Recent Foreign Trust Case Establishes Penalty Limits for Form 3520 and Form 3520-A Violations

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I. Introduction

The IRS is conducting a long list of international enforcement "campaigns," one of which focuses on non-compliance by U.S. taxpayers with respect to foreign trusts. As one would expect, penalties for violations can be quite large. What might be surprising, though, is that the IRS sometimes imposes multiple penalties, against the same taxpayer, with respect to the same foreign trust, for the same year, in connection with the same event. This is precisely what occurred in a recent case, *Wilson*, where the IRS attempted to sanction the taxpayer, as both the owner and sole beneficiary of an unreported foreign trust.[1] This article identifies the main duties related to foreign trusts, analyzes the recent case, and describes interesting, yet unaddressed, issues triggered by the case.

II. Overview of Applicable Rules, Forms, and Consequences

To appreciate the significance of *Wilson*, one must first have some background on the applicable rules.

A. Form 3520 and Form 3520-A Filing Requirements

Taxpayers must file Form 3520 (*Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*) and/or Form 3520-A (*Annual Information Return of Foreign Trust with a U.S. Owner*) in certain situations. A summary of the relevant terms and requirements is set forth below.

1. Duties of Responsible Parties

A "responsible party" generally must file a Form 3520 within 90 days of certain "reportable events."[2] For these purposes, the term "responsible party" means (i)

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the grantor, in cases involving the creation of an *inter vivos* trust, (ii) the transferor, where there is a reportable event, other than a transfer upon death, and (iii) the executor of a decedent's estate.[3] Moreover, the term "reportable event" includes the creation of any foreign trust by a U.S. person, the transfer of any money or other property (directly, indirectly or constructively) to a foreign trust by a U.S. person, and the death of a U.S. person, if such person was treated as the "owner" of any portion of the foreign trust under the grantor trust rules or any portion was included in the person's gross estate.[4]

2. Duties of Owners

If a U.S. person is treated as the "owner" of any portion of a foreign trust under the grantor trust rules at any time during a year, then, under the law in effect since March 2010, the person (i) "shall submit" such information as the IRS prescribes with respect to the trust, and (ii) "shall be responsible to ensure" that the trust files Form 3520-A and furnishes the information required by the IRS to each U.S. person who is treated as the owner of any portion of the trust, or who receives (directly, indirectly, or constructively) any distribution from the trust.[5]

3. Duties of Beneficiaries

A U.S. person ordinarily must file a Form 3520 if such person receives during the year any distribution from a foreign trust.[6] The IRS has issued guidance amplifying the concept of "distribution," as follows[7]:

> Generally, a U.S. person who receives a distribution, directly or indirectly, from a foreign trust … is required to report on Form 3520 the name of the trust, the aggregate amount of distributions received from the trust during the taxable year, and such other information as the [IRS] may prescribe …. Except as otherwise provided below, a distribution from a foreign trust includes any gratuitous transfer of money or property from a foreign trust, whether or not the trust is owned by another person. A distribution from a foreign trust includes the receipt of trust corpus and the receipt of a gift or bequest …. In addition, a distribution is reportable if it is either actually or constructively received.[8]

B. Additional Disclosure Duties on Tax Returns

In addition to the mandate to file Forms 3520 and/or Forms 3520-A, taxpayers have disclosure obligations on their income tax returns. For instance, in the case of individuals, Part III (Foreign Accounts and Trusts) to Schedule B (Interest and Ordinary Dividends) of Form 1040 (*U.S. Individual Income Tax Return*) presents the following question and warning about foreign trusts:

> During [the relevant year], did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back.[9]

The IRS's Instructions to Schedule B expand on the foreign trust concept, providing the following guidance:

> If you received a distribution from a foreign trust, you must provide additional information. For this purpose, a loan of cash or marketable securities generally is considered to be a distribution. See Form 3520 for details. If you were the grantor of, or transferor to, a foreign trust that existed during [the relevant year], you may have to file Form 3520 …. If you were treated as the owner of a foreign trust under the grantor trust rules, you are also responsible for ensuring that the foreign trust files Form 3520-A ….[10]

C. Penalty Issues

The penalty for not filing a timely, complete, accurate Form 3520 is $10,000 or 35 percent of the so-called "gross reportable amount," whichever is larger.[11]

If the violation involves Form 3520-A (pertaining to owners of foreign trusts) instead of Form 3520 (pertaining to responsible parties and beneficiaries), then the penalty is reduced from 35 percent to five percent.[12] To be precise, the relevant provision indicates that the IRS shall apply the general penalty after "substituting" five percent for 35 percent.[13]

Taxpayers might also be hit with a so-called "continuation penalty," if they fail to submit to the IRS the necessary Forms 3520 and/or Forms 3520-A, after the IRS notifies them of the infraction. Specifically, if taxpayers refuse to become compliant within 90 days of notice, then the IRS will assess an additional penalty of $10,000 per month.[14] This continuation penalty is limited, though. The relevant provision calls for the following cap:

> At such time as the gross reportable amount with respect to any failure can be determined by the [IRS],

any subsequent penalty … with respect to such failure shall be reduced as necessary to assure that the aggregate amount of such penalties do not exceed the gross reportable amount (and to the extent that such aggregate amount already exceeds the gross reportable amount the [IRS] shall refund such excess to the taxpayer).[15]

The preceding makes it apparent that, in determining the proper penalty amount, the key is calculating the "gross reportable amount." Consistent with the notion that all things tax are ultra-complicated, whether they need to be or not, this term has three different meanings. First, in the case of a violation by a "responsible party" to file a Form 3520 under Code Sec. 6048(a), it means "the gross value of the property involved in the [reportable] event (determined as of the date of the [reportable] event)."[16] Second, in instances when an owner does not file a Form 3520-A under Code Sec. 6048(b), it means "the gross value of the portion of the trust's assets at the close of the year treated as owned" by the U.S. person.[17] Lastly, where a U.S. beneficiary overlooks Form 3520 under Code Sec. 6048(c), it means "the gross amount of the distributions."[18] As explained later in this article, these disparate definitions can be pivotal in a tax dispute.

The IRS will not assert Form 3520 or Form 3520-A penalties where there is "reasonable cause" for the violation and it was not due to "willful neglect."[19] Because the IRS has never issued regulations explaining the significance of "reasonable cause" for purposes of Form 3520 and Form 3520-A, the courts have been receptive to arguments applying the reasonable cause standards set forth elsewhere in the Internal Revenue Code and Internal Revenue Manual.[20]

Importantly, unlike the long list of penalties that are linked to tax returns (such as negligence, late-filing, late-payment, substantial understatement of tax, civil fraud, *etc*.), Form 3520 and Form 3520-A penalties are "assessable" penalties, which means that the IRS immediately imposes them and starts collection actions, and the normal deficiency procedures do not govern.[21]

III. Analysis of *Wilson*

The ultimate holding by the District Court in *Wilson* centered on a novel issue, yet it received little attention from the tax community. An analysis of this important, obscure case is set forth below.

A. Relevant Facts

The facts in *Wilson* are not entirely clear from the major pleadings filed by the parties or the decision published by the District Court, but the following constitutes a best effort.[22] The taxpayer, in anticipation of a divorce action by his spouse and the resulting need for asset protection, formed Perfect Partner Trust ("PPT") in 2003. The taxpayer constituted both the grantor and sole beneficiary. PPT was administered by a U.K. company and it held accounts in Switzerland and Liechtenstein. The taxpayer did not start out with problems; indeed, he funded PPT with approximately $9 million that had already been taxed by the IRS. The divorce proceeding began in 2004, as suspected by the taxpayer, and they concluded around 2007. With no further need for asset protection abroad, the taxpayer terminated PPT in 2007 and had all funds openly wire-transferred to his accounts with major U.S. financial institutions. The funds had grown by that time to around $9.2 million.

> *The decision in Wilson is positive for taxpayers in that it seemingly limits the IRS's ability to penalize taxpayers occupying a dual role as owner and beneficiary of a foreign trust.*

The documentation related to *Wilso*n is vague with respect to tax and information-reporting compliance by the taxpayer during the existence of PPT. For instance, the Complaint alleged that, for 2003 and 2004, "information returns pertaining to [PPT] and its assets were timely filed with the IRS," but for 2005, 2006, and 2007, "information returns were not timely filed." The Complaint further stated that "various income tax and information returns … with the IRS reported the trust assets and [the taxpayer's] earnings for it." Similarly, the taxpayer filed a Claim for Refund well before the Complaint, which argued that "[i]t is beyond dispute that the taxpayer paid all taxes due on those earnings [by PPT] well before any IRS audit." The Department of Justice ("DOJ") did not seem to challenge any of the taxpayer's positions regarding compliance, and the District Court ultimately determined the following: "From 2003-2007, [the taxpayer] filed various income tax and information returns with the IRS, reporting [PPT's] assets and the interest it accrued" and maintained "general compliance with the IRS requirements."

To be clear, *Wilson* referenced neither a Tax Court proceeding involving supposed income tax liabilities related to PPT nor an action concerning FBAR penalties for the foreign accounts held by PPT. For purposes of this article, suffice it to note that *Wilson* centered on just one issue, the proper penalty or penalties to be assessed against the taxpayer for failure to file Form 3520 and/or Form 3520-A for 2007, only, with respect to PPT.

