Tax Court Rules that IRS Cannot Assess and Collect Form 5471 Penalties: Many Questions Triggered by Novel Ruling

*By Hale E. Sheppard**

I. Introduction

The Internal Revenue Service ("IRS") must cherish certain aspects of tax enforcement, such as its ability to *automatically* assess penalties and take collection actions when taxpayers file international information returns that are late, inaccurate, and/or incomplete. Why is automatic assessment a big deal? Well, it means that the IRS is *not* required to first issue an Examination Report proposing penalties, then give the taxpayer a chance to seek pre-assessment review by the Appeals Office, and later issue a Notice of Deficiency, thereby triggering the taxpayer's right to dispute matters in Tax Court, again on a pre-assessment basis. Among the returns historically hit with automatic penalties are Forms 5471 (*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*).

This article, the latest of several on these issues, explains international reporting duties, special rules for Forms 5471, aggressive practices traditionally used by the IRS in imposing penalties, the report by the National Taxpayer Advocate ("NTA") identifying the problem, and the recent case, *Farhy v. Commissioner*, where the Tax Court ruled that the IRS has *never* had the authority to assess and collect Form 5471 penalties, period.[1] This article highlights several important questions (for taxpayers, the IRS, and Congress) sparked by the Tax Court's decision.

HALE E. SHEPPARD, Esq. (B.S., M.A., J.D., LL.M., LL.M.T.) is a Shareholder in the Tax Controversy Section of Chamberlain Hrdlicka.

II. International Reporting Generally

Generally, U.S. persons, including U.S. citizens and U.S. residents, are subject to federal income tax on *all* income derived, regardless of where the income

originates.[2] In other words, U.S. persons face a system of worldwide taxation, requiring them to declare all income to the IRS on Form 1040 (*U.S. Individual Income Tax Return*), whether it was earned, obtained, received, or accrued in the United States or a foreign country.

Individual taxpayers with foreign involvement ordinarily have several information-reporting duties, too. For instance, they must file a FinCEN Form 114 ("FBAR") to provide details about foreign accounts. They are also obligated to report foreign financial assets, as this term is broadly defined, on Form 8938 (*Statement of Specified Foreign Financial Assets*). In addition, they have to file Form 8833 (*Treaty-Based Return Position Disclosure*) to claim that the application of a treaty between the United States and another country overrules or modifies normal tax treatment. Finally, in cases where taxpayers hold interests in, or have other links to, foreign entities, they need to report these relationships to the IRS on the appropriate international information return, such as Form 5471 (*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*). This article focuses on the last of these duties.[3]

III. Form 5471 Requirements and Penalties

Various categories of U.S. persons who are officers, directors, and/or shareholders of certain foreign corporations must file Form 5471 with the IRS.[4]

Form 5471 is filed as an attachment to an individual's Form 1040.[5] If a person fails to file Form 5471, files a late Form 5471, or files a timely but "substantially incomplete" Form 5471, then the IRS may assert an initial penalty of $10,000 per violation.[6] The IRS then imposes a so-called continuation penalty, at a rate of $10,000 per month, if the problem persists after notification by the IRS.[7] The continuation penalty is capped at $50,000.

The IRS will not levy penalties if there was "reasonable cause" for the violation. Additionally, the IRS will refrain from assessing penalties if the taxpayer filed a timely Form 5471 with certain omissions or inaccuracies, provided that it was "substantially complete."[8]

IV. Critical Context

Readers need some context to truly appreciate the significance of *Farhy v. Commissioner*. Taxpayers tend to be optimistic when they learn that Form 5471 penalties might be avoided if their infractions are attributable to reasonable cause, or the materials they filed with the IRS, while not perfect, were substantially complete. This positive energy quickly vanishes, though, when taxpayers later discover certain truths about historical IRS practices and court interpretations. Some of these realities are explored below.

A. First-Time-Penalty-Abatement Does Not Apply

The IRS has a general first-time-penalty-abatement policy, and taxpayers facing large Form 5471 penalties often cite it when seeking relief.[9] This policy establishes that the IRS will grant abatement, with respect to virtually all delinquency penalties in situations where a taxpayer has not been required to file certain returns before and has no prior penalties.[10] If the taxpayer meets these criteria, then the IRS generally issues a letter to the taxpayer confirming that it is granting abatement solely because of the first-time-penalty-abatement policy, not because the taxpayer demonstrated reasonable cause for the violation.[11]

The first-time-penalty-abatement policy is bittersweet, however, because for many years it did *not* apply to "returns with an event-based filing requirement" and "information reporting that is dependent on another filing, such as various forms that are attached [to income tax returns]."[12] The IRS relied on such guidance to consistently deny requests for waiver of Form 5471 penalties.

The tax community has notified the IRS for ages that widespread problems exist as a result of automatic penalty assessment, failure to consider legitimate "reasonable cause" positions, dishonoring of collection freezes, ignoring the first-time-penalty-abatement policy, and prematurely forcing taxpayers to seek justice through a Collection Due Process ("CDP") hearing or litigation.[13] Finally, in late 2022, the IRS issued a memo to its Appeals Officers indicating that they can now waive Form 5471 penalties using the first-time-penalty-abatement policy.[14] This recent change of heart by the IRS, while positive, does nothing to mitigate the harsh results suffered by taxpayers for decades.

