

# Farhy<sup>1</sup> Reminds the IRS to Turn Square Corners,<sup>2</sup> Not Cut Corners

By Edward M. Robbins, Jr.\*

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In *Farhy*, the Internal Revenue Service (“IRS”) cut corners on its assessment authority, improperly creating an assessment authority where none existed. With its manufactured assessment against the petitioner in hand, the IRS launched the full force of its collection apparatus against the petitioner. The petitioner pushed back. In the end, the Tax Court ordered that without assessment authority the IRS could not proceed with its collection actions relating to petitioner’s liabilities for Code Sec. 6038 penalties for the taxable years 2003–2010. The Tax Court’s analysis in *Farhy* applies to most of the foreign information penalties in Chapter 61 where the IRS also lacks assessment authority. A chart showing the application of the *Farhy* analysis to other penalties in Chapter 61 can be found below (*see* Table 1). If a taxpayer has one of these foreign information penalties at issue, consider raising the IRS’ lack of authority to assess the penalty. To protect the statute, you might want to file a protective claim for a refund if the taxpayer has already paid.

## Without a Valid Assessment, the IRS’s Administrative Collection Powers Are Absent

An assessment is a critical event in the life of a tax liability—critical for the taxpayer, the IRS, and the administration of the tax system. An assessment represents an IRS determination that the taxpayer owes a specified tax liability. The Code<sup>3</sup> authorizes the Commissioner of Internal Revenue to make “assessments” of tax liabilities.<sup>4</sup> An assessment is made “by recording the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the Secretary.”<sup>5</sup> The assessment is necessary and sufficient to trigger the IRS’ unique collection powers under the Code.

Normally, if someone owes money to a government agency, that agency essentially has the collection rights and remedies of an ordinary creditor. The IRS has these ordinary collection rights, but the Code also gives the IRS supercharged collection powers. After an assessment, the IRS has substantial collection powers

EDWARD M. ROBBINS, JR., Esq. is a Principal with Hochman, Salkin, Toscher & Perez P.C. in Beverly Hills, California.

TABLE 1.				
Section	Description of Filing Requirement	IRS Form	Penalty Statute(s)	Assessment Authority for Penalty?
Code Sec. 6031(e)	Return of partnership income for foreign partnerships	1065	Code Sec. 6698	YES. Code Sec. 6689 (c). All in Chapter 68.
Code Sec. 6031(b)	Copies to partners—furnish information to partners	-	Temporary Reg. §1.6031(b)-1T	YES, Temporary Reg. §1.6031(b)-1T Statements to partners (temporary) states under section (d) that penalties for failure to comply with Code Sec. 6031(b) are governed by Code Sec. 6722(a). All in Chapter 68.
Code Sec. 6032	Returns of banks with respect to common trust funds	-	-	This statute does not appear to have related penalties.
Code Sec. 6033	Returns by exempt organizations	-	Code Sec. 6033(o)	YES. Code Sec. 6033(o) states for provisions relating to penalties for failure to file under this section, see Code Sec. 6652(c). All in Chapter 68.
Code Sec. 6034	Returns by certain trusts	-	Code Sec. 6652(c), (d)	YES. Failure to file penalties. All in Chapter 68.
Code Sec. 6034A	Information to beneficiaries of estates and trusts—addition to tax for failure to comply with this section	-	Code Sec. 6034A(c)(5)	LIKELY YES. Please note that Code Sec. 6034A(c)(5) points to additions to tax and additional amounts: “For addition to tax in the case of a beneficiary’s negligence in connection with ... the requirements of this section, see part II of subchapter A of Chapter 68.” However, there appears no explicit reference to Code Sec. 6034A in that section.
Code Sec. 6034A	Information to beneficiaries of estates and trusts—effect of failure to notify	-	Code Sec. 6034A(c)(3)	YES. The effect of failure to notify inconsistent treatment between entity and beneficiary “shall be ... assessed according” to statute Code Sec. 6213(b)(1). All in Chapter 68.
Code Sec. 6035	Basis information to persons acquiring property from the decedent	8971	-	YES. The penalty related to the failure to file this information appears to have been removed from Code Sec. 6679 back in 2004.
Code Sec. 6036	Notice of qualification as executor or receiver	-	-	Does not assert a penalty.
Code Sec. 6037	Return of S corporation	1120-S	Code Sec. 6699	YES. Failure to file applicable forms. Also, the effect of failure to notify inconsistent treatment between entity and beneficiary “shall be ... assessed according” to the statute. All in Chapter 68.
Code Sec. 6038	U.S. person with an interest in: Foreign Corporation (FC)	5471	Code Sec. 6038(b)	NO. No link to Chapter 68.
Code Sec. 6038	U.S. person with an interest in: Foreign Partnership (FP)	8865	Code Sec. 6038(b)	NO. No link to Chapter 68.
Code Sec. 6038	U.S. person with an interest in: Foreign Disregarded Entity	8858	Code Sec. 6038(b)	NO. No link to Chapter 68.
Code Sec. 6038	Penalty reducing Foreign Tax Credit: Foreign Corporation (FC)	5471	Code Sec. 6038(c)	NO. No link to Chapter 68.
Code Sec. 6038	Penalty reducing Foreign Tax Credit: Foreign Partnership (FP)	8865	Code Sec. 6038(c)	NO. No link to Chapter 68.

