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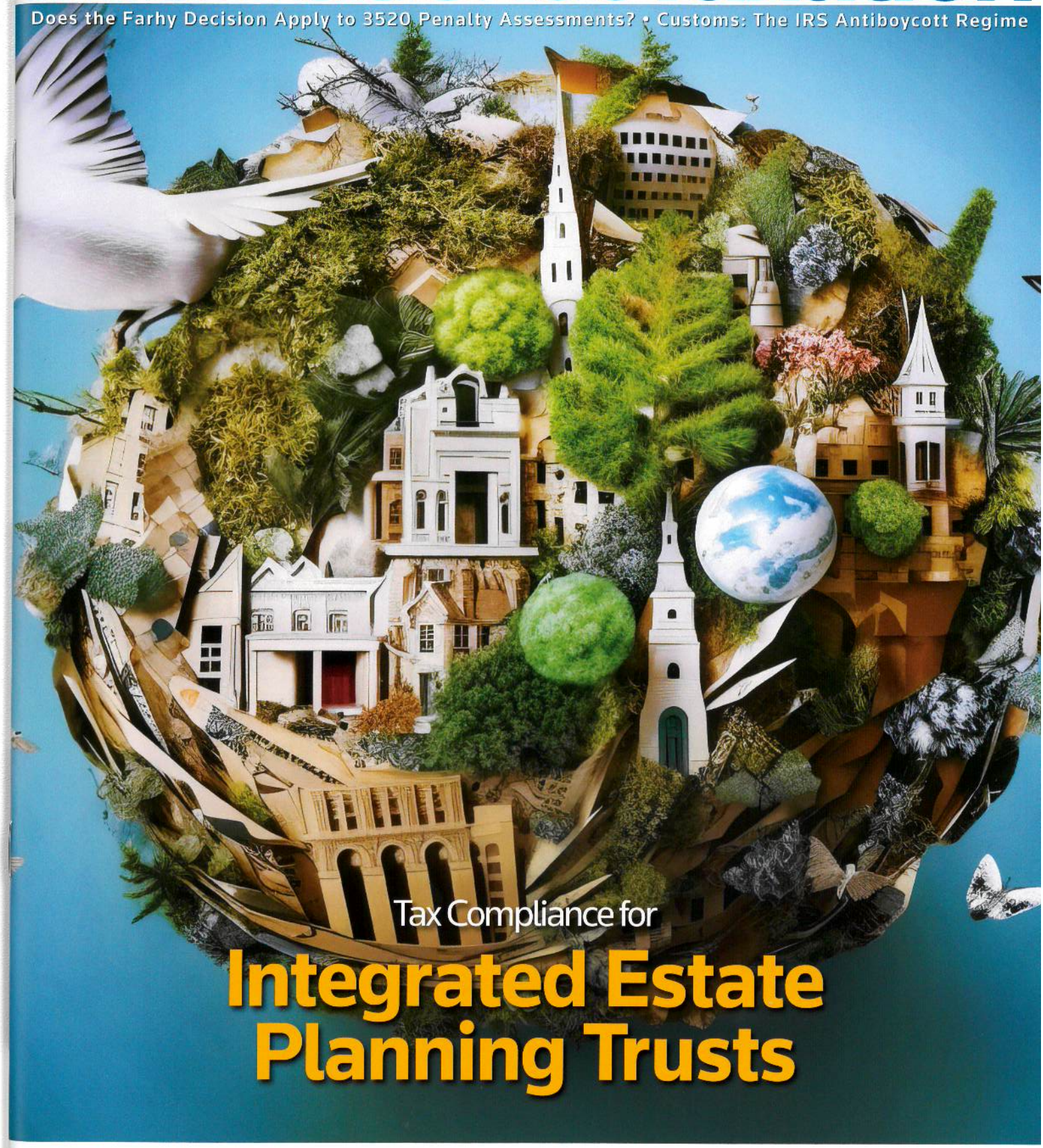

Tax Compliance for Integrated Estate Planning Trusts

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Does the Farhy Decision Apply to 3520 Penalty Assessments?

