IRS Insights

A closer look

In this issue:

Another Circuit Holds IRS Can Automatically Assess Section 6038(b) Penalty, Overturns Tax Court

The Second Circuit recently ruled that the IRS can automatically assess the section 6038(b) penalty for failure to file an information return regarding Controlled Foreign Corporations ("CFCs").[1] The appellate court overturned the Tax Court's ruling that the IRS must file a suit in district court before it can assess the penalty. So far, the two appellate courts that have heard the issue—the D.C. and Second Circuits—have sided with the IRS.

Background

Section 6038(b) imposes a $10,000 civil penalty against any taxpayer who fails to timely file Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*. For years, the IRS has treated the section 6038(b) penalty as an automatically assessable penalty. That is, if the IRS determines that the penalty applies, it can send a notice to the taxpayer and seek to collect the penalty. For such penalties, the taxpayer does not have an opportunity to dispute the penalty in court without first paying the penalty.

Previously Tax Court Decision

In *Farhy*, the IRS automatically assessed the section 6038(b) penalty against taxpayer for failure to timely file Forms 5471 for several years.[2] The taxpayer asserted the penalties were invalid because the IRS did not have legal authority to assess section 6038(b) penalties. The Tax Court agreed with the taxpayer and held the penalties invalid. Under the court's reading, the IRS can collect section 6038(b) penalties only through civil action.[3]

The D.C. Circuit overruled the Tax Court. It held the penalty was automatically assessable based on Congressional intent as well as the text and structure of section 6038(b) and related code sections.[4]

Second Circuit Case

The *Safdieh* case involved same penalty as *Farhy*—the IRS automatically assessed the section 6038(b) penalty against the taxpayer when he failed to timely file Form 5471. Under Tax Court jurisprudence, even if an appellate court has overturned its reason, the Tax Court will continue to apply that reasoning in cases appealable to different circuits. Thus, the Tax Court applied its reasoning in *Farhy* to the *Safdieh* case even though D.C. Circuit had overturned *Farhy* and held that the IRS lacked authority to assess the section 6038(b) penalty against the taxpayer.

On appeal, the Second Circuit agreed with the D.C. Circuit and overruled the Tax Court. The circuit noted that Congress enacted section 6038(b) to make penalties easier for IRS to assess and that Congress has amended that section several times, so it had the opportunity to revise the statute if it was concerned that the IRS was assessing the penalty automatically.

Potential Implications

Here, it remains to be seen whether the Tax Court will continue to apply its *Farhy* decision to cases in other circuits despite being overruled twice. It also remains to be seen whether the Supreme Court would weigh in on an issue where there is no current split. For the time being, taxpayers in circuits other than Second and D.C. Circuits should consult with their tax advisors on a *Farhy* argument if the IRS assesses a section 6038(b) penalty for failure to file Form 5471.

Tax Court Finds Administrative Error Does Not Invalidate FPA

In a recent decision[5], the Tax Court held that an IRS notice of final partnership adjustment ("FPA") to a conservation easement partnership was valid even though the proposed notice had been addressed to the former partnership representative at the incorrect address.

Background

In *Mammoth Cave*, Mammoth challenged a FPA disallowing a charitable contribution deduction for the 2018 tax year. In March 2021, Mammoth changed its partnership representative and designated individual. Mammoth also changed its address in January 2022, which was processed by the IRS as of August 2022. In July 2022, the IRS issued a notice of proposed partnership adjustment ("NOPPA") and sent a copy to the former partnership representative at the old address. The copy was sent to the attention of the designated individual for the new partnership representative.

The IRS issued a FPA to Mammoth on January 5, 2024, using the new address. Mammoth argued that because of the errors in the NOPPA, the limitations period for making adjustments under section 6235(a) had expired and the FPA was invalid.

Tax Court Decision

The Tax Court held that the IRS mailed the FPA before the deadline ended, and it was thus valid. Judge Kerrigan agreed with the IRS that the section 6231(a) requirement that the NOPPA be sent to the partnership was met, because the IRS mailed it to the attention of the correct designated individual, even though it was addressed to the old partnership representative at the old address. The designated individual was the "sole individual" through whom the partnership representative could act on the proposed adjustments.

Judge Kerrigan found that addressing the NOPPA to the old partnership representative was a mere technical defect because the correct designated individual received a copy of the NOPPA, and Mammoth timely responded to the NOPPA by requesting an extension to file a modification. The incorrect address also did not affect the notice's validity because the partnership received it.

