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New York Law Journal

'Farhy v. Commissioner': D.C. Circuit Reverses Win for Taxpayers

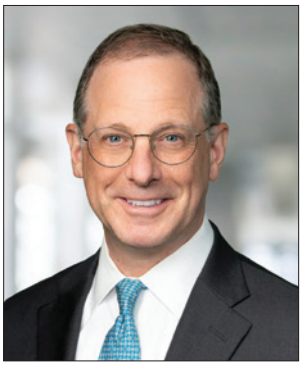
By Jeremy H. Temkin
May 15, 2024

The Internal Revenue Code contains over 100 provisions penalizing taxpayers for various acts of noncompliance. Certain penalties are expressly subject to "assessment" by the Internal Revenue Service (IRS) and therefore governed by administrative collection procedures, including the imposition of liens and levies. By contrast, other penalties can only be collected through a civil action in federal district court. Given the burden on the government in bringing such actions, penalties that are not assessable are far less likely to be pursued.

In *Farhy v. Commissioner*, 160 T.C. No. 6 (April 3, 2023), the United States Tax Court held that the statutory penalty for failure to file certain information reports was not assessable. The decision was widely applauded by tax practitioners representing clients with similar, if not identical, forms of noncompliance. On May 3, 2024, however, the U.S. Court of Appeals for the District of Columbia Circuit examined the statutory scheme at issue in *Farhy* and reversed the Tax Court's decision. *Farhy v. Commissioner*, ___ F.4th ___, 2024 WL 1945977 (D.C. Cir. 2024).

This article reviews the two decisions in *Farhy* and discusses the implications for determining the assessability of penalties going forward.

'Farhy' in the Tax Court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Between 2003 and 2010, Alon Farhy, a U.S. permanent resident, owned 100% of two Belize companies, which he failed to report on Form 5471 as required under 26 U.S.C. §6038(a). In 2012, Farhy acknowledged having illegally concealed his income from the IRS and entered into a non-prosecution agreement with the Department of Justice (DOJ).

Section 6038(b) of the Code provides for a fixed penalty of $10,000 for each year that a taxpayer fails to file information returns required under section 6038(a) and continuation penalties of up to $50,000 per year if the taxpayer fails to cure the deficiency after receiving notice from the IRS. In 2018, the IRS assessed $60,000 per year in penalties (totaling nearly $500,000) against Farhy and informed him of its intent to levy his property. Following that notice, Farhy requested an administrative collection due process hearing, after which an IRS appeals officer upheld the proposed levy.

Farhy then sought review in the Tax Court. In finding that penalties imposed under Section 6038(b) were not assessable, Judge L. Paige Marvel observed that while 26 U.S.C. §6201(a)

authorizes the IRS to make the inquiries, determinations, and "assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by [Title 26]," that provision does not specify which penalties are "assessable." Marvel further noted that "Congress has explicitly authorized assessment with respect to myriad penalty provisions in the Code, but not for section 6038(b) penalties."

The Tax Court then looked 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.'"

Given Congress's silence as to whether Section 6038(b) penalties were assessable, Marvel was "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."

Thus, to recover the Section 6038(b) penalty from Farhy, the IRS would have to resort to a separate civil action filed by the DOJ.

D.C. Circuit Reverses the Tax Court

The IRS appealed to the D.C. Circuit and, in an opinion drafted by Judge Cornelia Pillard, a panel of that court unanimously reversed the Tax Court's decision. While both sides argued for widely applicable rules, the court refused to "embrace either party's tax code-wide default rule to resolve [the] case." Instead, the court focused on "a narrower set of inferences" that demonstrated Congress' intent that the penalties provided in Section 6038(b) be assessable.

At the outset of the opinion, Pillard reviewed the nature of IRS assessments, which she described as "the cornerstone of the government's tax collection authority." After acknowledging that "not every tax-related penalty is assessable," Pillard described the procedures available to the IRS to collect assessments (including taxes, penalties, and interest), as well as avenues available to taxpayers seeking to dispute such liabilities.