ANTHONY DIOSDI

Recently, the United States Tax Court held in *Alon Farhy*[1] that the IRS lacked the authority to assess certain penalties against taxpayers under Code Section 6038(b). In *Farhy,* the petitioner was required to file Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, but he did not. The penalty for failure to file, or for delinquent, incomplete, or materially incorrect filing is a reduction of foreign tax credits by 10% and a penalty of $10,000. An additional $10,000 continuation penalty may be assessed for each 30-day period that noncompliance continues up to $50,000 per return.[2]

The IRS assessed penalties against the petitioner under Section 6038(b). The Tax Court determined that there is no law giving the IRS authority to assess penalties under Section 6038(b). For reasons discussed in this article, the IRS also lacks the authority to assess Section 6039F penalties associated with the failure to timely file a Form 3520.

IRS's Authority to Assess Penalties

Section 6201(a) authorizes and requires the Secretary of the Treasury to make assessments of all taxes, interest, additions to taxes, and assessable penalties imposed by the Internal Revenue Code. The Secretary of the Treasury has delegated these duties to the IRS Commissioner, who has delegated them in turn to other IRS officials. When a tax, interest, or assessable penalty is assessed, the IRS may take certain actions to collect the tax administratively through means such as liens and levies.

If there is no law giving the IRS the authority to assess a penalty, the IRS's only recourse to collect the penalty would be to ask the Department of Justice to sue the individual or entity assessed the penalty. This would involve bringing suit in a United States district court with proper venue and asking the court to liquidate the penalty assessment into a judgment.[3]

The Section 6039F Penalty and the IRS's Position Regarding Its Authority to Assess and Collect the Penalty

Code Section 6039F applies to U.S. persons (other than certain exempt organizations) that receive large gifts (including bequests) from foreign persons. The Section 6039F reporting provisions require U.S. donees to provide information concerning the receipt of large amounts that the donees treat as foreign gifts, giving the IRS an opportunity to review the characterization of these payments and determine whether they are properly treated as gifts. Donees are currently required to report certain information about foreign gifts on Part IV of Form 3520.

Section 6039F(b) generally defines the term "foreign gift" as any amount received from a person other than a U.S. person that the recipient treats as a gift or bequest. However, a foreign gift does not include a qualified transfer (within the meaning of Section 2503(e)(2)) or any distribution from a foreign trust. A distribution from a foreign trust must be reported as a distribution under Section 6048(c) and not as a gift under Section 6039F.

Section 6039F(c) provides that if a U.S. person fails, without reasonable cause, to report a foreign gift as required by Section 6039F, then (1) the tax consequences of the receipt of the gift will be determined by the Secretary and (2) the U.S. person will be subject to a penalty equal to 5% of the amount for the gift for each month the failure to report the foreign gift continues, with the total penalty not to exceed 25% of such amount.

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Under Sections 6039F(a) and (b), reporting is required for aggregate foreign gifts in excess of $100,000 during a taxable year. Once the $100,000 threshold has been met, the U.S. donee is required to file Form 3520 with the IRS.

The IRS treats Section 6039F penalties as summarily assessable, as they are not subject to the deficiency procedures, wherein taxpayers receive a notice of deficiency alerting them of the potential assessment and explaining the taxpayer's options for contesting or complying with the penalty assessment. The notice of deficiency also informs taxpayers of the last day to petition the Tax Court for pre-assessment and prepayment judicial review.

Many penalties related to income tax filings are not summarily assessable (that is, they are generally subject to deficiency procedures). For example, deficiency procedures typically apply when the IRS determines noncompliance of a taxpayer resulting in an underpayment of some type of tax. Common penalties associated with the issuance of a notice of deficiency include an accuracy or negligence penalty under Section 6662.

Summarily assessable penalties are primarily found in Sections 6671 through 6720C. Chapter 68, Subchapter B, titled "Assessable Penalties," authorizes the IRS to assess and collect penalties "in the same manner as taxes" without first sending a notice of deficiency. Summary assessments are made without the issuance of a notice of deficiency and "shall be paid upon notice and demand and collected in the same manner as taxes." Most of these "penalties" are included in Chapter 68 of the Internal Revenue Code. Chapter 68, Subchapter A, titled "Additions to the Tax and Additional Amounts," allows the IRS to impose penalties for failure to file or pay taxes, understatements or underpayments of tax, and penalties for fraud. However, Chapter 61 penalties are not located in Chapter 68 of the Internal Revenue Code and are not therefore assessable penalties.

