D.C. Circuit's First *Farhy* Opinion Requires Reconsideration

POSTED ON MAY 21, 2024

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In this post, Black argues that the D.C. Circuit incorrectly decided *Farhy v. Commissioner* and that the court should reconsider the case en banc.

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Just over a decade ago I started my tax law career in the IRS Office of the Associate Chief Counsel (Procedure & Administration). Among the many benefits the position[1] provided was early exposure to novel procedural issues being explored by the tax bar at large. Some of these issues, such as the supervisory approval requirement of section 6751(b), had a straightforward mechanism for review and were tested early in Tax Court. Other issues, such as the validity of both substantive tax and reporting requirements under the Administrative Procedure Act, were slower to work their way through the judicial system because of the Anti-Injunction Act's bar on some pre-collection review. Finally, issues such as the IRS's lack of authority to assess certain information reporting-related penalties under section 6201(a) are so procedurally confounding that they have taken my entire career to begin working their way through the courts.

The procedural hurdles to challenging such assessments are the most significant of the many reasons why I must disagree with the D.C. Circuit's apparently policy-based decision in *Farhy*

v. Commissioner[2] (and why I must disagree with the venerable Les Book when he states that the court reached the right legal result).

First off, as Les notes, the D.C. Circuit appears not to understand how collection due process works (or fails to work). Yes, CDP *can* provide for pre-collection judicial review of penalties, such as those assessed under section 6038(b) for failure to file Form 5471, but only when Jupiter is ascending and there is a full moon on a Tuesday in July. In other words, it is almost completely arbitrary whether the stars align properly to give a taxpayer the right confluence of events to obtain substantive review in a CDP hearing, which is a prerequisite to pre-collection judicial review (and still no bar to a dreaded notice of federal tax lien).

In my experience, and the experience of my colleague Victor Jaramillo,[3] there is usually *no* examination or substantive consideration of chapter 61 penalty liability prior to assessment. Meanwhile, a taxpayer who *is* examined will generally be afforded an Appeals hearing prior to assessment — thereby foreclosing substantive review in CDP of penalties not subject to deficiency procedures. Additionally, where there is no examination, the administrative review and the penalty collection "tracks" at the IRS generally operate independently and are not coordinated. Both tracks start with a CP15 or CP215 notice of assessment. If a taxpayer responds requesting abatement, the IRS will generally send a Letter 854C, which is an apparently automated denial of the request for abatement. This letter provides the opportunity to request an Appeals hearing. Although the taxpayer may have explained its reasonable cause for late filing when it filed the information report at issue, and it may have done so again in response to the notice of penalty assessment, it must do so a third time in a timely response to the Letter 854C (this time in the form of a protest). If it fails to do so, it has waived an opportunity for consideration on the merits, thereby foreclosing substantive review in CDP. Alternatively, if the taxpayer timely requests review by Appeals, Appeals may issue a determination prior to the IRS's issuance of a final notice of intent to levy[4] (for purposes of this discussion, the end of the "collection track"), thereby foreclosing substantive review in CDP which, as a reminder, is a prerequisite to pre-collection judicial review.

I tried to be concise, but I think the above discussion was sufficiently confusing that the D.C. Circuit can be forgiven for not knowing precisely how CDP works. Certainly, taxpayers can be, which is probably why such a small percentage of them actually receive CDP hearings at all, and why a much smaller percentage actually obtain judicial review. This is not to mention that

many taxpayers subject to these penalties live abroad and are victims of a seemingly unreliable and untimely mail service. In any event, CDP does not fill the gap. Les suggests a legislative overturn of *Flora*,[5] which would certainly do the job, as would legislative amendment of the AIA or the application of deficiency procedures to all penalties. But these alternatives require Congress to act, whereas the courts need only follow Judge Marvel's carefully reasoned opinion in the Tax Court below to resolve the lack of judicial due process implicated by the D.C. Circuit's opinion and the limitations on pre-collection judicial review.

The second reason why I must disagree with the D.C. Circuit opinion is its conflation of the section 6038(c) *tax* with penalties that are not subject to deficiency procedures. I discussed this with Victor, and his observations were as follows:

> The D.C. Circuit opinion states "all agree the IRS may *assess* subsection (c) penalties," and therefore concludes, based on the 1982 amendments to section 6038, "subsection (b) penalties must also be assessable." That statement, which is the underpinning of the holding, fails to note that subsection (c) penalties cannot be assessed without examination and are subject deficiency procedures. To begin, a taxpayer that fails to file Form 5471 will rarely be claiming a foreign tax credit for taxes deemed paid by the foreign corporation. In such circumstance, the IRS would not know the amount of foreign tax credit the taxpayer *could* claim or, consequently, the appropriate 10 percent reduction to such credit. In short, where the taxpayer fails to file a Form 5471 and does not claim a foreign tax credit, the subsection (c) penalty cannot be an assessable penalty because the IRS would lack the information necessary to make the assessment.[6] Moreover, the D.C. Circuit failed to realize that an individual that owns a foreign corporation is not entitled to a section 960 foreign tax credit for taxes deemed paid unless he or she makes a section 962 election.