B. Automatic Penalties

The IRS has been *automatically* imposing Form 5471 penalties for years. As far back as 2009, the IRS has

followed a procedure whereby it automatically assesses penalties and starts collection actions when a U.S. tax return enclosing a Form 5471 is filed late. These steps occur, regardless of whether the taxpayer includes a thorough and persuasive statement of "reasonable cause" with the late Form 5471.[15] Guidance to IRS personnel removes any doubt about the level of rigidity on this point. It states the following: "For Form 1120s filed late after December 31, 2008, the [IRS] *automatically* assesses an initial penalty of $10,000 for each Form 5471 attached. *It is assessed even when a request for reasonable cause was submitted with the Form 1120*."[16]

One must review two separate reports by the Treasury Inspector General for Tax Administration ("TIGTA") to understand how the IRS arrived at this assess-penalties-now-consider-justifications-later situation. The initial TIGTA report was released in 2006.[17] It recognized that Forms 5471, along with Forms 5472 (which are applicable to U.S. corporations owned by foreigners and foreign corporations conducting business in the United States), play a fundamental role in promoting international tax compliance. According to TIGTA, their importance is reflected "in the severity of the penalties" for filing violations.[18] TIGTA observed that (i) the IRS should have asserted $79.2 million more in penalties in just one year; (ii) the under-penalization was attributable to the fact that sanctions had historically been asserted by Revenue Agents, manually, only in limited situations where they detected the non-compliance during an audit; and (iii) the IRS was "missing opportunities to promote better compliance with the filing requirements for Forms 5471 and 5472 by not assessing the late-filing penalties more often."[19] TIGTA made two main recommendations to the IRS. First, the IRS should convene a study group to determine whether to "automate" the penalty-assessment process for Forms 5471 and 5472. Second, the IRS should commence a "pilot program" for the automatic assessment of penalties.[20] The IRS implemented both suggestions.

The follow-up TIGTA report was released in 2013.[21] It confirmed that the IRS officially introduced the automated penalty program for Form 5471 in 2009. Before the program was in place, in 2008, the total penalties were $7.6 million. Once the IRS started automatically imposing late Form 5471 penalties, however, the figures jumped dramatically. They averaged about $54 million annually during the first four years.[22] The report also explained that, in addition to assessing Form 5471 penalties more frequently, the IRS was granting fewer abatements after the fact. The IRS abated 78 percent of the total penalty amounts in 2009, but only 39 percent in 2012.[23] The report contained several recommendations, including further decreasing the number of penalty abatements. One way to achieve this reduction, said TIGTA, would be to obligate IRS personnel to implement the strict standards in the Form 5471 "Decision Tree" discussed below.[24]

C. The "Decision Tree"

For years, the IRS did *not* resolve Form 5471 penalties by applying normal standards, but rather by utilizing an obscure guide. The so-called "Decision Tree," which was found in the depths of the Internal Revenue Manual, featured standards that were much more stringent than those located elsewhere.[25] Below is a peek inside the "Decision Tree."

- If the taxpayer claims that it was unaware of the Form 5471 filing requirement, the "Decision Tree" instructed the IRS to deny abatement because "ordinary business care and prudence requires taxpayers to determine their tax obligations when establishing a business in a foreign country."
- The "Decision Tree" mandated that penalty abatement be denied where the taxpayer seeks clemency because of financial problems.
- The "Decision Tree" further indicated that the IRS will show no mercy in situations where a taxpayer states that Form 5471 was late because the transactions, tax laws, or business structure was complicated.
- If the taxpayer claims that multiple layers of ownership prevent the taxpayer from obtaining all the data necessary to file a timely Form 5471, the "Decision Tree" told the IRS not to abate penalties.
- Rejection of the penalty abatement request will also occur, according to the "Decision Tree," when the taxpayer cites challenges in obtaining the necessary foreign data as the excuse for late Form 5471.
- The "Decision Tree" demanded imposition of penalties if the reason for late Form 5471 is that the person with sole authority to file Form 5471 was absent for a reason other than death or serious illness. Moreover, even if the taxpayer demonstrates death or serious illness of the sole responsible person, the IRS will only accept this justification if (i) the taxpayer can provide tangible proof of the illness or death,

such as insurance claims, police reports, hospital bills, or newspaper clippings, (ii) the absence was not foreseeable, (iii) the absence occurred before and in close proximity to the filing deadline, and (iv) the taxpayer filed Form 5471 within two weeks of when the absence ended.

