay. What if they just got a name from the bar association LISTSERV referral service?

MS. KINDEL: So what I'm suggesting is that some -- well, I would expect a reasonable company would want to do some investigation into the expertise or the experience and background of the person that I'm going to be relying on to prepare my tax returns.

THE COURT: Well, I don't know if you've ever hired a lawyer internationally. But all the questions that you would know to ask in the United States might mean nothing in Tunisia or England. When you are an outsider trying to figure out who's the right person to hire -- today, I'm trying to hire an electrician. It is very, very hard. So I think you're setting up a very high standard for the foreign taxpayer to comply with. I invite your pushback.

MS. KINDEL: Well, I don't think I'm putting an unreasonable standard. When you're hiring, as you say, a plumber, you will ask him questions about what he's going to do and how he's going to do it. And you're going to use your --

THE COURT: You flatter me, madam.

MS. KINDEL: I mean, that's what -- I mean, that's what I would do when I'm talking to a plumber. I try to engage the person in conversation to evaluate if whether I can -- I'm comfortable with the services he's going to provide. I would expect that a corporation just doesn't go out willy-nilly and hire someone on someone's say-so. I would expect them to make some reasonable effort --

THE COURT: I don't know any other basis for hiring than the say-so of somebody that you trust. That is the gold standard.

*Grecian Magnesite* trial transcript pages 166-67.

Judge Gustafson did not accept the reasoning of the IRS attorney at trial or in the resulting opinion. The Tax Court's opinion stated:

Given what little GMM knew about the U.S. system of taxation, we cannot imagine GMM would have known how to conduct such an investigation, let alone what value such uninformed inquiries would have added. GMM acted reasonably, given its admitted inexperience: It relied on the recommendation of its trusted adviser, Mr. Phufas, when it chose to hire Mr. Rose.

*Grecian Magnesite*, at 54. We continue discussing *Grecian Magnesite* *infra* under *Neonatology*, prong 3, good faith reliance.

***Practice Points:***

- Be prepared for ridiculous IRS pushback on advisor competence.
- Document advisor competence with the advisor's website, LinkedIn profile, and any other social media bragging.
- The IRS occasionally interprets *Jarnagin v. United States*, 134 Fed.Cl. 368 (2017) as a relevant case on advisor competence. The taxpayers asserted reasonable reliance for the failure to file FBARs, and the Court of Federal Claims rejected the argument because the advisor was wholly unaware of the FBAR filing requirement. This case is

an outlier because although it cites *Neonatology*, it does not analyze the three prongs of *Neonatology*. To see the IRS' perspective on *Jarnagin*, review the appeals training material available on [Dan's website](#).

## ii. Taxpayer Provided Necessary and Accurate Information to the Advisor

Whether a taxpayer provided necessary and accurate information to the advisor is sometimes contested. Especially where the relationship between an advisor and the taxpayer sours, perhaps with the fear of a malpractice suit by the former client or possible preparer investigation by the IRS, advisors may tell the IRS they did not receive complete information from their clients.

*Kelly v. Commissioner*, T.C. Memo. 2021-76 illustrates that maintaining all email communication with a CPA may be crucial to proving this element. Mr. Kelly was a very sophisticated businessman. He was involved in multiple businesses including controlling a publicly traded company. *Id.* at 16. One of Mr. Kelly's businesses held a Cayman Island entity, KY&C. Mr. Kelly disclosed KY&C to his CPAs, a firm name abbreviated as S&C in the opinion. One of Mr. Kelly's CPAs sent an email to another CPA on the tax return:

[KY&C] is a Cayman Island Entity and I am not sure what taxes and returns have to be filed in the Cayman Islands. \* \* \* I am not sure what filing requirements we have in the US since this is a Cayman Island entity and how this flows through to Michael Kelly's personal return but it will have to be dealt with when filing returns for 2008.

*Id.* at 45.

Although Mr. Kelly provided information about his Cayman Island entity to his CPAs, his CPAs did not file Forms 5471 for KY&C. Mr. Kelly argued reliance on his tax professionals. The *Kelly* opinion discusses the test for reasonable reliance in *Neonatology*. *Id.* at 49. The *Kelly* court concluded that Mr. Kelly had reasonable cause for failing to file the Forms 5471. The Court stated:

The failure to file the Forms 5471 does not present an obvious tax obligation which was negligently omitted from information that a taxpayer provided to the return preparer. Mr. Kelly, through his staff, provided the necessary information to S&C [the CPA firm], identified KY&C as a foreign corporation, and stated that he was unsure of the reporting requirements. Having done this, Mr. Kelly reasonably relied on S&C to prepare his returns properly. While it could be argued that S&C should have done more to ascertain Mr. Kelly's filing obligations, it was reasonable for Mr. Kelly to rely on S&C do so. A taxpayer need not question the advice provided, obtain a second opinion, or monitor the advice received from the professional. *Boyle*, 469 U.S. at 251.

*Id.* at 48-49.

### **Practice Points:**

- If available, point out direct communication of key facts from the taxpayer or the taxpayer's staff to the tax professional.
- Review the appeals training material available on [Dan's website](#) on the common cases the IRS cites on this element.