TABLE 1. (Continued)				
Section	Description of Filing Requirement	IRS Form	Penalty Statute(s)	Assessment Authority for Penalty?
Code Sec. 6038	Penalty reducing Foreign Tax Credit: FC or FP with Foreign Disregarded Entity	8858	Code Sec. 6038(c)	NO. No link to Chapter 68.
Code Sec. 6038A	25-percent foreign-owned U.S. corporations	5472	Code Sec. 6038A(d)	NO. No link to Chapter 68.
Code Sec. 6038A	25-percent foreign-owned U.S. corporations that fail to: (1) authorize the reporting corporation to act as agent of a foreign related party, or (2) substantially comply with a summons for information	n/a	Code Sec. 6038A(e)	NO. No link to Chapter 68.
Code Sec. 6038B	Transferor of certain property to foreign persons: Foreign Corporation	Form 926	Code Sec. 6038B(c)	NO. No link to Chapter 68.
Code Sec. 6038B	Transferor of certain property to foreign persons: Foreign Partnership	Form 8865 Schedule G, H, and O	Code Sec. 6038B(c)	NO. No link to Chapter 68.
Code Sec. 6038C	Information with respect to foreign corporations engaged in U.S. business	5472	Code Sec. 6038C(c)	NO. No link to Chapter 68.
Code Sec. 6038D	Information with respect to foreign financial assets—failure to disclose	8938	Code Sec. 6038D(d)	NO—Please note, however, that under Reg. §1.6038D-8(f), penalties for underpayments attributable to undisclosed foreign financial assets, for application of the accuracy-related penalty, please see Code Sec. 6662(j). This provides for penalties under 6038, 6038B, and 6038D. No link to Chapter 68.
Code Sec. 6038E	Information with respect to the assignment of lower rates or refunds by foreign producers of beer, wine, and distilled spirits	-	-	Does not assert a penalty.
Code Sec. 6039	Returns required in connection with certain options	3921 & 3922	Code Sec. 6721	YES. Reg. §§1.6039-1(d), 1.6039-2(d) provides “For provisions relating to the penalty applicable to the failure to file a return under this section, see Code Sec. 6721” and “Code Sec. 6722,” respectively.” All in Chapter 68.
Code Sec. 6039C	Returns with respect to foreign persons holding direct investments in U.S. real property interests	-	Code Sec. 6652	YES. Penalties in Chapter 68. However, the IRS website states that “until such time that regulations under Code Sec. 6039C are issued, these provisions are not operative.” There do not appear to be regulations issued.
Code Sec. 6039D	Returns and records with respect to certain fringe benefit plans	-	Code Sec. 6652	YES. Penalties in Chapter 68.
Code Sec. 6039E	Information concerning resident status	N/A	Code Sec. 6039E(c)	NO. Code Sec. 6039E(c) provides that “failing to provide” required statement subject to \$500 for each failure but there is no assessment authority. No link to Chapter 68.