- The IRS will not waive penalties under the "Decision Tree" if the taxpayer personally neglected to submit a filing-extension request for the tax return to which Form 5471 was attached.
- Likewise, the "Decision Tree" denied abatement where the taxpayer hired a third party (such as an accounting firm) to prepare returns and believed, erroneously, that such party submitted a filing-extension request on behalf of the taxpayer.
- The IRS will also reject abatement requests under the "Decision Tree" if the taxpayer relies on the ignorance-of-the-law defense and the taxpayer was either a U.S. resident or lived outside the United States but failed to hire and get advice from a U.S. tax professional.
- For purposes of seeking penalty abatement, the "Decision Tree" clarified that reliance on an accountant or attorney might be appropriate in certain situations, but reliance by a taxpayer on the following types of people is not reasonable: bookkeeper, financial advisor, business associate, information in a tax plan or promotion, and the person assisting in establishing the corporation.
- Finally, the "Decision Tree" indicated that the IRS might abate penalties based on the reasonable-reliance-on-a-qualified-tax-professional defense if, and only if, the taxpayer relied on an accountant or tax attorney, the taxpayer provided such professional all relevant information, the taxpayer supplied the information before the deadline, the professional specifically advised the taxpayer that it was not required to file Form 5471, the taxpayer has tangible evidence to prove the preceding facts, and, in the opinion of the IRS, the taxpayer's reliance was reasonable. The "Decision Tree" goes on to state that the taxpayer's reliance will be considered unreasonable (and thus Form 5471 penalties will not be abated) if the taxpayer did not take reasonable steps to independently investigate or get a second opinion. This aspect of the "Decision Tree" is remarkable because it is contrary to the legal precedent established by the U.S. Supreme Court decades ago on this exact point, in *United States v. Boyle*.[26]

D. Substantially Complete Defense

The IRS trains its personnel in various ways, one of which is by issuing International Practice Units ("IPUs"). They do not constitute a legal precedent, but many Revenue Agents give IPUs considerable weight in conducting audits, determining penalties, *etc.*[27]

In 2015, the IRS released an IPU focused on penalties for Form 5471 violations by certain categories of U.S. persons.[28] It contains a fair amount of information about the rare circumstances under which the IRS will consider Forms 5471 to be "substantially complete." Based on the items cited in the IPU, Revenue Agents might determine that Forms 5471 are *not* "substantially complete" and thus should be penalized in the following situations: Where the taxpayer (i) omits identification data on Form 5471 (such as the filing category, amount of voting stock owned, full name and location of foreign corporation, *etc.*), (ii) states that certain information will be provided only upon request by the IRS, (iii) uses unofficial, computer-generated Forms 5471, (iv) lacks proper financial statements for the foreign corporation, (v) fails to report figures in U.S. dollars and/or using U.S. generally accepted accounting principles, (vi) cites as an excuse the high administrative cost of complying with Form 5471 requirements, (vii) overstates and/or understates certain amounts, even if such inaccuracies results in little or no overall change, (viii) reports unnecessary information, presumably on the theory that superfluous data distracts the IRS from the real issues, (ix) shows a "mismatch" on Forms 5471 for successive years, (x) leaves blank one or more required Schedules, or (xi) has either one large error or omission or several smaller errors or omissions.[29]

E. Loss of Passports

Depriving tax debtors of U.S. passports to boost tax revenue is not a new idea, but it resurged thanks to a report by the Government Accountability Office ("GAO").[30] The GAO report indicated that, in less than one year, approximately 225,000 individuals who owed the IRS over $5.8 billion in taxes were granted passports.[31] The GAO report urged Congress to enact new legislation using U.S. passports as leverage to collect unpaid taxes.[32] Congress took this advice and created Code Sec. 7345.[33]

This provision states that if the IRS Commissioner determines that an individual taxpayer has a seriously delinquent tax debt ("SDTD"), he will send a

certification to the Secretary of Treasury. That official, in turn, will notify the Secretary of State, who will ultimately deny, revoke, or limit the U.S. passport of the individual.

The term SDTD means (i) a federal tax liability, (ii) of more than $50,000, (iii) with respect to which the IRS has already filed a notice of federal tax lien or levied property, and (iv) the taxpayer has exercised his administrative rights, such as participating in a CDP hearing, or he has allowed such rights to lapse.[34]

Code Sec. 7345 indicates that an SDTD is a federal tax liability that exceeds $50,000, but it does not clarify the components of the calculation.[35] Legislative history provides some clues. One congressional report states that an SDTD includes any "outstanding debt for federal taxes in excess of $50,000, including interest and any penalties."[36] Other reports, likewise, state that an SDTD entails taxes and "interest and any penalties."[37]

At least one case has grappled with the issue of Form 5471 penalties as grounds for revoking passports. In *Ruesch v. Commissioner*, the IRS assessed penalties of $160,000 against a taxpayer not filing Forms 5471. She did not voluntarily pay the penalties, so the IRS sent her a pre-levy notice, and she filed a request for a CDP hearing in response. Next, the IRS filed a federal tax lien, and the taxpayer countered with another request for a CDP hearing. The IRS somehow failed to record both CDP hearing requests, the result of which was that the IRS erroneously certified her as having an SDTD. The taxpayer then filed a Petition with the Tax Court seeking several things, including a review of whether she should have been hit with Form 5471 penalties in the first place and a ruling that the IRS was wrong in having her passport confiscated.[38]

The IRS realized its blunder in not granting the taxpayer her two CDP hearings soon after Tax Court litigation was underway. To set matters straight, the IRS removed her SDTD status, notified the State Department accordingly, and rerouted the case back to the Appeals Office for a CDP hearing. The IRS believe that total harmony had thus been restored.