The IRS began an audit of the taxpayer at some point and eventually assessed a penalty of $3,221,183 based on the theory that (i) the taxpayer was the "beneficiary" of PPT, (ii) he received a distribution from PPT in 2007 (*i.e.*, the wire-transfer comprised of approximately $9 million in after-tax corpus and $200,000 in after-tax accretion), (iii) as a beneficiary, he was required to file a timely, accurate, complete 2007 Form 3520 reporting the distribution under Code Sec. 6048(c), (iv) because he failed to do so, the proper penalty was 35 percent of the total distribution amount, and (v) in situations where the taxpayer is both an owner and beneficiary of a foreign trust, and the taxpayer fails to file Form 3520 and Form 3520-A, the IRS can assess one penalty for 35 percent of the gross reportable amount under Code Sec. 6048(c) and/or one for five percent under Code Sec. 6048(b).

In July 2017, the taxpayer paid the entire penalty under protest, and then filed a Form 843 (*Claim for Refund*) soon thereafter, in August 2017.

Let's take a step back to understand what happened procedurally in *Wilson*. The IRS may allow a Claim for Refund in cases where a taxpayer has overpaid.[23] The first step to recouping the cash is for the taxpayer to file a timely Claim for Refund.[24] If the IRS formally denies it (in full or in part) by issuing a Notice of Disallowance, then the taxpayer can seek immediate help from the courts by initiating a Suit for Refund.[25] The taxpayer can also file a Suit for Refund if the IRS simply fails to respond to the Claim for Refunds within six months.[26] The latter is what occurred, or perhaps did not occur, in *Wilson*. The taxpayer filed a timely Claim for Refund, and the IRS simply ignored him. Therefore, the taxpayer exercised his right to file a Suit for Refund with the District Court in March 2018. Some tedious procedural wrangling initiated by the DOJ followed, the result of which was the taxpayer filing an Amended Claim for Refund, the IRS completely ignoring it again, and the taxpayer filing another Suit for Refund with the District Court in September 2019. Notably, the taxpayer, who was already in his late 80s back when he formed PPT many years ago, died in 2019 amid the procedural squabbling. The estate assumed the battle from that point forward.

B. Main Arguments Presented by Taxpayer

The Complaint filed by the taxpayer's estate, as well as various other pleadings lodged with the District Court, reveal three main argument as to why the taxpayer was entitled to a full refund of the previously-paid penalty. First, the taxpayer was both the owner/grantor and sole beneficiary of PPT, such that the IRS only had the right to assess a penalty equal to five percent under Code Sec. 6048(b) (as the owner of PPT), not a penalty of 35 percent under Code Sec. 6048(c) (as the beneficiary of PPT). In support of this first argument, the estate emphasized, among other things, that (i) the legislative history indicates that Congress did not intend for the 35 percent penalty to apply to taxpayers with a dual owner/beneficiary role, (ii) the relevant tax provisions are ambiguous, and the rules of statutory construction state that murkiness must be interpreted in favor of the taxpayer, (iii) there is no caselaw directly on point, and (iv) IRS guidance, supplied as Instructions to Form 3520 and Form 3520-A, is consistent with the inapplicability of the 35 percent penalty.

Second, the estate argued that any penalty would be based on the "gross reportable amount," which, in the case of the failure by an owner to file a Form 3520-A under Code Sec. 6048(b), means the gross value of the portion of "*the trust's assets at the close of the year*" treated as being owned by the U.S. person. The taxpayer completely emptied the foreign accounts held by PPT during 2007 by wiring all funds to U.S. financial institutions, such that the value of the assets held by PPT as of the key date (*i.e.*, December 31, 2007) was $0. Consequently, the penalty, even if one were to apply, would be $0.

Third, regardless of which penalty is applicable, the taxpayer should be exempt because there was "reasonable cause" for the violation in 2007 and he did not act with willful neglect. The Complaint and other filings with the District Court were remarkably scant on this point, simply stating that the taxpayer was a retired businessman in his late 80s when he formed PPT, he was unaware of the information-reporting requirements in 2007, he was never advised about such requirements, and the Internal Revenue Manual indicates that ignorance of the law equates to reasonable cause in certain circumstances.

C. Analysis by the District Court

The District Court first framed the issue as follows:

> At the outset, it is imperative to understand that a person in [the taxpayer's] situation—i.e., a sole grantor/owner and sole beneficiary of a foreign trust—would have only been required to file a *single* Form 3520 for fiscal year 2007. So the question then becomes, whether [Section 6677] permits a single person untimely filing a single IRS form to be penalized as two different people—as an owner *and* as a beneficiary.

The District Court then went on to rule in favor of the taxpayer on the following grounds. First, applying longstanding doctrines of statutory construction, the District Court determined that Code Sec. 6677 is clear on its face in that the IRS cannot penalize the owner of a foreign trust as a beneficiary. This is because Code Sec. 6677(b)(2) provides "a clear instruction" to "substitute" or "replace" the five percent penalty for the 35 percent penalty, not to select between the two, not to impose both, and not to ignore one. From the District Court's perspective, "[w]hen a foreign trust owner is required to file Form 3520, it falls under [Section 6048(b)'s] purview of 'such information as the [IRS] may prescribe with respect to' an owner of a foreign trust."

