IRS Form 3520, Penalties, and Whether to Make a Protective Filing

Information Reporting on Foreign Trusts and Gifts

By Caroline Rule

Whether a taxpayer is required to file IRS Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, is frequently unclear, yet penalties for a failure to file can be severe. As a result, although there is no formal procedure for filing a protective Form 3520, practitioners should consider doing so when there is any uncertainty about whether a taxpayer must file the form.

What Is IRS Form 3520?

Form 3520 is largely used to report information concerning foreign trusts required under Internal Revenue Code (IRC) section 6048. It must be filed by U.S. taxpayers who—

- owned a foreign trust;
- transferred money or other property to a foreign trust;
- held an outstanding obligation of a related foreign trust that was issued in the current tax year and reported as a "qualified obligation";
- were the executors of a U.S. decedent's estate if the decedent made a transfer to a foreign trust by reason of death, the decedent was treated as the owner of any part of a foreign trust immediately prior to death, or the estate includes any assets of a foreign trust;
- received a distribution from a foreign trust during the tax year; or
- were grantors or beneficiaries of a foreign trust that, during the tax year, loaned cash or marketable securities to the taxpayer or a related U.S. person, or from which the taxpayer or a related U.S. person received uncompensated use of trust property.

Unrelated to foreign trusts, Form 3520 is also used under IRC section 6039F to report gifts or bequests over $100,000 from a nonresident alien or foreign estate or gifts over $15,671 from a foreign corporation or partnership.

Form 3520 is due on the date that the taxpayer's income tax return is due, but it is filed separately with the IRS Service Center in Ogden, Utah [see *Instructions for Form 3520,* "When and Where to File;" see also Internal Revenue Manual (IRM) section 20.1.9.10.1(3) (07-08-2015)]. Many practitioners get this wrong and attach the Form 3520 to a taxpayer's income tax return.

Penalties for Failure to File Form 3520

IRC section 6677 provides for stiff penalties if Form 3520 is not timely filed or is incomplete or incorrect. The initial penalty is the greater of $10,000 or—

- 35% of the gross value of any property transferred to a foreign trust if a U.S. person fails to report the creation of or transfer to a foreign trust;
- 35% of the gross value of the distributions received from a foreign trust by a U.S. person who fails to report receipt of the distribution; and
- 5% of the gross value of all of a foreign trust's assets treated as owned by a U.S. person under the grantor trust rules (IRC sections 671–679) if the U.S. owner fails to report required information. The owner is also subject to an additional 5% penalty if the foreign trust itself fails to file a timely Form 3520-A ["Annual Information Return of Foreign Trust With a U.S. Owner"; see IRC section 6048(b)], does not provide all required information, or provides incorrect information.

If noncompliance continues for more than 90 days after the IRS mails a notice of failure to comply, there is a further penalty of $10,000 for each additional 30 days of noncompliance.

The penalty for failure to file a Form 3520 reporting a foreign gift or bequest, or for filing an incorrect or incomplete form with respect to a gift or bequest, is 5% of the gift or bequest for each month during which the failure continues, up to a maximum of 25% [IRC section 6039F(c)(1)(B)].

Reasonable Cause

Under IRC sections 6677(d) and 6039F(c)(2), no penalties will be imposed if a taxpayer can demonstrate that failure to file a required Form 3520, or filing of an inaccurate or incomplete return, was due to reasonable cause and not willful neglect. It is difficult to have any tax penalty abated for reasonable cause. A taxpayer's reliance on a professional for the "ministerial" act of filing a return is not reasonable cause [*Boyle v. U.S.,* 469 U.S. 241, 252 (1985)]. But a few cases have held that a taxpayer may rely, after full disclosure, on a professional's advice that a particular tax filing is not required [e.g., *McMahon v. Comm'r,* 114 F.3d 366, 369 (2d Cir. 1997); *Estate of La Meres v. Comm'r,* 98 T.C. 294, 316-17 (1992)].

Only two cases, however, have specifically addressed reasonable cause for failure to file Form 3520. In *James v. U.S.* [110 A.F.T.R.2d 2012-5587, 2012 WL 3522610 (M.D. Fla. 2012)], the court refused to grant summary judgment to the government, which sought significant penalties for each of three years. The taxpayer, who owned a foreign trust, relied on his accountant to handle all trust matters and provided all trust information to the accountant, who nevertheless checked "no" on the taxpayer's Form 1040, Schedule B, to the question: "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." The court held that this could be construed as the accountant's advice that the taxpayer need not file Form 3520, so there was a genuine issue of material fact as to whether the accountant provided the taxpayer with that advice and whether the taxpayer reasonably relied on the advice. At base, the court held that a taxpayer *may rely exclusively* on a tax advisor concerning whether to file Form 3520, so long as the taxpayer provides all necessary information to the advisor and the reliance is reasonable [see also *Nance v. U.S.,* 111 A.F.T.R.2d 2013-1616, 2013 WL 1500987 (W.D. Tenn. 2013)].

It should be noted that a taxpayer's inability to obtain information because of foreign bank secrecy laws is not reasonable cause [IRC section 6677(d)]. Moreover, under the IRM, a foreign trustee's refusal to provide information for *any* reason, including difficulty in obtaining the information, or a provision in the trust instrument that prevents disclosure of the information, is not reasonable cause [IRM section 20.1.9.13.5(2)(b)]. There is no guidance, however, about what the owner or beneficiary of a foreign trust should do in these circumstances.