TABLE 1. (Continued)

Section	Description of Filing Requirement	IRS Form	Penalty Statute(s)	Assessment Authority for Penalty?
Code Sec. 6039F	Notice of large gifts received from foreign persons	3520	Code Sec. 6039F(c)	NO. Code Sec. 6039F(c) provides a penalty for “failure to file information” but there is no assessment authority. No link to Chapter 68. However, Code Sec. 6039F(c)(1)(B) provides that the taxpayer to whom such penalty is imposed “shall pay [the penalty] (upon notice and demand by the Secretary and <b>in the same manner as tax</b> )” (emphasis mine).
Code Sec. 6039G	Information on individuals losing U.S. citizenship	8854 & W-8CE	Code Sec. 6039G(c)	NO. Code Sec. 6039G(c) provides a “penalty” if a required individual “fails to file” a required statement with the Secretary but there is no assessment authority. No link to Chapter 68.
Code Sec. 6039H	Information with respect to Alaska Native Settlement Trusts and Native Corporations	1041-N	-	Does not assert a penalty.
Code Sec. 6039I	Returns and records with respect to employer-owned life insurance contracts	8925	-	Does not assert a penalty.
Code Sec. 6039J	Information reporting with respect to Commodity Credit Corporation transactions	-	-	Does not assert a penalty.
Code Sec. 6046	Returns as to the organization or reorganization of foreign corporations and as to acquisitions of their stock			YES. For provisions relating to penalties for violations of this section, see Code Sec. 6679 Failure to file returns, etc., with respect to foreign corporations or foreign partnerships, and Code Sec. 7203.
Code Sec. 6046A	Returns regarding payments of remuneration for services and direct sales			YES. For provisions relating to penalties for violations of this section, see Code Sec. 6679 Failure to file returns, etc., with respect to foreign corporations or foreign partnerships and Code Sec. 7203 All civil penalties in Chapter 68.
Code Sec. 6048	Information with respect to certain foreign trusts’ reportable events			Does not assert a penalty.

found nowhere else in U.S. laws. Once made, an assessment, including accrued interest and penalties, must be paid by the date specified in any IRS notice of assessment and demand for payment.<sup>6</sup> The notice of assessment and demand for payment creates a lien attaching to all property and rights to property of the taxpayer, including after-acquired property and property in the hands of third parties. The taxpayer's failure to pay the tax in full and on time potentially subjects the taxpayer to many unwelcome collection activities,<sup>7</sup> including:

1. The IRS can seize and, if necessary, sell all property encumbered by the tax lien.
2. The IRS can notify any third-party holding property encumbered by the tax lien (*i.e.*, the taxpayer's banks, *etc.*) to turn that property over to the IRS or face serious financial penalties for noncompliance.
3. The IRS can perfect the tax lien by filing a notice of federal tax lien establishing the IRS' priority over later creditors of the taxpayer, as well as publicly recording that the taxpayer is delinquent in paying his taxes.
4. For unpaid assessments over \$55,000, the IRS can cause the Secretary of State to deny, revoke, or limit a taxpayer's U.S. passport.
5. Once made, an assessment is presumed correct in any later litigation where the merits of the tax may be challenged (tax refund suits, tax suits to collect, and bankruptcy).
6. In all other litigation involving a tax assessment, the assessment may not be collaterally attacked and has, in effect, the force and effect of a judgment.
7. Except for those taxes subject to the deficiency notice procedures, forced collection efforts to collect the assessment may be launched immediately. Unfortunately, the Farhy-type assessments are not subject to the deficiency notice procedures.

In other words, "it is the assessment, and only the assessment, which sets in motion the collection powers of the IRS, powers that include the seizure of assets, the freezing of bank accounts and the creation of liens, all without judicial process."<sup>8</sup>

If the IRS fails to properly assess a tax or a penalty, the IRS is prohibited from using the above tools for collecting the tax or penalty because of the improper assessment. In *Farhy*, the IRS failed to properly assess the penalty; therefore, the IRS was prohibited from using the above tools for collecting the penalty because of the improper assessment. Without an authorized assessment, the IRS must use the standard collection tools available to ordinary government agencies.