Second, even if the preceding conclusion were not "inescapably evident" from the text of Code Sec. 6677, the District Court held that ambiguous tax statutes must be interpreted strongly against the IRS and in favor of taxpayers.[27]

Third, the District Court reasoned that, if it were to accept the position advanced by the IRS, this would result in "an irreconcilable textual conflict." Code Sec. 6677 indicates that once the IRS has determined the "gross reportable amount," it must ensure that the penalties do not surpass it. The District Court acknowledged that this limit is primarily concerned with large "continuation penalties" for ongoing non-compliance after the IRS issues a penalty notice, but explained that the underlying directive appears to place a ceiling on all penalties. Consequently, concluded the District Court, "it follows that a taxpayer should not be liable for any two penalties if their combined assessment would add up to more than the gross reportable amount for any one violation." Because the "gross reportable amount" for a violation of Code Sec. 6048(b) is the gross value of the foreign trust's assets at the close of the relevant year, and because the value of PPT was $0 as of December 31, 2007, any additional penalty, such as the penalty of $3,221,183 assessed by the IRS, would exceed $0, and thus violate Code Sec. 6677.

Fourth, guidance from the IRS supports the notion that an owner of a foreign trust who receives a distribution should be treated as an owner, not a beneficiary. The District Court pointed to Part III of the IRS's Instructions to the 2007 Form 3520, which stated the following:

> If you received an amount from a portion of a foreign trust of which you are treated as the owner and you have correctly reported any information required on *Part II* and the trust has filed a Form 3520-A with the IRS, do not separately disclose distributions again in *Part III*.

The District Court explained that Part II of Form 3520 is only to be completed by the "U.S. Owner of a Foreign Trust" and Form 3520-A is the "Annual Information Return of Foreign Trust with a U.S. Owner." Thus, stated the District Court, if a foreign trust owner has received a distribution and reported it on Form 3520-A, he is not required to otherwise report it on Form 3520. Extrapolating from this, the District Court concluded that Form 3520 disregards the beneficiary status of the trust owner in favor of his owner status, at least for purposes of tracking distributions to the owner.

Finally, the District Court confirmed that the penalty amount, the "gross reportable amount," in this situation is five percent of the gross value of "the trust's assets at the close of the year." Because the value of PPT was $0 at the end of 2007, the penalty, even under the lower five percent rule, would still be $0.

The District Court described its overall holding as follows: "The IRS can therefore assess *only* the 5% penalty under [Section 6677]—not *both* or *either* the 5% and/or 35% penalty—for [the taxpayer's] untimely filing of his 2007 Form 3520."

IV. Interesting and Unaddressed Aspects

Peopled are bombarded with information these days, including tax-related data, in the form of cases, legislation, regulations, IRS pronouncements, and more. Therefore, the reality is that few will even remember *Wilson*, and if they do, the recollection will be superficial. This is regrettable because, as explained below, *Wilson* triggers a number of interesting issues that were not addressed by the parties or the District Court.

A. The Importance of Statutory Evolution and Effective Dates

At the core, the DOJ found itself in problems in *Wilson* because the taxpayer took the position that he was both the owner and the sole beneficiary of PPT, and the penalties applicable to owners supersede those pertinent to beneficiaries. Logic dictates, then, that if the taxpayer were only a beneficiary, and not also an owner, there would have been no dispute that (i) the higher penalty of 35 percent of the gross reportable amount applied to the taxpayer and (ii) such amount means the total distribution of approximately $9.2 million. Interestingly, it appears that the DOJ could have successfully made this argument with respect to a Form 3520 violation in 2007, but failed to raise it.

The provision containing the duties of owners, Code Sec. 6048(b)(1), generally provided as follows before Congress enacted the Foreign Account Tax Compliance Act ("FATCA") in March 2010:

> If, at any time during any taxable year of a United States person, such person is treated as the owner of any portion of a foreign trust under the [grantor trust rules], such person shall be responsible to ensure that (A) such trust makes a return for such year which sets forth a full and complete accounting of all trust activities and operations for the year, the name of the United States agent for such trust, and such other information as the Secretary may prescribe, and (B) such trust furnishes such information as the Secretary may prescribe to each United States person (i) who is treated as the owner of any portion of such trust or (ii) who receives (directly or indirectly) any distribution from the trust.

