Foreign Trusts, Foreign Gifts, and Ongoing Disputes: Public Comments and Possible Changes

*By Hale E. Sheppard**

I. Introduction

The rules regarding foreign trusts and foreign gifts have *always* been obscure, complex, and severe, and the situation has become even more troublesome in recent years. Convinced that taxpayers are engaged in international shenanigans, the Internal Revenue Service ("IRS") has taken several steps lately. Among them are initiating a Compliance Campaign, adopting a policy of automatically assessing maximum penalties in *all* cases, and offering relief only in the narrowest of circumstances. These actions, combined with several inactions by the IRS, have triggered significant disputes, often involving big dollars.

This article analyzes common filing duties for taxpayers with a global reach, specific obligations applicable to foreign trusts and gifts, a series of recent actions by the IRS and the courts in this realm, and comments submitted by several accounting and legal organizations underscoring problems with and proposed changes to the current international information returns.

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II. International Reporting

To appreciate this article, readers first need to understand the issues that taxpayers with a global slant often face. U.S. individuals who own foreign assets, engage in foreign activities, and/or receive foreign gifts often must do several things with the IRS, including the following:

- They must declare on Form 1040 (*U.S. Individual Income Tax Return*) all income derived from all sources, including active and passive income generated abroad;

- They must disclose on Schedule B to Form 1040 the existence and location of foreign accounts;
- They must file a FinCEN Form 114 ("*FBAR*") to provide details about foreign accounts;
- They must report foreign financial assets, as this term is broadly defined, on Form 8938 (*Statement of Specified Foreign Financial Assets*);
- In cases where taxpayers hold interests in or have other links to foreign entities, they must report these relationships to the IRS on the appropriate international information return, such as Form 5471 (for foreign corporations), Form 8865 (for foreign partnerships), and Form 8858 (for foreign disregarded entities and branches);
- They must file a Form 8833 (*Treaty-Based Return Position Disclosure*) if they are claiming that the application of a treaty between the United States and another country overrules or modifies normal tax treatment;
- In situations where taxpayers establish, fund, own, or have other connections with foreign trusts, they must reveal them on Form 3520 (*Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*) and/or Form 3520-A (*Annual Information Return of Foreign Trust with a U.S. Owner*); and
- If they receive gifts from a foreign individual or estate totaling more than $100,000 in a single year, they must note them on Form 3520.

This article focuses on the last two bullet points, related to foreign trusts and foreign gifts.

III. Foreign Trusts—Duties and Penalties

A taxpayer's obligations vary depending on his relationship to the foreign trust. In particular, expectations differ based on whether a taxpayer is a "responsible party," an "owner," and/or the recipient of a "distribution."

A "responsible party" generally must file a Form 3520 within 90 days of certain "reportable events."[1] For these purposes, a "responsible party" is (i) the grantor, in cases involving the creation of an *inter vivos* trust, (ii) the transferor, where there is a reportable event other than a transfer upon death, and (iii) the executor of a decedent's estate.[2] For its part, the term "reportable event" includes the establishment of a foreign trust by a U.S. person, the transfer of money or other property to a foreign trust by a U.S. person, and the death of a U.S. person if hewas treated as the "owner" of any portion of the foreign trust under the grantor trust rules or if any portion of the foreign trust was included in his gross estate.[3]

If a U.S. person is treated as the "owner" of any portion of a foreign trust under the grantor trust rules at any time during a year, then the person (i) "shall submit" such information as the IRS prescribes with respect to the trust, and (ii) "shall be responsible to ensure" that the trust itself files Form 3520-A with the IRS and furnishes the required information to each U.S. person who is the owner of any portion of the trust, or who receives any distribution from the trust.[4]

Finally, a U.S. person ordinarily must file a Form 3520 if such person receives during the year any "distribution" from a foreign trust, as this concept is broadly interpreted.[5]

The penalty for not filing a timely, complete, accurate Form 3520 is $10,000 or 35 percent of the so-called "gross reportable amount," whichever is larger.[6] If the violation involves Form 3520-A (pertaining to owners of foreign trusts) instead of Form 3520 (pertaining to responsible parties and beneficiaries), the penalty decreases from 35 percent to five percent.[7]

Taxpayers might also be hit with a so-called "continuation penalty" if they fail to submit the necessary Form 3520 and/or Form 3520-A after the IRS notifies them of the infraction. Specifically, if taxpayers refuse to become compliant within 90 days of notice, then the IRS will assess an additional penalty of $10,000 per month.[8]