Its next step was to get rid of the pending Tax Court case. To accomplish this, the IRS filed two Motions to Dismiss, arguing in one that the Tax Court is not empowered under Code Sec. 7345 to address whether the underlying Forms 5471 penalties were accurate. The Tax Court explained that Code Sec. 7345 creates *narrow* jurisdiction in passport cases: The *only* determination it can make is whether an SDTD certification was erroneous, and the only relief that it can provide is ordering the IRS to notify the State Department that a certification was erroneous. The Tax Court also emphasized that there is nothing in Code Sec. 7345 "that authorizes us to redetermine [a taxpayer's] underlying liability for [Form 5471] penalties the IRS has assessed."

The Tax Court then offered some *dicta* about the limited circumstances under which it could ever decide the appropriateness of "assessable" penalties related to international information returns, like Forms 5471. The Tax Court explained that such matters fall outside of its deficiency jurisdiction, meaning that these would not be part of a Tax Court trial triggered by the IRS issuing a Notice of Deficiency to a taxpayer. The Tax Court then indicated that this leaves two options for taxpayers. First, they could wait for the IRS to issue a federal tax lien or pre-levy notice, file a request for a CDP hearing, and, if the Appeals Office issues an unfavorable Notice of Determination, file a Petition with the Tax Court. Second, they could pay the penalties, file an administrative Claim for Refund, and if the IRS either disallows it or ignores it for more than six months, then they can file a Suit for Refund in the proper District Court.

F. Time Is Money

The normal Form 5471 penalty of $10,000 per violation can hurt a taxpayer. Perhaps the most significant consequence has nothing to do with money, though. It concerns time, specifically the period that the IRS has to audit the relevant issues.

The general rule is that the IRS has three years from the time a taxpayer files a tax return to identify it as problematic, conduct an audit, offer all required administrative procedures, and issue a final notice proposing adjustments, such as tax increases, penalties, and interest charges.[39] There are various exceptions to the normal three-year rule. One such exception applies to situations where a taxpayer fails to file information returns, such as Forms 5471.[40] This tax provision states the following:

> In the case of any information which is required to be reported [to the IRS on Form 5471 and other international information returns], the time for assessment of any tax imposed by [the Internal Revenue Code] *with respect to any tax return, event, or period*

> *to which such information relates* shall not expire before the date which is 3 years after the date on which the [IRS] is furnished the information required to be reported ...[41]

Congress and the IRS have adopted a broad interpretation of "related" tax returns, events, and periods. For instance, the legislative history indicates that amounts asserted by the IRS during the extended assessment period are *not* limited related to the items that should have been reported on an international information return, like Form 5471.[42] Rather, the IRS can attack *anything* on the entire U.S. tax return with which the late Form 5471 was enclosed.[43]

G. Case Highlighting Aggressive Enforcement

Various rulings reveal that the IRS has been fairly aggressive in attacking Form 5471 faults and rejecting excuses therefor. A recent Tax Court case, *Kelly v. Commissioner*, constitutes a good example.[44]

The taxpayer ran many businesses. As his operations grew and diversified, the taxpayer formed numerous domestic, single-member, limited liability companies, which were treated as disregarded entities for tax purposes. Thus, instead of filing separate tax returns for such companies, each was properly reported on its own Schedule C (*Profit or Loss from Business*) attached to the taxpayer's annual Form 1040.

A rarity occurred in 2008; the taxpayer formed a corporation, instead of a single-member limited liability company. In particular, the taxpayer established a corporation in the Cayman Islands ("Cayman Corporation") solely for purposes of buying a commercial yacht there from a distressed seller at a discounted price. The business plan consisted of renovating and selling the yacht at a profit or chartering it to generate an income stream. It appears that this was the *only* foreign entity owned by the taxpayer.

The taxpayer had a longstanding professional relationship with an independent accounting firm, working with them since 2000 ("Accounting Firm"). The Controller for various companies owned by the taxpayer timely sent the Accounting Firm all tax-related data, including that about the Cayman Corporation. Among other things, the Controller sent an email to the Accounting Firm expressly stating that the Cayman Corporation was a foreign entity, the taxpayer was the sole owner, he was unsure about which U.S. filing requirements applied, and the Cayman Corporation would need to be addressed starting in 2008. Despite this email, the Accounting Firm treated the Cayman Corporation as a domestic disregarded entity, reporting it on a Schedule C, and did not file a Form 5471 disclosing the Cayman Corporation to the IRS. In other words, as a result of the error or misunderstanding by the Accounting Firm, the taxpayer reported the existence and operations of the Cayman Corporation to the IRS on his Form 1040; he just neglected to submit a separate Form 5471.

The IRS started an audit of the taxpayer in late 2012, identified potential problems in multiple years, issued a Notice of Deficiency in 2016 proposing adjustments all the way back to 2008, and raised various theories for ignoring the normal three-year assessment period. Among them was that the unfiled Forms 5471 for the Cayman Corporation allowed the IRS to reach back nearly a decade.