FATCA expanded the duties of owners of foreign trusts in critical ways starting in 2010. The revised provision is set forth below, with the new language underlined and italicized:

> If, at any time during any taxable year of a United States person, such person is treated as the owner of any portion of a foreign trust under the [grantor trust rules], such person shall submit such information as the Secretary may prescribe with respect to such trust for such year and shall be responsible to ensure that (A) such trust makes a return for such year which sets forth a full and complete accounting of all trust activities and operations for the year, the name of the United States agent for such trust, and such other information as the Secretary may prescribe, and (B) such trust furnishes such information as the Secretary may prescribe to each United States person (i) who is treated as the owner of any portion of such trust or (ii) who receives (directly or indirectly) any distribution from the trust.[28]

The legislative history makes it clear that owners did not have any legal duty to personally file a Form 3520-A until the change introduced by FATCA in 2010. It states that the amended version of Code Sec. 6048(b)(1) "requires a U.S. person that is treated as an owner of any portion of a foreign trust under [the grantor trust rules] to provide information as the [IRS] may require with respect to the trust, in addition to ensuring that the trust complies with its [own] reporting obligations."[29] Likewise, commentary by tax practitioners regarding the changes introduced by FATCA confirms that owners had no personal duty to file Forms 3520-A, and thus could not be penalized for not doing so, until 2010.

> Although Code Sec. 6048(b)(1) purports to make U.S. owners of foreign grantor trusts file Form 3520-A, the change in law seems to signal the government's realization that such U.S. owners often have neither the legal authority nor the practical ability to make the trustees cooperate. U.S. owners in this situation sometimes take the proactive step of filing Form 3520-A themselves, based on whatever information is available to them, and disclosure that the signature provided is the U.S. owner's, not the trustee's. In other instances, U.S. owners that cannot convince the trustees of the foreign grantor trusts to file Form 3520-A simply do nothing, *e.g.*, because it does not occur to them that they should, or even could, purport to act for the trusts when they clearly are not authorized to do so. Therefore, the imposition of a new reporting obligation on the

> U.S. owners themselves should enable the IRS to obtain at least some information about foreign grantor trusts with uncooperative trustees.[30]

The sole year involved in *Wilson* was 2007, Congress did not impose the new filing duty on owners of foreign trusts until 2010, and, practically speaking, the duty did not take effect until 2011.[31] Consequently, the DOJ might have argued that the taxpayer in *Wilson* was just a beneficiary, not an owner, such that the only applicable penalty was 35 percent of the distribution from PPT of around $9.2 million. The DOJ did not, and the taxpayer prevailed.

B. Not the First Time

It is interesting to note that the IRS has previously adopted a position similar to that advanced in *Wilson*. Specifically, in Chief Counsel Advice 201150029, which dealt with the issue of whether multiple penalties assessed under Code Sec. 6677 could be considered a "divisible tax" for purposes of payment and jurisdiction, the IRS advanced the notion that Code Sec. 6048 mandates "three distinct and separate reporting obligations," such that various penalties might apply to the same situation. Taxpayers had no opportunity to dispute this position, of course, because the IRS propagated it *via* an internal document, not during litigation. The relevant portion of Chief Counsel Advice 201150029 states the following:

> [S]ection 6048 imposes three distinct and separate reporting obligations on the following parties: (1) U.S. persons that create, or transact with, a foreign trust (or in the case of a decedent who is a U.S. resident or citizen treated as owning a foreign trust, the responsible party); (2) U.S. persons that are treated as owning a foreign trust (as well as the trust itself); and (3) U.S. persons that receive a distribution from a foreign trust. Section 6677 imposes a penalty for each failure to meet the requirements of section 6048. Accordingly, where there are multiple, unreported transactions during the taxable year, the U.S. person will owe a penalty for each unreported transaction. Similarly, where a U.S. person is treated as the owner of multiple foreign trusts for which no Forms 3520-A have been filed, the U.S. person will owe a penalty with respect to each foreign trust. The amount of each penalty will depend on the gross amount of the unreported transaction or the amount of the assets in the unreported trust. A penalty assessment under section 6677, therefore, can reflect an aggregate of penalties imposed for multiple failures to meet any of the reporting obligations imposed by Section 6048. Because that single assessment can in actuality be an accumulation of separable penalties specific to each failure, the penalty assessment would appear to be a "divisible tax."[32]

Interestingly, Chief Counsel Advice 201150029, which was issued the year after FATCA was enacted, supports the theory discussed in the preceding segment of this article that the DOJ might have found success in *Wilson* had it argued that the taxpayer did not have any owner-based duties in 2007. Chief Counsel Advice 201150029 stated the following in this regard: "A U.S. person treated as the owner of a foreign trust who fails to file Form 3520 when required under Section 6048(b) will be subject to a penalty for such failure only with respect to tax years beginning after March 18, 2010."[33]

C. Potential Theory for Penalty-Free Resolution

As explained earlier in this article, the materials filed in connection with *Wilson* were vague regarding tax and information-reporting compliance by the taxpayer during the existence of PPT. However, at the end of the day, the critical point is that the District Court ruled that, during all relevant years, the taxpayer "filed various income tax and information returns with the IRS, reporting the [PPT's] assets and the interest it accrued" and maintained "general compliance with the IRS requirements." In other words, it appears that the violations in *Wilson* solely related to information-reporting, not unreported or underreported income generated by PPT.

