

Tax Court Rejects Constitutional Challenges to International Information Return Penalties

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In [*Mukhi v. Commissioner of Internal Revenue*](#), a collection due process case, the U.S. Tax Court considered multiple constitutional challenges to civil penalties for failing to file Forms 5471, 3520, and 3520-A. The Tax Court rejected the taxpayer's constitutional arguments but concluded that [*Farhy v. Commissioner of Internal Revenue*](#) prevented the Internal Revenue Service from automatically assessing the Form 5471 penalties, reiterating its prior position in *Farhy*.

In *Mukhi*, the taxpayer established a foreign corporation and two foreign trusts. The foreign entities held foreign brokerage accounts. Over the course of multiple tax years, the taxpayer transferred over \$9 million to the foreign entities. The taxpayer was indicted for filing false tax returns and FBARs (foreign bank and financial accounts) and pleaded guilty to two charges. The IRS then initiated a civil audit and assessed multiple international information return penalties: (i) an I.R.C. § 6038(b) penalty of \$120,000 for failing to report ownership of the foreign corporation; (ii) an I.R.C. § 6677 penalty of \$5,072,449 for failing to file Forms 3520 to report transfers made and distributions received from the foreign trust; and (iii) an I.R.C. § 6677 penalty of \$5,920,419 for failing to file Forms 3520-A to disclose his interest in the foreign trust.

The taxpayer filed a protest with the IRS's Independent Office of Appeals (Appeals), requesting a post-assessment appeals conference. Appeals concluded there was no basis for abating the international information return penalties in the post-assessment conference. While the post-assessment conference was pending, the IRS began collection of the international information return penalties. The taxpayer timely filed Forms 12153, Request for Collection Due Process (CDP) Hearing, contesting the underlying liabilities and requesting collection alternatives. The Settlement Officer referred the issue of the underlying liability to the International Operations specialist who previously considered the issue in the post-assessment conference. The settlement officer agreed with International Operations that there was no basis for abating the international information return penalties. The settlement officer then considered an installment agreement and two offers in

compromise proposed by the taxpayer but rejected these proposed collection alternatives and issued a notice of determination.

The taxpayer then filed a petition in the Tax Court, claiming (i) the notice of determination was invalid because the IRS failed to include two attachments cited in the notice; (ii) the settlement officer violated the taxpayer's Fifth Amendment due process rights by consulting with the Appeals Officer in International Operations about the underlying liability; (iii) the settlement officer erred in determining that the taxpayer was liable for the penalties and rejecting his proposed collection alternatives; and (iv) the international information return penalties violated the Eighth Amendment's excessive fines clause.

The Tax Court rejected the taxpayer's first argument that the notice of determination was invalid. According to the court, a notice of determination will not be invalidated when the technical error does not prejudice or mislead the taxpayer. The Tax Court upheld the notice of determination on multiple grounds, finding that the notice of determination (i) related to international information return penalties; (ii) identified the years at issue and the IRS's proposed collection actions; and (iii) sustained the IRS's proposed collection actions. The fact that the taxpayer was able to file a timely Tax Court petition demonstrated, moreover, that the taxpayer was not prejudiced by the IRS's failure to include the attachments. Therefore, the Tax Court concluded it had jurisdiction to consider the IRS's determination.

Second, the taxpayer argued the settlement officer violated the taxpayer's Fifth Amendment due process rights by consulting with the Appeals Officer in International Operations about the underlying liability. The Tax Court noted that due process does not require the IRS to conduct a hearing prior to taking collection actions so long as the taxpayer has an opportunity for judicial review of those actions. Congress created the pre-collection rights in I.R.C. §§ 6320 and 6330. Therefore, the relevant inquiry was whether the IRS complied with I.R.C. §§ 6320(b)(3) and 6330(b)(3), which require CDP hearings to be conducted by employees who have no prior involvement in the taxpayer's case. Because the settlement officer had no prior involvement in the taxpayer's case and made the final determination in the case, the court found there was no violation of sections 6320 and 6330. According to the court, the settlement officer's limited involvement in the CDP hearing did not cause him to become the "de facto Appeals Officer." Therefore, I.R.C. §6330(b)(3) did not apply to him. There also was no evidence that the settlement officer's limited involvement prevented him from being impartial. On these grounds, the Tax Court concluded the IRS did not violate the taxpayer's due process rights under the Fifth Amendment or his pre-collection rights under I.R.C. §§ 6320(b)(3) and 6330(b)(3).

Third, the Tax Court considered whether the settlement officer abused his discretion in rejecting the taxpayer's two offers in compromise. According to the Tax Court, the IRS has discretion to reject offers in compromise that are below the taxpayer's reasonable collection potential (RCP). Here, the settlement officer reviewed the taxpayer's financial information and determined that the two proposed offers in compromise were less than half of the taxpayer's RCP. Although the settlement officer provided the taxpayer with an opportunity to submit a revised offer in compromise or additional financial information, the taxpayer declined to do so. The Tax Court concluded the IRS did not abuse its discretion in rejecting the two offers in compromise.

Finally, the Tax Court considered the taxpayer's argument that the international information return penalties violated the Eighth Amendment's excessive fines clause. With respect to the Form 5471 penalties under I.R.C. § 6038, the Tax Court reasoned it was unnecessary to reach the constitutional issue because it had already concluded in *Farhy* that the IRS did not have authority to automatically

assess the Form 5471 penalties. Although the IRS urged the Tax Court to overturn *Farhy*, the court declined to do so despite acknowledging that *Farhy* was on appeal in the D.C. Circuit. Because *Mukhi* was appealable to the Eighth Circuit, the D.C. Circuit's ruling would not be binding and the Tax Court's own precedent in *Farhy* applied.

With respect to the Form 3520 and Form 3520-A penalties under I.R.C. § 6677, the Tax Court rejected the taxpayer's Eighth Amendment argument on two grounds: (i) the I.R.C. § 6677 penalties were not "fines" for purposes of the Eighth Amendment because they were enacted to encourage voluntary compliance, not to punish taxpayers; and (ii) even if they were fines, the I.R.C. § 6677 penalties were not so disproportionate to the harm suffered by the government to cause the excessive fines clause to apply.

Conclusion

Mukhi demonstrates that the Tax Court may continue to apply *Farhy* to Form 5471 penalty cases arising in circuits where the case has not been addressed on appeal. It remains to be seen whether the Eighth Circuit will uphold the Tax Court's decision in *Farhy* and whether other courts will apply the decision to different international information return penalties. The case also demonstrates that taxpayers are unlikely to prevail on constitutional challenges to the international information return penalties.

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