Leaving aside foreign secrecy issues, however, *James* and *Nance* merely denied summary judgment to the government and did not reach a final decision. In addition, these cases run counter to the IRS's position, which is that "it is not reasonable or prudent for taxpayers to have no knowledge of, *or to solely rely on others for,* the tax treatment of international transactions" [IRM section 20.1.9.1.1(4) (10-24-2013) (emphasis added)]. Consequently, the likelihood that a taxpayer will succeed on a defense of reasonable cause is unclear, which makes filing a protective Form 3520 particularly appealing.

A Protective Form 3520

A taxpayer and her preparer may reasonably believe that she is not required to file Form 3520, but they may not be 100% sure. It is often not readily apparent whether a foreign financial arrangement (such as an estate plan, retirement plan, or foreign foundation) constitutes a trust for U.S. tax purposes. A protective filing should then be considered.

Filing a protective Form 3520 has two primary benefits. The first is that, when reporting information related to a foreign trust, the applicable statute of limitations will begin to run. In such circumstances, the time for the IRS to assess "any tax imposed by this title with respect to any tax return, event, or period to which such information relates" is three years after the taxpayer furnishes the IRS with the Form 3520 information [IRC section 6501(c)(3)(8)]. Consequently, the statute of limitations on a taxpayer's entire tax return never begins to run if the taxpayer should have filed Form 3520 in connection with a foreign trust. Filing a protective Form 3520 is therefore a means of avoiding a perpetually open statute of limitations.

IRC section 6501(c)(3)(8) does not mention IRC section 6039F, which requires the reporting of foreign gifts and bequests. Consequently, when Form 3520 should report receipt of a foreign gift or bequest (which is unlikely to affect the taxpayer's income), the IRS treats Form 3520 as a separate return from the taxpayer's income tax return, and takes the position that section 6501(c)(3) applies only to the Form 3520. Thus, a taxpayer's failure to file Form 3520 reporting receipt of a foreign gift does not keep open the statute of limitations on the taxpayer's income tax return, but the taxpayer will obviously be subject to the applicable Form 3520 penalties [see IRS CCA 201402010 (Jan. 10, 2014)], plus interest.

The second benefit of filing a protective Form 3520 is that doing so will generally avoid the stringent penalties discussed above.

There is no statute or regulation providing for a protective Form 3520. The IRS does anticipate such filings, however; see IRM section 3.21.19.14.6 (11-10-2015, which discusses the internal routing of Forms 3520 marked as "Protective Filing." What a protective Form 3520 should include may, however, be gleaned from other areas. For example, a protective claim for a refund must, among other things, "be sufficiently clear and definite to alert the Service to the essential nature of the claim" [IRM section 25.6.1.10.2.6.5 (05-17-2004)].

In 2015, the IRS published a discussion of proposed regulations under IRC section 2801, which would have imposed a tax on the recipient of a gift or bequest from a person who expatriated in order to avoid U.S. taxes [Preamble to Proposed Regulations, Fed. Reg. Vol. 80, No. 175, p. 54447 (09/10/15)]. The regulations were never adopted, nor was a "Form 708," intended to report such gifts or bequests, ever published. Nevertheless, the proposed regulations are informative; they specifically provide for a protective Form 708 "in order to start the period for assessment of tax" [Proposed Regulations section 28.6011-1(b)(i)]. A U.S. taxpayer who received a gift or bequest from an expatriate and "reasonably concluded" that the gift or bequest did not fall under section 2801, could file a protective Form 708, together with an affidavit signed under penalties of perjury, setting forth information relied on

in concluding that the donor was not a "covered expatriate," or that the transfer was not a "covered gift" or "covered bequest," "as well as that person's efforts to obtain other information that might be relevant to these determinations." Absent fraud, a taxpayer who filed a proper protective Form 708 would not have been subject to any penalty for late filing, even if the IRS later determined that the gift was a "covered gift" from a "covered expatriate" [Proposed Regulations section 28.6011-1(b)(ii)].

Based on these authorities, a protective Form 3520 should do the following:

- State at the top, in large bold type, "Protective Filing"
- Be completed to the best of the taxpayer's ability, but with the caveat, "Protective filing; see attached affidavit," wherever substantive information is listed
- Attach the taxpayer's affidavit, which should include the taxpayer's name, address, TIN, and language that is "clear and definite" and straightforward about the "essential nature" of the taxpayer's position

In addition, the affidavit should—

- make clear that, by filing the protective Form 3520, the taxpayer is not conceding that he is, in fact, required to file the form;
- state that the taxpayer has reasonably concluded that Form 3520 is not required, but that the form is being filed protectively;
- make it plain that the taxpayer has provided her tax advisor with all available information about the Form 3520 issue, with an eye to establishing reasonable cause if the IRS later asserts a penalty;
- list all available information that went into the determination that Form 3520 was not required, in as much detail as possible, with attached documentation;
- state that the taxpayer's tax advisor, after reviewing the available information, has specifically advised the taxpayer that Form 3520 is not required, and that the form is nevertheless being filed in an excess of caution;
- discuss in detail all the efforts the taxpayer has made to obtain other relevant information, even if she was ultimately unsuccessful in doing so—especially if foreign bank secrecy laws are involved or a foreign trustee refuses to provide information, since those facts alone will not constitute reasonable cause; and
- if appropriate, state that the taxpayer has made reasonable estimates of reported dollar amounts, and what those estimates are based on.

Better to Have and Not Need

There may be a downside to filing a protective Form 3520—for example, if the protective form is inaccurate, and it can be shown that the taxpayer should have known of the inaccuracy, penalties may be asserted. In nearly all cases, however, the benefits of filing a protective Form 3520 will outweigh any potential downside should the IRS later conclude that Form 3520 should have been filed.❑

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