LATE FILED FORM 3520: WHAT PENALTIES TO EXPECT AND HOW TO RESPOND

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Tags
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INTRODUCTION

U.S. persons are required to file Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts) with the I.R.S. to report

- certain transactions with foreign trusts,
- ownership of foreign trusts under the grantor trust rules of Code §§671 through 679, and
- the receipt of certain large gifts or bequests from foreign persons.

The penalty for filing a delinquent Form 3520 is 5% of the value of the unreported gift for each month that passes after its due date. The maximum penalty is 25% of the amount of the gift. Form 3520 is due at the time of a timely filing of the U.S. income tax return. If the due date for filing the tax return is extended, the due date for filing the Form 3520 is automatically extended.

This article addresses the winding road that must be navigated when a U.S. person discovers that the Form 3520 has not been filed on a timely basis.

REPORTABLE GIFTS AND BEQUESTS

Outright gifts and bequests received from a foreign donor or the estate of a foreign decedent in excess of $100,000 must be reported by a U.S. recipient. Gifts received from related individuals are aggregated in determining whether the threshold has been exceeded. If none of the gifts exceed $5,000, a blanket statement is used to tell the I.R.S. that no gifts or bequests exceed that level.

Example:

Husband and wife are nonresident, noncitizen individuals. Their daughter lives and works in the U.S. She holds an H 1B visa. H gifts daughter. Husband gifts $78,000 to the daughter and wife separately gifts $25,000 to the daughter. The threshold of $100,000 is exceeded. Daughter must file Form 3520.

Distributions from a revocable, grantor trust that has a foreign person as grantor are treated as gifts from the foreign grantor for substantive U.S. tax purposes. If they exceed $100,000, they must be reported. For reporting purposes, and reporting purposes only, the receipt retains the character of a trust distribution and must be reported as such on the form.

I.R.S. WEBSITE

The I.R.S. website contains a page entitled “Delinquent International Information Return Submission Procedures.”[1] It provides as follows in pertinent part.

> **What do I do if I have a delinquent international information return?**
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> Taxpayers who have identified the need to file delinquent international information returns who are not under a civil examination or a criminal investigation by the IRS and have not already been contacted by the IRS about the delinquent information returns should file the delinquent information returns through normal filing procedures.
>
> Penalties may be assessed in accordance with existing procedures.
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> * * *
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> • All delinquent Forms 3520 and 3520-A should be filed according to the applicable instructions for those forms.
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> * * *
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> • 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.

On its surface, the page suggests the existence of a benign procedure designed to invite late compliance. In practice, late compliance is penalized.[2]

PENALTY REGIME

If a penalty is imposed, it is not a tax deficiency. Consequently, the U.S. Tax Court has no jurisdiction to review the asserted penalty. The I.R.S. treats the penalty as due when asserted unless appealed. The appeal is an administrative appeal to the I.R.S. Independent Office of Appeals based on reasonable cause for failure to timely file.

The appeal does not stop the running of collection notices. If the I.R.S. sends a notice to levy on bank accounts and other property under standard collection procedure, a Due Process Appeal to U.S. Tax Court may be filed.

Failure to file Form 3520 keeps the statute of limitations from. running as to the penalty until the date that is three years from filing.

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1 See the I.R.S. website.

2 See Wooyoung Lee, “When it Comes to Penalty Abatement, is the I.R.S. Offside?”

I.R.S. APPEALS PROCEDURE

The first communication from I.R.S. after submitting a reasonable cause statement is Form Letter CP 854C. It Informs the taxpayer that the request for a penalty waiver or abatement has been fully or partially denied. The taxpayer is invited to appeal. The deadline for responding is typically 60 days from the date of the letter. It is not uncommon for a taxpayer residing abroad to first receive the Form Letter CP 854C after the due date for responding has passed. To date, our experience is that the appeal will be processed by the I.R.S. even if late in that set of circumstances. Of course, that may change.

The appeal is filed with the Independent Office of Appeals. Filing an appeal does not stop the collection process. Typically, the appeal includes the following information:

- The name, address, and taxpayer identification number of the taxpayer
- A statement that the taxpayer appeals the findings
- A detailed statement of facts and law
- A copy of the original request for abatement of the penalty
- A copy of CP 854C

The I.R.S. Appeals Office typically responds to a protest by issuing Form Letter 5157, in which it schedules a conference call with the taxpayer. The letter typically grants one month's time to prepare for the call. The taxpayer is typically offered the opportunity to provide additional information to assist the Appeals Officer in reaching a decision. The Appeals Officer may be contacted in advance to reschedule the conference, at least one time.

If the Appeals Officer has not responded within 60 to 90 days of the filing date of a in response to Form Letter CP 854C, the I.R.S. can be contacted at the following telephone number: (559) 233-1267. A recorded message will invite the caller to leave a message and to provide a contact telephone number. The I.R.S. will research the status of the case and return the call within 48 hours. If the case hasn't been updated in the I.R.S. system, no callback will be received.