## Historical Timeline for the Chapter 61 Foreign Information Penalties

It is worth reviewing the history of the Chapter 61 foreign information penalties to see where the IRS erred and evaluate the impact of *Farhy*. Foreign information penalties have been in the Code for decades. The penalty in *Farhy* was under Code Sec. 6038, enacted in 1960. Elaborate procedures can be found in past Internal Revenue Manuals ("IRMs") instructing IRS personnel how to assess these foreign information penalties.<sup>9</sup> What was missing in the IRM until recently was a citation to any authority to assess these penalties. It is noteworthy that until recently the IRM correctly noted the anomaly that no statute of limitations existed for assessment of the foreign information penalties.<sup>10</sup> One might expect that someone in the IRS would have looked at the odd situation of no specific limitations statute for foreign information penalties, if only because it is at variance with the taxpayer's right to finality.<sup>11</sup> The absence of a statute of limitations for the foreign information penalties indicated the absence of a corresponding assessment statute.

In 2006, the Treasury Inspector General for Tax Administration ("TIGTA") recommended that the IRS consider a systemic assessment<sup>12</sup> of these Chapter 61 foreign information penalties.<sup>13</sup> After studying the issue further, as of January 1, 2009, the IRS began automatic assessments of the monetary penalty under Code Sec. 6038(b)(1) regarding Forms 5471, "*Information Return of U.S. Persons With Respect to Certain Foreign Corporations*," attached to late-filed Forms 1120, "*U.S. Corporation Income Tax Return*."<sup>14</sup>

In 2013, TIGTA evaluated the IRS' progress in implementing the systemic assessment.<sup>15</sup> Later in that same year, 2013, the IRS began automatically assessing a monetary penalty under Code Sec. 6038A(d)(1) on Forms 5472, "*Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*," attached to late-filed Form 1120 series returns.<sup>16</sup>

The IRM continued to proclaim that "Penalties that are not considered taxes generally have no statute of limitation for assessment. Penalties related to returns are generally treated as taxes and governed by the statute of limitation for assessment."<sup>17</sup> Again, the IRM raised no issue regarding this odd lack of a statute of limitations for assessment.

Beginning on January 1, 2014, the IRS expanded its automatic assessment of the monetary penalty under Code Sec. 6038(b)(1) to Forms 5471 attached to late-filed Forms 1065, "*U.S. Return of Partnership Income*."<sup>18</sup>

Between 2014 and 2018, the IRS was assessing over 10,000 foreign information penalties every year, including assessments against individuals.<sup>19</sup> So each year thousands of taxpayers were assessed the Code Sec. 6038 penalties by an IRS lacking the authority to make these assessments, and those taxpayers, like any delinquent taxpayers, were subject to the IRS' vast administrative collection powers. It is easy to imagine the collective distress felt by all the taxpayers undergoing the collection treatment accompanying these illegal assessments. It is also easy to imagine their irritation when they discover the collection efforts directed at them were illegal.

In 2018, I blogged<sup>20</sup> about a revision I noticed on some Forms 872 (*Consent to Extend the Time to Assess Tax*) with the additional language being typed on the Form by the Revenue Agents:

One version used occasionally contained a new paragraph 6:

**(6) Without otherwise limiting the applicability of this agreement, this agreement also extends the period of limitations for assessing any penalty imposed under IRC §§6038, 6038A, 6038B, 6038D, 6677 or 6679.**

Recall the IRM had pronounced for years that there was no statute of limitations for these penalties. What is the purpose of paragraph 6 if there are no statutes of limitations on the IRS' ability to assess these penalties? The second and worse problem with new paragraph 6 of Form 872: The IRS had no authority to assess the Code Sec. 6038 series of penalties in the first place. If a taxpayer signed this modified Form 872, was the taxpayer stipulating to an assessment statute? My questions went unanswered.

