

FARHY V. COMMR. – THE PENALTY FOR FAILING TO TIMELY FILE FORM 5471 MAY NOT BE ASSESSED ADMINISTRATIVELY

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Tags

Assessment
Code §603
Farhy
Form 5471
Levy
Penalty

INTRODUCTION

“Pygmalion” is a play by the great Irish playwright, George Bernard Shaw. It is named after the Greek mythological figure who carved a marble statue of a beautiful woman, fell in love with it, and finds that she has come alive. It is the basis for the Broadway play “My Fair Lady,” and the Hollywood movie that followed.

In the play, Alfred Doolittle seeks £5 from Professor Higgins for allowing him to teach Eliza Doolittle proper manners and etiquette. Professor Higgins refuses, but offers £10, instead. Refusing anything more than £5, Alfred Doolittle goes into a long explanation of the conditions of the undeserving poor. Later in the play he returns a changed man, looking to take on responsibility.

Sometimes, good things happen to the undeserving. In the play, Alfred Doolittle receives a bequest from a faraway benefactor. Recently, a scofflaw who refused to file Forms 5471 and received penalty notices regarding the seizure of his property convinced the Tax Court that the penalty was not self-enforcing. Rather, the Department of Justice would be required to initiate enforcement proceedings in District Court to collect the assessed penalties.

The case is *Farhy v. Commr.*¹ This article explains the rationale for the court’s decisions and provides excerpts from client alerts published by various law or accounting firms regarding the effect of the decision on other penalties that are imposed under the Internal Revenue Code.

FARHY V. COMMR.

During his 2003 through 2010 taxable years, Alon Farhy owned 100% of Katumba Capital, Inc., a foreign corporation incorporated in Belize. From 2005 or so through 2010, Mr. Farhy owned 100% of Morningstar Ventures, Inc., a foreign corporation also incorporated in Belize. During the years at issue, Mr. Farhy participated in an illegal scheme to reduce the amount of income tax that he owed, and on February 14, 2012, he signed an affidavit describing his role in that illegal scheme. He was granted immunity from prosecution by a nonprosecution agreement signed on September 20, 2012.

For the years in issue, Mr. Farhy had a reporting requirement under Code §6038(a) in regard to his ownership interests in both Katumba Capital and Morningstar Ventures. He was required to file Form 5471 (Information Return of U.S. Persons With Respect To Certain Foreign Corporations), but failed to do so. He continued to take no action after the I.R.S. brought the matter to his attention, leading the I.R.S. to assess penalties against him under Code §6038(b)(2).

¹ 160 T.C. __ No. 6 (April 3, 2023).

On February 9, 2016, the I.R.S. mailed Mr. Farhy a notice of his failure to file the required Forms 5471 for the years at issue. No forms were filed by Mr. Farhy and as a fact, the court found that failure to file was willful and not due to reasonable cause.

On November 5, 2018, the I.R.S. assessed an initial penalty under Code §6038(b)(1) of \$10,000 for each year at issue, and on November 12, 2018, the IRS assessed continuation penalties under Code §6038(b)(2) totaling \$50,000 for each Form 5471 for each foreign company for each year. The I.R.S. complied with the written supervisory approval requirements in Code §6751(b) in regard to the Code §6038 penalties.

On January 30, 2019, the I.R.S. issued Letter 1058, Final Notice of Intent to Levy and Notice of Your Right to a Hearing (the “Levy Notice”). In the Levy Notice, the I.R.S. sought to collect penalties under Code §6038 that were previously assessed in the matter.

Mr. Farhy timely requested a hearing pursuant to Code §6330. On February 19, 2019, Mr. Farhy’s legal counsel submitted Form 12153, Request for a Collection Due Process or Equivalent Hearing. In the form, Mr. Farhy disputed whether the I.R.S. had legal authority to assess section 6038 penalties.

On June 4, 2021, the I.R.S. issued a Notice of Determination Concerning Collection Actions under IRC Sections 6320 or 6330 of the Internal Revenue Code (the “Notice of Determination”), regarding Mr. Farhy’s liabilities for unpaid civil penalties imposed pursuant to section 6038. The Notice of Determination sustained the proposed collection action.

On June 9, 2021, Mr. Farhy timely filed a Petition with the Tax Court for a review of the determination. It was clear that, except for the assessment authority issue, the settlement officer conducting the Code §6330 hearing obtained verification from the I.R.S. that all requirements of applicable law and administrative procedure were met as required by Code §6330(c)(1).