The IRS believes it has a grant of authority to assess Section 6039F penalties under Section 6201(a) as a result of a Supreme Court decision in *NFIB v. Sebelius*.[4] As discussed above, this provision of the Internal Revenue Code permits the IRS to assess tax as well as interest and penalties. In *NFIB v. Sebelius*, the U.S. Supreme Court agreed that the plain language of Section 6201(a) places within the definition of tax for the purpose of granting the IRS the authority to assess Affordable Care Act (ACA) penalties.

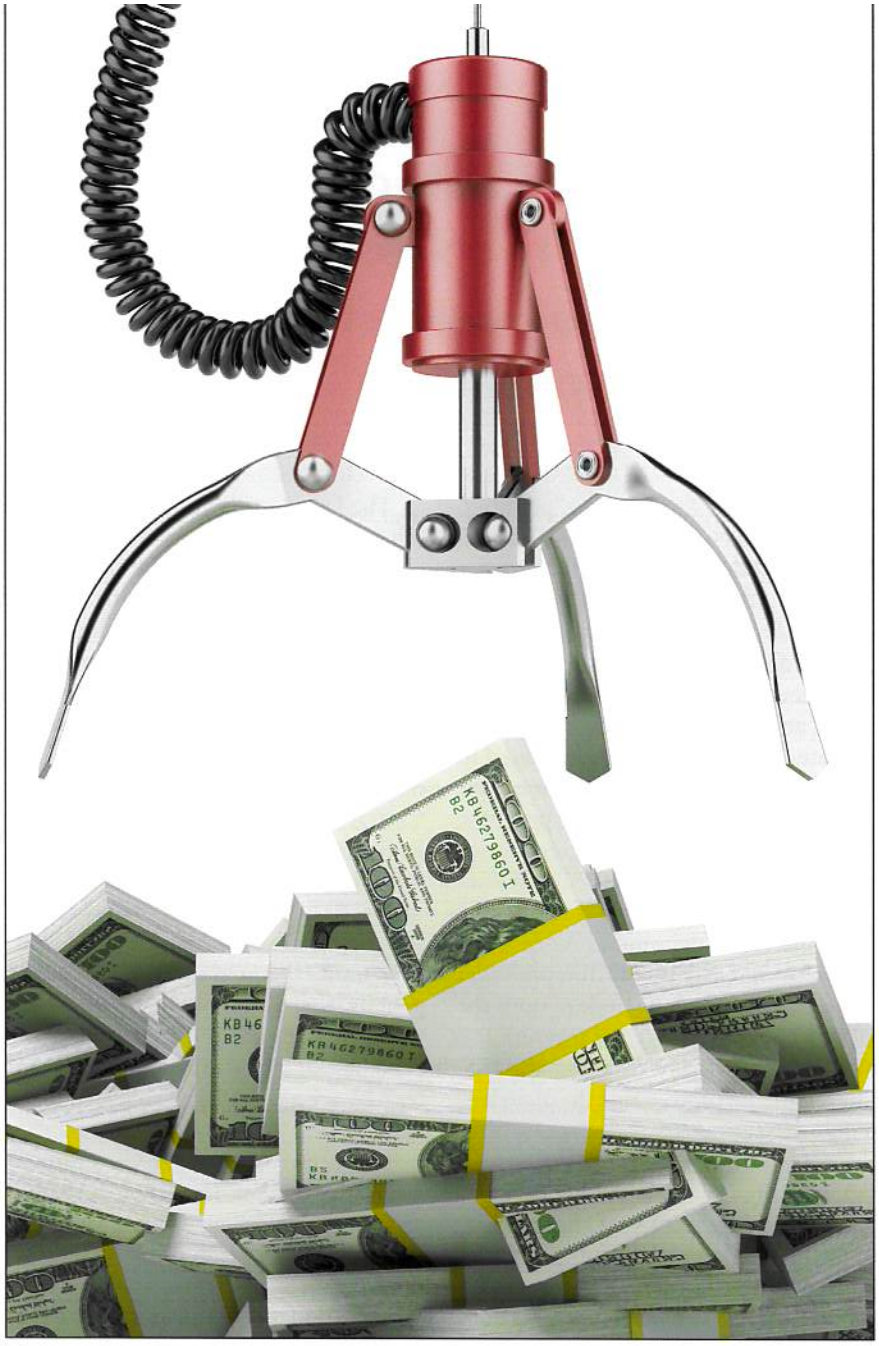
To reach this result, the Supreme Court had to clear the hurdle of the prohibition against injunctive relief in tax cases contained in the Anti-Injunction Act.[5] The Supreme Court stated that unlike penalties contained in Chapters 68A and 68B of the Internal Revenue Code, the ACA individual mandate penalty was not designated a tax, even though it was to be assessed and collected like a tax. Since the Anti-Injunction Act only applies to a "tax," the Anti-Injunction Act was not a bar to litigation involving the Affordable Care Act penalty.

