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Rafizadeh Limits IRS's Ability to Assess Tax on Foreign Accounts

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In this article, Pittard and Brunetti examine how the IRS tried to extend the statute of limitations beyond the general three-year rule to assess additional income tax in *Rafizadeh* and *Blak Investments*.

Introduction

On January 2, 2018, the Tax Court held in *Rafizadeh*[1] that the six-year statute of limitations in section 6501(e)(1)(A)(ii) did not apply to the petitioner, who had failed to report income from a foreign bank account, because there was no filing requirement under section 6038D for the years at issue. The court therefore determined that the general three-year statute of limitations on assessment applied, and held that the IRS failed to timely issue a notice of deficiency. Because of this decision, the IRS will no longer be able to justify a longer statute of limitations based solely on the taxpayer's failure to file the required foreign bank account report[2] forms. Although this decision will limit the IRS's ability to extend the statute of limitations to assess additional income tax in some circumstances, the IRS can take other positions to justify a notice of deficiency issued to a taxpayer with foreign accounts after the expiration of the general three-year statute of limitations.

Background

In recent years the IRS has focused on taxpayers that have failed to report income from foreign accounts or file required information reports, such as Financial Crimes Enforcement Network Form 114.[3] While many taxpayers have taken advantage of the various offshore disclosure programs[4] designed to minimize the likelihood of criminal sanctions and reduce the imposition of large civil penalties,[5] not all taxpayers were eligible to participate in them. As part of the offshore voluntary disclosure terms, taxpayers generally agree to waive any statute of limitations defenses for the years at issue in the disclosure.[6]

To be eligible to participate in the IRS's offshore disclosure programs, a taxpayer must meet the requirements set forth in Internal Revenue Manual section 9.5.11.9,[7] which include a timely submission of the disclosure. A voluntary disclosure is timely submitted when it is received before the IRS has received information from a third party alerting the IRS to the specific taxpayer's noncompliance and before the IRS has initiated a civil examination or criminal investigation directly related to the specific taxpayer.[8]

[1] *Rafizadeh v. Commissioner*, 150 T.C. No. 1 (2018).

[2] Reports of Foreign Bank and Financial Accounts. These reports were authorized by the Bank Secrecy Act of 1970. Generally, if a taxpayer has an aggregate value of more than $10,000 in one or more financial accounts, the taxpayer must report information on that account to Treasury.

[3] Known as TDF 90-22.1 until the 2013 tax year.

[4] Including the Offshore Voluntary Compliance Program in 2009 and the Offshore Voluntary Compliance Initiative that began in 2011, which has evolved over the years through a series of FAQs on the IRS's website.

[5] The civil penalty for failure to file a foreign bank account report could be as high as the greater of: (1) half the balance of the undisclosed account or (2) $100,000 for each year the taxpayer failed to file the FBAR form.

[6] Addressed under FAQ 42 in the IRS's Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers 2014.

[7] Addressed under FAQ 12 in the IRS's Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers 2014.

[8] IRM 9.5.11.9.4.

On November 16, 2010, the IRS withdrew a John Doe summons it had issued against a foreign bank seeking to obtain information regarding account holders after the foreign bank agreed to disclose the names of several accountholders.[9] Thus, if a taxpayer held an account at that bank and the IRS had not received that taxpayer's voluntary disclosure submission before it obtained their information from the bank, that taxpayer would be ineligible to participate in the IRS's offshore disclosure program.

The petitioner in *Rafizadeh* owned a foreign bank account at a bank that had received a John Doe summons from the IRS. When the petitioner attempted to submit his offshore voluntary disclosure, the IRS claimed it had already received information on his account. Thus, the IRS determined that the petitioner was not eligible to participate in the offshore disclosure program. The IRS then sought to assess additional income tax against the petitioner for years 2006 through 2009.

Statute of Limitations

When a taxpayer is under audit by the IRS for foreign account issues, the IRS, in addition to investigating to determine whether a penalty for willful failure to file FBAR forms is appropriate, examines the taxpayer's returns and seeks to assess additional taxes and penalties on unreported income from prior years. Thus, the audit can result in additional tax due, penalties and interest on the unpaid tax, and large FBAR penalties.