The key to determining the initial penalty is calculating the "gross reportable amount." This term has three different meanings. First, in the case of a failure by a "responsible party" to file a Form 3520, it means "the gross value of the property involved in the [reportable] event (determined as of the date of the [reportable] event)."[9] Second, in instances when an owner does not file a Form 3520-A, it means "the gross value of the portion of the trust's assets at the close of the year treated as owned" by the U.S. person.[10] Lastly, where a U.S. beneficiary overlooks Form 3520, it means "the gross amount of the distributions."[11]

The IRS will not assert penalties where there is "reasonable cause" for a violation and it was not due to "willful neglect."[12] Because the IRS has never issued regulations explaining the significance of reasonable cause for purposes of Form 3520 and Form 3520-A, the courts have been receptive to arguments applying standards set forth elsewhere in the Internal Revenue Code.[13]

Importantly, unlike the long list of penalties that are linked to tax returns, Form 3520 and Form 3520-A penalties are "assessable" ones. This means that the IRS immediately imposes them and starts collection actions, and the normal deficiency procedures do not govern.[14]

IV. Foreign Gifts—Duties and Penalties

If a U.S. individual receives a gift of property (including money) from a foreign individual totaling more than $100,000 during a given year, then he generally must file a Form 3520 with the IRS providing data about the event.[15] The receipt of the foreign gift does *not* trigger any immediate U.S. income taxes for the recipient, solely an information-reporting duty.

It is noteworthy that Form 1040, which all U.S. individuals ordinarily must file with the IRS to address income tax matters, does not raise the potential need to submit a Form 3520 upon receipt of a foreign gift. Schedule B to Form 1040 expressly warns taxpayers that they might have to file Form 3520 if they transfer anything to, serve as a grantor of, or get a distribution from a foreign trust. It makes no mention, however, of possible Form 3520 duties in situations where individuals receive foreign gifts.[16]

The penalty for filing a delinquent Form 3520 is five percent of the unreported gift for each month it is late, with a maximum penalty of 25 percent.[17] The IRS has the authority to waive the penalty, though, if the taxpayer can demonstrate that the violation was due to reasonable cause.[18] The legislative history indicates that IRS determinations about Form 3520 penalties will be subject to review by the courts, which will analyze whether the IRS acted "arbitrarily and capriciously."[19]

Interestingly, the IRS recently acknowledged that most taxpayers are oblivious to the need to file Form 3520 when they receive a foreign gift, particularly because such an event does not trigger a taxable event for U.S. purposes. The IRS stated the following in a recent training guide:

> In general, gifts and inheritances are not taxable to the recipient. Many taxpayers and representatives know that basic tenant of tax law but are not aware of the requirement to report large foreign gifts and inheritances under [Section] 6039F.[20]

V. Recent Events Involving Foreign Trusts and Gifts

Several things have occurred recently in the area of foreign trusts and gifts, many of them negative from the perspective of taxpayers. A few noteworthy items creating this perception are described below.

A. Compliance Campaign

In May 2018, the IRS introduced a "Compliance Campaign" centered on foreign trusts, Form 3520, and Form 3520-A.[21] Itwas designed to stop alleged shenanigans associated with foreign trusts. Unfortunately, taxpayers with legitimate reasons for establishing foreign trusts and those receiving foreign gifts have been caught in the enforcement net, too.

B. Selective Relief

The tax community has notified the IRS for ages that widespread problems exist as a result of immediate penalty assessment, failure to consider legitimate "reasonable cause" positions, dishonoring of collection freezes, ignoring the first-time abate policy, and prematurely forcing taxpayers to seek justice through a Collection Due Process hearing or Tax Court litigation.[22] As a partial concession, the IRS issued a memo to Appeals Officers in December 2022 indicating that they can now waive penalties using the first-time abate policy when it comes to Forms 5471 and 5472.[23] However, such memo confirmed that the first-time abate policy is *not* applicable to foreign trust and foreign gift situations, despite the fact that they are among the most commonly appealed penalties.[24]

C. Volatile Penalty Practices

The IRS has come under fire for its mishandling of international information returns over the past few years, both those filed in the normal course and those submitted pursuant to one of the many international disclosure programs offered by the IRS.[25] The IRS attempted to blame the Coronavirus, explaining that it "had an unprecedented effect on the IRS' personnel and operations" and that "the IRS has been working aggressively to process backlogged returns and taxpayer correspondence to return to normal operations."[26] The IRS released Notice 2022-36 in August 2022 in an effort to assuage past errors, delays, and widespread aggravation. It indicated, among other things, that certain Forms 3520, for only 2019 and 2020, would not be penalized. The IRS stated that, depending on the status of a particular case, the penalties would be "automatically abated, refunded or credited, as appropriate, without any need for taxpayers to request this relief."[27]

D. Novel Foreign Gift Case

There is a pending case centered on Form 3520 penalties linked to the receipt of foreign cash gifts, *Wrzesinki v. United States*, which is important for several reasons.[28] For starters, it appears to be the first case addressing this particular issue.

