Courts Water Down Stringent IRS Penalties at the Water's Edge

Jun 08, 2023

Categories:

Blogs
Tax Law Defined™ Blog

Authors:

Patrick W. Thomas

As the United States has steadily increased enforcement against U.S. citizens and residents with foreign income and assets over the past decade, stories have emerged of the significant hardship that even compliant taxpayers face in meeting these burdens. These are particularly striking where the U.S. person (1) may never have known of their U.S. citizenship, (2) did not receive significant taxable gain from the accounts in question, or (3) may not even speak English as their first language.

Regardless of these factors, the overarching bounds of the law remain clear: U.S. citizens and residents must pay taxes and file returns with respect to their **worldwide income**. In many instances, such persons need not actually pay any tax to the United States; for example, they may qualify for the foreign earned income exclusion or the foreign tax credit that offsets any tax owed. But these individuals must nevertheless file returns and reports, and otherwise interface with the U.S. tax system.

Beyond paying taxes and filing tax returns, U.S. law also requires U.S. citizens and residents to declare their interests in certain foreign financial accounts. Specifically, 31 U.S.C. § 5314 requires U.S. persons with at least one foreign financial account to file a report, known as a Foreign Bank Account Report (FBAR), if the aggregate balances of their foreign accounts exceed $10,000 at any time during the year. The FBAR is not filed with an individual's income tax return or with the IRS; rather, it is filed with the Financial Crimes Enforcement Network ("FinCen"), a division of the U.S. Department of the Treasury.

Additionally, U.S. persons must *separately* report any "specified foreign financial assets" exceeding $50,000 on Form 8938, filed with an individual's income tax return. A "specified foreign financial asset" is generally any financial account, foreign stock, an interest in a foreign entity, or any financial instrument or contract where the counterparty is not a U.S. person.

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

FBT Gibbons

Finally, there are a variety of other reporting requirements for U.S. persons who (1) receive foreign gifts (Form 3520), (2) engage in certain transactions involving foreign trusts (Form 3520), (3) bring currency or other valuable items into the United States (Customs Declaration Form and FinCen Form 105), or (4) have an ownership interest in a foreign corporation or partnership (Form 5471).

What happens if one doesn't comply with this labyrinth of requirements? A slew of potential civil penalties, that the IRS—through its increasing use of automation—may assess without consideration of a taxpayer's individualized circumstances. The penalties are, generally, as follows:

- **Failure to File a Federal Income Tax Return/Pay Federal Income Tax Due** – Up to 47.5% of any tax underpayment. IRC § 6651(a)(1), (a)(2).
- **Failure to File an FBAR** – 31 U.S.C. § 5321.
  - $10,000 for Non-Willful Failures to File
  - Up to $100,000 or half the account for Willful Failures
- **Failure to File Form 8938 (Statement of Specified Foreign Financial Assets**) – IRC § 6038D: $10,000 to $50,000 per year.
- **Failure to File Form 3520 (Foreign Trusts, Foreign Gifts)** – IRC § 6039F: 25% of the foreign gift value.
- **Failure to File Form 5471 (Interests in Foreign Entities)** – IRC § 6038: Reduced foreign tax credit + $10,000 – $50,000 per year.

Recent court decisions have diminished the onerous impact of some of these penalties. First, *Bittner v. United States* limits non-willful FBAR penalties to $10,000 per year, rather than per financial account per year—significantly reducing the potential penalties for affected taxpayers moving forward. Additionally, a recent precedential Tax Court decision, *Farhy v. Commissioner*, holds that the IRS has no assessment authority whatsoever for penalties under IRC § 6038(b)(1) and (2).

Bittner v. United States – Foreign Bank Account Penalties Capped

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

In *Bittner v. United States*, the Supreme Court resolved a long-standing quandary: do non-willful FBAR penalties apply (1) **per account** or (2) **per year**? Alexandru Bittner immigrated to the United States in the 1970s and obtained U.S. citizenship through naturalization. He moved back to Romania after the fall of Communism and started various successful businesses. But Mr. Bittner neglected his FBAR filing requirements—which have existed in U.S. law since the 1970s, but which the IRS only began to strictly enforce in the 2000s. Mr. Bittner became aware of his obligations in 2012, and filed late FBARs for 2007 through 2011. He had a lot of accounts—approximately 55 accounts for each year.

The IRS didn't accuse Mr. Bittner of willfully failing to file the reports. But the IRS did view the relevant law as applying a $10,000 penalty **for each account** that Mr. Bittner owned. Accordingly, the IRS assessed a penalty for each account for each year: 272 accounts over 5 years means a total penalty of **$2.72 million**!