Since Mammoth "received adequate or minimal notice resulting in a timely filed Petition," Judge Kerrigan wrote,"[i]t has not shown that it was prejudiced by errors in the NOPPA because the audit and communications between respondent and petitioner continued without interruption."

Conclusion

The Tax Court's decision emphasizes that mere administrative or technical errors may not render an IRS notice invalid in the Bipartisan Budget Act (BBA) audit regime context, provided that the taxpayer is given sufficient notice.

TIGTA Provides Feedback on IRS Partnership Compliance Initiatives

In the report "*The IRS Has Yet to Develop a Successful Strategy for Examining Large Partnership Returns*", the Treasury Inspector General for Tax Administration ("TIGTA") evaluated the IRS's partnership compliance activities.[6] Specifically, TIGTA reviewed the IRS's soft letter campaign regarding balance sheet discrepancies and its initiative to audit the largest partnerships.

Soft Letter Campaign

The TIGTA report evaluated the IRS's use of soft letters for compliance issues; a "soft letter" alerts a taxpayer to a potential issue with their return and potential noncompliance.

In October 2023, IRS sent soft letters to 483 partners whose balance sheets appeared to contain a discrepancy. Of those letters, 163 partnerships did not respond. Of the partnerships that responded, the IRS accepted responses for 138 and rejected responses for inadequate documentation for 182.

In April 2024, IRS officials decided not to conduct examinations related to the soft letter campaign, in part because the statute of limitation was closing for the 2021 tax year.

TIGTA found that the IRS review of the responses from the soft letter had redundancies (that is, two revenue agents reviewed each response to see if both agreed if responses should be accepted or rejected) and that consumed valuable examination time. TIGTA recommended that the IRS ensure future projects eliminate duplicative steps and that it consider the relevant statute of limitations to allow compliance actions to occur.

Large Partnership Examinations

The other initiative TIGTA focused on was the IRS's examination efforts for the 82 "largest" US partnerships. Of those 82 audits, 43 were still under audit at the end of 2025. Of the 36 that were closed, TIGTA reported that 92 percent were no-change determinations. The remaining 3 returns have not yet been assigned to a reviewer.

TIGTA reviewed the IRS's procedures for selecting returns. The IRS used AI models that were programmed after Subject Matter Experts identified high-risk domestic and international business transactions. TIGTA noted that the IRS ran the passthrough case selection model only once during the year so most of the returns selected had a December year-end. Whereas the corporate case selection model is run multiple times a year to capture taxpayers with fiscal year ends. TIGTA recommended the IRS develop procedures to ensure that all large partnership returns filed throughout the year are considered for risk assessment.

Conclusion

The TIGTA report confirms that the IRS is still actively focusing on partnership compliance, although the IRS is adjusting its compliance efforts in response to various factors.

Tax Court Applies Economic Substance Doctrine to Disallow Partnership Basis Adjustment

In a recent decision,[7] the Tax Court disallowed approximately $714M of a claimed section 743(b) basis deduction, finding in part that the underlying restructuring transactions lacked economic substance under the Ninth Circuit's common law doctrine. The Court, however, rejected all asserted penalties on reasonable cause grounds.

Background

Otay Project LP ("OPLP") was a California limited partnership that developed a master planned residential community in San Diego County. OPLP used the completed contract method of accounting under section 460 to defer gain on land sales requiring future infrastructure construction. Two brothers, who co-owned the partnership, on the advice of outside tax counsel, undertook a series of restructuring and estate planning transactions that triggered a technical termination under former section 708(b)(1)(B) and generated a section 743(b) basis adjustment exceeding $867M. When OPLP liquidated in 2012, it recognized its deferred income but claimed a corresponding basis deduction of approximately $744M to offset the gain. The IRS disallowed $714M of the deduction and asserted accuracy-related penalties, including a gross valuation misstatement penalty.

Tax Court Decision

Applying the Ninth Circuit's common-law economic substance doctrine[8], the Tax Court found the restructuring transactions lacked both objective economic substance and subjective business purpose.

On the objective inquiry, the Court found that the partnership had retained all ongoing construction obligations while transferring out cash-generating assets funded circular related-party cash flows in a series of complex transactions entirely contrived by outside tax advisers. The Court credited the IRS's expert witness who concluded that pre-tax profit expectations, risk allocations, and liability exposures were substantively unchanged by the restructuring.

