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Alon Farhy,

Petitioner

v.

Commissioner of Internal Revenue

Respondent

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Document No. 26

Simultaneous Answering Brief

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UNITED STATES TAX COURT

ALON FARHY,	)	
	)	
Petitioner,	)	
	)	
v.	)	Docket No. 10647-21L
	)	
COMMISSIONER OF INTERNAL REVENUE,	)	Filed Electronically
	)	
Respondent.	)	Judge L. Paige Marvel

ANSWERING BRIEF FOR RESPONDENT

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ANSWERING BRIEF FOR RESPONDENT

PRELIMINARY STATEMENT

On May 12, 2022, this case was submitted for decision pursuant to Rule 122,[1] before the Honorable Richard T. Morrison. On August 22, 2022, this case was reassigned to the Honorable L. Paige Marvel.

Petitioner filed his Opening Brief on September 8, 2022, and respondent filed his on September 9, 2022. The Court ordered the parties to file simultaneous answering briefs on or before November 8, 2022.

Respondent's Answering Brief is confined to matters not previously discussed and matters requiring clarification. Respondent's Reply Brief contains respondent's objections to petitioner's proposed findings of facts. Failure to

[1]Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the relevant time, and all Rule references are to the Tax Court Rules of Practice and Procedure.

address issues in this Reply Brief that have already been addressed in respondent's Opening Brief does not constitute an abandonment or concession of those issues.

RESPONDENT'S OBJECTIONS TO PETITIONER'S REQUESTED FINDINGS OF FACT

1. Unnumbered finding: "This Collection Due Process (CDP) case involves a final levy notice for petitioner's unpaid liabilities for section 6038 civil penalties for tax years 2003 through 2010." No objection. *See* respondent's requested finding of fact ¶ 3 for additional clarification.

2. Unnumbered finding: "The section 6038 [civil penalties] arose from petitioner's failure to file a required Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations)." No objection. *See* respondent's requested findings of fact ¶¶ 8-16 for additional clarification.

3. Petitioner's unnumbered finding that petitioner's requested findings are the only relevant and material facts. Objection. Several other facts are relevant and material as to whether the levy action should be sustained. Respondent respectfully requests the Court to adopt the findings of facts as requested in respondent's Opening Brief.

ARGUMENT

I. The Statute's Plain Language and Legislative History Prove Congress Intended to Treat the Section 6038 Penalty as an Assessable Penalty

Respondent's position is consistent with the plain language of the text in sections 6201(a) and 6038(b); respondent has both the authority and the duty to assess the penalties in section 6038 pursuant to the broad grant of authority in section 6201(a). This penalty is an assessable penalty. Its location outside of Subtitle F, Chapter 68 has neither legal nor practical significance, and petitioner's interpretation of the Code would produce an absurd disposition. *See Lamie v. U.S. Tr.*, 540 U.S. 526, 534 (2004) (citations and internal quotation marks omitted). The organizational structure for the section 6038 penalty is explained by the legislative history of the Code.

Section 6038 was enacted on September 14, 1960. Pub. L. No. 86-780, § 6(a), 74 Stat. 1014 (1960). Since its enactment, section 6038 incorporated a civil penalty, unlike other provisions of the Code that have separate sections that require an information return and impose a penalty. The original version of section 6038 imposed a penalty in the form of a reduced foreign tax credit that is now contained in section 6038(c), which explains why Congress did not create a separate section to impose a penalty in Chapter 68. The original text of section 6038 stated:

> § 6038 (1960). INFORMATION WITH RESPECT TO CERTAIN FOREIGN CORPORATIONS.
>
> (a)(1) IN GENERAL. A domestic corporation shall furnish, with respect to any foreign corporation which it controls [such information required by the Secretary relating to the foreign corporation] . . .
>
> (b) EFFECT OF FAILURE: TO FURNISH INFORMATION. If a domestic corporation fails to [timely] furnish . . . any [required] information with respect to any foreign corporation or foreign subsidiary . . . then, in applying section 902 (relating to foreign tax credit . . .), the amount of taxes paid or deemed paid by each foreign corporation and foreign subsidiary with respect to which the domestic corporation is required to furnish information . . . shall be reduced by 10 percent. If such failure continues 90 days or more after notice by the Secretary or his delegate to the domestic corporation, then the amount of the reduction under this subsection shall be 10 percent plus an additional 5 percent for each 3-month period, or fraction thereof, during which such failure to furnish information continues after the expiration of such 90-day period. No taxes shall be reduced under this subsection more than once for the same failure.