The Tax Court acknowledged that the taxpayer did not file timely Forms 5471 going back to 2008, but warned that the IRS could only make adjustments related to the Cayman Corporation (and not related to anything else on Forms 1040) if there was "reasonable cause" for the taxpayer's non-compliance. The Tax Court then turned to applicable standards, pointing out that both the Supreme Court and Tax Court have previously accepted reasonable reliance on tax professionals as "reasonable cause" in certain circumstances.[45]

The Tax Court emphasized the following facts: the Accounting Firm had been preparing the taxpayer's Forms 1040 since 2000, including Schedules C for his many companies; the relevant accountants at the Accounting Firm have no prior adverse disciplinary actions or IRS penalties; the accountants have decades of experience preparing Forms 1040; the taxpayer timely notified the Accounting Firm about the Cayman Corporation, its foreign status, and its ownership; the Accounting Firm did not have a conflict of interest; and the situation did not involve some tax or financial result that was "too good to be true."

The IRS urged the Tax Court to believe that the taxpayer's actions were not enough. Specifically, the IRS argued that not only did the taxpayer need to inform the Accounting Firm about the existence, location, and ownership of the Cayman Corporation, but he also needed to expressly tell the Accounting Firm that it had to file Forms 5471. The IRS's idea, in short, was that the taxpayer, who possessed no tax-related education, training, or experience, should

have told the Accounting Firm how to do its job. Classic.

The Tax Court rejected the IRS's stance. It ruled that the taxpayer had "reasonable cause" for not filing timely Forms 5471, and the IRS could only make proposed adjustments limited to the Cayman Corporation. In reaching this decision, the Tax Court referenced the list of facts described in the preceding paragraphs. It did some less obvious, but more important things, too. Namely, it explained that the Accounting Firm's complete lack of prior experience with Forms 5471 before 2008 was not detrimental to the taxpayer's reasonable reliance position. It also clarified, citing Supreme Court precedent, that taxpayers do *not* need to question the advice they receive from tax professionals, do *not* need to obtain second opinions, and do *not* need to monitor the advice received from the professionals. Moreover, the Tax Court recognized that the taxpayer could have done more to ascertain his filing duties related to the Cayman Corporation, but it was reasonable for him to rely on the Accounting Firm to do so for him. Lastly, with respect to timing, the Tax Court noted a degree of hypocrisy, underscoring that the IRS itself failed to advise the taxpayer of his Form 5471 problems until 2019, which was nearly a decade *after* the audit started and three years *after* the Tax Court litigation began.

V. Inevitable Showdown

What is particularly interesting about *Farhy v. Commissioner* is that it was inevitable. The debate is fleshed out in several documents, chief among them the NTA's Annual Report to Congress for 2020.[46]

The NTA started boldly, declaring that the IRS's treatment of Form 5471 penalties as automatically assessable is "legally unsupportable, administratively problematic, and imposes costs, delays, and stress for taxpayers."[47] The NTA then offered some history about Form 5471 duties, the original practice of Revenue Agents *manually* assessing penalties during audits, and the drastic change, in 2009, of the IRS *automatically* assessing penalties in cases of late or incomplete Forms 5471. The NTA suggested that many violations triggering automatic penalties result from "benign circumstances," such as ignorance of obscure filing requirements, unavailability of all the data needed to populate Forms 5471, and errors by the IRS.[48]

The NTA next introduced and compared two distinct portions of the Internal Revenue Code, namely, Chapters 68 and 61. It explained that Subchapter B of Chapter 68, called "Assessable Penalties," covers Code Secs. 6671–6720B, while Chapter 61, called "Information and Returns," encompasses Code Secs. 6001–6117.[49]

The NTA then underscored two important points. First, Code Sec. 6671 states that "the penalties and liabilities provided by [Subchapter B of Chapter 68] shall be paid upon notice and demand by the [IRS] and shall be assessed and collected in the same manner as taxes."[50] Second, the provisions that impose Form 5471 filing duties (*i.e.*, Code Secs. 6038 and 6038A) are found in Chapter 61, *not* Chapter 68, and thus are *not* covered by the automatic-assessment-and-collection language in Code Sec. 6671.[51] The NTA summed up its reasoning as follows: "Chapter 61 penalties, which include [Form 5471 penalties], are *not* in Chapter 68, and, in the view of the [NTA], among others, are therefore *not* assessable."[52]

The NTA then summarized the IRS' point of view, as follows. Code Sec. 6201 grants the IRS its *general* assessment authority. That provision broadly states that the IRS "is authorized and required to make the inquiries, determinations, and assessments of all taxes (including interest, additional amounts, additions to tax, and *assessable penalties*) imposed by" the Internal Revenue Code.[53] Several judicial decisions, including one issued by the Supreme Court, have held that Form 5471 penalties do not benefit from the normal tax deficiency procedures. This means that the IRS is not required to first issue an Examination Report proposing the penalties, allow the taxpayer a chance to file a Protest Letter and seek pre-assessment reconsideration by the Appeals Office, and if settlement is not achieved with the Appeals Office, issue a Notice of Deficiency. The IRS reasoned that, because Form 5471 penalties do not benefit from the deficiency procedures, they must be automatically assessable, despite the fact that the relevant provisions, Code Secs. 6038 and 6038A, are *not* located in Chapter 68, and thus are *not* explicitly covered by the automatic-assessment-and-collection language in Code Sec. 6671.[54] The IRS acknowledged that Subchapter B of Chapter 68 is expressly called "Assessable Penalties." However, it argued that one should not read too much into such language because the Internal Revenue Code warns that no inference, implication, or presumption of legislative intent can be drawn from the location or grouping of provisions, and "descriptive matter relating to the contents" of the Internal Revenue Code shall not "be given any legal effect."[55] The NTA was highly critical of the IRS's

analysis, calling it "a circular argument without legal support."[56]

Farhy v. Commissioner solves one issue, which is whether the IRS, under current law, can automatically assess and collect Form 5471 penalties.