On the subjective inquiry, the Court found the transactions were inconsistent with the brothers' original objective of dividing jointly held property under an arbitration order. The intermediary structures, a general partner substitution, and related-party note swaps were layered on at the recommendation of tax advisors. The Court also noted that joint construction and public bond obligations remained within the partnership after the restructuring, undercutting claims that the transactions were intended to separate business operations.

The Court nevertheless rejected all penalties, finding that the taxpayer's reliance on detailed opinions from three separate firms established reasonable cause under section 6664(c). Because the transactions predated section 7701(o), the strict-liability penalty under section 6662(i) which does not permit a reasonable cause defense, was not at issue.

Conclusion

Otay Project LP addresses the application of the economic substance doctrine to partnership restructuring transactions generating large basis adjustments. Although the Court applied the common-law economic substance doctrine rather than section 7701(o), the factual characteristics identified by the Court may be relevant to the type of threshold relevancy inquiry contemplated in *Patel v. Commissioner,* 165 T.C. No. 10 (2025). The decision warrants review by practitioners advising on partnership transactions involving significant basis adjustments.

Tax Court Cautions: Rejection of IRS Appeals Conference Precludes Subsequent Liability Challenges

In *Diversified Group Inc. v. Commissioner*,[9] consistent with its prior decisions, the Tax Court held that a taxpayer who has declined an offer to meet with IRS Appeals is barred from challenging the underlying liability in a subsequent Collection Due Process ("CDP") hearing.

Background

In 2002, the Internal Revenue Service ("IRS") informed Diversified Group, Inc ("Diversified") and its owner (collectively, "Taxpayers") that it was examining Diversified for potential penalties pursuant to sections 6707 and 6708. The IRS examination continued for over 11 years. At the conclusion of the examination, the IRS determined that Taxpayers had arranged for their clients to participate in certain transactions that should have been registered with the IRS, and the IRS later assessed significant penalties against them for failing to do so.

During and after the examination, the IRS afforded Taxpayers multiple opportunities to challenge the penalty assessments through the IRS Appeals process, but Taxpayers refused and instead only contested the penalties later during the IRS's collection efforts. The IRS said that Taxpayers could not use the subsequent CDP hearing as an opportunity to dispute the penalties because Taxpayers had already been given earlier opportunities to do so. Taxpayers petitioned the Tax Court for review..

Tax Court Decision

Under section 6330(c)(2)(B), taxpayers may challenge their underlying tax liability for any tax period if the taxpayer did not otherwise have an opportunity to dispute such tax liability. In this case, the Tax Court agreed with the IRS that the offers to conference with IRS Appeals were opportunities for Taxpayers to dispute their penalty liabilities within the meaning of section 6330(c)(2)(B) and that, because of that prior opportunity, Taxpayers were precluded from challenging their liability in a subsequent CDP hearing and before the Tax Court.

The Tax Court remarked that, on multiple occasions, it has held that "an offer of a conference with Appeals is sufficient to preclude subsequent collection review consideration."

Conclusion

The Tax Court's decision in *Diversified* is a reminder to taxpayers that rejecting the opportunity to conference with IRS Appeals may preclude taxpayers from raising liability challenges at a subsequent CDP hearing. Taxpayers seeking to challenge an IRS determination may want to seek the assistance of a tax professional to advise.

Endnotes

1. *Safdieh v. Commissioner*, 2026 U.S. App. LEXIS 5796 (D.C. Circ. Feb 27, 2026).
2. *Farhy v. Commissioner*, 160 T.C. No. 6 (April 23, 2023).
3. *See* 28 U.S.C. § 2461(a) ("Whenever a civil fine, penalty or pecuniary forfeiture is prescribed for the violation of an Act of Congress without specifying the mode of recovery or enforcement thereof, it may be recovered in a civil action.").
4. *Farhy v. Comm'r of IRS*, 100 F.4th 223, 230 (2024).
5. *Mammoth Cave Property LLC v. Commissioner*, No. 5401-24, 166 T.C. No. 4 (filed March 9, 2026).
6. Treasury Inspector General for Tax Administration, *The IRS Has Yet to Develop a Successful Strategy for Examining Large Partnership Returns*, Report Number 2026-308-011 (March 18, 2026).
7. *Otay Project LP v. Commissioner*, T.C. Memo. 2026-21 (Feb.23, 2026).
8. The transaction at issue occurred before 2010 and therefore the codified economic substance did not apply to this case.
9. *Diversified Group Inc. v. Commissioner*, 166 T.C. No. 2 (2026).

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