Generally, the statute of limitations on assessment of tax is three years from the date the return was filed.[10] However, in some situations the statute of limitations on assessment can be extended beyond three years. For example, a substantial understatement of income can result in a six-year statute of limitations on assessment,[11] and understatements attributable to fraud can result in an open-ended statute of limitations.[12] In the case of a taxpayer's failure to file FBARs, the IRS has relied on section 6501(e)(1)(A)(ii) to extend the statute of limitations to six years from the filing date when no other justification existed to extend the statute.[13]

The Notice of Deficiency Issued to Petitioner

The IRS issued a notice of deficiency to the petitioner on December 8, 2014, for years 2006, 2007, 2008, and 2009, indicating that additional tax was due and assessing an accuracy-related penalty for each year.[14] With the exception of 2009, the IRS assessed additional income exceeding $5,000 for the years at issue.

The petitioner timely filed a petition in Tax Court challenging the assessment on the basis that the statute of limitations to assess tax for the years at issue had expired. In its answer to the petition, the IRS argued that the statute of limitations had not expired because section 7609(e)(2) tolled the statute of limitations for 664 days while the John Doe summons was pending, and it applied the six-year statute of limitations in section 6501(e)(1)(A)(ii).[15] In the reply to the IRS's answer, the petitioner asserted that the section 6501(e)(1)(A)(ii) six-year statute of limitations did not apply because there was no section 6038D filing requirement for the years at issue.

Section 6501(e)(1)(A)(ii)

Section 6501(e)(1)(A)(ii), which was enacted March 18, 2010, in section 513 of the Hiring Incentives to Restore Employment (HIRE) Act,[16] provides:

> if the taxpayer omits from gross income an amount properly included therein and . . . such amount (I) is attributable to one or

[9] *Rafizadeh*, 150 T.C. No. 1, at 3.

[10] Section 6501(a).

[11] A "substantial understatement" is defined as an omission of gross income amounting to at least 25 percent of the gross income stated in the return. Section 6501(e)(A)(1)(i).

[12] Section 6501(c)(1).

[13] The improper use of this statute was predicted by Robert Schwartz in "Statute of Limitations: IRS Examination Goes Too Far in Extending Statute of Limitations for Unreported Foreign Source Income," 15 *J. Tax Prac. & Proc.* 33 (Mar. 1, 2013).

[14] Before the issuance of the notice of deficiency, Appeals had agreed that the fraud penalty the examining agent had sought to impose was not appropriate.

[15] The IRS also took the position that the statute of limitations remained opened for years 2007, 2008, and 2009 in accordance with section 6501(e)(2). However, the IRS later conceded that section 6501(e)(2) did not apply because this section dealt with estate and gift returns and stated that section 6501(e)(2) had been cited in error.

[16] Hiring Incentives to Restore Employment (HIRE) Act of 2010 (P.L. 111-147, 124 Stat. 71, enacted Mar. 18, 2010, H.R. 2847).

> more assets with respect to which information is required to be reported under section 6038D (or would be so required if such section were applied without regard to the dollar threshold specified in subsection (a) thereof and without regard to any exceptions provided pursuant to subsection (h)(1) thereof), and (II) is in excess of $5,000, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.

Thus, for the six-year statute of limitations to apply under section 6501(e)(1)(A), the following facts must be present:

1. the taxpayer must have omitted gross income that should have been reported on the return;
2. the omitted gross income must be attributable to assets that are required to be reported under section 6038D, or would be reportable if not for the dollar threshold in section 6038D(a) or the exceptions in section 6038D(h)(1); and
3. the amount of omitted gross income must exceed $5,000.

Section 6038D

Like section 6501(e)(1)(A)(ii), section 6038D was enacted as part of the HIRE Act.

