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Court upholds higher IRS penalty on late filing of Forms 3520 and 3520-A

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Introduction

On 28 July 2021 the Court of Appeals for the Second Circuit handed down its decision in *Wilson v United States*, opining that:

when an individual is both the sole owner and beneficiary of a foreign trust and fails to timely report distributions she received from the trust, the government has the authority under the IRC [Internal Revenue Code] to impose a 35% penalty.

The estate of the deceased US taxpayer lost its argument that the Internal Revenue Service (IRS) should have assessed only the 5% penalty levied on US owners who fail to ensure that their foreign trust files an annual return in a timely manner. The IRS assessed a penalty because both Form 3520, Annual Return to Report Transactions with Foreign Trusts, and Form 3520-A, Annual Information Return of Foreign Trust with a US Owner, had been

filed late. Trustees are advised to be aware of increased IRS scrutiny of US beneficiaries and US grantors resulting from their Foreign Account Tax Compliance Act (FATCA) reporting.

Wilson v United States

In this case,⁽¹⁾ Joseph Wilson, a US person, was the sole owner of a foreign trust under the grantor trust rules, and the trust's sole beneficiary. During the tax year at issue, Wilson received a final terminating distribution from the trust of approximately \$9.2 million. Wilson was required to report the receipt of this distribution to the IRS on Form 3520. In addition, a foreign trust with a US owner is required to file an annual report with the IRS on Form 3520-A (for further details please see "Preparing US tax and information returns: Forms 3520 and 3520-A").

Wilson failed to file Form 3520 and to ensure that his trust filed Form 3520-A by their respective deadlines. The IRS assessed a late penalty of 35% of the \$9.2 million distribution amount applicable to failures to file Form 3520. Wilson (who died while his claim for refund was pending) argued that because he was both the sole beneficiary and the sole owner of the trust, only the 5% penalty applicable to reporting requirements for trust owners via Form 3520-A should have been assessed. Wilson's estate filed a claim for refund, pursuing Wilson's 5% penalty argument and alleging in the alternative that there was "reasonable cause" that excused Wilson's late filing.

The district court agreed with the taxpayer but the court of appeals held that the district court's analysis was wrong and the plain language of the tax code requires that when an individual fails to report distributions received from a foreign trust in a timely manner, the 35% penalty applies; the taxpayer's concurrent status as owner of the trust does not alter this rule. The case was remanded to the district court where it will be interesting to see whether the reasonable cause issue is resuscitated.

Form 3520, Annual Return to Report Transactions with Foreign Trusts

US beneficiaries who receive distributions from a foreign trust, regardless of the amount, must file Form 3520 with the IRS by 15 April of the year following the distribution. If the US taxpayer is granted an extension to file

their federal income tax return, the due date for filing Form 3520 is extended to 15 October (for further details please see "Reporting Deadlines Draw Near").

The US beneficiary must indicate on Form 3520 whether they received from the trustee of the foreign trust either a foreign grantor trust beneficiary statement or a foreign non-grantor trust beneficiary statement. This statement, or lack thereof, will affect the calculation of tax and a possible interest charge.

Form 3520-A, Annual Information Return of Foreign Trust with a US Owner

A US person who is treated as an owner of any portion of a foreign trust under the US grantor trust rules must ensure that the foreign trust files Form 3520-A, which is due by 15 March (for further details please see "Overview (January 2021)"). Form 7004 must be filed to request an extension to file Form 3520-A, and it must be submitted prior to the original due date. The US taxpayer's income tax return extension does not extend the time for the trustee to file Form 3520-A. If the trustee files a Form 3520-A reporting distributions, the owner-beneficiary is not required to duplicate the distribution information on Form 3520, but rather directs the IRS to the Form 3520-A by ticking a box in part II of the Form 3520.

Form 3520-A is used to provide information about the foreign trust and its US grantor. The trustee must also provide the grantor with a foreign grantor trust owner statement, the form for which is contained in Form 3520-A. If the foreign trust fails to file Form 3520-A, the US grantor (not the foreign trust) is subject to penalties (for further details please see "US reporting: requesting IRS filing extensions").

FATCA alerting IRS to late filings

Although the years at issue in the Wilson case predated FATCA, IRS attention to late or missing returns is increasing because of information it receives from FATCA reporting. Where a foreign trust has been classified as an "investment entity" under FATCA, such as a trustee-documented trust under an intergovernmental agreement (IGA), the trustee will file a FATCA report with details of any distributions to US beneficiaries or any US persons treated as owners under the grantor trust rules. In situations where a foreign trust has instead been classified as a "passive nonfinancial

foreign entity", foreign financial institutions such as banks and investment funds are providing the IRS with details on US persons identified as substantial US owners (for further details please see "FATCA reporting: who and what").

Comment

The IRS has a currently active Form 3520/3520-A compliance campaign, which takes a multifaceted approach to improving compliance with respect to the timely and accurate filing of information returns reporting ownership of and transactions with foreign trusts. The IRS is addressing non-compliance through a variety of approaches including, but not limited to, examinations and penalties assessed when the appropriate forms are received late or are incomplete. Offshore trustees of foreign trusts are required to know the tax residence of a trust's settlor and beneficiaries and are actively filing reports to the relevant jurisdiction under FATCA or the Common Reporting Standard (CRS). Trustees should be diligent to remind US grantors and US beneficiaries of their tax and reporting responsibilities (for further details please see "US reporting checklist for foreign trusts").

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Endnotes

- (1) *Wilson v United States*, 20-603 (2d Cir 2021).