### iii. Taxpayer Relied in Good Faith

Occasionally, the IRS will challenge the reliance in good faith aspect of *Neonatology*. IRS attacks on good faith reliance often boil down to asserting a taxpayer should have done more research about an advisor's qualifications before retaining the advisor; this argument sometimes springs from arguments over the competence of advisors. *Grecian Magnesite*, discussed earlier, includes an IRS attack on reliance in good faith. The excerpt from the trial transcript included argument on this point. Fortunately, Judge Gustafson did not accept the reasoning of the IRS. He said at trial: "I don't know any other basis for hiring than the say-so of somebody that you trust. That is the gold standard." His logic carried through in the Tax Court's opinion:

The Commissioner argues that GMM's reliance on Mr. Rose was not in good faith. The Commissioner finds fault with the fact that GMM relied on Mr. Phufas' recommendation of Mr. Rose when GMM hired him to prepare its tax returns, rather than conducting an investigation of Mr. Rose's background and experience in tax return preparation at the time. Given what little GMM knew about the U.S. system of taxation, we cannot imagine GMM would have known how to conduct such an investigation, let alone what value such uninformed inquiries would have added. GMM acted reasonably, given its admitted inexperience: It relied on the recommendation of its trusted adviser, Mr. Phufas, when it chose to hire Mr. Rose.

*Grecian Magnesite Mining, Industrial & Shipping Co. v Commissioner*, 149 T.C. 63, 96 (2017).

### d. Must Advice From a Tax Professional be Explicit?

The IRS and the Department of Justice Tax Division may counter a *Neonatology* reasonable reliance argument by claiming that advice must be explicit and not implicit. This arises when an advisor fails to identify a required form or schedule, especially in the context of international reporting. A recent case involving reasonable cause relating to a domestic trust filing provides taxpayer-favorable reasoning. *Murphy v. United States*, 2025 U.S. Dist. LEXIS 28771 \*; 2025 WL 535666 (E.D. Cal. 2025). In *Murphy* the district court considered a government argument that the taxpayer should have known of a trust income tax return filing obligation. Mr. and Mrs. Murphy and a business relied on a long-time CPA for tax advice and return preparation. *Id.* at \*3. After the death of Mr. Murphy, a new trust income tax return filing obligation arose. *Id.* The CPA did not identify that issue and reported income for that trust on the individual income tax returns. *Id.* Later, Mrs. Murphy's tax counsel identified the issue, and delinquent trust returns were filed with reasonable cause statements. *Id.* at 3-4.

Mrs. Murphy completely relied on her CPA who failed to identify the return filing obligation for the trust formed after the death of Mr. Murphy. Mrs. Murphy argued reasonable cause based on reliance on her CPA. The government opposed that position and even filed a motion to dismiss for failure to state a claim asserting that Mrs. Murphy lacked reasonable cause as a matter of law. *Murphy*, 2025 U.S. Dist. LEXIS 28771 at \* 10. The court rejected the government's position. The court considered the elements of *Neonatology*, and concluded that Mrs. Murphy was entitled to rely on her accountant's advice.

The district court reasoned on relevant caselaw and distinguished various cases cited by the government. *Id.* at \*21-22. The key portion of the opinion stated:

This case is not one in which the taxpayer's responsibility to file a return, and the deadline to do so, was readily discernable such that her agent's failure to timely file the return should be

attributed to her. Rather, Ms. Murphy's husband's death triggered complicated legal consequences difficult to discern even for tax professionals. Her husband's death converted a trust that was revocable into one that was irrevocable and triggered a new filing requirement of which she was unaware. To exercise ordinary business prudence, Ms. Murphy was not required to research the intricacies of revocable and irrevocable trusts and their effect on tax law. She was entitled to provide her long-time accountant with the relevant information and rely on him to prepare proper income tax returns. She reasonably relied on her accountant, who determined (erroneously as it turned out) that certain income was reportable on the Murphys' personal returns, instead of on a return for the Administrative Trust.

*Id.* at \*25-26.

Then, the court considered the government's specious argument that Mrs. Muphy lacked reasonable cause because her CPA did not provide her with explicit advice "but rather that she received a lack of advice." *Murphy*, 2025 U.S. Dist. LEXIS 28771 at \*27. The district court rejected the government's argument and noted:

[The CPA] exercised his judgment in continuing to report the shares and other income on the Murphys' individual returns, rather than on a return for the Administrative Trust. Ms. Murphy sufficiently alleges that she reasonably relied on her accountant's judgment as to which returns needed to be filed and how income needed to be allocated on the returns.

*Id.* at \*27-28.

The key point from *Murphy* is that implicit advice constitutes tax advice. When a taxpayer provides all necessary information to a tax professional, the tax professional fails to identify a filing requirement, and the taxpayer relies on the tax professional's recommendation on what to file, the taxpayer has established reasonable cause.