§ 6038 (1960).

A major revision to section 6038 occurred in 1982 when Congress added a monetary penalty to supplement the existing foreign tax credit reduction. Pub. L. No. 97-248, Title III, § 338(a)-(c), 96 Stat. 63 (1982). The plain language of the revised statute established: (1) an initial monetary penalty for failure to furnish required information; and (2) a monetary continuation penalty for failure to furnish required information after the IRS mails notice of such failure:

> § 6038 (1982). INFORMATION WITH RESPECT TO CERTAIN FOREIGN CORPORATIONS.
>
> (b) DOLLAR PENALTY FOR FAILURE TO FURNISH INFORMATION.
> (1) In general. If any person fails to [timely] furnish . . . any [required] information with respect to any foreign corporation . . . , such person shall pay a penalty of $1,000 for each annual accounting period with respect to which such failure exists.
>
> (2) Increase in penalty where failure continues after notification. If any failure described in paragraph (1) continues for more than 90 days after the day on which the Secretary mails notice of such failure to the United States person, such person shall pay a penalty (in addition to the amount required under paragraph (1)) of $1,000 for each 30–day period (or fraction thereof) during which such failure continues with respect to any annual accounting period after the expiration of such 90–day period. The increase in any penalty under this paragraph shall not exceed $24,000.

§ 6038(b) (1982).

Not only is the plain language of section 6038 clear, but the legislative history also shows Congress intended to create an additional, monetary assessable penalty to reconcile complaints about inadequate reporting with the IRS's sporadic usage of the foreign tax credit reduction. S. Rep. No. 97-494, at 299-300 (1982). When section 6038(b) was amended in 1982 to add a monetary assessable penalty for noncompliance, in addition to the existing penalty of a reduced foreign tax credit, the Senate Finance Committee reported the reasons for the change and an explanation of the provision:

Reasons for the Change

> Despite complaints about inadequate reporting with respect to controlled foreign corporations, penalties generally are not imposed (sec. 6038(b)). In part, this is because *the penalty is complicated*. It also may be unduly harsh in some cases, because a taxpayer could incur a substantial penalty for a minor failure. On the other hand, a sanction *reducing creditable foreign taxes is of no use if the U.S. person required to report paid no foreign income taxes* during the year in question.

Explanation of the Provision

> *The committee bill adds a fixed-dollar penalty* for failure to furnish the Internal Revenue Service the information required by present section 6038 of the Code . . . The bill retains the potentially significant penalty of a reduction in foreign tax credit to be imposed where the Internal Revenue Service considers it appropriate. *Where both penalties are applied*, the amount of the reduction in the foreign tax credit is reduced by the amount of the *fixed-dollar penalty imposed*. It is intended that the reduction in foreign tax credit penalty may be waived in some cases where *the flat $1,000 penalty will be imposed*.

Id. Emphasis added. *See also* H.R. Rep. No. 97-760, at 589-590 (1982).

The Committee noted that the existing penalty provision was "complicated," and that the penalty was also useless if the taxpayer did not pay foreign taxes and claim a credit that the IRS could reduce. S. Rep. No. 97-494, at 299. To simplify the penalty provision and penalize taxpayers who failed to furnish required information but did not pay foreign taxes, rather than create a new Code section, Congress created a new monetary assessable penalty in the same section where the

information reporting requirement and original penalty were contained. *Id.* Congress clearly intended for section 6038 penalties to be "applied" by the IRS when appropriate, and that the IRS would determine whether to waive the foreign tax credit reduction in some cases where the IRS had "imposed" the fixed dollar penalty. *Id.* at 300. Penalties are "applied" and "imposed" by the IRS through its use of assessments, and the IRS has consistently applied that interpretation in its guidance. *See* I.R.M. 4562.5 (2-2-1986) ("any [section 6038] penalty imposed …may be assessed and collected without regard to [deficiency procedures]").