The Declaratory Judgment Act prohibits suits for declaratory relief concerning "federal taxes."[6] Since the Declaratory Judgment Act is almost identical to the Anti-Injunction Act, the Declaratory Judgment Act does not bar a court from granting declaratory relief with respect to a penalty that is not deemed a "tax" under the Internal Revenue Code. Like the individual mandate penalty of the Affordable Care Act, no provision of the Internal Revenue Code states that the foreign information reporting penalties contained in Part III of Chapter 61A of the Internal Revenue Code are deemed a tax. Moreover, unlike the ACA individual mandate penalty, there is no provision in the Internal Revenue Code stating that the penalties contained in Part III A of Chapter 61A are assessed and collected like a tax.[7]

In *NFIB v. Sebelius*, the Government argued that the Anti-Injunction Act barred any challenge to the penalty provisions, since they were contained in the Internal Revenue Code and, thus, a tax. A group of legal scholars filed an amicus brief arguing that the Anti-Injunction Act barred the Supreme Court from hearing the case. The Supreme Court disagreed. In reaching its conclusion, the Supreme Court stated as follows:

> "We think the Government has the better reading. As it observes, "Assessment" and "Collection" are chapters of the Internal Revenue Code providing the Secretary authority to assess and collect, and generally specifying the means by which he shall do so.[8] Section 5000A(g)(1)'s command that the penalty be "assessed and collected in the same manner" as taxes is best read as referring to those chapters and giving the Secretary the same authority and guidance with respect to the penalty. That interpretation is consistent with the remainder of Section 5000A(g), which instructs the Secretary on the tools he may use to collect the penalty.[9] The Anti-Injunction Act, by contrast, says nothing about the proce-

1 *Farhy*, 160 T.C. No. 6 (2023)
2 *See* IRC Section 6038(b) and (c).
3 *See* IRC Section 2461(a).
4 *National Federation of Independent Business v. Sebelius*, 567 U.S. 519. (2012).
5 *See* IRC Section 7421.
6 *See* 28 USC section 2201.
7 *See* California Lawyers Association Taxation Section 2019 Washington D.C. Delegation, *Clarifying Provisions on the Assessment and Collection of Foreign Information Reporting Penalties (IRC Sections 6038, 6038A, 6038C, 6038D, 6039F, 6046, 6046A, 6048)*, Robert S. Horwitz and Jonathan Kalinski.
8 *See* IRC Section 6201 (assessment authority); IRC Section 6301 (collection authority).
9 *See* Section 5000A(g)(2)(A)(barring criminal prosecutions); Section 5000A(g)(2)(B)(prohibiting the Secretary from using notices of lien or levies).



dures to be used in assessing and collecting taxes. Amicus argues in the alternative that a different section of the Internal Revenue Code requires courts to treat the penalty as a tax under the Anti-Injunction Act. Internal Revenue Code Section 6201(a) authorizes the Secretary to make "assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties)."

"Amicus contends that the penalty must be a tax, because it is an assessable penalty and Section 6201(a) says that taxes include assessable penalties. That argument has force only if Section 6201(a) is read in isolation. The Internal Revenue Code contains many provisions treating taxes and assessable penalties as distinct terms.[10] There would, for example, be no need for Section 6671(a) to deem "tax" to refer to certain assessable penalties if the Internal Revenue Code already included all such penalties in the term "tax." Indeed, amicus's earlier observation that the Internal Revenue Code requires assessable penalties to be assessed and collected "in the same manner as taxes" makes little sense if assessable penalties are themselves taxes. In light of the Internal Revenue Code's consistent distinction between the terms "a tax" and "assessable penalty," we must accept the Government's interpretation: Section 6201(a) instructs the Secretary that his authority to assess taxes includes the authority to assess penalties, but it does not equate assessable penalties to taxes for other purposes."