#### **e. Reasonable Reliance – Foreign Trusts and Schedule B, Section III Questions**

Since foreign trust reporting penalties can be crushing and many CPAs make mistakes in classifying foreign trusts, we briefly address a case specific to Forms 3520, *James v. United States*, 2012 U.S. Dist. LEXIS 114356 \*; 2012-2 U.S. Tax Cas. (CCH) P50,520; 110 A.F.T.R.2d (RIA) 2012-5587; 2012 WL 3522610 (M.D. Fla. 2012). Mr. James was a physician specializing in pain management. *Id.* He formed a foreign trust in Nevis and made contributions to it. *Id.* at \*1-\*2. Mr. James was required to but failed to file Forms 3520 relating to the trust. *Id.* at \*2. Mr. James asserted reasonable reliance on his accountant, and the court opinion recites the key facts on this point as follows:

James argues that his failure to file Form 3520 is the fault of his former accountant, George Famiglio. Famiglio had prepared James's personal and business taxes for a number of years, and James relied on Famiglio to properly oversee and advise him about the tax requirements of the foreign trust. According to James, he or his agent timely provided Famiglio with all appropriate trust documents and information, for each year in question, yet Famiglio failed to timely file Form 3520, and/or advise James that it should be filed. James further contends that he was personally unaware of the requirement to file Form 3520.

James argues that he acted prudently and with sound business judgment in engaging Famiglio to handle all issues related to the foreign trust, and that his accountant simply

dropped the ball. Although James does not remember the details of most conversations he had with Famiglio, or any specific advice he received, he recalls that they “talked a pretty good bit” about the trust, and he believed at the time that “[Famiglio] had filed all the—everything required with the IRS.” In short, James argues that he had “reasonable cause” in failing to file Form 3520 by reasonably relying on Famiglio.

*James*, 2012 U.S. Dist. LEXIS 114356 \*2-\*3.

In essence, Mr. James argued that his accountant had all the facts and failed to advise him to file Form 3520. The Court disagreed with the government’s argument that reliance on an accountant in this context cannot constitute reasonable cause. The court stated:

There has been considerable case law on whether reliance on the advice of an expert can constitute reasonable cause for failing to file one's tax returns. It is clear that a taxpayer may reasonably rely on an expert's advice that no return is required; thus, if an expert erroneously advises him that no return is required, or erroneously advises him that it can be filed beyond the due date, reasonable cause may be found.

*Id.* at \*7-\*8.

The court also noted that Mr. James’ accountant checked “no” to the Schedule B question concerning foreign trusts. “Answering ‘no’ to this question could be construed as Famiglio providing advice that James need not file Form 3520, advice upon which James could have potentially reasonably relied.” *Id.* at \*9.<sup>1</sup>

The *James* case provides a helpful analysis for not only concerning failures to file Forms 3520 but also concerning the three questions on Schedule B, Part III. The IRS and the Department of Justice Tax Division often focus on the Schedule B, Part III questions concerning foreign bank accounts in willful FBAR cases. James provides a useful counterargument about relying on a professional for completing those questions.

***Practice Points:***

- Explicitly address reliance on a tax professional and explicitly state it was in good faith.
- Review the appeals training material available on [Dan’s website](#) on the common cases the IRS cites on this element.

**f. Potential Waiver of Privilege**

Asserting reasonable cause based on substantial authority or reliance on a tax professional may waive attorney-client privilege. “When a person puts into issue his subjective intent in deciding how to comply with the law, he may forfeit the privilege afforded attorney-client communications.” *AD Inv. 2000*

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<sup>1</sup> The *James* case involved cross-motions for summary judgment, and the court denied the government’s motion for summary judgment on the lack of reasonable cause. Interestingly, in analyzing the law, the court noted that the “IRS has failed to issue regulations explicating the meaning of ‘reasonable cause’ for failure to file Form 3520” and looked to the broad principles of reasonable cause as summarized in the I.R.M. 20.1.1.3.2 et seq. *Id.* at \*6.

*Fund LLC v. Commissioner*, 142 T.C. 248, 255 (citing *United States v. Exxon Corp.*, 94 F.R.D. 246, 248 (D.D.C. 1981)).

### **g. Practical Strategies for Reasonable Reliance Defenses**

The following practical suggestions may help you build strong reasonable reliance defense arguments.

- As early as possible after being retained, obtain from your client a release for the accountant's files and secure the accountant's workpapers, client questionnaire, and documents submitted by the client to the accountant. After reviewing the files, interview the accountant.
- If the accountant made a mistake that resulted in the IRS asserting a penalty, prepare a declaration or affidavit recounting all facts. Include facts relevant to the *Neonatology* elements. Asking the accountant to "fall on the sword" serves two purposes: (1) the IRS may be persuaded to abate a penalty that was the result of a professional's mistake and (2) a declaration will lock in the facts in the event the matter proceeds to a refund suit (the declaration may be used to support a motion for summary judgment). The accountant may be reluctant to put the facts in writing, but it may be possible to negotiate the scope of use if that becomes a sticking point.
- If appropriate, refer the client to malpractice attorney to discuss a tolling agreement to keep open a possible malpractice claim against the accountant.

