

## [Journal of Tax Practice and Procedure, PENALTIES—The IRS’s New Practice of Assessing Late-Filing Penalties on Timely Filed Substitute Forms 3520-A, \(Jun. 22, 2021\)](#)

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The IRS has begun systematically imposing late-filing penalties on substitute Forms 3520-A even when they have been filed on time. This new mistaken practice forces a taxpayer who does not owe a late-filing penalty to file a protest or a request for collection due process (“CDP”) with the IRS Independent Office of Appeals (“IRS Appeals”) and suffer the attendant unnecessary financial and emotional toll.

Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner*, must be filed by any foreign trust when a U.S. person is treated as an owner of any portion of the trust (“U.S. owner” or “taxpayer”). <sup>[1]</sup> A copy of Form 3520-A is attached to a U.S. owner’s Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*, which is due at the same time as the U.S. owner’s annual federal income tax return but need not be attached to the return. <sup>[2]</sup>

Form 3520-A is required in accordance with [Code Sec. 6048\(b\)](#), which provides:

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 ... 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. (Emphasis added.)

The statute seemingly places the onus on the U.S. owner to make sure that the foreign trust files a Form 3520-A and provides a copy to the U.S. owner, and does not mention a substitute Form 3520-A.

The IRS’s Instructions for Form 3520, however, first ask if the foreign trust filed a Form 3520-A for the current year, and if not, instruct that the U.S. owner should “*to the best of your ability, complete and attach a Substitute Form 3520-A for the foreign trust.*” <sup>[3]</sup> The Form 3520 instructions also provide that, if a foreign trust does not file a Form 3520-A, “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 ... is considered timely filed.” <sup>[4]</sup> The Internal Revenue Manual (“IRM”) confirms that “[i]f a foreign trust fails to file a Form 3520-A, the U.S. owner may complete and attach a substitute Form 3520-A to the U.S. owner’s Form 3520.” <sup>[5]</sup>

To file a substitute Form 3520-A, the U.S. owner must check the “Substitute Form 3520-A” box on Form 3520-A, and must sign and date the return (normally the foreign trustee would sign a Form 3520-A) and provide their name and taxpayer identification number in the signature box. <sup>[6]</sup>

## Potentially Confusing Due Dates for Form 3520, Form 3520-A, and Substitute Form 3520-A

The due dates for Form 3520 and Form 3520-A are usually different. A U.S. taxpayer’s Form 3520 is due on the 15th day of the fourth month after the end of the taxpayers’ tax year—April 15, assuming a calendar-year tax year, plus any applicable extension. <sup>[7]</sup> So, Form 3520 is due at the same time as the taxpayer’s income tax return, and 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.

In contrast, Form 3520-A is normally due on the 15th day of the third month after the end of the foreign trust’s tax year—if the trust’s tax year is the calendar year, the form is due on March 15. <sup>[8]</sup> An automatic six-month extension to file Form 3520-A, however, may be obtained if the foreign trust files Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns*.

The instructions to Form 3520 provide that a Form 3520-A may be filed after March 15 either “if an extension of time to file is granted or if filing a substitute Form 3520-A.” <sup>[9]</sup> A substitute Form 3520-A is, like Form 3520, due on the same date as the U.S. owner’s tax return, and Form 7004 is not required to obtain an extension to file substitute Form 3520-A:

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. <sup>[10]</sup>

The IRM provides that a U.S. owner who files a valid substitute Form 3520-A “*will not* be subject to the penalty for failure to file Form 3520-A,” <sup>[11]</sup> and instructs IRS compliance employees: “Do not assess a penalty if a Substitute Form 3520-A was filed ... and there is proof the Form 3520 was timely.” <sup>[12]</sup> Yet the IRS has begun assessing late-filing penalties for a substitute Form 3520-A even when it has been timely filed with a timely Form 3520.

## Late-Filing Penalties

Taxpayers who file a late Form 3520 or a late Form 3520-A are subject to an initial penalty equal to the gross reportable amount if that amount is less than \$10,000. <sup>[13]</sup> (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 U.S. owner.) <sup>[14]</sup> If the gross reportable amount is greater than \$10,000, the initial penalty is five percent of the gross reportable amount. <sup>[15]</sup> An additional continuation penalty of \$10,000 for each 30-day period applies if Form 3520 or Form 3520-A is not filed more than 90 days after the IRS mails the taxpayer a notice of failure to file the form. <sup>[16]</sup> The maximum penalty that can be applied for failure to file Form 3520 or Form 3520-A is the gross reportable amount. <sup>[17]</sup>

