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Does the IRS Have Statutory Authority to Assess Penalties Under IRC § 6038?

By: Jennifer Chang, MST Student

In the U.S. Tax Court case of *Farhy v. Commissioner*¹, decided on April 3, 2023, the Tax Court ruled that the IRS lacked statutory authority to assess Section 6038(b) penalties against an individual taxpayer. These penalties were related to the taxpayer's failure to file Forms 5471 (the *Information Return of U.S. Persons Concerning Certain Foreign Corporations*) for the years 2003-2010 concerning his Belize foreign corporations. Additionally, the Tax Court held that the IRS could not proceed with collecting the penalties through its proposed levy against the taxpayer.

Subsequently, on July 12, 2023, the IRS filed notice of its intention to appeal the Tax Court's ruling in the United States Court of Appeals, District of Columbia Circuit, which it subsequently did (the case is discussed later). The key issues at hand in both cases are whether the IRS has statutory authority to assess penalties under IRC Section 6038(b)(1) or (2) against the taxpayer and whether the IRS can proceed with collecting these penalties from the taxpayer using a levy and other IRS collection methods, without having to sue the taxpayer in court.

On May 3, 2024, the United States Court of Appeals, District of Columbia Circuit, disagreed with the Tax Court's interpretation². It held that the text, structure, and function of Section 6038 demonstrate that Congress authorized the assessment of penalties imposed under subsection (b) and therefore the IRS is not required to sue taxpayers in order to collect on this particular penalty. It reversed the Tax Court's decision and remanded the case to the Tax Court with instructions to enter a decision in favor of the IRS.

This article covers the Tax Court's analysis first, then followed by the Court of Appeals analysis.

Background of the Case

- The taxpayer, Farhy, owned 100% of a Belize corporation from 2003 until 2010.
- During the same period, he owned 100% of another foreign corporation incorporated in Belize.
- The taxpayer was involved in an illegal scheme aimed at reducing his income tax liability.
- He signed an affidavit describing his role in the scheme and was granted immunity from prosecution.
- Despite being required under IRC Section 6038(a) to file Form 5471, the taxpayer did not comply, and his failure to file was willful and not due to reasonable cause.

On November 5, 2018, the IRS assessed an initial penalty of \$10,000 under Section 6038(b)(1) for each year the taxpayer owned the corporations. Subsequently, on November 12,

¹ 160 T.C. No. 6

² 133 AFTR 2d 2024-1462, 100 F4th 223

2018, the IRS imposed an additional \$50,000 per year in continuation penalties based on Section 6038(b)(2).

On January 30, 2019, the IRS issued a levy notice to the taxpayer, seeking to collect Section 6038(b) penalties assessed for the relevant tax years. The taxpayer promptly requested a Collection Due Process (CDP) hearing, arguing that the assessment was unlawful because the IRS lacked legal authority to impose these penalties. Section 6038(b) lacked a provision expressly authorizing such assessments.

Later, on June 4, 2021, the IRS issued a Notice of Determination regarding the taxpayer's liabilities for the unpaid Section 6038(b) penalties, affirming its proposed collection action.

The taxpayer filed a petition with the U.S. Tax Court on June 9, 2021, seeking a review of the determination. Meanwhile, following the Collection Due Process (CDP) hearing, the settlement officer from appeals verified that the IRS had met the requirements to collect the penalties.

Ultimately, the Tax Court agreed with the taxpayer. While the IRS possesses explicit authority to assess penalties under various provisions in the Code, it lacks authority to assess the penalties outlined in IRC Section 6038(b)(1) and (2) and therefore it would have to sue the taxpayer to collect the penalties.

Laws:

- Section 6330(d)(1): A levy may only occur if the IRS has notified the taxpayer in writing of their right to a CDP hearing before the levy. The Independent Office of Appeals conducts this hearing, providing due process for the taxpayer to challenge the levy.
- Section 6038(b)(1): Imposes a penalty of \$10,000 for each annual accounting period in which a failure exists to furnish required information regarding any foreign business entity in a timely manner.
- Section 6038(b)(2): Imposes a continuation penalty of \$10,000 for each 30-day period (or fraction thereof) during which such failure continues.
- Section 6201(a) authorizes and requires the Treasury Secretary to assess all taxes (including interest, additional amounts, additions to tax, and assessable penalties) imposed by the Code, which the Treasury Secretary has delegated to the IRS. The IRS may take certain actions to collect the tax administratively when they assess a tax.
- Section 7203, a criminal penalty provision, covers failures to pay estimated tax, failure to file a return, failure to keep records, and failure to supply information. Violations of this section can subject individuals to fines of up to \$25,000.
- *Ruesch v. Commissioner*, 154 T.C. No. 13 (2020): The taxpayer contested the IRS's certification of her seriously delinquent tax debt under IRC § 7345. The IRS had assessed penalties of \$160,000 for failing to file timely information reports related to foreign corporations and partnerships. The Tax Court's jurisdiction was limited to reviewing the certification process, not the underlying tax liability. Ultimately, the case was dismissed as the IRS had already "decertified" Ruesch's debt before trial.