## **6. Reasonable Cause – Other Reasons**

### **a. Incapacity – Individuals**

A taxpayer's incapacity may provide the basis for reasonable cause. For example, if a taxpayer were comatose at the filing deadline and failed to file his income tax return, the medical condition and incapacity would provide the basis for reasonable cause. Critical to an analysis reasonable cause based on incapacity or other circumstances is the duration of the incapacity. The Tax Court has for many decades consistently analyzed the duration of events giving rise to incapacity and the duration of noncompliance. For example, in *Williams v. Commissioner*, 16 T.C. 893 (1951), the taxpayer's surviving relatives asserted that two strokes in 1939 and 1947 excused the non-filing of his 1944 and 1945 income tax returns. *Id.* at 905-906. The Court focused on the duration of the alleged incapacity as follows:

Relatives of the deceased George Herder, Jr., testified that he suffered his first stroke in 1939, and suffered several other strokes before his death in 1947. **The testimony failed to establish that the impairment of decedent's mental and physical condition was continuous**; perhaps, he was incapacitated only at certain intervals recurring with each stroke. The facts are not clear. It was not established that George Herder, Jr. was incapacitated and unable to prepare his returns on the dates they were due. Petitioners failed to explain why the decedent was able to have the returns prepared and filed in December 1946, and yet he was unable to file his tax returns on the due dates.

*Id.* at 906 (bold added). *See also Verdusco v. Commission*, T.C. Memo. 2010-278 at \*7 (concluding a "pattern of chronic noncompliance further weighs against finding reasonable cause").

*Williams* and other cases clearly establish that medical impairment, including psychological impairment, may constitute reasonable cause. The key consideration is the duration of the impairment and

any pattern of noncompliance. *Wright v. Commissioner*, T.C. Memo. 1998-224 \* 5 (noting “the duration of the incapacity must approximate that of the failure to file”).

*Tabbi v. Commissioner*, T.C. Memo. 1995-463 considers circumstances where a taxpayer’s preoccupation with caregiving for a close family member constitutes reasonable cause for the failure to timely file an income tax return. Mr. Tabbi was a real estate broker, operated rental properties, and engaged in other business ventures. *Id.* at \*3. Mr. Tabbi arguably was sophisticated in business and operated his businesses through several corporations formed in several states. *Id.* Mr. and Mrs. Tabbi filed income tax returns timely for tax year 1988 but filed their 1987 and 1989 returns late. *Id.* at \*6, \*16. The IRS even asserted that Mr. and Mrs. Tabbi were liable for fraud penalties for all three tax years. *Id.* at \*14.

The Tax Court determined that the fraud penalties were not applicable. *Tabbi*, T.C. Memo. 1995-463 at \*16. Then, the Court analyzed whether Mr. and Mrs. Tabbi were liable for the late filing penalty under I.R.C. § 6651(a)(1). Focusing on 1989, they asserted they were not liable for the late filing penalty for 1989 because they were caring for their infant son who was hospitalized and later died. *Id.* “Illness of a taxpayer or member of his or her immediate family may be reasonable cause for late filing if the taxpayer shows that he or she cannot file a timely return because of such illness.” *Id.* at 17 (citations omitted). The Court explains why Mr. and Mrs. Tabbi were not liable for the late filing penalty in the following passage:

Respondent [the IRS] argues that, despite petitioners’ [Mr. and Mrs. Tabbi’s] personal problems resulting from Antonino’s tragic illness and death, petitioner husband was not ill and was able to carry on his business activities in 1989. We disagree. Petitioners’ son had heart surgery in April 1990, around the time that their 1989 return was due to be filed. He was hospitalized until late July. Petitioners were at the hospital with him continuously during these 4 months. Petitioners’ son died in August 1990, and they filed their 1989 return in October 1990. We are convinced by these facts that petitioners’ late filing of their 1989 return was due to reasonable cause and not willful neglect.

*Id.*

*See also Rogers v. Commissioner*, T.C. Memo. 2016-152 (finding reasonable cause due to difficult life circumstances including possible mental health issues); *Carnahan v. Commissioner*, T.C. Memo. 1994-163 (finding that petitioner, an attorney, was mentally incapacitated and disabled during the relevant period and not liable for various penalties); *Hayes v. Commissioner*, T.C. Memo. 1967-80 (finding reasonable cause due to caregiving for two children who experienced serious health problems and petitioner-husband “suffered a mental and physical collapse”); *In re Erickson*, 172 B.R. 900 (Bankr. D. Minn. 1994) (finding reasonable cause for the failure to file personal income tax returns based on mobility issues of a quadriplegic taxpayer and the taxpayer’s reliance on an accountant).

***Practice Points:***

- Decision makers, such as Appeals Officers and attorneys in Chief Counsel, have emotions. Including sympathetic facts might strike a cord with the individual Appeals Officer or attorney considering the case.
- Medical incapacity may be another argument to layer into a penalty abatement request to improve a hazards of litigation settlement with the Independent Office of Appeals. But use discernment. Layering in a very weak medical incapacity argument with a strong reasonable

reliance argument may undercut the primary theory. But if both theories have roughly equal strength, together they may contribute to a more favorable hazards settlement with Appeals.