Mr. Bittner challenged the penalty, arguing that at least for the non-willful FBAR penalty, Congress only intended for a $10,000 maximum penalty per year. He ultimately prevailed in the Supreme Court, which in a closed divided opinion authored by Justice Neil Gorsuch, held that the penalty applies only on annual basis. Therefore, no matter how many accounts, the maximum penalty applicable for non-willful failures to file an FBAR is $10,000 per year.

The *Bittner* case leaves a few open questions. First, will the decision be applied **retroactively?** As a theoretical matter, the case should be able to be applied retroactively; new laws may generally be applied retroactively, outside of narrow constitutional exceptions, such as the *Ex Post Facto* clause that prohibits the retroactive imposition of criminal law.

A more difficult question for affected taxpayers is how to receive a refund. Unlike ordinary tax refunds, the FBAR penalty is not reported on any tax return or subject to an ordinary refund claim. Indeed, there is no apparent statutory provision that authorizes taxpayers to claim a refund of an overpaid FBAR penalty. Possible claims could exist under the federal Tucker Act—but these claims have a six-year statute of limitations. So, if an individual has paid FBAR

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

penalties greater than $10,000 in a calendar year, they would be well advised to contact an experienced tax lawyer to explore their options as soon as possible.

Fahry v. Commissioner –Assessments of IRC § 6038 Penalties are Unlawful

In *Farhy v. Commissioner,* 160 T.C. No. 6 (2023), Alon Fahry owned two Belizean corporations from 2003 to 2010; as such, because he was a U.S. person, he was required to report his ownership interests of the corporations under IRC § 6038(a) on Form 5471. But he didn't file these forms—in fact, the parties stipulated that he willfully failed to file. So, after providing him with notice, the IRS imposed penalties of $50,000 per year, as authorized under IRC § 6038(b). Mr. Fahry refused to pay, and so the IRS attempted to levy against Mr. Farhy's assets and income.

When that happens, the IRS must issue a Notice of Intent to Levy, which provides a right to a Collection Due Process (CDP) hearing with IRS Appeals. Further, it provides a right to petition the U.S. Tax Court for review of IRS Appeals' decision. Mr. Farhy availed himself of this hearing, which meant that by law, the IRS could not levy against Mr. Farhy until the hearing and all appeals were complete. The Appeals officer held that the IRS *could* impose a penalty, and so Mr. Farhy petitioned the Tax Court.

The Tax Court held that the IRS lacks statutory authority to assess penalties under IRC § 6038—i.e., the penalty for failure to disclose an individual's interest in a foreign entity, which can range from $10,000 to $50,000 per year. In contrast to the IRS's broad authority under IRC § 6201(a) to assess federal income tax, penalties relating to tax deficiencies, and certain other "assessable penalties", the Tax Court found that no such authority applies to IRC § 6038. Unlike many other penalties throughout the Code—for example, penalties for erroneous refund claims, frivolous tax submissions, or sanctions in the Tax Court—IRC § 6038 contains no cross reference that broad statutory authority. Therefore, while the IRS can "impose" such a penalty on the taxpayer it cannot "assess" the penalty.

So, what's the big deal? The IRS can *impose* the penalty but not "assess" it. Assessment is, in fact, the key turning point in federal

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

(and most state) tax controversies. An assessment is simple in definition—it's just the recording of a liability against a particular taxpayer in the IRS's computer systems.

But after assessment, the IRS's awesome powers of tax collection are able to be unleashed. Most private creditors have to resort to the courts to collect against a debtor who won't pay; not the IRS. After assessment (and adherence to the various collections rights such as the Notice of Intent to Levy and the CDP hearing, noted above), the IRS can forcibly take assets and income from a delinquent taxpayer without ever filing a proceeding in court. While the IRS can certainly sue a taxpayer to collect on a tax debt, the threat of administrative levies is how the IRS enforces the vast majority of its unpaid balances. So, in *Farhy*, and in any case under IRC § 6038, the IRS can no longer use that authority.

But as the Tax Court notes, the IRS can always still collect the penalty by filing a lawsuit against a taxpayer. Additionally, under longstanding precedent, the IRS can also lawfully withhold any refund due to the taxpayer for another tax period, even though no assessment exists.

What's the fallout from this decision? First, we'll need to see if the IRS appeals the Tax Court's decision to the D.C. Circuit Court of Appeals. In the meantime, taxpayers with active IRC § 6038 penalties should act now to have their assessments abated. Further, under the Tax Court's reasoning, the decision may apply with equal force to penalties under IRC § 6038A, 6038B, 6038C, 6038D, and 6038E—all of which seem to lack a similar authorizing statute.

Ultimately, this may be an issue that Congress steps in to resolve by providing the IRS with the necessary statutory authority. But with gridlock currently prevailing, the timing of such a move is anyone's guess.

For more information about these developments, please contact any attorney in Frost Brown Todd's Tax practice group.

© 2026 FBT Gibbons LLP. May be considered attorney advertising in some jurisdictions.

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

FBT Gibbons