

Tax Controversy and Litigation Series – Look to Cases from 2024

APRIL 21, 2025

Pushback on Penalties — 2024 Court Decisions Challenge International Penalty Enforcement

The year 2024 brought a breadth of noteworthy and significant tax decisions impacting both individual and corporate taxpayers. In the first of a recurring series, this article discusses tax cases from 2024 that we found intriguing and relevant to taxpayers.

“ I’d like to get home and tell my wife about this. She thinks all of my cases are boring.

My Favorite Wife (1940)

In our first installment, we focus on jurisprudence from the 2024 calendar year concerning penalties imposed pursuant to section 6038(b) of the Internal Revenue Code.^[1] Section 6038(a) concerns international information return reporting and requires U.S. persons to file information returns reporting their control of any foreign business. Penalties are imposed under sections 6038(b) and 6038(c) for the failure to file such information returns. The question presented in these cases was whether the Code provided authority for the IRS’s long-standing practice of summarily assessing the penalty and commencing collection if the taxpayer fails to pay the penalty within 90 days of the date of the collection notice. The issue raises important statutory interpretation questions, because summarily assessable penalties are found under Subchapter B of chapter 68 of the Code, and international information return penalties under section 6038 are not among the many assessable penalties found under chapter 68 and are instead found under chapter 61. Accordingly, taxpayers argued that Congress did not explicitly authorize assessment of section 6038 penalties, and therefore the Internal Revenue Service (IRS) is required to ask the Department of Justice (DOJ) to reduce penalties to judgment for collection in district court actions.

This issue has been percolating since at least 2020, when it was highlighted by the Taxpayer Advocate Service. See Taxpayer Advocate Service, National Taxpayer Advocate Annual Report to Congress 124-26 (2020) (noting that in 2018, 90% of section 6038 penalties and section 6038A penalties were systemically assessed upon receipt of a late international information reporting return without any review or action from IRS personnel rather than manually).

Below we outline three notable cases decided in calendar year 2024 and highlight the conflicting rulings observed between the Tax Court and the Court of Appeals regarding this issue.

“ Father, I wish you’d try a little love and compassion instead of these harsh punishments. – That would be nice. ”

The Spongebob Squarepants Movie (2004)

CASE 1: FARHY V. COMM’R OF INTERNAL REVENUE, 100 F.4TH 223 (D.C. CIR. 2024)

In *Farhy*, the taxpayer, a U.S. permanent resident, failed to disclose his ownership of Belizean corporations to the IRS in violation of section 6038(a).

While Section 6038(a) requires U.S. persons to file information returns regarding their control of any foreign business, Section 6038(b) imposes monetary penalties—typically \$10,000 per violation—on any U.S. person who fails to furnish the information required under section 6038(a) in a timely manner; specifically, forms such as Form 5471, reporting information about certain foreign corporations. Although Farhy acknowledged his violation, Farhy challenged the IRS’s authority to assess and collect these penalties directly, without first going through judicial processes, arguing that the IRS lacked statutory authority to assess and administratively collect section 6038(b) penalties. Farhy contended that the IRS was required to collect liabilities under section 6038(b) through a civil action under 28 U.S.C. § 6038(b) brought in federal district court.

The Tax Court agreed with petitioner Farhy, ruling in its April 2023 decision that the IRS lacked express statutory authority to assess and administratively collect penalties under section 6038(b). The decision was a major departure from longstanding IRS practice, which had routinely assessed these penalties administratively. The court reasoned that while Congress had authorized assessment for penalties under sections 6671 through 6725, no such express authorization existed for penalties under section 6038(b).

On appeal, the U.S. Court of Appeals for the District of Columbia Circuit (D.C. Circuit) reversed the Tax Court’s prior decision and held that Congress intended for these penalties to be assessable.

The court delved into the legislative history of section 6038 and concluded that the “text, structure, and function of Section 6038 demonstrate that Congress authorized assessment of penalties imposed under [section 6038(b)].” The court highlighted that Congress aimed to streamline the enforcement of international information reporting penalties, making the process more efficient and effective. The court reasoned that requiring the government to sue taxpayers to collect the penalties would be impractical and contrary to Congress’s intent to streamline penalty enforcement. The court reasoned that it would be “highly anomalous” for Congress to create a penalty that is simpler to calculate but much harder to enforce. This would be counterproductive and contrary to the legislative intent to address the underuse of penalties under section 6038(c).

Accordingly, the court ultimately concluded that Congress has the authority to make a penalty assessable by implication, and it exercised that authority in this instance.