## **b. Incapacity – Business Entities**

Corporations and other business entities may assert reasonable cause based on incapacity arising from the conduct of its managers or officers. In those cases, the analysis may focus on the corporation's internal controls and whether the people in charge of the corporation rendered the corporation unable to comply with its obligations. *See Conklin Bros. of Santa Rosa, Inc. v. U.S.*, 986 F.2d 315 (9th Cir. 1993) (finding no reasonable cause where controller concealed failure to make payroll tax payments); *Matter of American Biomaterials Corp.*, 954 F.2d 919 (3rd Cir. 1992) (finding reasonable cause with issue in a case with an interesting procedural posture).

## **c. Substantiating the Claim of Incapacity**

Every case involving reasonable cause based on incapacity will have unique facts. Collect evidence on how the incapacity impacted other areas of life. For example, do credit reports show mistakes and delays in making mortgage payments and other loan payments. Secure credit reports to see if they provide evidence of financial disarray beyond tax matters. Try to obtain affidavits and declarations from persons who can testify about the incapacity. For some cases, medical records may support incapacity claims. Additionally, depending on the nature of the claimed incapacity and amount in controversy, consider expert reports to support the claim of incapacity.

## **7. I.R.C. § 6751(a) Penalty Computation**

In the context of penalties, Congress mandated the following for the IRS when providing notices of penalties to taxpayers:

(a) Computation of penalty included in notice. The Secretary shall include with each notice of penalty under this title information with respect to the name of the penalty, the section of this title under which the penalty is imposed, **and a computation of the penalty.**

I.R.C. § 6751(a) (bold added).

Congress wrote § 6751(a) to require that the IRS show its mathematical calculation of the penalty in order to explain the penalty. In plain English, Congress mandated that the IRS show its math for penalties so that taxpayers could understand how the IRS arrived at the amount of the penalty. By requiring the computation, Congress was mandating an element of fairness and communication so that taxpayers could understand penalties asserted by the IRS. *See generally*, S. Rep. No. 105-174, at 65 (1998), 1998-3 C.B. 537, 601.

This issue arises in the context of systemic penalties assessed by IRS campuses. Some IRS campuses include penalty computations in penalty notices but others do not. Review the penalty notice and determine whether the IRS followed the law.

**Practice tip:** At times the IRS names the wrong assessable penalty in a CP Notice. For example, I recently had a case where a client late-filed a Form 3520 based on erroneous advice from an accountant. The resulting penalty notice stated the IRS assessed a penalty for the willful failure to file Forms 8300. I was successful in quickly getting the IRS to abate the penalty. My leading argument in the abatement requested focused on failing to correct identify and name the penalty in the CP Notice.

## 8. I.R.C. § 6751(b)(1) Supervisory Approval

### a. Background

I.R.C. § 6751(b)(1) states: “No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher-level official as the Secretary may designate.”

A complete summary of the caselaw under § 6751(b)(1) is beyond the scope of this outline. See Monica Gianni, *Supervisory Approval of Penalties: The Opening of a Graev Pandora’s Box*, THE TAX LAWYER (Fall 2022) (providing an excellent summary of the caselaw). On April 20, 2023, the IRS [proposed regulations](#) under § 6751(b)(1). Those proposed regulations received substantial negative [public comments](#). Some view the draft regulations as inappropriately slanted and incomplete. Hopefully the IRS will take into account the public comments and craft a balanced final version of the regulations.

To briefly summarize, the Tax Court and other federal courts recognize that the IRS must secure written supervisory approval for penalties at some critical stage. *Clay v. Commissioner*, 152 T.C. 223 (2019) (requiring written supervisory approval no later than (i) the date on which the IRS issues the notice of deficiency or (ii) the date, if earlier, on which the IRS formally communicates to the taxpayer the Examination Division’s determination to assert a penalty and notifies the taxpayer of his right to appeal that determination). *Belair Woods, LLC v. Commissioner*, 154 T.C. 1 (2020) (requiring written supervisory approval no later than when the IRS sends a letter “formally notifi[ng]” the taxpayer that “the Examination Division had completed its work and ... had made a definite decision to assert penalties”).

Recent cases have moved toward a later point in time for written supervisory approval of penalties. *Laidlaw’s Harley Davidson Sales, Inc. v. Commissioner*, 29 F.4th 1066 (9th Cir. 2022) (requiring written supervisory approval at any time when the supervisor still has discretion to withhold approval). *Kroner v. Commissioner*, 48 F.4th 1272 (11th Cir. 2022) (requiring written supervisory approval before the assessment is made).

The Code provides for significant exceptions to written supervisory approval of penalties under I.R.C. § 6751(b)(2):

- (A) any addition to tax under § 6651, 6654, 6655, or 6662 (but only with respect to an addition to tax by reason of subsection (b)(9) thereof); or
- (B) any other penalty automatically calculated through electronic means

Focusing on the second exception, for penalties automatically calculated through electronic means with no IRS employee involvement, the IRS does not need to secure written supervisory approval of penalties. See *Walquist v. Commissioner*, 152 T.C. 61 (2019) (finding § 6662(a) penalties generated by an IRS computer program to fit within § 6557(b)(2)). When the IRS asserts that a penalty meets the exception for penalties automatically calculated through electronic means, the IRS will generally provide

no support or documents underlying its assertion during administrative consideration of penalty abatement and refund cases.

