

The IRS's Assessment of Penalties On Substitute Forms 3520-A

by Megan L. Brackney

Reprinted from *Tax Notes Federal*, April 19, 2021, p. 385

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Megan L. Brackney is a partner in the New York office of Kostelanetz & Fink LLP.

In this article, Brackney explores the IRS's assessment of penalties on timely filed substitute Forms 3520-A, "Annual Information Return of Foreign Trust With a U.S. Owner," contrary to its own guidance,

and she details the procedures for challenging those late-filing penalties.

In recent months, we have seen several clients being heavily penalized for purportedly late filing Form 3520-A, "Annual Information Return of Foreign Trust With a U.S. Owner," when they had filed a timely *substitute* Form 3520-A. The IRS's practice of assessing these penalties contradicts its own published guidance.

We have succeeded in getting these penalties reversed after filing protests and requests for collection due process with the Independent Office of Appeals. Rather than placing the burden on the taxpayer to challenge an improperly assessed penalty, the IRS should stop automatically imposing these penalties and instead should review the taxpayer's submission and apply its own guidance.

What Is the Form 3520-A Filing Requirement?

Section 6048(b) requires U.S. owners of foreign trusts to file Form 3520-A and to furnish a copy to any person who is treated as the owner of any portion of the trusts or any person who receives

(directly or indirectly) any distribution from the trusts.¹ When filed by the U.S. owner of a foreign trust, Form 3520-A is due by the 15th day of the third month after the end of the trust's tax year. If the trust has a calendar-year tax year, the Form 3520-A is due by March 15. The deadline for Form 3520-A can be extended by timely filing Form 7004, "Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns."

A U.S. beneficiary of a foreign trust must file Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts." The taxpayer must attach a copy of Form 3520-A furnished by the U.S. owner of the foreign trust with the Form 3520. The Form 3520 is due at the same time as the taxpayer's income tax return; a valid extension on Form 4868, "Application for Automatic Extension of Time to File U.S. Individual Income Tax Return," will extend the filing deadline for Form 3520.

What if Form 3520-A Isn't Received?

What should taxpayers do if the U.S. owner of the foreign trust fails to furnish them with the Form 3520-A? The instructions to Form 3520 Part II, line 22, state the following:

Did the foreign trust file Form 3520-A for the current year? Yes/No.

If "Yes," attach the Foreign Grantor Trust Owner Statement you received from the foreign trust. If "No," to the best of your ability, complete and attach a *Substitute* Form 3520-A for the foreign trust. [Emphasis added.]

¹Section 6048(b)(1).

A legal memorandum reinforces that “Part II of Form 3520 tells the U.S. owner that if the foreign trust did not file Form 3520-A for the current year, the U.S. owner must, to the best of his or her ability, complete and attach a Substitute Form 3520-A for the foreign trust.”²

The Form 3520 instructions also state:

If a foreign trust fails to file a Form 3520-A, the U.S. owner must complete and attach a Substitute Form 3520-A to the U.S. owner’s Form 3520 by the due date of the U.S. owner’s Form 3520 (and not the due date for Form 3520-A) in order to avoid being subject to a penalty for the foreign trust’s failure to file a Form 3520-A. For example, a Substitute Form 3520-A that, to the best of the U.S. owner’s ability, is completed and attached to the U.S. owner’s Form 3520 by the due date for the Form 3520 (such as April 15 for the U.S. owners who are individuals) is considered timely filed.³

What Are the Penalties for Failing to File?

Unless the taxpayer can establish reasonable cause, the penalty for failure to timely file Form 3520-A, or failure to file a complete Form 3520-A, results in penalties of 5 percent of the “gross reportable amount.”⁴ Also, if the IRS mails notice to a taxpayer of failure to file the Form 3520-A, and the taxpayer doesn’t file the form in the next 90 days, there is an additional penalty of \$10,000 for each 30-day period (or fraction thereof) during which the failure to file continues, up to the gross reportable amount.⁵ For Form 3520-A penalties, the gross reportable amount is “the gross value of the portion of the trust’s assets at the close of the year treated as owned by the United States person.”⁶

² ILM 201208028.

³ IRS, “Instructions for Form 3520-A” (2020).

⁴ Section 6677(b), (c).

⁵ Section 6677(b).

⁶ Section 6677(c)(2).

When to File Substitute Form 3520-A?