“ Guards! Throw them in the dungeon for 300 years. ”

Rudolph the Red-Nosed Reindeer and the Island of Misfit Toys (2001)

CASE 2: MUKHI V. COMMISSIONER, 162 TC NO. 8 (2024)

In November 2024, the Tax Court in *Mukhi v. Commissioner* upheld its position that the IRS lacks authority to assess section 6038(b)(1) penalties. The Tax Court’s decision in *Mukhi* reaffirmed the decision of the Tax Court in *Farhy v. Commissioner* and rejected the reasoning of the D.C. Circuit, which had reversed *Farhy* on appeal.

The facts in *Mukhi* were similar to those in *Farhy* and centered about the IRS assessing section 6038(b) penalties against a taxpayer who failed to file Forms 5471 for three foreign entities. The IRS assessed \$120,000 in penalties under § 6038(b)(1) for this failure and initiated collection actions via lien and levy. Mukhi challenged these actions, leading to a series of decisions by the Tax Court.

On April 8, 2024, the Tax Court ruled in favor of Mukhi, holding that the IRS lacked statutory authority to assess penalties under § 6038(b)(1) and relying nearly entirely on its previous decision in *Farhy*. The court emphasized that, unlike other penalties explicitly designated as assessable, section 6038(b)(1) does not provide such authority, and accordingly, the IRS must pursue these penalties through civil litigation rather than administrative assessment.

Following the April 2024 decision, the IRS filed a motion for reconsideration in light of the D.C. Circuit decision in *Farhy*, asking the Tax Court to reconsider its decision from the prior Tax Court decision. Nevertheless, on November 18, 2024, the Tax Court reaffirmed its earlier decision in *Mukhi*, holding that the IRS did not have statutory authority to assess penalties under section 6038(b). Citing the *Golsen* rule, the Tax Court reasoned that it was not bound to follow the D.C. Circuit's decision since an appeal would be heard by the 8th Circuit (as opposed to the D.C. Circuit), and that it was therefore not bound by the precedent set by the *Farhy* decision.

Furthermore, the court compared section 6038 with other provisions of the Code that expressly authorize the IRS to assess penalties for violations. In its decision, the Tax Court relied on the plain text of section 6038(b)(1) and rejected the IRS's argument that the IRS has authority to assess discussed penalties under section 6201(a), which provides that the IRS has authority to assess "all taxes (including interest, additional amounts, additions to the tax, and assessable penalties)." The court found that section 6038(b)(1) lacks explicit language granting the IRS authority to assess penalties, unlike other sections where such authority is clearly stated. The court saw no evidence that Congress intended for section 6038(b)(1) penalties to be assessable administratively, and arguments regarding administrative efficiency or consistency were deemed insufficient to override the lack of statutory authority.

While *Farhy* was the first to shake the foundation by holding that the IRS lacked assessment authority under that section, the *Mukhi* case extended this reasoning even after the D.C. Circuit reversed *Farhy* on appeal. By refusing to adopt the appellate reversal and instead sticking to its original interpretation, the Tax Court in *Mukhi* created a split in authority and elevated the issue for possible resolution by higher courts.

“ You do that, you go to the box, you know. Two minutes by yourself, and you feel shame, you know. And then you get free. ”

Slap Shot (1977)

CASE 3: SAFDIEH V. COMMISSIONER, NO. 11680-20L (TC DEC. 5, 2024)

In *Safdieh v. Commissioner*, the Tax Court once again found that the IRS did not have statutory authority to assess penalties under section 6038(b), granting summary judgment against the Commissioner. The ruling in *Safdieh* aligned with the Court's earlier decisions in *Farhy* and *Mukhi*, emphasizing that such penalties require judicial action rather than administrative assessment.

Petitioner Safdieh faced penalties for not filing Forms 5471, leading the IRS to issue a notice of federal tax lien to collect penalties. Acknowledging that the basic facts underlying *Farhy*, *Mukhi* and the underlying cases “do not differ,” the Court entered a decision in petitioner's favor, holding once again that the IRS lacks the ability to assess penalties under section 6038. The court echoed its decision from the *Mukhi* case—noting a decision to “continue our disagreement with the D.C. Circuit in cases appealable to other circuits” and its position that “we still think we're right in our interpretation of section 6038.”

This decision underscores a growing judicial consensus outside the jurisdiction of the D.C. Circuit that the IRS's authority to assess certain international information return penalties may be limited.

CONCLUSION

The *Safdieh* case was appealed to the Second Circuit on February 28; *Mukhi* is appealable to the Eighth Circuit; and the *Farhy* decision was a D.C. Circuit Court decision. The conflicting results observed between the Tax Court and the Court of Appeals suggest the possibility of a circuit split, and consideration by the Supreme Court of the United States. Until the issue is decided more conclusively, taxpayers should continue to monitor future developments regarding the IRS's authority to assess penalties under section 6038(b).

[1] All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the regulations promulgated thereunder, unless otherwise indicated.

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