IRS Insights

A closer look

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Court Holds that IRS has Authority to Assess Penalties for Late-filed Form 3520

In a recent decision[1], the U.S. District Court for the Northern District of California upheld the IRS's ability to assess penalties under section 6039F without having to first go to court.

Background

In *Zhang v. IRS*, the taxpayer, a Chinese citizen and U.S. tax resident, received $287,109 in wedding gifts from her family in China during 2017. The taxpayer failed to file Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, until 2018, when she first learned of the filing requirement. The IRS assessed penalties under section 6039F.

[1] *Zhang v. Internal Revenue Service et al.*, No. 24-cv-8210, 2026 WL 1210079 (N.D. Cal. May 4, 2026).

The taxpayer's request for reasonable cause abatement was rejected by the IRS, so the taxpayer paid the penalty and filed a refund suit. The taxpayer argued that the IRS does not have authority to assess this penalty without filing a civil suit, because section 6039F is not explicitly identified as an "assessable penalty."[2]

Court Decision

The Court rejected the taxpayer's argument, and determined that the language of section 6039F plainly gives the IRS assessment authority. Because the penalty must be paid "upon notice and demand by the Secretary and in the same manner as tax," this language references the standard procedure that accompanies an IRS assessment.

Further, the Court found that the penalty imposed was remedial, and not a "fine" that implicates the Excessive Fines Clause under the Eighth Amendment. The Court allowed the taxpayer's claim to go forward for reasonable cause relief, and it left open the question of whether there was an alleged failure by the IRS to get the required managerial approval for the penalty to move forward.

Conclusion

The Court's decision supports the IRS's broad ability to assess penalties on late international information returns. Taxpayers who miss an international information return filing deadline (such as for the Form 3520) must exercise caution when contesting penalties and confirm that they submit a strong reasonable cause statement that outlines the facts to support penalty relief.

Fast Track Settlement Statements are Likely Protected from Use as Evidence in Federal Court, IRS Attorney Says in Email Advice.

In recently published email advice[3], the IRS Chief Counsel attorney concluded that taxpayers are likely barred from using statements made by IRS employees during a Fast Track Settlement ("FTS") against the IRS in litigation. Based on the IRS attorney's reasoning, the IRS may also be barred from using statements made by the taxpayer as evidence.

Fast Track

In FTS, an IRS Appeals Officer mediates disputes between the taxpayer and IRS Exam team. It is a voluntary alternative dispute resolution program available to taxpayers before they move on to IRS Appeals and potentially litigation. In 2025, the IRS sought to increase Fast Track participation by expanding eligibility. Under the new procedures, the IRS needs a first-line executive's approval to deny a taxpayer's FTS request and taxpayers can now go to FTS on an issue-by-issue basis (previously, if the taxpayer had an ineligible issue, it could not go to FTS even for the eligible issues).

An IRS official recently announced that the new policies are proving effective and FTS participation has grown by 35%[4].

Statements Made During FTS

An IRS attorney recently provided informal internal guidance on whether taxpayers could use IRS employee's statements during FTS against the IRS in litigation. Considering the federal law and federal rules of evidence, the guidance concludes that taxpayers are unlikely to use such statements in litigation.

In the email, the IRS attorney first considers 5 USC § 574, a federal statute that establishes confidentiality rules for dispute resolution proceedings involving the US government. The revenue procedure that established FTS specifically provides that this confidentiality statute applies to FTS[5]. Based on that and the language of 5 USC § 574, the IRS attorney concludes that statements made in FTS are barred from use in litigation.

[2] This argument is similar to the argument on which taxpayer initially prevailed in Tax Court, but then later overruled in *Farhy v. Comm'r,* 100 F.4th 223 (D.C. Cir. 2024), reversing 160 T.C. 399 (2023), in which the D.C. Circuit held that a similar foreign-reporting penalty was assessable by implication.

[3] CCA 202625021

[4] *IRS Fast Track Dispute Settlement Program Usage Surging*, BLOOMBERG 25 June 2026

[5] Rev. Proc. 2003-40, Section 5.10.