The NTA went on to underscore similar views expressed by several tax practitioners in articles dating back to 2019. The practitioners theorized that (i) a statute creating a penalty, and a statute empowering the IRS to assess and collect such penalty, are two entirely different beasts; (ii) under the current rules, the IRS is not authorized to assess Form 5471 penalties, file federal tax liens, or take levy actions; (iii) the only recourse available to the IRS at this juncture is to ask the Department of Justice to pursue collection litigation against taxpayers in District Court; (iv) all prior Form 5471 penalties that have been automatically assessed by the IRS "are legally dubious and therefore open to challenge"; and (v) as a matter of fundamental fairness, and to avoid costs associated with administrative and judicial actions by taxpayers, the IRS should pro-actively abate or refund all improper Form 5471 penalties.[57] The NTA offered the following reflections on comments by practitioners: "This is an area of controversy that could easily generate unwelcome litigation for the IRS, but more importantly, one that imposes unreasonable burdens on taxpayers and is inconsistent with the statutes."[58]

The NTA report featured the following recommendations for the IRS. First, it should stop automatically assessing penalties found in Chapter 61 of the Internal Revenue Code, including Form 5471 penalties. Second, the IRS must refer assessment and collection actions to the Department of Justice, when appropriate. Third, instead of attempting to penalize all taxpayers filing delinquent Forms 5471, the IRS should send "soft notices" to remind taxpayers of their duties and potential sanctions for non-compliance. Fourth, the IRS should extend the first-time-abatement-penalty policy to *all* penalties in Chapter 61, including Form 5471 penalties.[59]

The NTA did not overlook Congress, of course. It suggested that lawmakers amend the Internal Revenue Code to ensure that *all* penalties in Chapter 61 are subject to the deficiency procedures, such that taxpayers can challenge penalties *before* the IRS assesses them, during audits, conferences with the Appeals Office, or Tax Court litigation.[60]

VI. New Case of First Impression

The theoretical conflict described in the NTA report for 2020 became a reality when the Tax Court decided *Farhy v. Commissioner* in April 2023.

A. Background and Procedure

The taxpayer in *Farhy v. Commissioner* owned two corporations in Belize during the relevant years. According to the Tax Court, the taxpayer participated in an "illegal scheme" to reduce his income taxes, signed an affidavit admitting it, and was granted immunity from criminal prosecution, presumably in exchange for cooperating with the U.S. government in its investigation of others.

The taxpayer did not file timely Form 5471 to disclose the Belizean corporations. The IRS sent the taxpayer notices in 2016 about the infractions, but he did not respond. The Tax Court noted that the taxpayer's inactions were "willful" and "not due to reasonable cause." In 2018, the IRS assessed initial penalties of $10,000 per violation, followed by continuation penalties reaching the maximum of $50,000. The IRS then commenced collection actions, sending the taxpayer a pre-levy notice in early 2019. The taxpayer reacted by filing a timely request for a CDP hearing with the Appeals Office. He challenged the proposed levies on grounds that the IRS lacked the authority to assess Form 5471 penalties in the first place.

The Appeals Office apparently disliked the taxpayer's argument because it issued a Notice of Determination approving the IRS's proposed levy to collect penalties. The taxpayer disagreed, of course, and filed a Petition with the Tax Court.

B. Analysis by the Court

The Tax Court began by describing the genesis of Form 5471 penalties, Code Secs. 6038 and 6038A. It concluded that "[t]here is no statutory provision, in the [Internal Revenue] Code or otherwise, specifically authorizing assessment of these penalties."[61] Next, the

Tax Court turned to Code Sec. 6201 and other provisions, which *generally* allow the IRS to assess certain items and take collection actions. It underscored that, while Code Sec. 6201 includes the term "assessable penalties," it fails to define it. This oversight creates "uncertainty about which penalties the IRS may assess and ultimately collect through administrative means."[62]

The Tax Court then summarized the legal positions of the parties. It comes as no surprise that the taxpayer adopted many of the arguments previously made by the NTA in its report from 2020, expanding in certain areas. Equally predictable, the IRS largely stuck to its guns, relying on the same reasoning explained in the NTA report grounded in Code Sec. 6201 and court rulings that normal deficiency procedures do not apply to Form 5471 penalties.[63]

The Tax Court got right to the point, announcing that the taxpayer's interpretation of the Internal Revenue Code "is the correct one."[64] It discussed various tax provisions to support the notion that Congress has explicitly authorized the IRS to assess many types of penalties, but *not* Form 5471 penalties. The Tax Court then identified a catch-all provision, which states 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."[65] It explained that Code Sec. 6038 creates a Form 5471 filing duty and penalty, but omits an enforcement mechanism. The Tax Court exhibited restraint in holding in favor of the taxpayer, deciding that the IRS could *not* carry out its proposed levy to collect penalties.