In 2018 and 2019, at least three sets of tax practitioners published papers noting that not only was there no statute of limitations for the assessment of these Chapter 61 foreign information penalties as correctly stated in the IRM, but there was also no assessment statute for these same foreign information penalties.<sup>21</sup>

On January 13, 2021, in her Annual Report to Congress 2020, the National Taxpayer Advocate ("NTA") publicly brought the issue of the missing assessment authority to the attention of the IRS, and the IRS first offered a written theory defending these foreign information assessments and the resulting administrative collection actions. The IRS' theory explains<sup>22</sup>: There are only two types of penalty assessments. One type is a deficiency assessment resulting from a penalty

being processed under the deficiency rules. The second type is an assessable penalty that is assessed outside the deficiency procedures. The IRS then takes a leap and posits that, since these foreign information penalties are not subject to the deficiency procedures, it necessarily follows that they are assessable outside the deficiency procedures. The problem is that the Code does not supply any language supporting the IRS' theory.

A few days later, on or about January 29, 2021, tracking the theory the IRS offered to the NTA, the IRS modified IRM 20.1.9 International Penalties (Nov. 30, 2015) stating, in part:

(2) Assessable Penalties—Penalties listed in this section, unless otherwise noted, are assessable penalties and are not covered by deficiency procedures of IRC 6211 through IRC 6215 (relating to deficiency procedures for income, estate, gift, and certain excise taxes). Assessable penalties are paid upon notice and demand. For assessable penalties, there is no 30-day letter, no agreement form, and no notice requirements prior to assessment.<sup>23</sup> \* \* \*

(3) Statute of Limitations—In general, international information returns are assessed in the same manner as taxes pursuant to IRC 6201(a) and IRC 6671(a). Therefore, pursuant to IRC 6501(a), international information return penalties generally must be assessed within three years after the return was filed. \* \* \*

- Rules related to consents to extend the statute of limitations for some international information return penalties are provided in IRM 25.6.22.6.17.10, Assessable Penalties. Generally, Form 872, Consent to Extend Time to Assess Tax, can be used to extend the statute of limitations on certain international information return penalties by adding the following language to the form:

“Without otherwise limiting the applicability of this agreement, this agreement also extends the period of limitations to assess any penalty imposed for failure to provide information required under IRC §§6038, 6038A, 6038B, 6038D, 6046, 6046A, or 6048.”<sup>24</sup>

Note that the IRS dropped its long-standing statement in the IRM that there was no statute of limitations for the assessment of the foreign information penalties.



Later that year, the IRS brought IRM 25.6.22.6.17.10, Assessable Penalties, in sync with the changes in IRM 20.1.9, International Penalties.<sup>25</sup>

The IRS theory is in focus at this point. For the IRS, the lack of a specific assessment statute for the Chapter 61 foreign information penalties is immaterial to the IRS since these penalties must be assessable penalties under the Code. The IRS' position is that they just must be assessable. Therefore, foreign information penalties are assessable penalties. And they contend, as assessable penalties their statute of limitations falls under Code Sec. 6501.

The structure of the IRS' argument is interesting, because it takes you past the sale of the issue of whether

there is any assessment authority for these foreign information penalties in the first place, jumps to assuming assessment authority, then analyzes what type of assessment authority governs the foreign information penalty assessments. My copy of the Code still has no specific assessment authority for these foreign information penalties.

Most of the foreign information penalties identified in Table 1 are not assessable penalties, and, therefore, they have no statute of limitations for assessment.<sup>26</sup> Stated another way, there is no statute of limitations on assessment because they cannot be assessed. The IRS never made this connection.<sup>27</sup>

## ENDNOTES

<sup>1</sup> A. Farhy, 160 TC No. 6, Dec. 62,191 (2023). Andrew Velarde's article at Tax Notes Federal, Dec. 5, 2022, P. 1428; 177 Tax Notes Federal 1428 (Dec. 5, 2022) contains hyperlinks to the trial briefs.

<sup>2</sup> See generally *St. Regis Paper Co.*, S Ct, 368 US 208, 229, 82 S Ct 289, 301, 7 L Ed2d 240 (1961) (Black, J., dissenting) ("Our Government should not by picayunish haggling over the scope of its promise, permit one of its arms to do that which, by any fair construction, the Government has given its word that no arm will do. It is no less good morals and good law that the Government should turn square corners in dealing with the people than that the people should turn square corners in dealing with their government"); *Federal Crop Insurance Corp. v. Merrill*, S Ct, 332 US at 387-388, 68 S Ct at 4-5 (Jackson, J., dissenting) ("It is very well to say that those who deal with the Government should turn square corners. But there is no reason why the square corners should constitute a one-way street").