Section 6038D imposes a filing requirement on "any individual who, during any taxable year, holds any interest in a specified foreign financial asset . . . if the aggregate value of all such assets exceeds $50,000 (or such higher dollar amount as the Secretary may prescribe)."[17]

A "specified foreign financial asset," as defined in section 6038D(b), is:

> any financial account[18] maintained by a foreign financial institution,[19] and . . . any stock or security issued by a person other than a United States person, any financial instrument or contract held for investment that has an issuer or counterparty which is other than a United States person, and any interest in a foreign entity.[20]

If a taxpayer has an interest in a specified foreign financial asset, he must report to the IRS the account number and the name and address of the financial institution where a financial account is maintained; the name and address of the issuer of the stock or security; any information necessary to identify the class of that stock or security; and the name and address of the issuer of any instrument, contract, or interest.[21] The maximum value of each foreign financial asset must also be reported.[22] This information must be reported on Form 8938, which is submitted with the taxpayer's income tax return.[23]

This filing duty was initially to be required for tax years ending on or after March 18, 2010, but the IRS later pushed the filing requirement back to years ending after December 19, 2011.[24]

Arguments of the Parties

The IRS and the petitioner agreed that the statute was unambiguous but differed over the "plain meaning" of the statute.

Petitioner argued, under the canon of statutory interpretation that all words in a statute are given meaning and assumed not to be

[17] Section 6038D(a).

[18] Defined in section 1471(d)(2) to include any depository account maintained by a financial institution, any custodial account maintained by a financial institution, and any equity or debt interest in a financial institution (other than interests which are regularly traded on an established securities market).

[19] Defined in section 1471(d)(4) as "any financial institution which is a foreign entity," and does not include "a financial institution which is organized under the laws of any possession of the United States."

[20] Defined in section 1473(5) as "any entity which is not a United States person."

[21] Section 6038D(c).

[22] Section 6038D(c)(4).

[23] Reg. section 1.6038D.

[24] *See, e.g.*, reg. section 1.6038D-2(g).

superfluous, that the phrase "is attributable to one or more assets with respect to which information is *required to be reported* under section 6038D"[25] means there must be a section 6038D filing requirement in effect if the six-year statute of limitations is to apply. Allowing the six-year statute of limitations to apply to years before the section 6038D filing requirement would be ignoring the phrase "required to be reported." Further, if Congress had meant for section 6501(e)(1)(A)(ii) to apply to any tax years in which a specified foreign financial asset is or was the source of an omission of income, Congress would have merely cross-referenced the definition of "specified foreign financial asset" in section 6501(e)(1)(A)(ii), as it had done for other statutes.[26]

The IRS, on the other hand, read the phrase "is attributable to one or more assets with respect to which information is required to be reported under section 6038D" to mean the six-year statute of limitations applies to the *type* of assets required to be reported under section 6038D in any tax years in which the statute of limitations was still open as of the effective date of section 6501(e)(1)(A)(ii). In other words, the IRS's position was that if a specified foreign financial asset, as defined in section 6038D(b), is the source of the unreported income, the six-year statute of limitations under section 6501(e)(1)(A)(ii) applies as long as the statute of limitations for assessment for the tax year at issue has not expired, regardless of whether there was a section 6038D filing requirement in effect for that year.

The IRS further argued that adopting the petitioner's position that section 6501(e)(1)(A)(ii) applies only to years in which there is a section 6038D filing requirement would result in nullifying the effective date of the law that enacted section 6501(e)(1)(A)(ii), and would mean that there could be no set of facts under which section 6501(e)(1)(A)(ii) would apply before its enactment date.

To support this position, the IRS argued that the outcome in *Blak Investments*[27] was determinative. In that case, the court determined whether the effective date of section 6707A[28] precluded application of the listed transaction assessment statute suspension rule of section 6501(c)(10). The petitioner in *Blak Investments* asserted, in an argument resembling the petitioner's in *Rafizadeh*, that because section 6501(c)(10) "cross-referenced section 6707A the effective date of section 6707A controlled."[29] The *Blak Investments* court found "application of the effective date of section 6707A to section 6501(c)(10) would render the express effective date of section 6501(c)(10) meaningless, violating the cardinal principle of statutory construction."[30] Therefore, the IRS stated, the petitioner's position that the six-year statute of limitations applies only when there is a section 6038D filing requirement would have violated the holding in *Blak Investments* because that reading would nullify the effective date in section 513 of the HIRE Act.