The D.C. Circuit indicates concern that Congress would not have intended to bifurcate administration of penalties under sections 6038(b) and 6038(c). But unless the implication is that section 6038(b) penalties are also subject to deficiency procedures like section 6038(c) penalties, the administration of these two penalties must be "bifurcated" under any interpretation of the IRS's assessment authority.

The third reason for my disagreement with the D.C. Circuit is the notion that the lack of authority in section 6201(a) to assess certain penalties would implicate a lack of authority to make necessary "inquiries" and "determinations." Sections 7601 and 7602 already provide express authority to make inquiries, and section 7801 provides for administration and enforcement (including, by implication, the authority to make determinations). In other words, the IRS has all the statutory authority it needs to do its job properly, including its obligation to determine whether a taxpayer who presents evidence of reasonable cause satisfies the statutory criteria to avoid liability for a penalty. The IRS only lacks the authority to assess penalties other than those that "must be paid upon notice and demand and assessed and collected in the same manner as taxes."[7]

The fourth reason, relatedly, is the implication that the statute requires a "*post-assessment* administrative process in which the taxpayer could make a reasonable cause showing to the Secretary" (emphasis added), or that the Tax Court opinion in *Farhy* would leave it "for the district court rather than the Secretary to determine the taxpayer's liability for the penalty." There is no need to read the Tax Court's opinion to mandate that the IRS, without first determining whether the taxpayer is actually liable for a penalty or whether the taxpayer has reasonable cause, refer all potentially applicable penalties to Justice Department for prosecution. And there is no lack of coordination between the IRS and DOJ in other contexts, such as foreign bank account reporting penalty collection or prosecution referrals, where the IRS first considers the taxpayer's liability despite unambiguously having no assessment authority.

My fifth and final reason is just that which ostensibly sunk the boat for Mr. Farhy — his purported "concession" that "Justice Department wouldn't touch [a $10,000 penalty prosecution] with a ten-foot pole." As Les notes, the DOJ's policy is merely a sound exercise of administrative discretion that can be modified as appropriate. In fact, the IRS itself may well have similar policies in determining whether to exercise its own collection powers by filing notices of federal tax lien or issuing levies, and the DOJ declining prosecution makes no less sense. Is there not a certain value of *assessed* taxes (and penalties) that the IRS loses to section 6502 every year because collection is not administratively sound? And what happens to all those $10,000 FBAR penalties? Does the DOJ prosecute for those? What about when they stack up to more substantial figures?

If the government, which has its own law firm filled with overworked and underpaid lawyers, is unlikely to file a suit for $10,000 penalties, certainly taxpayers, who must foot the bill for market-rate legal fees,[8] can't be expected to. It is cheaper and more equitable to make the government sue for collection than to make taxpayers sue for refund, and long gone are the days when the need for immediate collection of taxes to fund war efforts created a rationale for the AIA.[9]

To be sure, the Internal Revenue Code is not a code of equity, but it is a carefully drafted code that expressly contains no authority for assessment of chapter 61 penalties. The D.C. Circuit should not have substituted its judgment of what makes for efficient tax administration for the sound judgment of Congress. If the D.C. Circuit does not reconsider this case en banc, the Tax Court should hold firm in its interpretation on remand, and the Eighth Circuit should follow suit if *Mukhi*[10] is appealed.

I have other issues with the D.C. Circuit opinion, such as its disregard for the canons of statutory construction, but the IRS does keep me quite busy, so I will leave those for other commentators to address.

Much obliged to Victor for contributions to my thoughts here and to Les for indulging me in publication.

FOOTNOTES

[1] Procedure & Administration is a great place to work, by the way, and it would probably suit any fan of Procedurally Taxing.

[2] *Farhy v. Commissioner*, No. 23-1179 (D.C. Cir. 2024).

[3] We've easily handled over $100,000,000 in chapter 61 penalties.

[4] The "real" final notice of intent to levy, typically LT11 or Letter 1058, which provide a right to a hearing, not the CP504, which confusingly looks roughly the same but provides no right to a hearing.

[5] *Flora v. United States*, 362 U.S. 145 (1960).

[6] Furthermore, the subsection (c) penalty is limited to the greater of $10,000 or the income of the foreign business entity for its annual accounting period with respect to which the failure occurs. I.R.C. section 6038(c)(2). The IRS cannot determine the appropriate penalty without the information in the Form 5471.

[7] *Farhy v. Commissioner*, 160 T.C. No. 6, slip op. at 11 (2023).

[8] The attorney fees provision of section 7430 is small comfort, even in the limited cases where it is available, because the recovery allowed is significantly below market rates.

[9] As a reminder, these penalties aren't taxes. Unlike Mr. Farhy himself, the taxpayers subjected to these penalties often do not owe any taxes—they just didn't timely discover one of the IRC's numerous reporting requirements.

[10] *Mukhi v. Commissioner*, 162 T.C. No. 8 (2024).

END FOOTNOTES

DOCUMENT ATTRIBUTES

JURISDICTIONS	UNITED STATES
SUBJECT AREAS / TAX TOPICS	LITIGATION AND APPEALS PENALTIES PRACTICE AND PROCEDURE
AUTHORS	JONATHAN BLACK
TAX ANALYSTS DOCUMENT NUMBER	DOC 2024-15191