

Alert | Tax Controversy and Litigation

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IRS Lacks Statutory Authority to Assess International Information Return Penalties: U.S. Tax Court

On April 3, 2023, the U.S. Tax Court ruled in *Farhy v. Commissioner*¹ that the IRS lacks statutory authority to assess Form 5471 penalties under I.R.C. § 6038(b)(1) or (2). As a result, the IRS cannot proceed with the collection of the penalties against the taxpayer. In recent years, the IRS has aggressively enforced foreign information return penalties, including the penalty for failing to file timely and complete Forms 5471. *Farhy* may have significant implications for taxpayers who have paid or are contesting Form 5471 penalties.

Background on I.R.C. § 6038 Penalties

Several categories of U.S. taxpayers are required to report their interests in foreign corporations. I.R.C. § 6038 imposes multiple penalties for failing to file timely and complete Forms 5471. Under I.R.C. § 6038(b)(1), if a U.S. person fails to furnish required information with respect to a foreign corporation, the IRS can impose a \$10,000 penalty. If the IRS notifies the taxpayer of the failure and the taxpayer fails to correct such failure within 90 days, the IRS can impose a \$10,000 continuation penalty for each 30-day period the failure continues (or fraction thereof), up to a maximum of \$50,000.

¹ 160 T.C. No. 6 (2023).

U.S. Tax Court Holding in *Farhy*

In *Farhy*, the taxpayer owned 100% of the interests in two foreign corporations. The taxpayer entered into a non-prosecution agreement with the United States in which he admitted that he participated in an illegal scheme to reduce his income tax liability. For the 2003 through 2010 tax years, the taxpayer failed to report his interests in the two foreign corporations on Forms 5471. The IRS notified the taxpayer of his failure to file Forms 5471, but the taxpayer never complied. The IRS assessed multiple penalties for each unreported entity: (i) a I.R.C. § 6038(b)(1) penalty of \$10,000 for each tax year; and (ii) a I.R.C. § 6038(b)(2) penalty of \$50,000 for each tax year.

The IRS issued the taxpayer a final notice of intent to levy to collect the I.R.C. § 6038 penalties. The taxpayer filed a timely request for a Collection Due Process Hearing in which he contested the IRS's legal authority to assess the I.R.C. § 6038 penalties. The IRS issued a Notice of Determination sustaining the IRS's collection actions. The taxpayer filed a petition in Tax Court.

After stipulations from the parties, the sole issue for the Tax Court's determination was whether the IRS had authority to automatically assess penalties under I.R.C. § 6038. An assessment is a formal recording of a taxpayer's tax liability. Once the assessment is made, the IRS can enforce collection through administrative actions such as liens and levies. Generally, there are two categories of civil penalties: (i) penalties subject to the IRS's deficiency procedures; and (ii) assessable penalties that must be paid on notice and demand of the IRS. But, according to the Tax Court, there is no statutory provision specifically authorizing the assessment of the I.R.C. § 6038 penalties. The IRS took the position that I.R.C. § 6038 penalties are automatically assessable penalties under I.R.C. § 6201(a). The taxpayer argued that the IRS had no authority for treating I.R.C. § 6038 penalties as assessable penalties. Therefore, according to the taxpayer, the IRS could only collect the I.R.C. § 6038 penalties through a civil action.

The Tax Court agreed with the taxpayer. According to the Tax Court, Congress specifically authorized the assessment of many penalties, but not I.R.C. § 6038 penalties. The Tax Court rejected the IRS's argument that I.R.C. § 6038 penalties were assessable penalties because they were not subject to the deficiency procedures. Moreover, the Tax Court rejected the IRS's broad interpretation that I.R.C. § 6201(a) applied to I.R.C. § 6038 penalties because they are a "tax." According to the Tax Court, legal precedent makes it clear that taxes and penalties are distinct forms of exactions unless a statute provides otherwise. Because I.R.C. § 6038 penalties were neither assessable penalties nor subject to the deficiency procedures, 28 U.S.C. § 2461(a) provided a remedy. According to 28 U.S.C. § 2461(a), when a statute prescribes a penalty without providing a method of recovery, the government can recover the penalty through a civil action.

Conclusion

It remains to be seen whether the IRS will appeal the Tax Court's decision in *Farhy*, but the decision likely will have widespread implications for thousands of taxpayers who are contesting or have paid I.R.C. § 6038 penalties. The decision may also have implications on other civil penalties where Congress has not prescribed the method of assessment, including penalties for failing to file Forms 8865, 5472, 8938 and 926. *Farhy* does not apply to penalties for failing to file Forms 3520 and 3520-A. It also remains to be seen whether this decision will apply to other civil penalties where Congress has not prescribed the method of assessment. Taxpayers who have paid I.R.C. § 6038 penalties may wish to consult with their tax advisor to determine whether they are eligible to file a claim for refund.

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