Information Return Penalty Assessment Fight Coming to a Head

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A case directly challenging the IRS's legal authority to assess international information return penalties is advancing in Tax Court and could upend penalty collection procedures if the taxpayer prevails.

Although the timing of any decision remains uncertain, addressing the issue may ultimately be unavoidable if one is reached in *Farhy v. Commissioner*. In September simultaneous opening briefs were filed in the Tax Court. The taxpayer and the IRS subsequently filed simultaneous answering briefs that were served November 9. The sole legal issue revolves around whether the IRS can use its assessment powers for section 6038 penalties, which the taxpayer contends is unlawful because it is not authorized under the code.

"The argument is very simple, and the interesting thing is [the government] doesn't really have an answer for it. . . . If it ain't in the code, it don't exist," said Edward M. Robbins Jr. of Hochman Salkin Toscher Perez PC, who represents the taxpayer, expressing some surprise that the IRS had not conceded the case. "This is the first time any taxpayer has been able to maneuver the issue in front of the court. . . . Assume I'm right: [The IRS] has illegally been using their collection powers for quite some time, especially when they started automatically assessing [the penalties]. So imagine the chaos that they've caused by assessing thousands and thousands of these things."

The facts generally are not in dispute. Alon Farhy failed to file his Forms 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations," for his Belize foreign corporations. For that the IRS imposed under section 6038 $60,000 in penalties per year for the tax years 2003 through 2010. Because the facts are undisputed and there are no other legal issues before the court, Robbins predicted that the issue of assessability, which has been raised along with other arguments in litigation previously, will finally be addressed.

"We are left to guess whether the code creates 'emanations' of power that created 'penumbras' of authority within which the Commissioner can operate to assess the [section] 6038 penalties even if he is not explicitly authorized in the Code. Or is the Commissioner falling back on an ipse dixit argument: 'It is, because I say it is,'" the petitioner's opening brief states. "The unprecedented power the Commissioner claims here, assessing a penalty with no statutory authorization to do so, contravenes rules governing self-government, equality, fair notice, federalism, and the separation of powers. Is the Commissioner required to follow the law, like all taxpayers are so required, or not?"

The Office of the Taxpayer Advocate's 2020 annual report to Congress identified assessment of international penalties under sections 6038 and 6038A as one of its most serious problems, finding

that systematic assessments are a burden to the IRS and taxpayers and are "legally unsupportable." It argued that summarily assessable penalties are found under chapter 68 of the code and that the punitive penalties under sections 6038 and 6038A are in chapter 61. In its 2021 annual report, the office warned of the potential for future litigation and recommended legislation that would subject foreign information reporting penalties to deficiency procedures.

For years practitioners have loudly objected to the IRS's systematic and summary assessment of penalties after a return is filed late, which makes it impossible for taxpayers to avail themselves of deficiency procedures.

Section 6201(a) authorizes the IRS to make assessments on taxes and assessable penalties. After assessment and a failure to pay, the IRS can enforce collection through liens and levies. Section 6212 requires a notice of deficiency before a liability assessment, and under section 6213 a taxpayer may petition the Tax Court for review. Section 6671 under chapter 68 provides the rules for assessable penalties, which allow for those penalties without a notice of deficiency. Taxpayers must pay those assessable penalties before judicial review is allowed in a district court or the Court of Federal Claims.

Robbins said that a fix to the IRS's assessment conundrum would not be difficult, simply requiring a small legislative fix. Alternatively, he acknowledged that arguably the IRS could have addressed the issue in regs under section 6201. But the lack of any action doomed the IRS, he argued.

Not Either/Or

Farhy does not argue for deficiency procedures for his penalties, because he acknowledges that section 6038 is not subject to those provisions of the code. Other penalties not subject to deficiency procedures that are summarily assessed are included in chapter 68 of the code, which defines assessable penalties. But section 6038 penalties are not found under that chapter, and there is no corresponding authority in the code for assessment of section 6038 penalties, he argues.

Instead, Farhy asserts that without assessment or deficiency procedures, the IRS must ask the Justice Department to reduce the penalties to judgment for collection through a district court action. His answering brief draws comparison with the actions taken in foreign bank account reporting penalty cases.

The petitioner notes that *National Federation of Independent Business v. Sebelius*, 567 U.S. 519 (2012), ruled that assessable penalties are within the definition of tax in allowing the IRS to assess penalties. But the taxpayer objects to the IRS's position that allows it to assess any penalties not subject to deficiency proceedings even if they are not listed in chapter 68. The taxpayer asserts that while section 6201(a) is extensive in its grant of authority on "assessable penalties," it does not include chapter 61 penalties. It accuses the IRS of using circular logic in arguing that because deficiency procedures don't apply, summary assessments do.

"These are not either/or propositions, and the authority to assess is in no way conferred by the unavailability of deficiency procedures. The Commissioner simply has no ability to assess Chapter 61

penalties under the Code as currently codified. This unfortunate and likely unintended situation is why assessment and collection of Chapter 61 penalties should be referred to the Department of Justice," the petitioner's opening brief states. "Here, there is no reason to think that Congress used the term 'assessable penalties' to mean 'every penalty mentioned in the Code.'"

According to the IRS, however, it has the power to collect section 6038 penalties under its ordinary collection mechanisms. The IRS argues that section 6201(a)'s reference to assessable penalties should be read broadly to include section 6038, even if it is not contained in chapter 68. Its opening brief also argues that the penalties are included under the definition of taxes under section 6201(a), which not only allows for but requires IRS assessment. The section's reference to assessable penalties, as well as interest, additional amounts, and additions to tax, is contained in a parenthetical after the term "all taxes," indicating that Congress was using "taxes" expansively, the government argues.