The court then turned to the history of Section 6038, which it described as "one of dozens of provisions across the Internal Revenue Code that require taxpayers and other third parties to file certain information returns with the IRS or face penalties." Enacted in 1960, Section 6038 first penalized the failure to file Forms 5471 identifying controlled foreign corporations through a 10% reduction in the foreign tax credit available to the delinquent taxpayer. In 1982, Congress moved the credit-reduction provision to section 6038(c) and added a fixed dollar penalty codified at Section 6038(b).

Significantly, among Congress' reasons for adding the fixed-dollar penalty were concerns that the foreign tax credit reduction penalty was rarely used due to its complexity; could be unduly harsh for minor violations; and could not be applied to violators who had not paid foreign income taxes and therefore had no foreign tax credit to reduce. Thus, the 1982 amendment provided "a fixed-dollar penalty that could be more simply and consistently collected" and required that the two provisions be coordinated so that any penalty imposed under subsection (b) would be used to offset any penalty due under subsection (c). *See* 26 U.S.C. §6038(c)(3).

Pillard added that the subsection (b) penalties would be of limited value if they were not assessable since the IRS could only collect them through an action filed by the Justice Department in federal district court, which Farhy acknowledged was exceedingly unlikely. Citing the IRS brief, Pillard noted that "[i]t would be 'highly anomalous' for Congress to have responded to the identified problem of the underuse of subsection (c) penalties by promulgating a penalty that, while simpler to calculate, is much harder to enforce."

Moreover, treating subsection (b)'s penalties as non-assessable would undermine Congress's intent that the penalty provisions be applied in tandem. In this regard, Pillard "assume[d] that Congress

intended the subsection (b) penalty to be routinely assessed, but credited back in cases in which the Service also imposes a subsection (c) penalty."

Under the Tax Court's approach, however, the IRS could not even assess a penalty under subsection (c) until after the conclusion of a civil action in district court that determined the amount of penalties to be recovered under subsection (b) that would be deducted from the assessable subsection (c) penalty. As Pillard noted, "[t]o agree with that reading, we would have to conclude that, in enacting subsection (b), Congress not only failed in its avowed quest to streamline, but also counterproductively threw sand in the gears of section 6038's existing enforcement scheme."

The court bolstered its decision by observing that, as with many other Code provisions, aspects of the penalties provided for in subsections (b) and (c) are subject to a "reasonable cause" defense, which allows a taxpayer to avoid the penalty by demonstrating that she exercised ordinary business care and prudence in attempting to adhere to her reporting obligations.

In the case at hand, however, Section 6038(c)(4)(B) expressly provides that whether reasonable cause existed must be shown "to the satisfaction of the secretary," which Pillard reasoned would make little sense if the subsection (b) penalty is non-assessable since there would be no administrative proceeding in which to demonstrate reasonable cause. Rather, "Congress's specification that the Secretary, not the district court, evaluates taxpayers' assertions of reasonable-cause defenses to Section 6038(b) penalties dovetails neatly with section 6201(a)."

Implications of 'Farhy'

When the Tax Court issued its decision in *Farhy* last year, tax practitioners viewed it as a possible game-changer with respect to a wide range of penalties that were not specifically designated as assessable. While the D.C. Circuit's decision may dampen some of that enthusiasm, the D.C. Circuit did not announce a broad rule that all penalties are assessable. Rather, the Court of Appeals used the ordinary tools of statutory interpretation and looked to contextual clues in the specific penalty provision before it.

Going forward, taxpayers seeking to challenge a penalty as non-assessable will need to evaluate the penalty's contextual references, which may well be dispositive. Indeed, in dicta, the D.C. Circuit discussed Sections 6038D and 45(b)(7)(B), which provide practitioners with additional examples of contextual clues that support treating a penalty provision as assessable in the absence of clear language addressing the issue.

Finally, practitioners will also have to contend with the broad-based arguments that the IRS made in *Farhy*. The D.C. Circuit was able to decide the case before it without addressing the IRS's most sweeping arguments, including its claim that all exactions are covered by Section 6201(a) unless Congress specifies otherwise. Although the D.C. Circuit did not need to reach that broad question in *Farhy*, it is fair to assume the IRS will make a similar argument in the future.

Practitioners challenging a penalty as non-assessable should study all of the ordinary tools of statutory interpretation before arguing that Congressional silence—if such silence is genuinely present—renders a penalty non-assessable.

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