As noted above, ordinarily, the Form 3520-A is due on March 15 (that is, three months after the close of the trust’s tax year), unless the taxpayer seeks an extension by filing Form 7004. However, for substitute Forms 3520-A, the due date is the same as for Form 3520.⁷ Thus, a taxpayer who files a substitute Form 3520-A with his timely filed Form 3520 shouldn’t be subject to penalties for late filing of the Form 3520-A. As stated in the Internal Revenue Manual:

If the foreign trust does not file Form 3520-A, but the U.S. owner completes and attaches a Substitute Form 3520-A for the foreign trust to the U.S. owner’s timely filed Form 3520 in accordance with the instructions for Form 3520, *the U.S. owner will not be subject to the penalty for failure to file Form 3520-A.*⁸ [Emphasis added.]

Consistent with this policy, the IRM instructs IRS compliance employees as follows: “*Do not assess a penalty if a Substitute Form 3520-A was filed . . . and there is proof the Form 3520 was filed timely.*”⁹ (Emphasis added.)

Why Penalties and How to Challenge Them?

Despite its own guidance, the IRS has been systematically assessing penalties of 5 percent of the reported value of the foreign trust for late filing of substitute Forms 3520-A that were, in fact, timely filed along with Forms 3520. Although I can only speculate, I assume that the personnel at the IRS service center have been directed to impose penalties on all Forms 3520-A filed after March 15 unless the taxpayer filed a Form 7004 request for extension.

The IRS’s failure to recognize the substitute Form 3520-A for what it is causes enormous hardship for taxpayers who are assessed these penalties and are then forced to navigate the confusing system for challenging penalties.

A taxpayer who has been assessed a Form 3520-A penalty, or any other foreign information

⁷ Internal Revenue Manual section 20.1.9.14(2); IRS, “Instructions to Form 3520A.”

⁸ IRM section 21.8.2.19.3(7).

⁹ *Id.*

return penalty, should be offered an opportunity to appeal by submitting a protest with Appeals, usually within 30 days of the date of the notice of the determination of the penalty. The IRM states that the taxpayer is entitled to prepayment appeals review, meaning that the IRS shouldn't attempt to collect the penalty while the appeal is pending.¹⁰ As practitioners handling these cases know all too well, however, taxpayers may still be subject to enforced collection while their appeals are pending. In fact, many taxpayers receive collection notices even before the time to appeal has elapsed.

If the IRS issues a notice of intent to levy, the taxpayer can submit a request for collection due process (CDP) and raise the challenges to the penalty in that forum because there has not yet been an opportunity for review of the penalty.¹¹ If Appeals doesn't grant relief during the CDP hearing, the taxpayer may seek review of that determination by filing a petition in the Tax Court for lien or levy action under section 6330(d).¹²

An ironic wrinkle to the IRS's failure to comply with the IRM is that when the IRS proceeds with enforced collection despite the timely filing of an appeal and issues the notice of intent to levy, the taxpayer may benefit because the CDP determination will be subject to prepayment review in the Tax Court, when otherwise, a disappointed taxpayer would have to pay in full and bring a claim for refund before being able to obtain judicial review. That is because foreign information return penalties are "assessable penalties," meaning that they are "paid upon notice and demand" and aren't subject to the deficiency procedures.¹³

Regarding the specific context of the Form 3520-A imposed on timely filed substitute Forms 3520-A, it is unlikely that the taxpayer will require judicial review because the appeal should be successful since the Form 3520-A is not actually late. Even though we have seen taxpayers obtaining relief from these penalties through

Appeals and CDP, it is unfortunate that they must engage in this battle and often incur significant professional fees and stress in the process.

There are some things that a tax adviser can do to avoid these penalties. First, even though not required, if the taxpayer expects that the U.S. owner of the foreign trust won't file Form 3520-A before the general deadline, the taxpayer could file Form 7004 and obtain an extension. Next, return preparers should note on the Form 3520-A that (1) it is a substitute Form 3520-A; (2) the taxpayer is filing a substitute Form 3520-A under the IRS's instructions because the U.S. owner of the foreign trust did not furnish the taxpayer with the form; and (3) under the IRS's guidance, the return is considered timely. Providing this explanation with the return should help the taxpayer avoid the penalty assessment. ■

¹⁰IRM section 8.11.5.1(1) (taxpayers entitled to post-assessment prepayment appeal).

¹¹Section 6330(c)(2)(B); reg. section 601.103(c)(1); and *Interior Glass Systems Inc. v. United States*, 927 F.3d 1081, 1087 (9th Cir. 2019).

¹²Tax Court Rules 330, *et seq.*

¹³Section 6671(a).