> We [the Tax Court] are loath to disturb this well-established statutory framework by inferring the power to administratively assess and collection [Form 5471 penalties] when Congress did not see fit to grant that power to the [IRS] expressly as it did for other penalties in the [Internal Revenue] Code.[66]

The Tax Court proceeded, over seven pages and in great detail, to explain why each of the arguments presented by the IRS failed.[67]

VII. Conclusion

Farhy v. Commissioner solves one issue, which is whether the IRS, under current law, can automatically assess and collect Form 5471 penalties. However, the case elicits many more questions than answers, including the following: Will the IRS challenge the Tax Court decision with the proper Court of Appeals? Will the IRS issue an Action-on-Decision essentially announcing that it plans to ignore *Farhy v. Commissioner* for the moment and continue assessing and collecting Form 5471 penalties? Will the IRS cease assessing Form 5471 penalties? Will the IRS begin referring Form 5471 penalty matters to the Department of Justice, such that it can pursue actions against taxpayers in District Court? Will large numbers of taxpayers who previously paid Form 5471 penalties, or who currently face such penalties, take administrative or judicial actions to recover or avoid them? Will the IRS concede such refund or abatement actions once filed? To avoid the costs and drain on its resources resulting from such actions, will the IRS pro-actively grant penalty refunds or abatements? Will the IRS coordinate with the NTA in urging Congress to amend the Internal Revenue Code to ensure that *all* international information return penalties are subject to deficiency procedures, thereby allowing taxpayers to challenge penalties *before* the IRS assesses them, during audits, conferences with the Appeals Office, or Tax Court litigation? Taxpayers and practitioners will be looking to the IRS and Congress for answers to these critical questions, and others.

ENDNOTES

* Hale specializes in tax audits, tax appeals, and tax litigation. You can reach Hale by phone at 404-658-5441 or by email at *hale.sheppard@chamberlainlaw.com*.

1 *A. Farhy*, 160 TC No. 6, Dec. 62,191 (2023). For earlier articles by the author about Form 5471 issues, *see* Hale E. Sheppard, *International Tax Disputes: Recent Cases Show Ways Taxpayers Give the IRS Forever to Audit, Tax and Penalize*, 47, 6 INT'L TAX J. 19 (2021); Hale E. Sheppard, *Has the IRS Declared Dead the Substantial Compliance Defense for International Information Returns? Lessons from a New International Practice Unit*, 43, 5 INT'L TAX J. 57 (2017); Hale E. Sheppard, *Flume v. Commissioner and Form 5471 Penalties for Unreported Foreign Corporations: A Glimpse at Unique Aspects of International Tax Disputes*, 95, 8 TAXES 39 (2017); Hale E. Sheppard, *Form 5471: How Does New IRS Guidance Impact the "Substantially Complete" Defense?* 94, 4 TAXES 39 (2016); republished in 42, 2 INT'L TAX J. 33 (2016).

2 Code Sec. 7701(a)(30)(A); Reg. §7701(b)-1; Code Sec. 61(a) and Reg. §1.61-1(a) both provide that "gross income" generally means "all income from whatever source derived."

[3] For a discussion of common international filing requirements, *see* Hale E. Sheppard, *Extended Assessment Periods and International Tax Enforcement: Rafizadeh v. Commissioner, Unreported Foreign Assets, and Use of FATCA Weapons*, 44, 5 J. Int'l Tax'n 25 (2018); and Hale E. Sheppard, *Lessons from an International Tax Dispute: Three Interrelated Cases, in Three Different Proceedings, Generating Three Separate Liabilities*, 46, 5 Int'l Tax J. 43 (2020).

[4] Code Sec. 6038; Reg. §1.6038-2; Code Sec. 6046; Reg. §1.6046-1; Code Sec. 6679; Reg. §301.6679-1; Instructions to Form 5471.

[5] Code Sec. 6038(a)(2); Reg. §1.6038-2(i).

[6] Code Sec. 6038(b)(1); Reg. §1.6038-2(k)(1)(i); Code Sec. 6046(f); Reg. §§1.6046-1(k).

[7] Code Sec. 6038(b)(2); Reg. §1.6038-2(k)(1)(ii); Code Sec. 6046(f); Reg. §§1.6046-1(k).

[8] Reg. §§1.6038-2(k)(3)(i) and (ii).

[9] IRM §20.1.1.3.6.1(7) (Aug. 5, 2014).

[10] *Id.*

[11] *Id.*

[12] IRM §§20.1.1.3.6.1(8) and (9) (Aug. 5, 2014).

[13] *See, e.g.*, Kristen A. Parillo, "IRS Looking to Fix Problems with Some Automatic Assessments," Federal Tax Notes Today Doc. 2019-47399 (Dec. 16, 2019); Andrew Velvarde, Practitioners Fault Accelerated Assessable Penalty Collection," Federal Tax Notes Today Doc. 2020-10055 (Mar. 28, 2020).

[14] "Appeals Guidance Issued on Abatement for International Penalties," 2022 Tax Notes Today International 248-23 (Dec. 7, 2022).

[15] IRM §21.8.2.20.1 (Oct. 1, 2014).

[16] "Failure to File the Form 5471—Category 4 and 5 Filers—Monetary Penalty." International Practice Unit (updated as of October 7, 2015) (emphasizes added).