The petitioner disagreed with the IRS's position that having section 6501(e)(1)(A)(ii) apply only to years in which there is a section 6038D filing requirement would render the effective date meaningless. The petitioner indicated that section 6501(e)(1)(A)(ii) is not the only change involving the statute of limitations in section 513 of the HIRE Act. For example, section 513(b) and (c) of the HIRE Act also amended section 6501(c)(8) by adding language that pertained to extending the statute of limitations for failure to file required information reports. Also, section 513(a)(2)(B) of the HIRE Act amended section 6229(c)(2) by increasing the statute of limitations for some omissions of gross income on partnership returns from three years to six years. Thus, when taking into account that other sections were affected by section 513 of the HIRE Act, the Tax Court could harmonize the effective date provisions with a reading of section

[25] Emphasis added.

[26] For example, in *Leslie v. Commissioner*, 146 F.3d 643 (9th Cir. 1998), *aff'g* T.C. Memo. 1996-86, which was a case that the court in *Blak Investments v. Commissioner*, 133 T.C. 431 (2009), relied on in rendering its decision, the court held that Congress, by using the parenthetical phrase "as defined in section 1092(c) without regard to subsection (d) or (e) of section 1092" in section 6621(c)(3)(A)(iii), referenced section 1092 "for one simple reason: 1092 contains what the drafters of 6621 deemed to be a useful definition of 'straddle.' In the interest of expediency, rather than trotting out the same exact definition again, they simply cross referenced 1092 which a prior Congress had already adopted." *Leslie*, 146 F.3d 643, at 651.

[27] *Blak Investments*, 133 T.C. 431.

[28] Section 6707A imposes a penalty on a taxpayer that fails to report information on a reportable transaction.

[29] *Rafizadeh*, 150 T.C. No. 1, at 11-12.

[30] *Blak Investments*, 133 T.C. 431, 441.

6501(e)(1)(A)(ii) that applies the six-year statute of limitations only to years in which there is a section 6038D filing requirement.

Also, the petitioner distinguished the facts of *Blak Investments* from the facts at issue in *Rafizadeh*. First, in *Blak Investments*, for the years at issue, the secretary had issued temporary regulations[31] that included a provision effective for returns filed after February 28, 2000, providing that "if a transaction becomes a reportable transaction after the taxpayer has filed the return for the first year in which the transaction affected the taxpayer's or a partner's tax liability, the disclosure must be filed as an attachment to the taxpayer's next filed return."[32] The final regulations[33] required taxpayers to prospectively report the listed transaction in a statement attached to their 2002 tax returns. Thus, the taxpayer in *Blak Investments*, unlike the petitioner, had an obligation to file a disclosure for years before the enactment of reporting obligation.

Secondly, the petitioner argued that the language of the statute at issue in *Blak Investments* differs significantly from the wording in section 6501(e)(1)(A)(ii). The wording of section 6501(c)(10) — the statute at issue in *Blak Investments* — explicitly indicates that the statute of limitations can be applied retroactively: Section 6501(c)(10) states that it applies when "a taxpayer fails to include on any return or statement *for any taxable year* any information with respect to a listed transaction (as defined in section 6707A(c)(2)), which is required under Section 6011 to be included with such return."[34] The language of section 6501(e)(1)(A)(ii), however, indicates that the extended statute of limitations for assessment applies only when there is a section 6038D reporting requirement.

In addition to the issue of whether section 6501(e)(1)(A)(ii) applies only to years in which there is a section 6038D filing requirement, the petitioner argued that section 6501(e)(1)(A)(ii) did not apply to their 2009 income because the omitted income was less than $5,000, and section 6501(e)(1)(A)(ii)(II) requires that for the six-year statute of limitations to apply the omitted gross income must exceed $5,000. The IRS conceded this issue and acknowledged that the statute of limitations had expired for 2009 in its reply to the petitioner's summary judgment motion.