The above recitation of facts strongly suggests that Mr. Farhy was undeserving. Yet, he won his case because he correctly parsed the words of the Internal Revenue Code regarding assessment of penalties.

Code §6038(b)(1) and (2) impose penalties. However, there is no statutory provision, in the Code or otherwise, specifically authorizing assessment of these penalties.

Code §6201(a) authorizes the Secretary of the Treasury to make assessments of all taxes (including interest, additional amounts, additions to tax, and assessable penalties) imposed by the Code. That grant of authority has been delegated to the Commissioner of Internal Revenue, and further delegated to other I.R.S. When a tax – including a deemed tax, such as an additional amount, addition to tax, assessable penalty, or interest – is assessed, the I.R.S. may take certain actions to collect the tax administratively. Examples follow:

- Under Code §6502(a), the I.R.S. is permitted to collect tax by levy. According to the I.R.S. website,² a levy is a legal seizure of a taxpayer’s property to satisfy a tax debt. Levies are different from liens. A lien is a legal claim against property to secure payment of the tax debt, while a levy actually takes

² See [here](#).



the property to satisfy the tax debt. Code §6502(a) also provides a ten-year period of limitation for collection by a proceeding in court or by levy when a tax has been assessed.

- Code §6322 provides a lien arises when an assessment is made. The I.R.S. may immediately assess the tax determined by a taxpayer on his or her own return, as well as certain assessable penalties not otherwise subject to the Code's deficiency procedures. If deficiency procedures apply, a taxpayer has the right to seek a determination in Tax Court before an assessment of tax can be made. However, the term "assessable penalties" is left undefined. This raises the question regarding which penalties the I.R.S. may assess and ultimately collect through administrative means.

Agencies have only those powers given to them by Congress. On that basis, Mr. Farhy contended that the I.R.S. lacked authority to assess the penalty under Code §6038(b) because no law gives the I.R.S. authority to assess penalties under that provision. Assessment powers are not given to the I.R.S. under that section. Consequently, while the I.R.S. may be able to collect liabilities for these penalties through a civil action, the I.R.S. may not assess or administratively collect these penalties. The court accepted the argument and ruled in favor of Mr. Farhy.

Congress has explicitly authorized assessment with respect to myriad penalty provisions in the Code, but not for Code §6038(b) penalties. A non-tax provision of the U.S. Code, 28 U.S.C. § 2461 (Mode of Recovery), does so as well. Paragraph (a) of that section expressly provides as follows:

Whenever a civil fine, penalty or pecuniary forfeiture is prescribed for the violation of an Act of Congress without specifying the mode of recovery or enforcement thereof, it may be recovered in a civil action."

In sum, the Code §6038(b) penalties at issue in the *Farhy* case are prescribed for the violation of the reporting obligations under Code §6038(a)(1) and (2). No mode of recovery or enforcement is specified for these penalties, unlike for myriad other penalties in the Code. Hence, the assessed penalties can be collected by a proceeding in District Court to obtain a judgment.

PATH FORWARD

In *Farhy v. Commr.*, the court required the I.R.S. to collect penalties for a violation of U.S. tax law by commencing an action in U.S. District Court against the taxpayer. The immediate question is which other penalties imposed on taxpayers for the failure to timely file a required form may be collected only by a court hearing. To answer that question, a survey was made of pronouncements by various law or accounting firms. The survey was limited to an unscientific Google search of items published on the internet using the search term "Farhy tax court case." Only postings on the first page were used and only if the posting was in the form of a client alert. Here are excerpts of the published material.

FGMK³

The IRS has relied on its “machines” to auto-generate and mail penalty notices for missed or late Form 5471 filings to taxpayers for many years. These “machines” were programmed to identify a missed or late filed Form 5471 (among other international centric forms) and auto-assess penalties under Section 6038. The Tax Court’s ruling challenges the validity of the auto-assessments, not only to Form 5471, but other international tax forms as well (e.g., Forms 5472, 8865, 8858).

Further, those who have paid these assessments may now seek recourse depending on the statute of limitations. It would not be surprising to see taxpayers facing such penalties argue, based on the reasoning in this ruling, that the Commissioner has no authority to collect the penalty without first filing a lawsuit. Thus, while the liability is not being absolved in the case, it would appear that the Tax Court is indicating that the IRS must take civil action and seek a resulting judgement to secure an amount a taxpayer owes.