[17] U.S. Treasury Inspector General for Tax Administration. Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work Is Needed. Report 2006-30-075 (May 2006).

[18] *Id.*, pgs. 1 and 2.

[19] *Id.*, pg. 2.

[20] *Id.*, pgs. 7 and 8.

[21] U.S. Treasury Inspector General for Tax Administration. Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement. Report 2013-30-111 (September 25, 2013).

[22] U.S. Treasury Inspector General for Tax Administration. Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement. Report 2013-30-111 (September 25, 2013), pg. 2. The Form 5471 penalties rose to $71.5 million in 2009, $48.6 million in 2010, $54.3 million in 2011, and $41 million in 2012.

[23] U.S. Treasury Inspector General for Tax Administration. Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement. Report 2013-30-111 (September 25, 2013), pg. 2.

[24] *Id.*, pg. 8.

[25] IRM Exhibit 21.8.2-1 (Oct. 01, 2022)—Failure to File or Late-Filed Form 5471—Decision Tree.

[26] *R.W. Boyle*, SCt, 85-1 USTC ¶13,602, 469 US 241, 251, 105 SCt 687 (1985).

[27] Jasper L. Cummings, Jr., *LB&I International Practice Units*, Tax Notes (Nov. 23, 2015), p. 1077; Kristen A. Parillo & Jaime Arora, *IRS Plans to Release International Training Materials*, Tax Notes (Mar. 24, 2014), p. 1317.

[28] "Failure to File the Form 5471—Category 4 and 5 Filers—Monetary Penalty." International Practice Unit (updated as of October 7, 2015).

[29] *Id.*

[30] U.S. Government Accountability Office. Federal Tax Collection—Potential for Using Passport Issuance to Increase Collection of Unpaid Taxes. GAO-11-272 (Mar. 2011).

[31] *Id.*, pg. 4.

[32] *Id.*, pg. 16.

[33] Fixing America's Surface Transportation Act. Public Law No. 114-94 (Dec. 4, 2015).

[34] Code Sec. 7345(b)(1). The key amount, $50,000, is subject to change. It increases annually for inflation and rounded to the nearest multiple of $1,000. *See* Code Sec. 7345(f).

[35] Code Sec. 7345(b)(1).

[36] U.S. House of Representatives, 114th Cong., 1st Sess., Conference Report 114-357, Dec. 1, 2015, p.531.

[37] U.S. Joint Committee on Taxation. General Explanation of Tax Legislation Enacted in 2015. JCS-1-16 (March 2016), pg. 92.

[38] *V. Ruesch*, 154 TC 289, 154 TC 13, Dec. 61,708 (2020).

[39] Code Sec. 6501(a).

[40] Code Sec. 6501(c)(8).

[41] Public Law 111-147 (March 18, 2010), Title V, Subtitle A, Parts I through V, Code Sec. 511(b) (emphasis added).

[42] U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions Contained in Senate Amendment to the House Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010. JCX-46-10. Aug. 10, 2010, pg. 36 (emphasis added); *See also* U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act." JCX-4-10. Feb. 23, 2010, pg. 66 (emphasis added).

[43] IRSIG SBSE-25-0312-022 (March 9, 2012) (emphasis added).

[44] *M.R. Kelly*, 121 TCM 1561, Dec. 61,888(M), TC Memo. 2021-76.

[45] *M.R. Kelly*, 121 TCM 1561, Dec. 61,888(M), TC Memo. 2021-76, pgs. 48 and 49 (referencing *R.W. Boyle*, SCt, 85-1 USTC ¶13,602, 469 US 241, 246, 105 SCt 687 (1985), *E.S. Flume*, 113 TCM 1097, Dec. 60,822(M), TC Memo. 2017-21, and *Neonatology Associates, P.A.*, 115 TC 43, Dec. 53,970 (2000), *aff'd*, CA-3, 2002-2 USTC ¶50,550, 299 F3d 221 (2002).

[46] National Taxpayer Advocate. Annual Report to Congress 2020, pgs. 119–131.

[47] *Id.*, pg. 119.

[48] *Id.*, pg. 122.

[49] *Id.*, pg. 121.

[50] Code Sec. 6671(a); Reg. §301.6671-1(a).

[51] National Taxpayer Advocate. Annual Report to Congress 2020, pg. 121.

[52] *Id.* (emphasis added).

[53] Code Sec. 6201(a) (emphasis added).

[54] National Taxpayer Advocate. Annual Report to Congress 2020, pg. 123.

[55] *Id.*, pg. 129 (citing Code Sec. 7806).

[56] *Id.*, pg. 123.

[57] *Id.*, pgs. 123 and 124 and the articles cited.

[58] *Id.*, pg. 124.

[59] *Id.*. 128.

[60] *Id.*

[61] *A. Farhy*, 106 TC No. 6, Dec. 62,191 (2023), pg. 5.

[62] *Id.*, pg. 6.

[63] *Id.*, pgs. 6 and 7.

[64] *Id.*, pg. 7.

[65] *Id.*, pg. 7 (citing 28 USC §2461(a) (emphasis added)).

[66] *Id.*, pg. 8.

[67] *Id.*, pgs. 8–14.