"The Affordable Care Act does not require that the penalty for failing to comply with the individual mandate be treated as a tax for purposes of the Anti-Injunction Act. The Anti-Injunction Act therefore does not apply to this suit, and we proceed to the merits."

Based on the Supreme Court's rationale, none of the penalties contained in Part A III of Chapter 61A can be classified as a "tax." Consequently, the Anti-Injunction Act or the Declaratory Judgment Act would not prevent a taxpayer from filing suit for injunctive or declaratory relief in connection with a penalty contained in Part A III of Chapter 61A. The Supreme Court ultimately determined in *NFIB v Sebelius* that a penalty found in Section 5000A(g)(1) was to be paid upon notice and demand and was assessed and collected in the same way as assessable penalties under Chapter 68B, and as a result, the Affordable Care Act penalty was to be assessed and collected in the same manner as a tax.

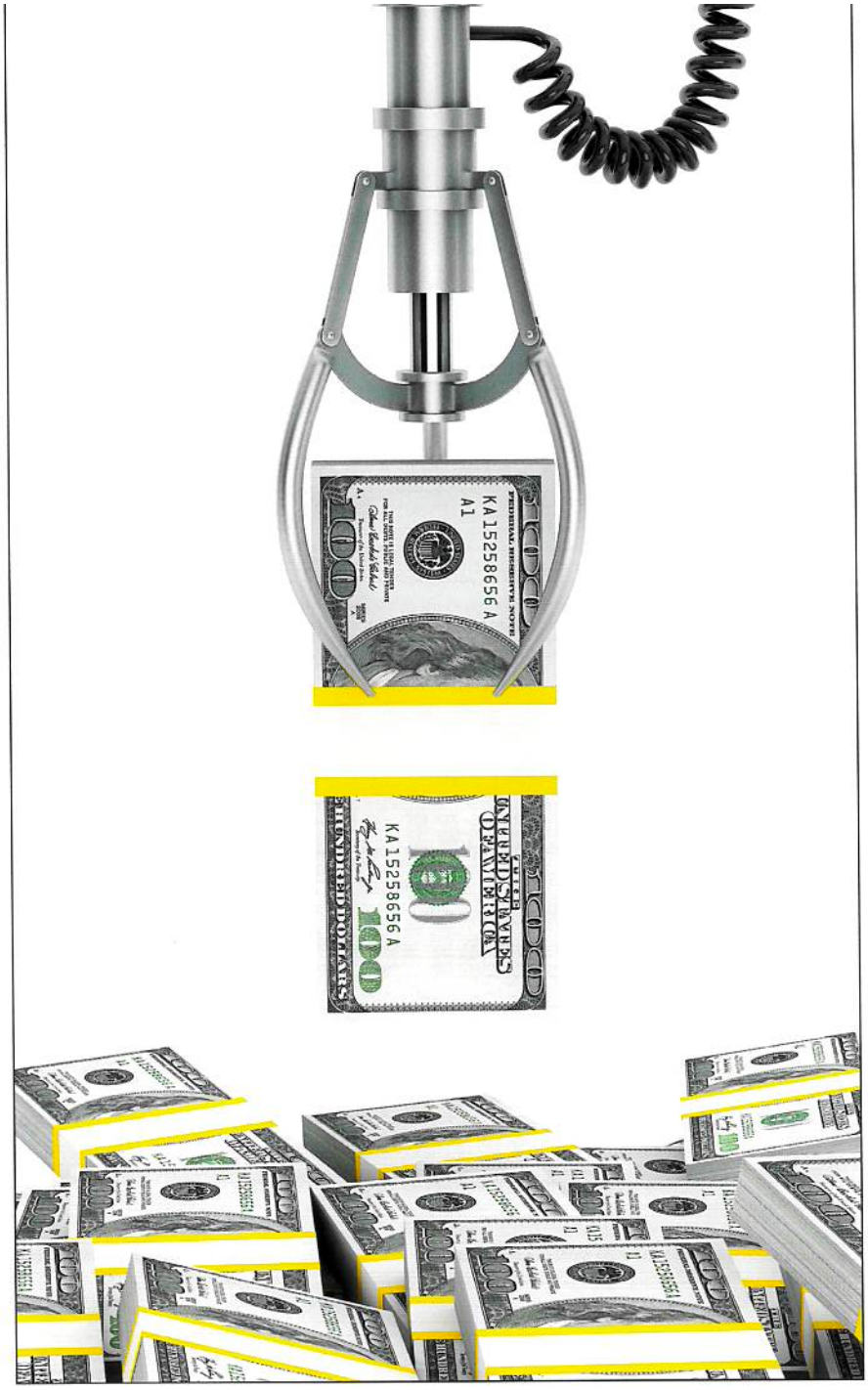
The Tax Court's Farhy Reasoning and the Farhy Court's Application to Section 6039F Penalties