Decision

The court concluded that "the most natural reading of [the phrase 'assets with respect to which information is required to be reported under section 6038D'] is that the six-year statute of limitations applies only when there is a section 6038D reporting requirement" and that the aforementioned phrase "does not simply incorporate the definitions of assets in section 6038D."[35]

Although both parties cited various portions of the legislative history asserting that it supported their respective positions, the court found the legislative history to be unhelpful because it merely "track[ed] the statute" in this matter.[36]

However, the court found helpful a comparison of how Congress generally cross-references definitions in other sections of the IRC by using the parenthetical phrase "as defined in section" and then referencing the section that is being cross-referenced.[37] For example, in section 6501(c)(10) Congress cross-references the definition of a listed transaction by using the parenthetical phrase "as defined in section 6707A(c)(2)."

In making its determination, the court found that applying section 6501(e)(1)(A)(ii) only to years in which there is a section 6038D filing requirement does not render the effective date provision of Section 513 of the HIRE Act meaningless because that effective date applies to other provisions of section 513 of the HIRE Act, "namely the expansion of section 6501(c)(8)(A) to

[31] Reg. section 1.60l l-4T(g), 67 F.R. 41360 (June 18, 2002).

[32] *Blak Investments*, 133 T.C. 431, 448.

[33] Reg. section 1.6011-4(h).

[34] Emphasis added.

[35] *Rafizadeh*, 150 T.C. No. 1, at 7-8.

[36] *Id.* at 9.

[37] *Id.* at 8.

all items on a tax return and the addition to section 6501(c)(8)(A) of reporting relating to passive foreign investment companies" as well as "other reporting requirements to the existing list in section 6501(c)(8)(A)."[38]

The court also distinguished the case from *Blak Investments* because the taxpayer in *Blak Investments* had a preexisting filing obligation and section 6501(c)(10) expressly applies to "any taxable year."[39] The petitioner in *Rafizadeh*, by contrast, had no filing obligation, and the phrase "any taxable year" does not appear in section 6501(e)(1)(A)(ii).

Based on the above, the court determined that "the wording of the effective date for section 6501(e)(1)(A)(ii) limits its application to years for which the reporting requirement of section 6038D also is effective."[40]

Effects on Future Cases

For years before 2011, the *Rafizadeh* holding prohibits the IRS from extending the general three-year statute of limitations against a taxpayer merely because the taxpayer omitted income from a foreign source.

Now, if the IRS desires to assess additional income tax for years before 2011 against a taxpayer who has unreported income from a foreign source, it must find some alternative basis to do so. For example, if the IRS can prove that the taxpayer filed a false or fraudulent return with the intent to evade tax, it can assess additional tax at any time.[41] Likewise, if the IRS can show that the taxpayer omitted an amount from income that is more than 25 percent of the gross income stated on the return, it can assess additional tax within six years of the filing of the return.[42]

However, this case does not help a taxpayer who failed to file Form 8938 for any years in which it was required to be filed. Unless the taxpayer failed to file its FBAR forms after 2011 but managed to file its Form 8938 as required by section 6038D, this holding will not provide any relief. In fact, its dicta regarding section 6501(c)(8) makes clear that the statute of limitations on assessment for those who failed to file their Form 8938 is three years from the date on which the information return is filed, which means the statute remains open until Form 8938 is filed.

Thus, the holding provides relief for taxpayers who either chose not to participate in the IRS's offshore voluntary disclosure programs or were prohibited from doing so for failing to meet the requirements of a voluntary disclosure, as long as those taxpayers became compliant with their filing requirements on their 2011 tax returns and the omission of income was not substantial in nature or attributable to fraud.

Conclusion

For taxpayers who merely owned a foreign account and had unreported income for years before 2011, the IRS will have to show some other reason — such as fraud or a substantial omission of income — to extend the statute of limitations beyond the general three-year rule to assess additional income tax for years before 2011. Thus, taxpayers who failed to file their FBAR forms and to report their income from foreign financial assets on income tax returns before the 2011 tax year should take a close look at the facts of their case to determine whether they should participate in an offshore voluntary disclosure program, because the statute of limitations on assessments of additional income tax and FBAR penalties might have already expired. ■

[38] *Id.* at 10.

[39] *Id.* at 12-13.

[40] *Id.* at 7.

[41] Section 6501(c)(1).

[42] Section 6501(e)(1)(A)(i).