"The authority to assess section 6038(b) penalties is a critical tool used in fulfilling the IRS's duty to ensure taxpayer compliance with the Code," the respondent opening brief states. "If section 6201 excluded the section 6038(b) penalty from the scope of 'taxes,' then that provision would run contrary to the duty that section 6201 imposes on the IRS to make inquiries and determinations of tax."

The government cites several cases for support, including *Ruesch v. Commissioner,* 154 T.C. 289 (2020), *aff'd in part, vacated and remanded in part,* 25 F.4th 67 (2d Cir. 2022), for the proposition that section 6038 penalties are not within the Tax Court's deficiency jurisdiction and that a prepayment forum may be used to contest them; and *Flume v. Commissioner*, T.C. Memo 2017-21 (2017), which involved a collection due process case challenging section 6038 penalties. The opening brief asserts that even though Flume did not bring up an argument of assessment authority, the court must have found that the IRS could assess section 6038 penalties because it ruled entirely in favor of the IRS.

But Farhy argues that the IRS's cited case authorities miss the mark. *Flume* and *Ruesch* are "garden variety" collection due process cases that are not instructive, the taxpayer answering brief says, noting that both cases argued that reasonable cause excused penalties.

"The Commissioner has known of this issue since at least 2018. He ignored it. He litigated around this issue and never brought it to any Court's attention. The Commissioner never brought it to the *Ruesch* Court's attention," the brief argues. "Lacking the Commissioner's mind reading skills, we are forced to look at the words in *Flume* to deduce [its] meaning. *Flume* adds nothing to the analysis of our issue. We note that the Commissioner did not point out to the Court in *Flume* there existed no specific assessment authority in the Code for the section 6038 penalties. Neither did Mr. Flume."

The IRS's answering brief argues that Farhy's position would lead to an absurd result and that the location of section 6038 penalties outside chapter 68 "has neither legal nor practical significance." It looks to the legislative history of section 6038 to support its position, noting that the $10,000 penalty under section 6038(b) was layered on top of the foreign tax credit reduction, which was complicated and had no effect if the taxpayer did not pay foreign taxes. Congress placed the new assessable penalty in the same section where the original penalty was contained, it argues, and there is no indication that Congress intended for the IRS to have to refer the penalties to the Justice Department

for enforcement. The brief also argues that finding section 6038(b) penalties as not assessable would create a completely novel type of penalty that would be "unable to interact with the vast interconnected web of the Code."

"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," the IRS argues in its answering brief, noting that no other title 26 penalty requires Justice Department referral, including the similar section 6048 penalty relating to foreign trust reporting. "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."

Frank Agostino of Agostino & Associates PC said that legislative history is irrelevant to the analysis, however, and that reference in a statute or reg is necessary.

Agostino previously criticized the IRS's contention that because section 6038 penalties are not subject to deficiency proceedings, they should be summarily assessable. He has also litigated the issue several times — though usually in conjunction with other arguments such as reasonable cause or section 6751(b) supervisory approval of penalties, such that an answer on the question of assessability hasn't been reached.

The IRS "conceded on [section] 6751(b), which I knew would kill them. But they would rather concede on that than open this door," Agostino said. "I don't think they want a Tax Court opinion in light of the way the [Administrative Procedure Act] cases are coming out."

Agostino pointed to the November 9 decision in *Green Valley Investors LLC v. Commissioner*, 159 T.C. No. 5. In that decision, the Tax Court held that Notice 2017-10 is invalid because the IRS did not comply with notice and comment procedures under the APA.

Waiting Is the Hardest Part

The ramifications of a taxpayer win would be significant, especially because, according to Agostino, the IRS has been summarily assessing the penalties by "assessing first and asking questions later."

"The first thing that has to be done in collection due process is for the IRS Independent Office of Appeals to evaluate whether the IRS has followed all applicable laws, regulations, and IRS procedure. If the law doesn't allow for summary assessment, then they will tell the Service you must abate all of these," Agostino said. "If the courts rule against the Internal Revenue Service on this summary assessment, all of the assessments are void, or voidable."

Positing that there is arguably a lack of a relevant statute of limitations provision for chapter 61 penalties under the code, both Agostino and Robbins pointed to further potential fallout caused by

the need to look to the default statute of limitations under title 28, section 2462. That requires an action, suit, or enforcement proceeding to begin within five years of when the claim accrues.

According to Agostino, the argument goes that if the penalties are not summarily assessable, they are return-based penalties or information return-based penalties subject to the five-year statute of limitations. The statute would have run on many of the penalties under the theory that the claim is tied to the due date of the Form 1040 with which the information should have been provided, he said.

The IRS " has adopted a litigation strategy to wait until they've got better precedent. That better precedent is taking a very long time," Agostino said.

In a 2015 international practice unit, the IRS stated that the statute of limitations for assessing and collecting section 6038 penalties is three years after the Form 5471 is substantially completed and filed. As authority, it cites a memo from David W. Horton, then IRS Large Business and International Division director of international individual compliance.

Robbins is optimistic that in a matter of months, a decision in *Farhy* could be issued that finally addresses directly whether section 6038 penalties are subject to assessment. But Agostino is not holding his breath.

"He will not see an opinion for years . . . even though he has one issue and it's set up," Agostino predicted. "It will affect so many different things . . . if he wins that case."

Regardless of the outcome at the Tax Court level, Robbins predicted an appeal would follow.

The case is *Farhy v. Commissioner*, No. 10647-21L.