* * *

How the IRS responds to the Tax Court’s ruling is yet to be seen. The IRS may appeal or ask for reconsideration with the Tax Court. An appeal would be heard by the Circuit Court of Appeals for the District of Columbia. Alternatively, the IRS could file a Decision of Nonacquiescence concerning the ruling, indicating that it does not agree with the Tax Court’s decision but will not pursue an appeal. The IRS could also let the ruling stand and seek a cure by way of Congressional intervention, something the IRS has had to do previously when a Tax Court case does not go its way. The legislative fix would likely have to include an amendment to Section 6038 or to some other statute that would expressly grant the IRS the authority to assess and collect the penalties in Section 6038(b) or in all of Subpart A. Any decisions made by the Commissioner will be in published guidance.

Skadden⁴

* * * This decision could affect a broad range of taxpayers and provide a basis for them to either challenge the automatic imposition of these and other penalties, including those under Sections 6038 and 6038A-D, or request refunds of such penalties previously imposed and paid.

* * *

Taxpayers should consider the impact of this decision on any penalties alleged by the I.R.S. under Sections 6038, 6038A, 6038B, 6038C or 6038D – including those that have been previously assessed and paid – and ensure that any resulting refund claims are filed within the appropriate statute of limitations.

³ See [here](#).

⁴ See [here](#).

Eisner Amper⁵

While not certain, the Farhy ruling may extend to the following other international information reporting penalties:

- Forms 5471 (for certain foreign corporations) under IRC 6038, 6038A and 6038C.
- Forms 5472 (for certain foreign-owned U.S. corporations) under IRC 6038A and 6038C.
- Forms 8865 (for transfers to certain foreign partnerships) under IRC S 6038 and 6038B.
- Forms 8858 (for certain foreign disregarded entities) under IRC 6038.
- Forms 926 (for certain transfers to foreign persons) under IRC 6038B.
- Forms 8938 (regarding foreign financial accounts) under IRC 6038D.
- Forms 8992 (US Shareholder GILTI calculation) under IRC 6038.
- Forms 3520 (for foreign gifts) under IRC 6039F.

In contrast, the Internal Revenue Code does provide statutory authority to assess penalties on the following international information returns and Farhy does not change the rule for these forms:

- Forms 3520 and 3520-A (for reportable events for foreign trusts) under IRC 6048, with penalties imposed under IRC Sec. 6677.
- Form 5471, Schedule O (for acquisitions and dispositions of an interest in a foreign corporation) under IRC 6046, with penalties imposed under IRC Sec. 6679.
- Form 8865 (for acquisitions or dispositions of an interest in a foreign partnership) under IRC 6046A, with penalties imposed under IRC Sec. 6679.



Procopio⁶

Based on the Tax Court's reasoning in Farhy, the IRS may also lack authority to assess civil penalties for failing to timely file other various international information returns (e.g., Forms 3520, 5472, 8938, etc.). Each case, however, must be analyzed individually.

Time is of the essence (generally two years from when the penalty was paid) to request a refund of any penalties paid to the IRS.

⁵ See [here](#).

⁶ See [here](#).

Please contact any member of Procopio's International Tax Group if you have further questions or need any assistance.

Olshan⁷

The Tax Court's holding in Farhy could be interpreted to mean that penalties under Section 6038(b), as well as similar penalties that the IRS is not specifically authorized to assess, are not subject to administrative collection actions, since the penalties should not have been assessed in the first place. Taxpayers who have paid penalties assessed pursuant to Section 6038(b) may consider the possibility of seeking a refund.

Greenberg Traurig⁸

It remains to be seen whether the IRS will appeal the Tax Court's decision in Farhy, but the decision likely will have widespread implications for thousands of taxpayers who are contesting or have paid I.R.C. § 6038 penalties. The decision may also have implications on other civil penalties where Congress has not prescribed the method of assessment, including penalties for failing to file Forms 8865, 5472, 8938 and 926. Farhy does not apply to penalties for failing to file Forms 3520 and 3520-A. It also remains to be seen whether this decision will apply to other civil penalties where Congress has not prescribed the method of assessment. Taxpayers who have paid I.R.C. § 6038 penalties may wish to consult with their tax advisor to determine whether they are eligible to file a claim for refund.

⁷ See [here](#).

⁸ See [here](#).