The dispute is in the early stages, with the taxpayer filing a Complaint in District Court in September 2022. It indicates that the taxpayer was born, raised, and educated in Poland, and then immigrated to the United States when he was 19 years old. He has been in public service, working as a police officer, for nearly a decade. In 2010, his mother, both a citizen and resident of Poland, won the lottery there and decided to gift the taxpayer $830,000.

The taxpayer called his tax advisor from Poland to inquire about any U.S. duties triggered by the receipt of the gift. The tax advisor, who is an Enrolled Agent with the IRS, expressly told the taxpayer that the gift did not cause U.S. income tax liabilities or any other duties. The mother made the gift *via* four separate transfers, from Poland to the United States, spanning 2010 (a total of $350,000) and 2011 (a total of $480,000). Thus, the taxpayer received over $100,000 in cash gifts from a foreign person each year.

In early 2011, during preparation of the taxpayer's Form 1040 for 2010, he again asked the tax advisor if he needed to file anything with the IRS in connection with the gift from his mother. The tax advisor, as before, incorrectly told the taxpayer that nothing was due.

Nothing happened for a long time, but things changed in 2018. The taxpayer wanted to engage in some re-gifting, sending a portion of the money that he received from his mother years ago to his godson in Poland. The taxpayer thought that he, as a U.S. person, might have some tax-related duties when sending a gift abroad. Therefore, he did some searches on the Internet. This led him to various articles about duties of U.S. persons who receive money from foreign persons, as he did back in 2010 and 2011. Shocked by this information, the taxpayer contacted a local attorney with experience regarding international matters.

The attorney informed the taxpayer of his duty to file Forms 3520 for 2010 and 2011 to report the cash gifts from his mother. He also explained to the taxpayer that there might be a way for him to rectify matters with the IRS on a penalty-free basis, the delinquent international information return submission procedure ("DIIRSP"). The taxpayer, with the assistance of the attorney, filed Form 3520 pursuant to the DIIRSP, along with statements explaining reasonable cause. This occurred in August 2018. The statements contended several things, the most important of which were that the taxpayer consulted with his tax advisor before filing his Form 1040 for 2010, gave the tax advisor details about the foreign gifts, received erroneous advice from the tax advisor, and relied on such advice.

After nearly a year, the IRS sent the taxpayer two notices in May 2019, indicating that he owed total penalties of $207,500 for the late Form 3520. That figure represented *the highest possible amount*, which was 25 percent of the gifts received. In essentially rejecting the DIIRSP application and accompanying statements, the IRS notices concluded that ordinary business care and prudence requires taxpayers to make themselves aware of their duties and that ignorance of tax laws could not serve as a basis for reasonable cause.

The taxpayer disputed the penalties by filing a Protest Letter in June 2019. To strengthen his position, the taxpayer later filed a Supplemental Protest Letter, attaching a letter from the tax advisor in which he admits that the facts in the Complaint are accurate. The advisor, in other words, corroborated the taxpayer's reasonable-reliance defense to penalties.

Another year and a half passed. In December 2020, the Appeals Officer assigned to review the penalties, Protest Letter, and Supplemental Protest Letter issued a so-called Case Memo. He agreed to abate $166,000 of the total penalty of $207,500. That left a penalty of $41,500, or five percent of the total gifts that the taxpayer received from his mother.

The taxpayer paid the $41,500. He then filed Claims for Refund with the IRS in March 2022, which the IRS swiftly denied. In doing so, the IRS took the position that the Claims for Refund did not establish reasonable cause and were "frivolous." The taxpayer next filed his Complaint with the District Court, thereby initiating the Suit for Refund.

E. Penalty Stacking

The IRS and the courts have exhibited a willingness in recent years to "stack" penalties related to foreign trusts in different manners. One noteworthy case is *Wilson v. United States*.[29] It addresses penalty stacking in situations where one U.S. person plays two roles with respect to a foreign trust.