The IRS attorney also noted that Federal Rule of Evidence ("FRE") 408 could apply. FRE 408 is an evidence rule for federal court that prohibits the use of evidence of conduct or statements made during compromise negotiations. Whether FRE 408 applies depends on whether compromise negotiations have begun. In one case, the Tax Court found that the mere fact the issue was with the Independent Office of Appeals does not automatically protect the communication under FRE 408[6]. Based on that, the IRS attorney concluded that a fact intensive inquiry is required to determine if statements made during FTS were subject to FRE 408.

For taxpayers, the guidance supports the view that FTS may offer a protected forum to test positions and explore resolution without necessarily creating admissions for future litigation. Taxpayers should still prepare FTS submissions and discussions carefully, because the availability of confidentiality or evidentiary protection may depend on the facts, the nature of the communication, and the applicable legal rules.

Court Concludes That Taxpayers' Extension of the Time to File, Underestimating Their Tax Liability by More Than $100,000, is Valid Because the Estimate Was Reasonable

In *Karp v. United States*, the Court of Federal Claims held that an extension requested on Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, was valid, even though the taxpayers reported $0 estimated tax liability, because $0 was a bona fide and reasonable estimate under the facts presented.[7]

Background

The Karps ("Taxpayers") are a married couple with a history of overpaying their federal income tax liability annually and electing to apply each year's overpayment as a credit to their subsequent tax year. For 2016, Taxpayers timely filed Form 4868 in connection with their 2016 Form 1040, *U.S. Individual Income Tax Return*, estimating their 2016 tax liability to be $0 and reporting total payments and credits of $511,788, including an overpayment from 2015 applied as a credit to 2016. Taxpayers ultimately filed their 2016 income tax return on October 15, 2020, showing that their 2016 payments and credits exceeded their actual tax liability for the 2016 tax year and requesting that the resulting overpayment be applied as a credit to their tax account for the 2017 tax year. Taxpayers' 2016 income tax liability of $131,201 exceeded the $0 estimate; however, their tax liability was less than the $511,788 of payments and credits applied to their 2016 Form 1040 account.

The IRS initially denied Taxpayers' request for the 2016 overpayment to be applied as a credit to Taxpayers' 2017 Form 1040 account on the basis that Taxpayers had filed their 2016 return after the deadline for Taxpayers to file a claim for credit or refund had passed. Taxpayers filed suit in the Federal Court of Claims, seeking a refund of their 2016 overpayment. The IRS later acknowledged that Taxpayers' 2016 Form 1040, claiming a credit-elect to 2017, was filed by October 15, 2020. The IRS issued a partial refund and applied a portion of the 2016 Form 1040 overpayment to Taxpayers' 2022 Form 1040 account.

The government later offered a new rationale for disallowing Taxpayers' 2016 claim, arguing that the 2016 extension was void because Taxpayers had not properly estimated their 2016 tax liability on the Form 4868, rendering the refund claim untimely. The IRS removed the credit applied to Taxpayers' 2022 Form 1040 account and argued that Taxpayers were required to return the refund of $154,720.45, issued out of Taxpayers' 2016 Form 1040 account, to the IRS.

The Court's Analysis

The court explained that the standard for estimating tax liability is not rigid; in this case, Taxpayers were required to provide a good-faith estimate based on the information available when the extension was filed.

The court rejected the government's argument that the 2016 extension was void and concluded that Taxpayers' 2016 extension request was valid because Taxpayers provided a reasonable estimate of their tax liability, accounting for their 2015 overpayment applied as a credit to their 2016 Form 1040 account. Even though Taxpayers mistakenly estimated their net tax liability, rather than their gross tax liability, the court determined that this error was insufficient to invalidate the extension.

[6] *Kaleb J. Pierce v.* CIR, Docket No. 24786-18

[7] *Karp v. United States*, No. 1:23-cv-00926 (Fed. Cl. May 21, 2026).

The court also distinguished earlier court cases invalidating extensions, emphasizing that, in those cases, the taxpayers had not made bona fide estimates of their tax liability on Form 4868 and the government was harmed by the late payment of tax.

The court also noted that modern extension procedures include methods that do not require a taxpayer to provide any tax estimate at all, making it unreasonable to penalize Taxpayers for choosing to paper-file the Form 4868 by scrutinizing their estimate and voiding their extension due to an imprecise estimate.