At the time that the taxpayer paid the penalty of $3,221,183 and filed the original Claim for Refund in 2017, the IRS already had in place various voluntary disclosure programs, one of which was specially designed for taxpayers whose problems are limited to information-reporting mistakes.[34] The pertinent program, which was introduced in 2014 and is still available today, is called the delinquent international information return submission procedure ("DIIRSP"). It provides that taxpayers who/that have not filed one or more international information returns can file them, on a penalty-free basis, if the taxpayers (i) previously filed U.S. tax returns each year, reporting all income, (ii) have "reasonable cause" for not timely filing the information returns, (iii) are not under a civil examination or a criminal investigation by the IRS or DOJ, and (iv) have not already been contacted by the IRS about the delinquent information returns. The guidance that the IRS issued later about the DIIRSP relaxed the eligibility criteria. In particular, Frequently Asked Question ("FAQ") #1 expressly states that the existence of unreported income in earlier years does *not* necessarily exclude a taxpayer from the DIIRSP:

> QUESTION. Are the Delinquent International Information Return Submission Procedures announced on June 18, 2014 different from the [previous] procedures?
>
> ANSWER. Yes. The IRS eliminated 2012 OVDP FAQ 18, which gave automatic penalty relief, but was only available to taxpayers who were fully tax compliant. The Delinquent International Information Return Submission Procedures clarify how taxpayers may file delinquent international information returns in cases where there was reasonable cause for the delinquency. Taxpayers who have unreported income or unpaid tax are not precluded from filing delinquent international information returns ….[35]

The taxpayer in *Wilson* did not strictly meet the eligibility criteria for the DIIRSP because he was audited by the IRS, instead of pro-actively approaching the IRS. Nevertheless, given the policy of the IRS, as reflected in the DIIRSP, of not penalizing taxpayers who only have information-return problems, and given that the IRS has broadened the DIIRSP to allow participation by taxpayers with both information-return and income tax issues, the taxpayer in *Wilson* might have strengthened his case by discussing the relevance and effect of the DIIRSP.

D. Measuring Dates Make All the Difference

How and when penalties are determined is critical, but not always predictable. As explained above, the key in the context of foreign trust violations is the "gross reportable amount," which has three distinct definitions. Where an owner does not file a Form 3520-A under Code Sec. 6048(b), it means "the gross value of the portion of the trust's assets *at the close of the year* treated as owned" by the U.S. person.[36] The District Court in *Wilson* focused on this snapshot, holding that the five percent penalty would be $0 because the value of PPT was $0 as of December 31, 2007; the taxpayer had fully domesticated all funds from the underlying foreign accounts by that time.

A similar, yet slightly more complicated issue, would have arisen if the IRS were to have asserted penalties against the taxpayer in *Wilson* for not filing a Form TD F 90-22.1 ("FBAR") for the only relevant year, 2007, to report the two foreign accounts held by PPT.

FBARs must be filed "with respect to foreign financial accounts exceeding $10,000 maintained during the previous calendar year."[37] The breadth of this requirement is evident; an FBAR must be filed if the combined value of the foreign accounts surpasses the $10,000 threshold at any time from January 1 to December 31. The rules have radically changed since 2007, but for that year, the relevant regulations explained that the deadline for filing FBARs related to the preceding calendar year was June 30.[38] For instance, if a U.S. person had a financial interest in foreign accounts during calendar year 2007, and if the value of such accounts topped $10,000 at any time during 2007, then the person had to file an FBAR by June 30, 2008.

In terms of timing, the amount of the FBAR penalty is determined by looking at the balance in the relevant account "at the time of the violation."[39] This raised a critical question back in 2007, the year relevant to *Wilson*: When did the violation occur? June 30 (the deadline for filing the FBAR)? December 31 (the last day of the calendar year)? Any day on which the balance in the account exceeded $10,000? Neither the law nor the regulations specifically address this issue, but other documents reveal the IRS's position. For example, an IRS legal memorandum stated the following:

> The decision to base the FBAR penalty on the highest balance in the account during the year was a policy decision made during the development of the FBAR mitigation guidelines. Section 5321(a)(5), however, limits the amount of the penalty to [a particular amount] or the balance of the account at the time of the violation which, for failure to report accounts, is June 30 of the succeeding year.[40]

The IRS's position on when a violation occurs is also evident from the FBAR penalty guidelines.[41] In determining the proper penalty amount, this document directs IRS personnel to the balance in the account "as of the due date for filing the FBAR."