The taxpayer, in anticipation of a divorce action by his spouse, formed the Perfect Partner Trust ("PPT") in

2003. The taxpayer was both the grantor and sole beneficiary, which is the key to this case. PPT held accounts in Switzerland and Liechtenstein. The divorce proceeding began in 2004 and concluded in 2007. With no further need for holding assets abroad, the taxpayer terminated PPT in 2007 and had all funds wire-transferred back to domestic accounts. The funds had grown to around $9.2 million by then.

The IRS began an audit of the taxpayer and eventually assessed a penalty of approximately $3.2 million on the following building blocks. The taxpayer was the beneficiary of PPT and he received a distribution in 2007 (*i.e.*, the wire-transfer when he terminated PPT). As a beneficiary, he was required to file a timely, accurate, complete Form 3520 reporting the distribution under Code Sec. 6048(c). Because he failed to do so, the proper penalty was 35 percent of the total distribution. The taxpayer was also the owner of PPT. In situations where the taxpayer is both an owner *and* a beneficiary of a foreign trust, and the taxpayer fails to file Forms 3520 *and* 3520-A, the IRS can assess one penalty for 35 percent of the gross reportable amount under Code Sec. 6048(c) *and/or* one for five percent under Code Sec. 6048(b). The IRS chose the higher penalty, of course.

The taxpayer disagreed with the penalty, but he paid it anyway. He then filed a timely Claim for Refund. The IRS simply ignored the taxpayer, so he exercised his right to file a Suit for Refund with the District Court. The taxpayer, who was already in his late 80s back when he formed PPT, died in 2019 amid the procedural squabbling. The estate assumed the battle from that point forward.

The District Court, which handled the case initially, held in favor of the taxpayer. It concluded that under the relevant provision the IRS can *only* assess the five percent penalty, *not* the five percent and 35 percent penalty, and *not* either the five percent or the 35 percent penalty. Fueling the ire of the IRS, the District Court added that the penalty, derived from the "gross reportable amount," would be five percent of the value of "the trust's assets at the close of the year." Because the value of PPT was $0 at the end of 2007, the penalty would be $0.

The government asked the Second Circuit Court of Appeals to review the District Court's decision.[30] This superior judicial body saw things differently, holding in favor of the IRS on all counts. The Court of Appeals began by explaining that Code Sec. 6048(c) demonstrates that when a "U.S. person" fails to report to the IRS a distribution from a foreign trust, he triggers a penalty equal to 35 percent of the "gross reportable amount" under Code Sec. 6677. The Court of Appeals then noted that the term "U.S. person" generally includes "everyone [and] makes no exception for a beneficiary who is also the owner of a foreign trust." The taxpayer in *Wilson v. United States* was a U.S. person who did not file a Form 3520 to disclose the distribution of about $9.2 in 2007. Therefore, concluded the Court of Appeals, the IRS was correct in imposing the 35 percent penalty.[31] The Court of Appeals summarized its ruling as follows:

> The plain language of [Sections] 6048 and 6677 requires that when an individual fails to timely report the distributions she received from a foreign trust, then a 35% penalty applies; *her concurrent status as owner of the trust does not alter this rule*. Because the statute's meaning is clear based from its text, we need not consider any extrinsic sources.[32]

F. Ambiguity with Foreign Retirement Plans

The Government Accountability Office recently issued a report strongly criticizing the IRS and Congress for perpetuating a complex, obscure, and inconsistent system affecting foreign retirement plans, including those characterized as foreign trusts ("GAO Report").[33]

The GAO Report acknowledges that the IRS has provided some limited guidance about foreign retirement plans, such as the International Tax Gap Series and Publication 54, titled "Tax Guide for U.S. Citizens and Resident Aliens Abroad." However, the GAO Report explains that neither item "describes in detail how taxpayers are to determine if their foreign workplace retirement plan is eligible for tax-deferred status, or how to account for contributions, earnings, or distributions on their annual U.S. tax return, particularly whether and when contributions and earnings should be taxed as income."[34]

Lack of clarity from the IRS has created disagreement among U.S. tax practitioners about how to treat foreign plans. According to the GAO Report, some practitioners advise their clients to report them as passive foreign investment companies ("PFICs") on Form 8621 (*Return by U.S. Shareholder of a Passive Foreign Investment Company*), others recommend disclosing them as foreign financial accounts on FBARs and Form 8938, while still others

suggest that they should be treated as foreign trusts and reported on Forms 3520 and 3520-A.[35]

Indeed, the IRS launched a specialized Compliance Campaign, refused to extend the FTA policy to Forms 3520 and 3520-A, imposed the highest possible penalties against a taxpayer who belatedly reported his foreign gifts pursuant to the DIIRSP, stacked penalties against a taxpayer who played two roles with a foreign trust, adopted a policy of assessing maximum penalties automatically and without analyzing "reasonable cause" statements from taxpayers, neglected to issue guidance about the proper treatment of foreign retirement plans, and offered only limited relief for certain foreign trusts under Rev. Proc. 2020-17.