Nowhere does the legislative history suggest that Congress intended for the IRS to enforce these penalties through a referral to the Department of Justice. Indeed, conjuring this requirement now would produce an absurd disposition, in contradiction of Congress's explicit intent to make the section 6038 penalty less complicated and improve the adequacy reporting with respect to controlled foreign corporations. *See Lamie*, 540 U.S. at 534; S. Rep. No. 97-494, at 299-300.

No other Title 26 penalty requires referral to the Department of Justice for assessment and collection, and petitioner's reading would lead to absurd results when compared to the similar requirements of section 6048, which relates to the filing requirements for foreign trusts. Unlike section 6038, section 6048 has a corollary penalty in section 6677 located within Subchapter B of Chapter 68, which petitioner recognizes as an assessable penalty merely because of its location

in the Code. Pet'r's Op. Br. p. 17-18. Thus, under petitioner's argument, if a taxpayer had an undisclosed foreign trust, the IRS could examine, assess, and collect penalties for failure to comply with reporting requirements, but a similarly situated taxpayer with a foreign corporation or partnership would only face penalties if the Department of Justice brought suit. That result is even more absurd considering that the penalties for failure to disclose a foreign trust are often much greater than the penalties for failure to disclose a foreign corporation or partnership. *See* §§ 6038, 6677(a)-(b). Sections 6038 and 6048 are similar, designed by Congress to ensure that taxpayers voluntarily report information regarding foreign entities. The only logical way to effectuate Congressional intent is for the Court to hold that the section 6038(b) penalty is an assessable penalty.

II. Petitioner Cited No Authority That Section 6038 Penalties Are Not Assessable Penalties, and He Cited Authority that Supports Respondent's Position

Petitioner's argument that the list of assessable penalties ends with those contained in Subtitle F, Chapter 68 fails. The fact that section 6038 is not located in Chapter 68 has neither legal nor practical significance. Petitioner contended that the "assessable penalties" referenced in section 6201(a) do not include section 6038 penalties, but he could not cite any authority to support his argument. Neither section 6201, nor any other provision of the Code states that Chapter 68 contains all assessable penalties, and no provision of the Code states that any

penalty located outside of Chapter 68 is not an assessable penalty. Quite the contrary, the Code itself mandates that "[n]o inference, implication, or presumption of legislative construction shall be drawn or made by reason of the location or grouping of any particular section or provision or portion of this title, nor shall any table of contents, table of cross references, or similar outline, analysis, or descriptive matter relating to the contents of this title be given any legal effect." § 7806(d). It would violate this statutory mandate to conclude that a penalty is not an assessable penalty simply because it is not located in a particular chapter. Moreover, it would violate common sense to conclude that a penalty that is structured and functions like other assessable penalties is not also an assessable penalty.

Assessable penalties are not subject to deficiency procedures because they are not based on a deficiency in tax. This is due to the nature of the penalty and not, as petitioner suggests, because a penalty is located in Chapter 68. Pet'r's Op. Br., p. 14. In fact, the case cited by petitioner for this suggestion explained that Title 26 "taxes" – which include penalties and additions to tax per section 6201(a)– can be immediately assessed if they are not among one of the enumerated categories of taxes cited in sections 6212(a) and 6213(a). *Williams v. Commissioner,* 131 T.C. 54, 58 (2008). Further, the very footnote petitioner cited supports respondent's position because the Court specifically stated that the

assessable penalties in Chapter 68 are only an *example* of the types of assessable penalties not subject to deficiency procedures ("*For example*, the 'Assessable Penalties' provided under Chapter 68 (i.e., within Subtitle F, 'Procedure and Administration') fall outside the deficiency notice regime of sections 6212 to 6214 . . ."). *Id.* at 58 n. 4. Emphasis added. Assessable penalties are not limited to those contained in Chapter 68. Rather, "[by] negative implication," *Id.* at 58, assessable penalties include all Title 26 penalties other than penalties that relate to a tax deficiency in one of the categories listed in sections 6212(a) and 6213(a).

