THE IRS CANNOT ASSESS OR COLLECT CERTAIN INTERNATIONAL PENALTIES – NOW WHAT?

By: Cory Stigile & Michael Greenwade

Background – The Tax Court's *Farhy* Decision

The Tax Court has determined that the IRS lacks authority to assess penalties under IRC § 6038(b) for failing to file Forms 5471, in a recent decision, *Farhy v. Commissioner*, 160 T.C. No. 6 (T.C. April 3, 2023). As further held by the court, absent such an assessment, the IRS has no administrative authority to pursue collection, including filing of Notices of Federal Tax Liens or issuing Notices of Intent to Levy. While the Tax Court's decision is limited to the IRC § 6038(b) penalty, its reasoning is applicable to all foreign information return reporting penalties contained in IRC Chapter 61A. Both determinations now raise a flurry of questions as to what actions taxpayers should consider when receiving a penalty notice for the failure to file informational returns, such as the Form 5471, from the IRS.

Edward M. Robbins, Jr., Esq., a principal with our firm, Hochman Salkin Toscher Perez, P.C., successfully argued to the Tax Court in *Farhy*, which was a Collection Due Process (CDP) case, that the IRS lacks the power to assess penalties under IRC §§ 6038(b)(1) and/or (b)(2) for failure to file Forms 5471. He also argued the IRS similarly did not have the power to assess the following international information returns governed by the same subchapter in the Internal Revenue Code:

- Foreign-owned U.S. corporations (Form 5472),
- Foreign partnerships (Form 8865), foreign disregarded entities (Form 8858),
- Transfers to foreign persons (Forms 926 and 8865), or
- Foreign financial assets (Form 8938).

The Tax Court agreed and ruled that Congress did not grant the IRS assessment and collection power for penalties under IRC §§ 6038(b)(1), (b)(2), and thus the IRS must refer such matters to the United States Department of Justice (the "DOJ") to file suit to formally recover such penalties through a civil action. The *Farhy* decision has enormous implications for those who are subject to the IRS's attempts to collect the penalties mentioned above as well as for those who may have recently paid such penalties after demands by the IRS.

Please note that while the *Farhy* ruling may apply to failure to file Form 3520 with regards to large gifts received from foreign persons—with the penalties being governed by IRC § 6039F, which is in the same chapter of the Code as the penalty at issue in the *Farhy* case—failure to file Form 3520 with regards to trust exposure is governed by IRC § 6677, which is contained in Ch. 68B. Unlike the penalties in Ch. 61A, certain penalties in Ch. 68 can be assessed in collected. The *Farhy* decision describes that under IRC § 6671, numerous penalties found in Ch. 68B (i.e., in sections 6671-6725) are assessed and collected in the same manner as taxes. Similarly, IRC § 6665(a)(1) contains a statement that additions to tax, additional amounts, and penalties in Ch. 68 (including

sections 6651-6751 in Ch. 68A) shall be assessed, collected, and paid in the same manner as taxes. Thus, the analysis here does not apply to the IRC § 6677 penalties regarding foreign trusts.

Potential Timing Implications for Prospective Form 5471 Filings (and Other Information Returns)

28 U.S.C. § 2462 provides that the IRS cannot request the DOJ to file suit to recover said penalties unless the IRS does so within five years from when the claim "first accrued." This raises a question of when the five-year clock that allows the IRS to file a claim for said penalties begins to run.

In *Gabelli v. S.E.C.*, 568 U.S. 442 (2013), the Supreme Court held the five-year clock does not start ticking on the date the Government discovers or should have discovered the misconduct that gives rise to their enforcement action seeking civil penalties; rather, the clock starts ticking when the misconduct occurs. Under this view, the IRS needs to request the DOJ to file suit to recover said penalties within five years from the date the information return should be filed.

However, the continuation doctrine suggests that for continuing violations, the five-year clock starts on the last date of ongoing misconduct as opposed to its earliest manifestation. See *S.E.C. v. Almagarby*, 479 F.Supp.3d 1266 (2020). Given the failure-to-file information returns is misconduct that continues until the returns are filed, this view suggests the five-year clock does not start ticking until the returns are filed, albeit late. This view also suggests that as long as required information returns are not filed, the five-year clock will continue to run because of the on-going misconduct.

Regardless of the prevailing view, determining the date in which a penalty claim "first accrued" for late-filed information returns and other implications arising from such late-filed returns will present issues for the foreseeable future following the *Farhy* decision.

Potential Opportunities To Obtain a Refund for Penalties Already Paid

The Tax Court in *Farhy* not only puts a crimp in the IRS's attempts to assess and thus, administratively collect, the noted foreign information penalties, it also discusses that recovery of any monies already paid toward the penalties mentioned will most likely need to be through a civil action. Citing 28 U.S.C. § 2461(a), *Farhy* stated whenever a civil fine is prescribed for the violation of an Act of Congress without specifying the mode of recovery, it may be recovered in a civil action. There are, however, statutes of limitations and administrative steps that need to be complied with in most cases for the recovery of money from the government that need to be considered under the law. For example, 26 U.S.C. § 7422, et seq., provides that no suit or proceeding shall be maintained in any court for the recovery of any tax or penalty claimed to have been collected without authority until a claim for refund or credit has been duly filed with the Secretary. Thus, a taxpayer would need to file a timely refund claim for any amounts paid toward the penalty.

Other Things to Consider

There are many potential circumstances taxpayers may find themselves needing to consider in the aftermath of the *Farhy* decision. For example:

- What are the implications to taxpayers with these wrongfully assessed penalties who are currently in Collection Due Process proceedings?
- Should taxpayers with these wrongfully assessed penalties pending before the Independent Office of Appeals consider the *Farhy* decision as one of the hazards of litigation?
- Should taxpayers with wrongfully assessed penalty cases in Appeals request abatement?
- If wrongfully assessed penalties in Appeals for five or more years are abated, is the Government barred from bringing suit?
- How should unfiled foreign information returns be brought into compliance?

While the IRS may appeal or request the Tax Court to reconsider the decision in *Farhy*, or even seek a Congressional fix, for now, *Farhy* has opened the door to many options for taxpayers who have issues regarding penalties assessed and or paid on previously delinquently filed foreign information returns as well as considerations in addressing still yet to be filed foreign information returns. While the Tax Court may have closed the door on further assessment and administrative collection of these foreign information reporting penalties by the IRS, it has now opened the door for many taxpayers to consider their options going forward. Unless the IRS acquiesces in *Farhy*, taxpayers should not expect that claims for the refund for such amounts paid toward such penalties will be automatically allowed or that the IRS will not continue to take administrative actions to assess and collect such foreign information return penalties.

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