## **b. Importance to Penalty Disputes**

The IRS' failure to comply with § 6751(b)(1) concerning written supervisory approval of penalties can provide taxpayers with an all or nothing solution for assessed penalties. Analyze each element and seek evidence on:

- Was supervisory approval documented in writing? Can the IRS meet its burden of production on this point? *See McCarthy v. Commissioner*, T.C. Memo. 2020-74 (finding IRS failed to meet its burden on the issue and noting IRS “has not established which ... employee made the initial determination of any accuracy-related penalty, who that IRS employee’s immediate supervisor was, or that the penalty was approved timely in writing by that immediate supervisor”). *See also*, Andrew Velarde, Foreign Information Return Penalty Approval Spat Now at Tax Court, TAX NOTES FEDERAL (July 24, 2023) (discussing a recently filed Tax Court case (docket no. 10523-23L) challenging the sufficiency of written supervisory approval where the IRS asserts summary entries in a computer system constitute proper written supervisory approval).
- Was supervisory approval timely?
- Was person who provided written approval a supervisor as required by the Code?
- Do you suspect penalty backdating? *See generally, Lakepoint Land II, LLC v. Commissioner*, T.C. Memo. 2023-111 (sanctioning IRS for its conduct involving a backdated penalty approval).

### ***Practice Points:***

- IRS employees generally assume the IRS complied with § 6751(b)(1). You will need to affirmatively raise and argue the issue.
- The IRS may inappropriately rely on computer entries with scant information as evidence of written supervisory approval. This is especially true with international penalties assessed by the IRS’ Ogden Campus (Forms 3520, 3520-A, and others).
- Do not assume a penalty meets the exception of § 6751(b)(2). Argue the issue and ask the IRS to provide evidence that the penalty meets the exception.
- Considering using the Freedom of Information Act in your penalty disputes to try to obtain evidence relating to IRS non-compliance with § 6751(b)(1).

## **9. Other Potential Penalty Arguments**

### **a. Reliance on FAQs**

The IRS finally conceded that taxpayer reliance on FAQs provides a basis for some penalty relief. IRS guidance on FAQs indicates that taxpayers who reasonably relied in good faith on an FAQ will not be assessed a penalty that might otherwise apply. Concerning reliance on FAQs, the IRS states in part:

Notwithstanding the non-precedential nature of FAQs, a taxpayer’s reasonable reliance on an FAQ (even one that is subsequently updated or modified) is relevant and will be considered in determining whether certain penalties apply. Taxpayers who show that they relied in good faith on an FAQ and that their reliance was reasonable based on all the facts and circumstances will not be subject to a penalty that provides a reasonable cause standard for relief, including a negligence penalty or other accuracy-related penalty, to the extent that reliance results in an underpayment of tax. See Treas. Reg. § 1.6664-4(b) for more information. In addition, FAQs that are published in a Fact Sheet that is linked to an IRS news release are considered authority for purposes of the exception to accuracy-related penalties that applies when there is substantial authority for the treatment of an item on a return. See Treas. Reg. § 1.6662-4(d) for more information.

<https://www.irs.gov/newsroom/general-overview-of-taxpayer-reliance-on-guidance-published-in-the-internal-revenue-bulletin-and-faqs>

When applicable, the IRS guidance on FAQs may provide for penalty relief.

***Practice Point:***

- Print out and provide the FAQs on which your client relied with your penalty abatement claim.
- If you have difficulty locating old versions of FAQs, use [www.archive.org](http://www.archive.org) to locate prior versions of IRS.gov and IRSvideos.gov webpages.

**b. Reliance on IRS Oral Advice**

The IRS recognizes that taxpayer reliance on the erroneous oral advice of IRS employees should not be subject to penalties. IRM 20.1.1.3.3.4.2 (12-11-2009) “Oral Advice From IRS” states at (1):

The IRS may provide penalty relief based on a taxpayer’s reliance on erroneous oral advice from the IRS where the penalty allows relief for reasonable cause. The IRS is required by IRC 6404(f) and Treas. Reg. 301.6404-3 to abate any portion of any penalty attributable to erroneous written advice furnished by an employee acting in their official capacity. Administratively, the IRS has extended this relief to include erroneous oral advice when appropriate.

***Practice Point:*** Document reliance on oral advice and include details. Answer the normal who, what, when, where, and how questions by means of a letter from the person who received the oral advice, contemporaneous notes, etc.

**c. Lack of assessment authority – *Farhy* argument**

- a. Analyze the statute imposing the penalty and consider raising arguments using the logic of *Farhy v. Commissioner*, 160 T.C. 399 (2023), rev’d and remanded, 100 F.4th 223, 465 U.S. App. D.C. 202 (D.C. Cir. 2024).

