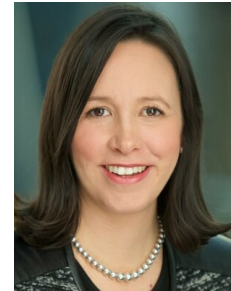


How Foreign Info Return Penalty Case May Benefit Taxpayers

By **Sarah Constantine, Jonathan Green and Rebecca Gordon** (May 24, 2023)

On April 3, in *Farhy v. Commissioner*, the U.S. Tax Court rejected the Internal Revenue Service's efforts to impose penalties on a taxpayer for failure to file foreign corporation information return Form 5471. According to the Tax Court, foreign information return penalties are neither taxes nor assessable penalties and, therefore, the IRS lacks statutory authority under Internal Revenue Code Section 6038 to assess and collect such penalties.



Sarah Constantine

Though based on the definition of "assessable penalties," the *Farhy* decision has implications far beyond failures to file Form 5471. The IRS will likely seek relief, either by appealing the Tax Court's decision or through legislation, but taxpayers who have been assessed or paid penalties for late-filed information returns should consider how to protect their rights in the interim.



Jonathan Green

Background

IRC Section 6038 requires certain U.S. persons to report information regarding foreign business entities they control on Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, filed with their yearly federal income tax return.

The requirement applies to U.S. persons who control foreign corporations and U.S. shareholders of controlled foreign corporations, among others. Under IRC Section 6038(b), for each taxable year that U.S. persons fail to file, they are subject to a penalty of \$10,000 per foreign corporation, and an additional "continuation penalty" of up to \$50,000 if they continue to fail to file after receiving notice.



Rebecca Gordon

In *Farhy*, for at least five years the taxpayer had refused to file Form 5471 providing information about his ownership interests in two foreign companies incorporated in Belize. He did not have a reasonable basis for failing to file such forms. Indeed, a nonprosecution agreement that was introduced in the Tax Court established that *Farhy's* noncompliance with IRC Section 6038 was part of an illegal scheme to reduce his tax obligations.

The IRS sent *Farhy* notice, and later assessed penalties under IRC Section 6038 after he continued to refuse to file. The IRS then issued a final notice of intent to levy to collect the penalties.

Farhy filed a timely request for a collection due process hearing, in which he challenged the IRS' authority to assess Section 6038 penalties. The IRS sustained the collection action, and *Farhy* then filed a petition in Tax Court.

The Court's Reasoning

The issue before the Tax Court was whether the IRS had authority to automatically assess penalties under Section 6038 after satisfying its administrative procedures. Before *Farhy*, in

the normal course, the IRS had assessed civil penalties under Section 6038 and collected them by administrative means, such as a notice of levy or lien.

The Internal Revenue Manual provided that information return penalties, such as those assessed under Section 6038, are assessable penalties that must be paid upon notice and demand.

Assessable penalties are not subject to deficiency procedures, wherein taxpayers receive a notice of deficiency alerting them to the potential assessment and explaining their options for contesting or complying with the penalty assessment, and informing them of the last day to petition the Tax Court for preassessment and prepayment review.

Many penalties related to income tax filings are not assessable penalties.

The IRS took the position that Section 6038 penalties are assessable penalties under IRC Section 6201(a). Farhy argued that the IRS had no authority for treating Section 6038 penalties as assessable penalties.

The Tax Court agreed with Farhy, reasoning that Section 6038, which establishes the reporting requirement regarding foreign corporations and the consequent penalties, does not specify a mode of assessing the penalties.

Notably, as the Tax Court observed, there are other code provisions establishing penalties that explicitly state that the respective penalties are assessable. Thus, the Tax Court found that the penalties for failure to file Form 5471 are not subject to the deficiency procedures.

The Tax Court also rejected the IRS' argument that IRC Section 6201(a) applied to Section 6038 penalties because they are a tax. Since the Tax Court found that the penalties for failure to file Form 5471 under Section 6038 are neither assessable penalties nor subject to the deficiency procedures, the Tax Court concluded that the IRS could recover the penalties only through a civil action.

The full Tax Court issued the decision without any dissent. The IRS has the right to appeal the decision within 90 days of the Tax Court ruling.

Implications

The Farhy decision overturns long-standing IRS practice and legal precedent taking for granted that Section 6038 penalties for failure to file Form 5471 were automatically assessable and subject to payment on notice and demand by the IRS.

Courts had not been directly confronted with this question before in the context of IRC Section 6038, so Farhy represents a novel holding that will undoubtedly lead to further judicial consideration.

The ruling further signals that there may be other penalties that the IRS is currently automatically assessing and administratively collecting without clear statutory authority to do so — such as penalties relating to Form 926 on the transfer of property to a foreign corporation, Form 5472 on 25% foreign ownership in a U.S. corporation or a foreign corporation engaged in U.S. trade or business, Form 8854 on expatriation, Form 8858 on foreign disregarded entities and foreign branches, Form 8865 on foreign partnerships and Form 8938 on specified foreign financial assets.

More broadly, the ruling constrains the government's ability to deter foreign business entities from concealing income, particularly those incorporated in tax-haven jurisdictions, where it may be difficult for the U.S. Department of the Treasury to otherwise obtain information. This deterrence was one of the legislative aims of IRC Section 6038.[1]

It is widely expected that the commissioner will appeal the decision or seek a congressional fix for this issue. In the meantime, taxpayers who have paid Section 6038 penalties for failure to file Form 5471 may wish to determine whether they should file a protective claim for refund within the applicable statute of limitations.

Also, taxpayers currently challenging Section 6038 penalties for failure to file Form 5471 — and possibly other forms listed above — may wish to determine whether they should amend their claim for refund or abatement, or appeal request pending with the IRS Independent Office of Appeals to explicitly rely on the Farhy decision.

However, the IRS may not consider Farhy to be binding authority, and may instead resist claims for refund, claims for abatement or appeal requests based on the decision. Moreover, the IRS may try to force the taxpayer's hand by refusing to respond to claims or requests based on the Farhy decision and then, when the taxpayer files suit, assert a counterclaim to recover the penalty.

Taxpayers with issues relating to IRC Section 6038 penalties for failure to file information reporting forms should consider each of these issues.

Sarah Constantine and Jonathan E. Green are partners, and Rebecca L. D. Gordon is counsel, at Arnold & Porter.

Arnold & Porter partner James J. Joseph and senior associate Reuven Graber contributed to this article.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of their employer, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] See Joint Comm. Tax'n, 104th Cong., General Explanation of Tax Legislation Enacted in the 104th Congress (Dec. 18, 1996).