The Tax Court's Analysis

The Tax Court has jurisdiction to review the IRS's determination regarding a levy action when the taxpayer petitions for review in a timely manner.

The taxpayer argued that Section 6038(b), unlike other penalty sections in the Code, lacks a provision authorizing assessment of the penalty it provides for. Consequently, the taxpayer contended that a Section 6038(b) penalty is not an assessable penalty, although it may be collected through a civil action.

The IRS responded by asserting that "assessable penalties" encompasses any penalties found in the Code that are not subject to the Code's deficiency procedures. The IRS further argued that neither Section 6201 nor any other Code section restricts "assessable penalties" solely to those found in Subchapter B of chapter 68 of subtitle F (which covers assessable penalties). Additionally, the IRS maintained that the term "taxes" in Section 6201 is broad enough to encompass Section 6038 penalties. Lastly, the IRS cited the legislative history of Section 6038(b) to support its position.

The Tax Court concurred that the IRS is authorized to assess penalties under Subchapter B of chapter 68 of subtitle F (Section IRC 6671-6725), but not for Section 6038(b) penalties. Notably, Section 6038(b) contains only a cross-reference to a criminal penalty provision, specifically Section 7203.

In addition, the Tax Court reviewed the legislative history of Section 6038(a)(1) and (2), which was enacted by the Revenue Act of 1962. The Court noted that no specific mode of recovery or enforcement is specified for these penalties. The Tax Court agreed with the taxpayer's contention that Section 6038(b), unlike many other penalty sections, does not include a provision authorizing assessment of the penalty. Consequently, the Court found that the Section 6038(b) penalty is not assessable. The Tax Court expressed reluctance to disrupt the well-established statutory framework by inferring the authority to administratively assess and collect the Section 6038(b) penalties, especially when Congress did not explicitly grant this power to the Secretary of the Treasury, as it did for other penalties in the Code.

Furthermore, the Tax Court rejected the IRS's argument that Section 6038(b) penalties are necessarily assessable penalties simply because they are not subject to deficiency procedures. The Court also dismissed the IRS's reliance on the holding in the *Ruesch* case. The Tax Court clarified that "the mere absence of deficiency procedures does not automatically lead to the conclusion that a penalty is assessable." In this case, Congress had not granted the Commissioner the authority to assess the penalty. There is no provision mandating that Section 6038(b) penalties must be paid upon notice in the same manner as taxes.

The Court also disagreed with the IRS's assertion that the term "taxes" in Section 6201(a) encompasses Section 6038(b) penalties, even if they are not assessable penalties. The Tax Court emphasized that taxes and penalties are distinct categories of exactions. The Court declined to substitute the Commissioner's judgment for Congress' decision regarding the classification of Section 6038(b) penalties for assessment and collection purposes.

Although the IRS referenced the legislative history in Section 6038(c), which covers creditable foreign taxes, the Court held that this provision does not apply to the treatment of Section 6038(b) penalties.

The Court of Appeals Analysis

The Court of Appeals for the District of Columbia Circuit (“Appeals Court”) believed Congress intended to render the Section 6038 penalties assessable by the IRS. The conclusion was based on the text, structure, and function of Section 6038 and the fact that the section originally authorized only a percentage-based, assessable penalty for the same underlying failure to file.

The Appeals Court argued that Farhy’s reading would create parallel and substantively overlapping judicial tracks for determination of twinned penalties for the same noncompliance. This would introduce potential inconsistent doctrinal development.

The Court also pointed out that Section 6038 empowers the IRS, and not a court, to grant or deny the “reasonable cause” affirmative defense. This suggests that Congress expects the IRS, and not a federal district court, to assess subsection (b) penalties.

The Appeals Court argued that section 6038(b) penalties are assessable even though the text of section 6038 does not explicitly label them as such. The Court concluded that nothing establishes Farhy’s categories as exhaustive of the ways the IRS designates penalties as assessable.

Conclusion

The Tax Court held that the IRS lacks statutory authority to assess penalties under IRC Section 6038(b) against the taxpayer for failing to file Form 5471. Additionally, the Tax Court ruled that the IRS may not proceed with collecting these penalties from the taxpayer via levy. Congress explicitly authorized assessment for numerous penalty provisions in the Code, but not for Section 6038(b) penalties. The Tax Court expressed reluctance to disturb the well-established statutory framework by inferring the power to administratively assess and collect the Section 6038(b) penalties when Congress did not expressly grant that power to the Secretary of the Treasury, as it did for other penalties in the Code.

However, in a complete reversal of the Tax Court, the Court of Appeals concluded based on the statute’s text, structure, and function, Congressional intent and the impracticality of the taxpayer’s interpretation that penalties imposed under Section 6038(b), and like the related penalties under section 6038(c) are assessable by the IRS and therefore collectible by the IRS without having to file suit against the taxpayer. It reversed the judgment of the Tax Court and remanded the case back to the Tax Court with instructions to enter a decision in favor of the Commissioner.