The IRM states that international penalties, which include penalties for late-filed Forms 3520-A, are not subject to deficiency procedures and can be appealed *pre-payment* and *post-assessment*. <sup>[18]</sup> Accordingly, the IRS will not send a 30-day or 90-day letter before assessing late-filing penalties on Forms 3520-A, and penalties must be assessed before the taxpayer may go to IRS Appeals. <sup>[19]</sup> Therefore, a taxpayer who is assessed a

late-filing penalty for what is in fact a timely filed substitute Form 3520-A should be able to appeal the penalty *before* paying, and the IRS should suspend collection procedures until IRS Appeals resolves the issue. [\[20\]](#) Nevertheless, taxpayers who timely filed substitute Forms 3520-A are being subject to unnecessary enforced collection while their appeals are pending. [\[21\]](#)

## Why Are Penalties Being Imposed on Timely Filed Substitute Forms 3520-A?

### IRM Inconsistencies

While we can only surmise why the IRS has begun imposing late-filing penalties on timely filed substitute Forms 3520-A, one possibility may be the IRM. Several IRM sections contradict other sections about substitute Forms 3520-A, and also contradict the instructions to Form 3520-A itself. For example, the IRM states:

A foreign trust with a U.S. owner must file Form 3520-A in order for the U.S. owner to satisfy its annual information reporting requirements under IRC 6048(b). *Each U.S. person treated as an owner of any portion of a foreign trust under IRC 671 through IRC 679 is responsible for ensuring that the foreign trust files Form 3520-A and furnishes the required annual statements to its U.S. owners and U.S. beneficiaries.* [\[22\]](#) (Emphasis added.)

This is in accordance with [Code Sec. 6048\(b\)](#), *supra*, and indicates that the U.S. owner of a foreign trust is responsible for ensuring that the foreign trust files Form 3520-A and provides a copy to the U.S. owner. This leaves no allowance for a foreign trust’s failure to file Form 3520-A for reasons outside the U.S. owner’s control, which is the reason for allowing the substitute Form 3520-A. Similar language is repeated in other IRM sections, particularly Section 20.1.9 “International Penalties,” *et seq.* (“Section 20.1.9”). [\[23\]](#)

Section 20.1.9, dated January 2021, is more recent than a 2020 IRM provision that specifically governs Forms 3520-A and states that a penalty “*will not*” be imposed if a substitute Form 3520-A is attached to a timely Form 3520. [\[24\]](#) Applying more generally to all international reporting penalties, Section 20.1.9 merely provides, more than once, that: “If a foreign trust fails to timely file Form 3520-A, penalties are imposed on the U.S. person who is treated as the owner of the foreign trust [but] the U.S. owner *may be able to avoid penalties* by attaching a substitute Form 3520-A to a timely filed Form 3520.” [\[25\]](#) There is no further discussion of *how* the U.S. owner *may* (rather than *will*) avoid penalties by filing a substitute Form 3520-A.

### Possible IRS Confusion Over When Extensions Are Required

A second possibility for mistaken penalties is that, contrary to the instructions that a *substitute* Form 3520-A is only due on the same date as the U.S. owner’s income tax return, including extensions, IRS compliance officers at service centers may assume that *all* Forms 3520-A filed after March 15 are untimely unless a Form 7004 was filed requesting an extension.

Section 20.1.9 contains a note that a Form 3520-A is considered timely (and hence not subject to a penalty) if it is attached to a timely filed Form 3520, and instructs IRS compliance employees to review the Form 3520 master file account, and to check if there was an extension granted *to file Form 3520*, before determining that a Form 3520-A was filed late. [\[26\]](#) While this is correct, the reference to an extension may be confusing and suggest incorrectly that a Form 7004 extension request is required for a substitute Form 3520-A.

### The IRM Should Be Rationalized

To help ensure that the IRS does not wrongly penalize a taxpayer who timely files a substitute Form 3520-A that is attached to a timely filed Form 3520, and to accord with the Instructions for Form 3520-A, the IRM should be

amended to remove contradictions and ambiguities; to provide consistent guidance about when penalties for late-filed Forms 3520-A apply; and to clarify when penalties *do not* apply to *substitute* Forms 3520-A.

## Possible Mistaken Cross-Over from IRS Clarification of the Delinquent International Information Return Submission Procedures

The IRS also may be mistakenly assessing late-filing penalties on timely filed substitute Forms 3520-A because of confusion with a recent policy change to the Delinquent International Information Return Submission Procedures (DIIRSP). The DIIRSP allows taxpayers to late-file delinquent international information returns and to avoid civil penalties if they can establish reasonable cause. <sup>[27]</sup> Taxpayers may attach a reasonable cause statement to a delinquent international information return. Prior to the IRS’s recent update, it seemed that IRS agents reviewed a reasonable cause statement *before* the IRS assessed any penalties. However, on November 5, 2020, the IRS clarified that:

Taxpayers may attach a reasonable cause statement to each delinquent information return filed for which reasonable cause is being asserted. *During processing of the delinquent information return, penalties may be assessed without considering the attached reasonable cause statement.* It may be necessary for taxpayers to respond to specific correspondence and submit or resubmit reasonable cause information. <sup>[28]</sup>

This change is apparently because reviewing individual reasonable cause statements interferes with automated procedures to assess penalties at IRS service centers.