The GAO Report painted a bleak picture for U.S. individuals with foreign retirement plans, and several real-life examples have underscored this viewpoint. Take the following situation involving a common retirement vehicle, the Australian Superannuation Fund ("ASF"). Taxpayers and practitioners have sought guidance from the IRS for many years with respect to ASFs. Among other things, they have sent letters highlighting the inconsistent tax treatment provided by the U.S. and Australian tax authorities, as well as the lack of specific language in the U.S.Australian treaty to correct the issue.[36] Published materials indicate that the IRS is not heeding the call for change. For instance, the IRS was obligated to publicly release written guidance that it provides to its workers who are tasked with fielding questions about voluntary disclosures. The IRS guidance instructed workers to say the following with respect to ASFs: (i) ASFs are not covered by a favorable treaty provision; (ii) the voluntary disclosure programs offered by the IRS do not have special provisions for ASFs; (iii) the highest value of ASFs that are not compliant with U.S. tax and/or information-reporting obligations are subject to penalties; and (iv) ASFs must be reported on various international information returns, including, but not limited to, Forms 3520 and 3520-A for foreign trusts.[37]

G. Limited Administrative Salvation

The IRS recently issued Rev. Proc. 2020-17, which offered beneficial treatment to certain U.S. individuals with interests in "applicable tax-favored foreign trusts."[38] Its primary purpose was to create an exemption from certain information-reporting requirements (but not from income-reporting and tax-payment requirements) for U.S. individuals regarding their ownership of, and transactions with, certain types of foreign trusts.[39] How can the IRS do this? Well, the law states that the IRS can unilaterally suspend or modify information-reporting duties if it determines that it "has no significant tax interest" in obtaining the relevant data.[40]

An "eligible individual" in this context is a U.S. citizen or U.S. resident who was compliant or "comes into compliance" with his duty to file tax returns for all years and who reported as income on such returns all contributions to, accumulated income in, and actual distributions from the foreign trust.[41] Put another way, only individuals who paid all income taxes related to foreign trusts are in a position to derive the benefits of Rev. Proc. 2020-17.[42]

Rev. Proc. 2020-17 covers *both* "tax-favored foreign *retirement* trusts" and "tax-favored foreign *non-retirement* trusts."[43] The former means (i) a trust, plan, fund, scheme, or other arrangement, (ii) established under the laws of a foreign country (iii) to provide pension or retirement benefits, and (iv) meets a long list of requirements under local law, the most important of which is that contributions to the trust are limited, and distributions from the trust are contingent upon death, disability, or reaching a particular age.[44] The latter is largely the same, except that its objective is to provide medical, disability, or educational benefits.[45]

Rev. Proc. 2020-17 offers *prospective* benefits in that eligible individuals are excused from filing Forms 3520 and 3520-A for qualified foreign trusts in the future.[46] It contains *retroactive* benefits, too, in that any eligible individual against whom the IRS previously assessed penalties can seek an abatement or a refund, as appropriate.[47]

Any step by the IRS toward simplifying foreign trust reporting is positive, but taxpayers have identified some serious limitations of Rev. Proc. 2020-17. First, in order to qualify, a taxpayer must have filed his annual Form 1040 and reported *all* worldwide income, which ordinarily includes all contributions to, passive income generated by, and actual distributions from foreign trust.[48] The reality is that many taxpayers with foreign plans cannot meet this criterion because they failed to declare all income based on their incorrect understanding that they should treat the foreign plans like Code Sec. 401(k) plans under U.S. law. Second, even if a taxpayer were entitled to a future filing waiver under Rev. Proc. 2020-17, he likely still would need to report the foreign trust to the IRS on Form 8938, FBARs, Schedule B of Forms 1040, and perhaps elsewhere. The taxpayer, therefore, will not be relieved of many information-reporting and record-retention duties.[49] Third, the time for claiming a refund of penalties from prior years might have already expired for many taxpayers because Form 3520 and Form 3520-A penalties are immediately assessed and often swiftly collected by the IRS thanks to its authority to effectuate "administrative offsets."[50] Fourth, Rev. Proc. 2020-17 does nothing to resolve the larger problem underscored by the GAO Report, namely, the lack of comprehensive guidance about the proper characterization and tax treatment of foreign plans.[51]

VI. Public Comments on Forms and More

With all that background under their belts, readers are ready for the main event, the recent commentary about Form 3520, Form 3520-A, and related issues.