The impact of the preceding rules could be significant. Say a U.S. person had a financial interest in 2007 in foreign accounts whose aggregate value reached $5 million at some point during the year. Further assume that the person closed the account on June 29, 2008, thereby making the balance $0 as of the filing deadline, June 30, 2008. The person did not file an FBAR. The maximum penalty would have been $100,000, or 50 percent of the balance in the account "at the time of the violation," whichever amount is larger.[42] The time for determining the penalty was the filing deadline, *i.e.*, June 30, 2008. On that date, the balance in the account was $0. Therefore, although the person violated the law, the maximum penalty that the IRS could impose would have been $100,000, *not* 50 percent of the highest balance in the account at any time during 2007 (*i.e.*, $2.5 million).

A recent FBAR case involved this issue, *Horowitz*.[43] In that case, the IRS asserted various FBAR penalties, one of which pertained to an unreported account in 2008. The taxpayers closed an account at UBS bank in November 2008 and transferred all the funds elsewhere. Accordingly, as of the filing deadline for the 2008 FBAR (*i.e.*, June 30, 2009), the balance in the UBS account was $0, and the IRS was precluded from assessing large penalties.

V. Conclusion

The decision in *Wilson* is positive for taxpayers in that it seemingly limits the IRS's ability to penalize taxpayers occupying a dual role as owner and beneficiary of a foreign trust. This defeat for the IRS will not derail it for long, though. As highlighted in the introduction of this article, the IRS is actively scouring its data now to identify foreign trust non-compliance and is attacking the likely violators as part of its international enforcement "campaign." These challenges by the IRS come in the form of audits, automatically assessed penalties upon receipt of late or incomplete Forms 3520 and Forms 3520-A, and letters to taxpayers warning them to get compliant fast because the IRS has already received data from third-parties about potential foreign trust infractions.[44] Taxpayers still have several options for resolving foreign trust problems on favorable terms, depending on the circumstances. Given the IRS's current focus in this area, taxpayers would be wise to consult tax professionals with foreign trust and tax dispute experience to analyze their situation and determine the best course of action, before the proverbial knock on the door.

ENDNOTES

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1 *Emily S. Wilson, as Executrix of the Estate of Joseph A. Wilson, and the J.A. Wilson Est.*, 124 AFTR 2d 2019-6693 (D.C. NY 2019).

2 Code Sec. 6048(a)(1).

3 Code Sec. 6048(a)(4).

4 Code Sec. 6048(a)(3)(A). The "grantor trust rules" are located in Code Secs. 671 through 679.

5 Code Sec. 6048(b)(1), after March 18, 2010; Notice 97-34, Section IV.

6 Code Sec. 6048(c)(1).

7 Congress enacted the law regarding foreign trusts in 1996 as part of the Small Business and Jobs Protection Act, P.L. 104-188. Despite the fact that more than two decades have passed, the IRS has never issued regulations. Instead, it issued Notice 97-34 in 1997, which stated the following: "Treasury and the [IRS] expect to issue regulations incorporating the guidance set forth in [Notice 97-34]. Until such regulations are issued, taxpayers must comply with the guidance set forth in [Notice 97-34]." Notice 97-34; Introduction.

8 Notice 97-34, Section V.

9 2019 Schedule B (Interest and Ordinary Dividends), Part III (Foreign Accounts and Trusts), Question 8.

10 IRS 2019 Instructions for Schedule B, pg. B-3.

11 Code Sec. 6677(a). Congress added the $10,000 minimum penalty in March 18, 2010, *via* Section 535(a) of the Hiring Incentives to Restore Employment ("HIRE") Act. It applied to Forms 3520 and Forms 3520-A required to be filed after December 31, 2009, pursuant to Section 535(b) of the HIRE Act.

12 Code Sec. 6677(b).

13 Code Sec. 6677(b)(2).

14 Code Sec. 6677(a).

15 Code Sec. 6677(a) (emphasis added).

16 Code Sec. 6677(c)(1).

17 Code Sec. 6677(c)(2).

18 Code Sec. 6677(c)(3).

19 Code Sec. 6677(d); Notice 97-34, Section VII.

20 *James*, 100 AFTR 2d 2012-5587 (Aug. 14, 2012).

21 Code Sec. 6677(e).

22 The author obtained from the District Court the following documents related to *Wilson* in preparing the article. Complaint filed September 4, 2019 (including all exhibits); Motion for Pre-Motion Conference and Motion for Partial Dismissal of Complaint by United States filed October 9, 2019; Plaintiffs' Opposition to the Government's Motion for Partial Dismissal of the Complaint filed October 21, 2019; Plaintiffs' Memorandum in Support of Their Cross-Motion for Partial Summary Judgment filed October 28, 2019; Defendant United States of America's Response in Opposition to Plaintiff's Cross-Motion for Partial Summary Judgment filed November 12, 2019; Memorandum Decision and Order filed November 18, 2019.