- b. See also *Mukhi v. Commissioner*, 162 T.C. No. 8; 2024 U.S. Tax Ct. LEXIS 853 (April 16, 2024) (following the Tax Court’s decision in *Farhy* concerning the lack of assessment authority); *Safdieh v. Commissioner*, docket no. 11680-20L (order dated Dec. 5, 2024) (following the Tax Court’s decision in *Farhy* concerning the lack of assessment authority).

**d. APA Challenges to Penalties and Enforcement**

**e. Constitutional Challenges to Penalties**

- a. 5<sup>th</sup> Amendment- Does imposition of a specific penalty in a specific context possibly violate the Due Process clause of the Fifth Amendment?
- b. 7<sup>th</sup> Amendment- Consider whether an argument using *SEC v. Jarkesy*, 603 U.S. 109 at 122 (2024) might apply to a specific penalty. See Keith Fogg, *What Does the Seventh Amendment Have to Do With Tax Penalties?* TAX NOTES (Aug. 4, 2025).
- c. 8<sup>th</sup> Amendment- *U.S. v. Schwarzbaum*, 2025 U.S. App. LEXIS 1500 (11th Cir. Jan. 23, 2025) (carefully exploring the history of the Eighth Amendment and finding that civil willful FBAR penalties are subject to the Eighth Amendment)

**f. Other arguments and claim variance**

Other arguments may apply to your penalty case. Even if you are certain that the IRS will not consider an agreement, raise all potential arguments during administrative proceedings with the IRS to preserve them for litigation. If the penalty matter proceeds to refund litigation, the IRS may assert that claims not presented administratively have been waived. Treas. Reg. § 301.6402-2(b)(1) states: “The claim must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof. . . .” Courts will bar claims that substantially vary from refund claim presented to IRS. A thorough discussion of the exceptions to variance is beyond the scope of this outline. See generally, *Computervision Corp. v. United States*, 445 F.3d 1355 (Fed. Cir. 2006) (discussing the “substantial variance doctrine” and circumstances when it applies). See also Megan L. Brackney, *The Variance Doctrine: An Important Variable to Consider When Drafting Refund Claims*, JOURNAL OF PASSTHROUGH ENTITIES (September-October 2017).

**10. Penalty Resolutions**

**a. Binary (All or Nothing) Resolutions**

Several of the bases summarized above present binary settlement options. For example, FTA, § 6751(b)(1), § 6751(a), and the like are generally all or nothing bases for settlement. Of course, at the margins evidentiary matters concerning those issues may lead to hazards of litigation settlements.

**b. Hazards of litigation**

The Internal Revenue Manual authorizes Appeals personnel to settle penalty matters based on the hazards of litigation. The Internal Revenue Manual states:

- (1) Penalties may be settled based on hazards of litigation. Unlike Compliance, Appeals may consider the hazards of litigation in attempting to reach a settlement. The proper use of this settlement authority given to Appeals is critical in fulfilling its mission.
- (2) The settlement process is based on the ATE's experience and judgment after considering the facts and the law.
- (3) ATEs must evaluate the facts pertinent to the issue under consideration, the applicable law, and the potential outcome in the event the case is litigated.
- (4) The hazards of litigation are the uncertainties of the outcome of the court's decision in the event of a trial.
- (5) Litigating hazards generally fall into three categories: factual, legal and evidentiary. Note: Lack of case law should not be considered a hazard of litigation.
- (6) Appeals may weigh these factors and determine an appropriate settlement range for the issue and obtain a realistic settlement.

I.R.M. 8.11.1.2.7.5.

In applying the concept of hazards of litigation, hazards may include factual hazards, legal hazards, and evidentiary hazards. The three types of hazards may overlap. Factual hazards relate to lack of salient facts concerning whether the taxpayer meets a basis of relief. Legal hazards relate to the status of case law, law of circuit, and related concepts. Evidentiary hazards may involve admissibility of evidence, willingness/availability of witnesses to testify, and the like.

***Practice Points:***

- Explicitly raise hazards of litigation in penalty abatement and refund protests for Appeals. Emphasize where the government has hazards of litigation.
- If you are handling a significant penalty, and an Appeals Officer makes a low settlement offer based on hazards of litigation, consider requesting Post Appeals Mediation to attempt to get a better settlement. *See infra d)* for more information about Post Appeals Mediation.

**c. Penalty Mitigation**

If you search the Internal Revenue Manual for the terms “penalty” and “mitigation” within the same sentence, most of the relevant results pertain to FBAR penalty mitigation guidelines. *See* I.R.M. Exhibit 4.26.16-2. Penalty mitigation as used in this section does not refer to FBAR penalty mitigation and refers to a concept not currently addressed in the Internal Revenue Manual.

Appeals secretly developed a penalty settlement approach known as mitigation. Tax Analysts uncovered Appeals' use of penalty mitigation by means of a Freedom of Information Act request for Appeals training material on reasonable cause. *See* Andrew Velarde, IRS Appeals Training Materials on Reasonable Cause Bring Worry, TAX NOTES (October 6, 2022). Appeals may offer a settlement under mitigation when Appeals perceives either minimal or no hazards of litigation but where extenuating circumstances exist. According to Appeals penalty training material: “Mitigation is available but should

be used sparingly.” Appeals conjured up mitigation from the foundations of IRS penalty policy to reduce the severity of an applicable penalty. *See* I.R.M. 20.1.1.2.1, 20.1.1.1.4, and Policy Statement P-1-18.