The I.R.S. sometimes responds by issuing Form Letter CP 15 instead of Form Letter CP 854C. This invites the taxpayer to file a submission to the I.R.S. prior to an appeal to the Independent Office of Appeals. Form letter CP 15 grants 30 days for the response to be submitted. Typically, the I.R.S. will issue a letter informing the taxpayer that the I.R.S. is not equipped to handle the matter and is forwarding the matter to the I.R.S. Independent Office of Appeals. This is simply one added step that increases processing time.

As mentioned above, the Appeals process does not stop the collection process. Consequently, while an appeal is pending, the taxpayer will continue to receive the following collection notices:

- CP 501 Reminder, We Show You Still Owe
- CP 503 Notice Important – Immediate Action Required

- CP 504 Notice Urgent Notice – We Intend to Levy on Certain Assets, Please Respond Now
- CP 90/ LT 11/ LT 1058 / Letter 3172 – Notice of Levy (prohibits the State Department from issuing or renewing a passport to a taxpayer with seriously delinquent tax debt in excess of $55,000.

COLLECTION DUE PROCESS HEARING

Before the I.R.S. can levy against the assets of a taxpayer, it will issue Form Letter 3172. This letter grants a Taxpayer the right to request a hearing under the Collection Due Process ("C.D.P.") program. The request is made by filing Form 12153. The C.D.P hearing provides a taxpayer with an opportunity to bring the case before the IRS Office of Appeals, which is independent and separate from the I.R.S. Collections office.

A hearing must be requested within 30 days from the date of Form Letter 3172. A negative determination by the Appeals Officer The Appeals determination can be challenged in Tax Court. If the 30-day period lapses, an equivalent hearing may be requested. However, the equivalent hearing does not allow a taxpayer the right to challenge the determination in Tax Court.

In a C.D.P. hearing, a taxpayer may raise issues relating to collection. In particular, a taxpayer may raise the following grounds for relief from the threat of a levy:

- The taxpayer believes all taxes due were paid.
- The taxpayer cannot pay the taxes due to one or more of the following reasons:
    - A terminal illness or high medical bills
    - Unemployment or no income
    - Reasonable expenses exceed income
    - The taxpayer's only source of income is social security, welfare, or unemployment benefits
- The taxpayer wants to pursue innocent spouse relief.
- The taxpayer thinks the statute of limitations on collection has expired.
- The taxpayer intends to propose a different way to pay the taxes owed.
- The I.R.S. made a procedural error in its tax assessment.
- The I.R.S. assessed taxes and initiated a levy when the taxpayer was in bankruptcy.
- The taxpayer wants a tax lien discharged to sell a piece of property and use the proceeds to pay off their tax liabilities.
- The taxpayer desires a tax lien subordination or withdrawal.

"A hearing must be requested within 30 days from the date of Form Letter 3172."

A taxpayer may also challenge the underlying tax liability for any tax period, but only if he or she did not receive a notice of deficiency or did not otherwise have an opportunity to dispute the liability.

A timely request for a C.D.P. hearing will prohibit levy action in most cases. It will also suspend the running of the statutory year period to collect the taxes. Both prohibition on levy and the suspension of the 10-year statutory period for collections will last until a determination by the I.R.S. Independent Office of Appeals. The suspended amount of time is, in effect, added to the time remaining in the 10-year period.

The taxpayer has a right to challenge and adverse determination in its C.D.P. hearing by filing a petition for review in the U.S. Tax Court.

THINGS TO REMEMBER WHEN DRAFTING AN APPEAL

When appealing the 25% penalty on a late-filed Form 3520, it is important to tell the whole story. A recitation of bare facts followed by a citation to a favorable decision in a court is a recipe for failure. The goal is to convince the Appeals Officer that the taxpayer acted responsibly even though a failure in compliance occurred. The Appeals Officer must be convinced that reasonable cause existed. This requires a full and complete submission that is true, accurate, and complete. False statements with the intent to mislead are punishable as felonies.

In fashioning the submission, emphasize the professional credentials of the tax adviser. Before arguing that the adviser or tax return preparer was at fault, explain in detail why it was reasonable to choose this tax adviser in the first place. Remember, the capability of the tax adviser or return preparer is a key decision point in determining that reasonable cause existed for the taxpayer's failure to timely Form 3520. If the adviser or preparer is painted as incompetent, the taxpayer's position is weakened, not strengthened.

Once it is established that the tax adviser or tax return preparer was highly competent to address this area of the law, the focus shifts to whether the taxpayer made full disclosure. This requires demonstrating that the person on whom the taxpayer relies was given sufficient information to advise properly. Avoid giving conclusions without a detailed recitation of facts.

The final piece of the puzzle is to demonstrate that the taxpayer actually relied in good faith on the advice. Here the standard of care varies depending on the profile of the taxpayer. If the taxpayer's business is in the financial services sector, a higher standard of care must be demonstrated. If the taxpayer is not a businessman, a lesser standard may be applied. Whichever standard applies, the taxpayer must demonstrate clearly that he or she exercised ordinary business care and prudence in determining applicable obligations, but nevertheless failed to comply with those obligations.

As a final point, a taxpayer should provide all facts in detail. Look for facts highlighted in cases that produced favorable results and see if they reasonably exist in the circumstances at hand. More detail is better than less detail.

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