

Client Alert

May 2023

Tax Court Finds IRS Lacks Authority to Assess Penalties for Failure to Report Interest in Foreign Corporations

On April 3, 2023, the U.S. Tax Court (the “Tax Court”) issued its opinion in *Farhy v. Commissioner*,¹ holding that the Internal Revenue Service (the “IRS”) lacks statutory authority under Section 6038(b)² to assess penalties related to the timely filing of IRS Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. This decision calls into question the agency’s authority to assess penalties under similar Code provisions, and may provide an argument for taxpayers who paid a penalty for the late filing of a Form 5471 to seek a refund from the IRS.

Background

Section 6038 and the regulations thereunder provide that a taxpayer who fails to report its interest in certain foreign corporations and timely file Form 5471 shall pay a penalty of \$10,000. From 2003 through 2010, the taxpayer in this case, Alon Farhy, owned various foreign corporations but failed to file Form 5471. The IRS assessed an initial penalty of \$10,000 for each year he failed to comply, and continuation penalties of up to \$50,000 for each year. The taxpayer requested a hearing to challenge these penalties. After the hearing, the IRS issued a Notice of Determination affirming the penalties. The taxpayer turned to the Tax Court for review of the Notice of Determination, arguing that while the IRS may be able to collect liabilities for these penalties through a civil action, the IRS may not assess or administratively collect these penalties.

Tax Court’s Decision

On trial, the issue before the Tax Court was whether the IRS had statutory authority to assess the penalties under Section 6038(b). The Tax Court

¹ *Farhy v. Comm’r of Internal Revenue*, No. 10647-21L, 2023 WL 2752459 (T.C. Apr. 3, 2023).

² All “Section” references are to the Internal Revenue Code of 1986, as amended (the “Code”).

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sided with the taxpayer and held that even though Section 6038(b) imposes penalties for failing to timely furnish the information required on Form 5471, it does not authorize the IRS to assess those penalties.

In agreeing with the taxpayer's reading of the Code, the Tax Court found that "Congress has explicitly authorized assessment with respect to myriad penalty provisions in the Code, but not for Section 6038(b) penalties." Other Code Sections contain specific provisions authorizing treatment of penalties as a tax or assessable penalty for which collection is authorized, or cross-reference to Sections where such treatment is afforded. On the other hand, Section 6038(b) does not contain similar language specifying that penalties for a late filing are a tax or assessable penalty, nor does it reference an authorizing provision elsewhere in the Code. If Congress had intended to authorize assessment of penalties under Section 6038(b), it would have included similar language. Finally, the Tax Court determined the proper method to collect a penalty under Section 6038(b) would be to file a civil action against the taxpayer.

Implications of *Farhy*

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.

It is likely, however, that the IRS will seek an appeal, or turn to Congress to amend Section 6038 and other similar Code provisions under which the IRS is not specifically authorized to make assessments.

Please contact the Olshan attorney with whom you regularly work or one of the attorneys below if you would like to discuss further or have any questions, including potential reimbursement for penalties paid under Section 6038(b) for late filings of Form 5471 or similar penalties.

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