23 Code Sec. 6402(a).

24 Code Sec. 6511(a).

25 Code Sec. 6532(a)(1); Reg. §301.6532-1(a); Code Sec. 7422(a).

26 Code Sec. 6532(a)(1); Reg. §301.6532-1(a); Code Sec. 7422(a).

27 The District Court does not expand on this point, but there are numerous cases, going back nearly a century, which stand for the proposition that any statutory ambiguity or doubt must be resolved in favor of the taxpayer, not the IRS. *See, e.g., Merriam*, SCt, 263 US 179, 187–188 (1923) ("On behalf of the government it is urged that taxation is a practical matter and concerns itself with the substance of the thing upon which the tax is imposed rather than with the legal forms or expressions. But in statutes levying taxes the literal meaning of the words employed is most important for such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the government and in favor of the taxpayer."); *Maryland Casualty Co.*, CA-7, 49 F2d 556, 558 (1931) ("[Tax] statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the government and in favor of the taxpayer. Such acts, including provisions of limitation embodied therein, are to be construed liberally in favor of the taxpayer. There must be certainty as to the meaning and scope of language imposing any tax, and doubt in respect to its meaning is to be resolved in favor of the taxpayer.") (citations omitted); *Bryson*, CA-9, 79 F2d 397, 402 (1935) ("It is familiar doctrine

that taxing acts, including provisions of limitation embodied therein [are] to be construed liberally in favor of the taxpayer."); *Holmes Limestone Co.*, DC-OH, 946 FSupp 1310, 1319 (1996) ("These rules of construction guide this court in most situations, however, materially different rules have been adopted for the interpretation of a revenue statute. '[A]s for any statute, the starting point is the words of the statute, taking the words in their ordinary meaning in the field of interest, and giving full effect to 'every word Congress used.' [However, a]s a special rule in tax cases, 'if doubt exists as to the construction of a taxing statute, the doubt should be resolved in favor of the taxpayer.'")

[28] Language added by Section 534(a) of P.L. 111-147 (Mar. 18, 2010), the Foreign Account Tax Compliance Act, which was a subpart of the Hiring Incentives to Restore Employment Act.

[29] U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the Hiring Incentives to Restore Employment Act, under Consideration by the Senate. JCX-4-10 (Feb. 23, 2010), at 73–74 (emphasis added).

[30] CCH, 2010 Tax Legislation, Patient Protection and Affordable Care, Health Care Reconciliation, HIRE, and Other Recent Tax Acts, Law, Explanation, and Analysis, at 334.

[31] Section 534(b) of P.L. 111-147 (Mar. 18, 2010), the Foreign Account Tax Compliance Act, which was a subpart of the Hiring Incentives to Restore Employment Act. The new duty imposed on owners of foreign trusts did not take effect until taxable years beginning after March 18, 2010.

[32] Chief Counsel Advice 201150029 (emphasis added).

[33] Chief Counsel Advice 201150029, footnote 2 (emphasis added).

[34] For more information about various voluntary disclosure programs offered by the IRS, *see* Hale E. Sheppard, *IRS Amnesty Covers More than Foreign Accounts: Analyzing the Updated Voluntary Disclosure Practice, New International Tax Withholding Procedure, and Guidelines for Late Returns by Foreign Corporations*, *Taxes*, 2019, at 19; Hale E. Sheppard, *Alarming U.S. Tax Rules and Information-Reporting Duties for Foreign Retirement Plans and Accounts: Analyzing Problems and Solutions*, 129 Journal of Taxation 14 (2018); *www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures*.

[35] *See www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures-frequently-asked-questions-and-answers*.

[36] Code Sec. 6677(c)(2).

[37] 31 CFR §103.27(c).

[38] 31 CFR §103.27(c). The current deadline for filing an FBAR is April 15 of the year after the relevant calendar year, and the IRS has automatically extended this deadline to October 15 recently. *See* Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, P.L. 114-41, Section 2006(b)(11).

[39] 31 USC §5321(a)(5)(C), (D)(ii) (as in effect after Oct. 22, 2004); 31 CFR §103.57(g)(2).

[40] *Service Discusses Foreign Bank and Financial Accounts Report Penalty*, 2006 Tax Notes Today 14-14 (Sept. 1, 2005) (emphasis added).

[41] Steven Toscher & Michael R.Stein, *FBAR Enforcement Is Coming!* J. Tax Practice & Procedure, Dec. 2003–Jan. 2004, at 31.

[42] Code Sec. 5321(a)(5)(D)(ii).

[43] *Horowitz*, 123 AFTR 2d 2019-500, 361 FSupp3d 511 (D.C. MD 1/18/2019).

[44] IRS Letter 6076 (10-2018).