\* The author can be reached at [EdR@taxlitigator.com](mailto:EdR@taxlitigator.com).

<sup>3</sup> 26 United States Code, the Internal Revenue Code.

<sup>4</sup> Code Sec. 6201(a).

<sup>5</sup> Code Sec. 6203; see also Reg. §301.6203-1 (describing the method of assessment).

<sup>6</sup> See Code Sec. 6601.

<sup>7</sup> See Code Secs. 6301-6344.

<sup>8</sup> *Philadelphia & Reading Corp.*, 944 F2d 1063, 1064 n. 1 (3d Cir. 1991).

<sup>9</sup> See generally IRM 20.1.9 International Penalties over the years.

<sup>10</sup> See e.g., "Statute of Limitations. Penalties that are not considered taxes generally have no statute of limitation for assessment." IRM 20.1.9.1.1—Common Terms (Nov. 20, 2007).

<sup>11</sup> See 26 USC §7801(a)(3)(F).

<sup>12</sup> Systemic penalty assessments are those that are electronically asserted as an automatic matter whenever a late-filed tax return includes an information return required by Code Secs. 6038 and 6038A and other foreign information reporting provisions in Chapter 61.

<sup>13</sup> National Taxpayer Advocate Annual Report to Congress 2020, p. 129.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at p. 120.

<sup>17</sup> IRM 20.1.9.1.1(3) Common Terms (Oct. 24, 2013). Statute of Limitations.

<sup>18</sup> National Taxpayer Advocate Annual Report to Congress 2020, p. 120.

<sup>19</sup> *Id.* at p. 125.

<sup>20</sup> [www.taxlitigator.me](http://www.taxlitigator.me). May 3, 2018, International Penalties Beware of Modified Form 872, Consent to Extend Time to Assess By Edward M. Robbins, Jr.

<sup>21</sup> Erin Collins & Garrett Hahn, *Foreign Information Reporting Penalties: Assessable or Not?* TAX NOTES TODAY 211-213 (Jul. 9, 2018); Robert Horwitz, *Can the IRS Assess or Collect Foreign Information Reporting Penalties?* TAX NOTES TODAY 301-305 (Jan. 31, 2019); Frank Agostino &

Phillip Colasanto, *The IRS's Illegal Assessment of International Penalties*, TAX NOTES TODAY 261-269 (Apr. 8, 2019).

<sup>22</sup> National Taxpayer Advocate Annual Report to Congress 2020, p. 129.

<sup>23</sup> IRM 20.1.9.1.5(2) (Jan. 29, 2021).

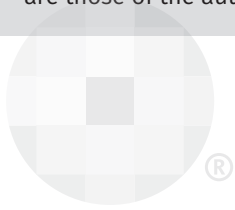
<sup>24</sup> IRM 20.1.9.1.5(3) (Jan. 29, 2021).

<sup>25</sup> IRM 25.6.22.6.17.10 (Nov. 17, 2021).

<sup>26</sup> As this article is being written, we have not seen the IRS' next move in this case. The time to file a Motion for Reconsideration and the time to file a Motion to Vacate or Revise Decision has expired with no action by the IRS. After that, the IRS has until Monday, July 17, 2023, to file a Notice of Appeal to the U.S. Court of Appeals District of Columbia Circuit. There is no evidence at this time that the IRS has modified its assessment procedures for these foreign information penalties. The Chief of the IRS Independent Office of Appeals recently said that the IRS may have to concede all cases matching the Tax Court's recent ruling that the agency lacks authority to assess some international penalties. Tax Notes Federal, June 12, 2023, P. 1885.

<sup>27</sup> To collect the foreign information penalties, IRS must ask the Department of Justice ("DOJ") to file a collection action. Under 28 USC §2462, DOJ has a five-year period for bringing a suit to collect any civil fine, penalty, or forfeiture.

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