

Tax Court Rules IRS Lacks Authority To Assess Penalties Under Section 6038

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On April 3, 2023, the Tax Court ruled in *Farhy v. Commissioner*¹ that the Internal Revenue Service (IRS) lacks the authority to assess penalties under Section 6038(b) of the Internal Revenue Code (the Code) and may not proceed with collection of such penalties via levy. 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.

The taxpayer in *Farhy*, an owner of two Belize-based corporations, had failed to file IRS Form 5471 — Information Return of U.S. Persons With Respect to Certain Foreign Corporations — for several years. Section 6038(b)(1) provides for an initial \$10,000 penalty for each year in which a taxpayer does not file the required form, and Section 6038(b)(2) provides for continuation penalties — capped at \$50,000 — if such failure continues after the taxpayer's receipt of notice from the IRS. In *Farhy*, the IRS assessed the maximum penalties allowable under the statute against the taxpayer and issued a levy notice to collect those amounts. The commissioner sustained this collection action, and the taxpayer appealed the commissioner's determination to the Tax Court. It was stipulated that the taxpayer's failure to file Form 5471 was willful and not due to reasonable cause.²

In holding for the taxpayer, the Tax Court rejected the government's arguments that Section 6021(a) provides the IRS with the authority to assess and collect Section 6038(b) penalties. Section 6021(a) authorizes the secretary "to make the inquiries, determinations, and assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties)." Based on this authority, the government argued that Section 6038(b) penalties either (i) qualify as "assessable penalties" or (ii) fall under a broad reading of the term "taxes."

In rejecting the first argument, the Tax Court stressed the "myriad" penalty provisions of the Code in which Congress has explicitly authorized assessment. "We are loath to disturb this well-established statutory framework by inferring the power to administratively assess and collect the Section 6038(b) penalties when Congress did not see fit to grant that power to the Secretary of the Treasury expressly as it did for other penalties in the Code."³ The Tax Court also rejected the government's contention that the term "assessable penalty" encompasses all penalties in the Code that are not subject to deficiency procedures. "Simply put, while Section 6038(b) provides for penalties, it does not provide for assessable penalties."⁴

The Tax Court responded to the second contention by noting that "[p]recedent firmly establishes that taxes and penalties are distinct categories of exactions, at least in the absence of a provision treating them as the same."⁵ Further, if all penalties were encompassed within the definition of "taxes," then the inclusion of the term "assessable penalties" in Section 6201(a) would not be necessary. The opinion also points to Code sections that explicitly detail circumstances in which non-tax amounts are deemed

¹ 160 T.C. No. 6.

² Section 6038(c)(4) provides relief to the penalties imposed under Section 6038(b) if the taxpayer can show reasonable cause for the failure to timely file.

³ 160 T.C. No. 6, *8.

⁴ *Id.* at *9.

⁵ *Id.*

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to be a “tax” for assessment and collection purposes. “Given this detailed statutory framework, we decline to substitute the Commissioner’s judgment for Congress’ decision not to deem the Section 6038(b) penalties “taxes” for assessment and collection purposes.”⁶

In holding that the commissioner lacks statutory authority to assess penalties under Sections 6038(b)(1) or (2), the Tax Court also pointed to 28 U.S.C. § 2461(a), which expressly provides that “[w]henever 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.” Thus, the Tax Court determined that a civil action, rather than an assessment by the IRS, is the only appropriate avenue for the government to enforce the penalty provisions of Section 6038(b).

Taxpayers should consider the impact of this decision on any penalties alleged by the IRS 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.

⁶ *Id.* at *10.