If the IRS’s current initial disregard of reasonable cause statements attached to delinquent international information returns is in fact the result of increased reliance on automation, imposition of penalties on late-filed Forms 3520-A *and* on timely substitute Forms 3520-A may have the same root cause. A cross-over error from the IRS’s automated pre-reasonable-cause-statement-review imposition of delinquent information return penalties, combined with a mistaken impression that *all* Forms 3520-A are untimely if filed after March 15 without a Form 7004 extension, may be causing automated penalties to be imposed for substitute Forms 3520-A. This error may be exacerbated because the IRM provides that the failure of a foreign trustee to provide a Form 3520-A or its required information to a U.S. owner does not constitute reasonable cause for failure to file a timely Form 3520-A. <sup>[29]</sup>

## What Are a Taxpayer’s Remedies?

To proactively avoid an improper late-filing penalty being assessed on a timely filed substitute Form 3520-A, a taxpayer may want to file an unnecessary Form 7004 requesting an extension of time to file the Form 3520-A. If penalties are assessed, the IRS will usually offer the taxpayer the opportunity for an administrative appeal with IRS Appeals within 30 days of initially receiving the notice of penalty determination. <sup>[30]</sup> If a substitute Form 3520-A was timely filed according to published guidance, an appeal of any late-filing penalty will very likely succeed. If the IRS begins collection proceedings while the appeal is pending, it may issue a notice of intent to levy, at which time the taxpayer can submit a request for CDP. A taxpayer may seek review of an unfavorable IRS Appeals decision by filing a petition in the Tax Court.

While a taxpayer who files a timely substitute Form 3520-A will ultimately obtain relief from improper late-filing penalties, the time, money, effort, and stress involved in obtaining this relief is a significant burden. The IRS should isolate the reason(s) why timely filed substitute Forms 3520-A are not being processed as such and take necessary steps to resolve this problem.

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### Footnotes

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- 1 IRS Instructions for Form 3520-A. (2020) (“Instructions for Form 3520-A”); *see also* IRM 21.8.2.19.3(1) & (2) (July 21, 2020).
- 2 *See* IRM 20.1.9.1.5 (Jan. 29, 2021) (“Form 3520, Annual Return to Report Transactions with Foreign Trust and Receipt of Certain Foreign Gifts, and Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner, ... are not required to be attached to an income tax return”).
- 3 IRS 2020 Instructions for Form 3520 (“Instructions for Form 3520”), Part 11, line 22 (emphasis added). An IRS 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.” ILM 201208028.
- 4 Instructions for Form 3520; *see also* IRM 21.8.2.19.3(7) (July 21, 2020); IRM 20.1.9.13.1(4) (Jan. 29, 2021); IRM 20.1.9.14.4(4) (Jan. 29, 2021); IRM 3.22.19.1.2(2) (Nov. 9, 2017); IRM 3.22.19.50(1) (Nov. 9, 2017); IRM 4.63.5.2.5(2) (Jan. 18, 2018); IRM 21.8.1.25(4) (Oct. 1, 2019).
- 5 IRM 3.21.19.35(8) (Jan. 1, 2021). The IRM, intended to provide guidance to IRS personnel, is, however, not binding on the IRS.
- 6 Instructions for Form 3520-A.
- 7 IRM 21.8.2.19.2(7) (Aug. 18, 2020).
- 8 IRM 21.8.2.19.3(4) (July 21, 2020).
- 9 Instructions for Form 3520 (emphasis added).
- 10 Instructions for Form 3520 (emphasis added).
- 11 IRM 21.8.2.19.3(7) (July 21, 2020) (emphasis added) (“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.”). IRM 21.8.2.19.3 specifically applies to “Form 3520-A & Applicable Penalties.”
- 12 IRM 21.8.2.19.3(7) (July 21, 2020).
- 13 [Code Sec. 6677\(a\)](#); IRM 20.1.9.14.4(1) (Jan. 29, 2021).
- 14 *See* [Code Sec. 6677\(c\)](#).
- 15 [Code Sec. 6677\(a\)](#); Instructions to Form 3520; Instructions to Form 3520-A.
- 16 [Code Sec. 6677\(a\)](#); IRM 20.1.9.14.1(2) (Jan. 29, 2021); IRM 8.11.5.2(5) (Dec. 18, 2015).
- 17 [Code Sec. 6677\(a\)](#); IRM 20.1.9.14.1(3) (Jan. 29, 2021).
- 18 IRM 8.11.5.1(1) (Dec. 18, 2015); IRM 8.11.5.2(4) (Dec. 18, 2015); IRM 20.1.9.1.5(5) (Jan. 29, 2021).
- 19 IRM 8.11.5.9(3) (Dec. 18, 2015); IRM 8.11.5.1(2) (Dec. 18, 2015); IRM 20.1.9.2(4) (Jan. 29, 2021).
- 20 IRM 20.1.7.5.2 (Oct. 12, 2017), addressing “Collection Delinquent Information Return Procedures,” provides:

Normally collection action will be suspended on the penalty portion of the assessment during the 15-day period granted to the taxpayer to file an appeal, or during the period the case is under consideration by Appeals. However, action need not be suspended if circumstances meriting

continuation of collection action exist. The Collection compliance function employee must obtain supervisory approval not to suspend collection of the penalty portion of the assessment.

More generally, the IRS will normally suspend collection activity on an unpaid penalty during the period Appeals is considering an abatement request, unless collection of the tax liability is in jeopardy or the taxpayer is attempting to delay collection. IRM 5.1.15.16.4(9) (Mar. 9, 2021); *cf.* IRM 4.13.3.16(1)(d) (Dec. 17, 2015) (collection activity should be suspended whenever a taxpayer requests Appeals reconsideration of an IRS action).

- 21 Although collection should be suspended during an appeal, the IRM recognizes that parallel collection and appeals procedures may occur for penalties assessed for late-filed international information returns, such as a Form 3520-A:

Collection Activity—While the case is in Appeals, it’s the taxpayer’s responsibility to communicate with the Collection function about the status of their case in Appeals.

Note: The Appeals Officer will assist a taxpayer in providing a collection contact person if the Taxpayer receives collection notices, and a collection employee has not been assigned to the Taxpayer’s case.

IRM 8.11.5.1(9) (Dec. 18, 2015).

- 22 IRM 8.11.5.9.1(1) (Dec. 18, 2015) (emphasis added); IRM 20.1.9.13.5 (Jan. 29, 2021) (“The taxpayer owner is also the person responsible for ensuring that the Form 3520-A is filed and that he or she receives a copy of the owner’s statement.”); *see also* IRM 20.1.9.14.5(2) (Jan. 29, 2021); IRM 20.1.9.14.1(1) (Jan. 29, 2021); IRM 3.21.19.35(2) (Jan. 1, 2021); IRM 3.22.19.1.2(2) (Nov. 9, 2017); IRM 21.8.1.25(3) (Oct. 1, 2019); IRM 4.63.5.2.5(1) (Jan. 18, 2018); Instructions for Form 3520A.
- 23 *See* IRM 20.1.9.14.1(1) (Jan. 29, 2021) (“Each U.S. person treated as an owner of a foreign trust [...] is responsible for ensuring that the foreign trust files an annual return,” and “the U.S. owner is responsible for ensuring that the trust annually furnishes such information [...] to U.S. owners and U.S. beneficiaries of the trust.”); *see also* IRM 20.1.9.14.5 (Jan. 29, 2021) .
- 24 IRM 21.8.2.19.3(7) (July 21, 2020); *see supra* note 11.
- 25 IRM 20.1.9.14(2) (Jan. 29, 2021) (emphasis added); *see also* IRM 20.1.9.14.1(3) (Jan. 29, 2021) (“If the foreign trust fails to timely file Form 3520-A, the U.S. owner *may be able to avoid penalties* by completing and attaching a substitute Form 3520-A to their timely filed Form 3520.”) (emphasis added).
- 26 IRM 20.1.9.14.1 (10) (Jan. 29, 2021).
- 27 Reasonable cause exists if a taxpayer exercised ordinary business care and prudence and was still unable to file a return by its due date. [Reg. §301.6651-1\(c\)\(1\)](#).
- 28 IRS, *Delinquent International Information Returns Submission Procedures*, available at [www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures](http://www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures) (emphasis added) (last updated Nov. 5, 2020).
- 29 IRM 20.1.9.13.5(3) (Jan. 29, 2021) (“The fact that the trustee did not provide the taxpayer with a copy of the owner’s statement of Form 3520-A is not reasonable cause.”); IRM 20.1.9.14.5(2) (Jan. 29, 2021) (“[F]ailure of the foreign trustee to provide a Form 3520-A or information required on that form does not constitute reasonable cause for a U.S. owner’s failure to file a Form 3520-A”); IRM 20.1.9.14.1(4) (Jan. 29, 2021) (same).
- 30 [Reg. §601.103\(c\)\(1\)](#).