Petitioner pointed to Code provisions similar to section 6038, where Congress created a separate section for the information reporting requirement and another for the penalties for violating those requirements. Pet'r's Op. Br. p., 17-18 (noting separate sections for 6048 and 6677 and separate sections for 6046, 6046A, and 6679). From this separation, petitioner infers Congressional intent to treat section 6038 penalties differently. Petitioner's analysis is misplaced. The authority to assess section 6038 penalties comes from section 6201(a), not their location within the Code. Further, petitioner misses an easier inference explaining the use of section 6038 to house the monetary penalty: the section already contained a penalty provision relating to the reduction of the foreign tax credit, which Congress kept in force to supplement the new monetary penalty. When Congress added the monetary penalty in 1982, it required that the two penalties

interact with one another by mandating that the amount of any disallowed foreign tax credit be reduced by the amount of the monetary penalty assessed. S. Rep. No. 97-494, at 299-300. None of the other penalties cited by petitioner have this type of legislative history.[2]

The lack of a separate Code section imposing penalties for section 6038 violations does not deny the IRS from having authority to assess them. The ability to assess these penalties is within the grant of authority in section 6201(a). The prior versions of the statutory text and the legislative history show that Congress did not create a separate Code section to impose section 6038 penalties because section 6038 incorporated a penalty provision in its original text. Petitioner cited no other Title 26 penalty that requires referral to the Department of Justice for assessment and collection, and no rational reason exists to believe that Congress intended to create such an overly burdensome and complex procedure for assessment and collection of section 6038 penalties. Rather, the plain text and legislative history show that Congress intended treat section 6038 penalties as assessable penalties subject to the IRS's regular collection procedures.

[2] Congress enacted sections 6048 and 6677 simultaneously. Pub. L. No. 87-834, § 7(f), 76 Stat. 987-988 (1962). Upon enactment, section 6046 did not impose any civil penalty for failure to furnish information for certain transactions related to foreign corporations. Pub. L. No. 591, ch. 736, 68A Stat. 747 (1954). *See also* Pub. L. No. 87-834, § 20(b), 76 Stat. 1061-1062 (1962); Pub. L. No. 97-248 (1982); Pub. L. No. 97-248, Title IV, § 405(b), (c)(2), 96 Stat. 634, 670 (1982).

If the section 6038(b) penalty is not an assessable penalty treated similarly to a "tax" under section 6201, it would be the first of its kind: a penalty sitting within the Code, unable to interact with the vast interconnected web of the Code. That result would nullify the purpose behind the statute and contradict existing case law. *See Dewees v. United States*, 272 F. Supp. 3d 96, 102 (D.D.C. 2017), aff'd, 767 F. App'x 4 (D.C. Cir. 2019) (holding that "[f]ull payment of the amount owed followed by a lawsuit in a district court seeking a refund is a proper procedure for challenging penalties assessed under I.R.C. § 6038.") (*citing Wheaton v. United States*, 888 F. Supp. 622, 627 (D. NJ. 1995)); S. Rep. No. 97-494, at 299-300. The extent to which any drafting ambiguity exists, the doctrine of *in pari materia* instructs that any ambiguity should be interpreted and resolved in favor of the omitted provision fitting harmoniously into the statutory scheme. Assessable penalties are not limited to those contained in Chapter 68. Section 6201 grants broad assessment authority over penalties that are by their very nature assessable. It is that grant of authority, not the location of those penalties within the Code that provide the IRS the ability to assess.

III. Petitioner's Arguments Regarding the IRS's Systematic Assessment of Section 6038 Penalties Are Irrelevant

Petitioner argued that the IRS systematically assesses section 6038 penalties on thousands of taxpayers every year, Pet'r's Op. Br., p. 5, in an apparent attempt to garner sympathy from the Court to support his position. This case is not about

thousands of taxpayers. This case is about petitioner, Alon Farhy, who participated in an illegal scheme for which he could have been prosecuted and who willfully failed to file Forms 5471. RPFOF ¶¶ 6-11, 13-14. Petitioner's arguments about the IRS's systematic assessment of section 6038 penalties are irrelevant and, in any event, do not provide support for his position that the section 6038 penalty is not applicable in this case.

CONCLUSION

As the IRS has authority to assess and collect section 6038 penalties and the parties have stipulated to all other facts required for the Court to sustain the levy action, it follows that the determination of the Commissioner of Internal Revenue, as set forth in the notice of determination, should be sustained.

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Date: November 8, 2022 By: _____

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