Conclusion

The *Karp* opinion suggests that, when a taxpayer incorrectly estimates the taxpayer's income tax liability on Form 4868, the extension should not be invalidated, provided the taxpayer can establish that the estimate was a reasonable, bona fide estimate of the taxpayer's income tax liability.

Federal Court Vacates IRS Notice 2025-42; "5% Safe Harbor" for Wind and Solar Facilities Restored

On June 6, 2026, the U.S. District Court for the District of Columbia vacated in full and remanded Notice 2025-42 to the Internal Revenue Service (IRS) in *Oregon Environmental Council v. Internal Revenue Service*, finding it was arbitrary and capricious and violated the Administrative Procedure Act (APA).

For wind and solar facilities, Notice 2025-42 had disallowed reliance on the five percent safe harbor to satisfy the beginning of construction (BOC) requirement except for certain smaller solar facilities, effectively requiring taxpayers to rely on the physical work test in order to avoid the new early credit termination provisions under sections 45Y and 48E. Notice 2025-42 had also required taxpayers to utilize a continuous program of construction rather than continuous efforts to demonstrate satisfaction of the BOC continuity requirement if the 4-year continuity safe harbor is not met.

Court's Decision

The court held that Notice 2025-42 was arbitrary and capricious in violation of the APA, vacating it in full, and remanding the matter to the IRS for further consideration. In reaching its conclusion, the court emphasized the longstanding nature of the IRS's BOC framework. Specifically, the court noted that the Inflation Reduction Act (IRA) created two technology-neutral clean energy tax credits, the Clean Electricity Production Tax Credit (PTC) under section 45Y and the Clean Electricity Investment Tax Credit (ITC) under section 48E, available to any taxpayer developing a zero-emissions electricity-generating facility, regardless of technology type. The court highlighted that, as originally enacted, both credits were available for facilities beginning construction before the end of 2033, and the IRS confirmed through Notice 2022-61 that taxpayers could establish eligibility using either the Physical Work Test or the Five Percent Safe Harbor.

Additionally, the court stressed the fact that the One Big Beautiful Bill Act (OBBBA) amended both the section 45Y PTC and the section 48E ITC by shortening the window in which some wind and solar projects can qualify. Under the OBBBA, both credits remain available for wind and solar projects that begin construction on or before July 4, 2026. Wind and solar projects that begin construction after that date are only eligible if placed in service by December 31, 2027.

Significantly, the court further noted that for purposes of the OBBBA's rules restricting tax credit eligibility for projects receiving material assistance from certain foreign entities, Congress expressly adopted the IRS's pre-existing BOC framework, specifically referencing Notice 2013-29 and Notice 2018-59 as in effect on January 1, 2025. The court found this significant, as it demonstrates that Congress was aware of and deliberately preserved the longstanding IRS BOC rules.

In delineating its grounds for vacating Notice 2025-42, the Court held that neither the Notice, nor the administrative record provide the required reasoned explanation required to justify the significant departure from over a decade of established BOC guidance. Notably, the Notice failed to address the extensive public comments received prior to its issuance, including several narrower alternatives proposed by commenters that could have addressed the IRS's stated concerns regarding circumvention and artificial manipulation without eliminating the Five Percent Safe Harbor altogether.

In reaching its decision, the court found that while the suit fell within the purview of the Anti-Injunction Act, as codified in section 7421, an exception under *South Carolina v. Regan*, 465 U.S. 367, 372–73 (1984), was applicable to all but one of the plaintiffs. Specifically, except for one utility company, none of the plaintiffs, including organizations, consultants, and electricity purchasers, had a realistic post-enforcement route of their own. Instead, the Court held that *South Carolina v. Regan*, forbade requiring the plaintiffs to depend on third-party taxpayers to raise a challenge to Notice 2025-42.

Observation

It is unclear whether on remand the IRS could seek to issue any new BOC guidance or whether such guidance could have retroactive effect, where the government typically provides a transition period for compliance with new rules in tax guidance. Because of these uncertainties, taxpayers should consider the potential risks associated with beginning construction of a solar or wind facility for purposes of the early credit termination provisions in a manner that does not comply with Notice 2025-42 in the event of a stay, change on appeal, or new BOC guidance.

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