Alon Farhy v. Commissioner of Internal Revenue, 160 T. C. No. 6 (2023)

In a landmark ruling, the U. S. Tax Court held that the IRS lacks statutory authority to assess penalties under I. R. C. § 6038(b) for failure to file information returns on foreign corporations. This decision clarifies that such penalties, while enforceable, cannot be administratively assessed and collected by the IRS, marking a significant limitation on the IRS's collection powers and affirming the importance of explicit statutory authorization for IRS actions.

Parties

Alon Farhy, the petitioner, sought review of a determination by the Commissioner of Internal Revenue, the respondent, to proceed with a proposed levy to collect penalties assessed under I. R. C. § 6038(b). Farhy was the plaintiff at the trial level, and the Commissioner was the defendant.

Facts

Alon Farhy, a resident of Israel, owned 100% of two foreign corporations incorporated in Belize, Katumba Capital, Inc. , and Morningstar Ventures, Inc. , during his 2003-2010 taxable years. Farhy participated in an illegal tax reduction scheme, for which he was granted immunity from prosecution. He failed to file required Forms 5471 for each year in question, a violation of I. R. C. § 6038(a). The IRS assessed initial and continuation penalties under I. R. C. § 6038(b) against Farhy for each year, totaling significant amounts. Farhy contested the IRS's authority to assess these penalties, leading to the present case.

Procedural History

The IRS issued a notice of intent to levy against Farhy for the unpaid penalties, prompting him to request a collection due process hearing under I. R. C. § 6330. The IRS issued a notice of determination sustaining the proposed levy, and Farhy timely petitioned the U. S. Tax Court for review. The court's jurisdiction was established under I. R. C. § 6330(d)(1), and the case was fully stipulated under Tax Court Rule 122. The court reviewed the underlying liability de novo and the IRS's determinations for abuse of discretion.

Issue(s)

Whether the IRS has statutory authority to assess penalties provided by I. R. C. § 6038(b) against a taxpayer who failed to file Forms 5471 as required by I. R. C. § 6038(a)?

Rule(s) of Law

I. R. C. § 6201(a) authorizes the Secretary of the Treasury to assess all taxes, including interest, additional amounts, additions to tax, and assessable penalties

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imposed by the Code. I. R. C. § 6038(b) imposes penalties for failure to file required information returns, but it does not explicitly authorize assessment of these penalties. I. R. C. § 6671(a) and § 6665(a)(1) specify that certain penalties are to be assessed and collected in the same manner as taxes, but I. R. C. § 6038(b) penalties are not included in these provisions.

Holding

The U. S. Tax Court held that the IRS lacks statutory authority to assess penalties under I. R. C. § 6038(b) against Farhy. Consequently, the IRS may not proceed with the collection of these penalties from Farhy via the proposed levy.

Reasoning

The court's reasoning centered on the absence of explicit statutory authorization for the IRS to assess I. R. C. § 6038(b) penalties. The court noted that while I. R. C. § 6201(a) authorizes the assessment of taxes and assessable penalties, the term "assessable penalties" is not defined and does not automatically include all penalties not subject to deficiency procedures. The court emphasized that numerous other penalty provisions in the Code explicitly authorize assessment, but I. R. C. § 6038(b) does not. The court rejected the IRS's arguments that the term "taxes" in I. R. C. § 6201(a) encompasses I. R. C. § 6038(b) penalties and that the penalties' exclusion from deficiency procedures implies their assessability. The court also distinguished its prior holding in Ruesch v. Commissioner, which did not address the issue of assessment authority. The court concluded that without explicit statutory authorization, the IRS cannot assess I. R. C. § 6038(b) penalties.

Disposition

The U. S. Tax Court entered a decision in favor of Farhy, holding that the IRS may not proceed with the collection of the I. R. C. § 6038(b) penalties via the proposed levy.

Significance/Impact

This decision significantly limits the IRS's authority to assess and collect certain penalties without explicit statutory authorization. It clarifies that the IRS must adhere strictly to the statutory framework when assessing penalties, even if they are not subject to deficiency procedures. The ruling may impact future IRS enforcement actions and could prompt legislative action to clarify the assessment authority for I. R. C. § 6038(b) penalties. It also underscores the importance of clear statutory language in delineating the scope of IRS powers, potentially affecting the interpretation of other penalty provisions in the Code.

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