Based on the Supreme Court's reasoning in *NFIB v. Sebelius*, a number of the Internal Revenue Code provisions that apply the term "tax" to foreign information reporting penalties are susceptible to challenge. As noted above, in *Farhy*,[11] the Tax Court recognized that certain Internal Revenue Code sections contain their own express provisions authorizing assessment of penalties provided therein, and that such penalties are encompassed within the "assessable penalty" reference in Code Section 6201(a).

In determining the term "assessable penalties" and holding that the Section 6038(b) penalty was not subject to the IRS's assessment authority under Section 6201(a), the Tax Court in *Farhy* com-

[10] *See, e.g.*, Sections 860(h)(1), 6324A(a), 6601(e)(1)-(2), 6602, 7122(b).

[11] *See Farhy*, 160 T.C. No. 6, 5 n.8 (2023).



pared Section 6038(b) to penalty Code sections outside Chapter 68, Subtitle F. The Tax Court in *Farhy* noted that Code sections outside Chapter 68 of Subtitle F whose violations the Internal Revenue Code specifically penalizes, commonly contained a reference to the treatment of the assessable penalty in one of three ways:

- The statute contains its own express provision specifying the treatment of penalties as a tax or an assessable penalty for purposes of assessment and collection (e.g., *see* IRC Section 527(j); IRC Section 5684(b); IRC Section 5751).
- The statute contains a cross reference to a provision within Chapter 68 of Subtitle F providing a penalty for their violation (e.g., *see* IRC Section 1275(c)(4); IRC Section 6033(o)).
- The statute is expressly covered by a penalty provision within Chapter 68 of Subtitle F (e.g., *see* IRC Section 6652(c) (Failure to file certain information returns, registration statements); IRC Section 6674 (Fraudulent statement or failure to furnish statement to employee); IRC Section 6677 (Failure to file information with respect to certain foreign trusts)).

Code Section 6039F is distinguishable from Code Section 6038(b), in that it contains language providing that the penalty must be paid upon notice and demand, in the same manner as taxes. Similar language is not present in Code Section 6038(b). Although Section 6039F provides that the penalty must be paid upon notice and demand, this language is not clearly indicative of the penalty being considered an "assessable penalty" for purposes of the general grant of the IRS's authority to assess "assessable penalties" in Code Section 6201(a).

In order for the IRS to have the authority to assess and collect a Section 6039F penalty, the penalty must be paid upon notice and demand and assessed and collected in the same manner as taxes.[12] While the express language of Code Section 6039F(c)(1)(B) states that the penalty is payable "upon notice and demand by the Secretary and in the same nature as tax," this express language is missing the key phrase "assessed and collected." The absence of this key phrase "assessed and collected" from the language of Code Section 6039F(c)(1)(B) is fatal to the IRS's argument that it has the authority under Section 6201 to assess and collect a Section 6039F penalty. The express language is insufficient to transform the penalty into an "assessable penalty"— i.e., the Code Section 6039F(c)(1)(B) penalty is not a penalty as to which the IRS (as the Treasury Secretary's delegate) is authorized by statute to use its administrative powers to levy (i.e., execute, enforce, and collect) on the extent of the penalty that has been determined by the IRS.

Conclusion

Since the IRS cannot assess and administratively collect the tax, a Section 6039F penalty can only be collected by authorizing the Department of Justice to file a lawsuit to collect the penalty. ●

[12] *See Smith*, 133 T.C. 424, 428 (2009).