The Appeals training material also provides a rationale for mitigation for penalties imposed by IRS computer systems (sometimes referred to within the IRS as “automatic penalties”). The training material notes: “With respect to these automatic penalties, there is no prior function that has exercised any independent judgment or assessment made with respect to the applied penalties... . As a result, it is appropriate for Appeals to incorporate penalty policy in resolutions to ensure that the proposed penalty enhances voluntary compliance and is in accordance with the IRM.”

The following hypothetical illustrates Appeals’ concept of mitigation and is derived from an example in Appeals training material:

Alpha Corp is a small family owned company with some manufacturing operations in Mexico, Alpha Corp relied on a CPA tax preparer to file its tax return extension. Due to a software glitch and oversight of an employee of the CPA firm not noticing the glitch, the electronic extension form was not received by the IRS. The staff at Alpha Corp was not aware of this problem. In fact, they received correspondence from the CPA firm which assured them that the appropriate extension had been filed. Ultimately, Alpha Corp was assessed \$100,000 for 10 delinquent Forms 5471 relating to the operating CFCs in Mexico. Alpha Corp has never been delinquent in filing returns or extensions in the past. Further, the delinquent return was filed within the extension period. Alpha Corp contested the Form 5471 penalties, but the IRS Campus group that considered the abatement request did not grant first time abatement or reasonable cause.

Applying the concept of penalty mitigation to the hypothetical above, Appeals would likely mitigate the penalty to 30% to 50% of the assessed amount. Appeals’ training material explicitly stated: “This is not a tool to give the house away!”

Practitioners have observed that Appeals uses mitigation in penalty cases to ensure taxpayers feel some sting and reduce the likelihood of litigation where taxpayers have compelling facts. Other practitioners see Appeals’ use of mitigation as an inappropriate shakedown of taxpayers.

***Practice Points:***

- Understanding the foundations for penalty mitigation in Appeals may provide an alternative settlement approach for your penalty case.
- If Appeals offers a percentage reduction settlement, ask Appeals whether it is offering a settlement based on hazards of litigation or mitigation.
- Some appeals officers may not know about penalty mitigation. It is more common in the context of international information return penalties. Be prepared to educate Appeals personnel on the topic and show Appeals personnel they have additional options to resolve cases.
- Review the [Appeals’ training slides that discuss mitigation](#) posted on Dan’s website to optimize your presentation to Appeals and to prepare for Appeals conferences.

#### d. Unpalatable Settlements and Options

On occasion, Appeals may offer a settlement that is highly unpalatable to your client. The Appeals Officer may say she is closing the case and it's time to "take it or leave it." What are your options?

First, politely ask for a managerial conference. Managerial conferences in Appeals are discretionary. You may need to make multiple requests.

Second, so long as the case has not been closed by Appeals, consider [Post-Appeals Mediation](#) (PAM). PAM allows Appeals to retain jurisdiction while the matter is mediated by another Appeals Officer. Rev. Proc. 2014-63 also allows, at the taxpayer's expense, a non-IRS co-mediator to be involved in PAM. Consider a non-IRS co-mediator for significant cases.

### 11. Drafting the Abatement or Refund Request

A comprehensive guide to writing abatement and refund requests is beyond the scope of this outline. The following tips summarize a few points for writing effective abatement and refund requests.

#### ***Practice Points:***

- Write at the high school level. Use plain language. Avoid legalese.
- For long penalty protests, provide an outline for the reader.
- Provide the facts. Do not assume that the IRS has any facts about the case, even facts about how the IRS computed the penalty and other facts that should be in the IRS' possession. Be honest and ethical. If the case has some bad facts, include them and explain them.
- Support your facts with documents. The IRS has been understaffed and overworked. It appears that some of its personnel who consider penalty abatement and refund requests have become jaded. Support your facts with documents, and the facts become easier for the IRS to accept.
- Clearly summarize the law: Do not assume the IRS understands the law. Summarize and then explain the law for the IRS. Try to keep your explanation of the law simple.
- Apply the law to the facts: Explicitly apply the facts of your case to the relevant law. Make it easy for the reader.
- Discuss policy: If assertion of a penalty runs contrary to the IRS' penalty policy, raise the issue. Explain the policy and how the IRS is acting contrary to its own policies.
- Write to compel: Avoid using generic terms like "taxpayer" or "corporation." Use names. Personalize the actors and make them real. Draft a moving narrative generally avoiding passive voice. Write with the goal of persuading a jaded decision maker to grant relief. *See* Stacy Caplow, Putting the "I" in Writing: Drafting an A/Effective Personal Statement to Tell a Winning Refugee Story, 14 Legal Writing: J. Legal Writing Inst. 249 (2008) (providing some good tips on writing a compelling story in different legal setting).