The IRS sought input in December 2022, and five groups responded.[52] The participants included the Texas Society of Certified Public Accountants, American Institute of Certified Public Accountants, Florida Bar Tax Section, and two tax practitioners.[53] Their comments have been aggregated, summarized, and enumerated below.[54]

- The IRS should update its statistics concerning how many taxpayers must file Forms 3520 and 3520-A and then significantly increase the "compliance burden" imposed on taxpayers in gathering data, analyzing issues, and completing returns.
- The IRS should make several changes to its penalty procedures, particularly when it comes to taxpayers voluntarily and proactively filing Forms 3520 and 3520-A through a disclosure program like the DIIRSP. Such changes should include giving a "fair and meaningful reasonable cause review *before* penalties are imposed," ensuring that the IRS personnel conducting such review possess the proper background and training, avoiding the use of "low-level clerks" in making initial penalty determinations, recognizing that U.S. expatriates have legitimate reasons for having foreign assets, and requiring that a supervisor review and approve all penalties in writing before assessing them.[55]
- The IRS should issue a Revenue Procedure or other similar item creating a "safe harbor" for filing delinquent Forms 3520 and 3520-A on a penalty-free basis.
- The IRS should change its current practice of not applying the First-Time-Abate ("FTA") policy to Forms 3520 and 3520-A. Expanding on this notion, one group suggested that the FTA cover not just the first return, but rather the first *set* of returns filed:

  "For example, if a taxpayer was not aware of the filing obligation, hires new counsel and learns of the obligation, and then files [Forms 3520 and Forms 3520-A] for the prior three, six or any amount of prior years in order to come into compliance, the taxpayer should be exempt from penalty for all of the years in question under FTA. This will reduce the chilling effect on compliance and reporting as taxpayers will not be fearful of penalties being assessed for multiple years when trying to come into compliance for the first time."[56]

- The IRS should expand the number and types of justifications that it accepts as "reasonable cause" for waiver of penalties and also provide numerous examples.
- The IRS should expand the information-reporting relief granted to taxpayers in Rev. Proc. 2020-17.
- The IRS should provide better guidance about whether and when foreign pensions and other retirement plans constitute foreign trusts.
- The IRS should exempt taxpayers from filing Forms 3520 and 3520-A with respect to foreign plans in cases where a treaty allows for the deferral of income taxes on passive earnings within the plans until distributions are made.
- The IRS should add a new box to Part III of Schedule B to Form 1040 asking taxpayers if they received any gifts or inheritances from foreign sources during the year. If the answer is "yes," then taxpayers should be notified of the potential duty to file Form 3520-A. This would be similar to existing boxes, questions,

and cross-references for foreign accounts and foreign trusts.[57]

- The IRS should clarify to taxpayers and tax professionals that its current policy is to assess maximum penalties when it comes to late or amended Forms 3520 and 3520-A, without contemplating the underlying facts or statements of reasonable cause. The commentators contend that the IRS' policy is creating a "strong disincentive" in two ways. First, taxpayers facing the certainty of large penalties might opt for future compliance only, rather than self-correcting past mistakes. Second, many accountants and other return-preparers, weighing the fees that they could earn against possible penalties and malpractice claims, have decided to cease preparing Forms 3520 and 3520-A for taxpayers.[58]
- The IRS should permit and facilitate electronic filing, as opposed to paper filing, of Forms 3520 and 3520-A.
- The IRS should create a *separate* return for reporting large foreign gifts because the current *multi-purpose* return, Form 3520, applies to those who made transfers to a foreign trusts, owned foreign trusts, received distributions from foreign trusts, *and/or* obtained gifts or inheritances from foreign persons.
- Congress should outright repeal Code Sec. 6039F, such that reporting foreign gifts on Form 3520-A would no longer be required. Alternatively, the scope of such provision should be radically reduced, and the IRS' reliance on it should be limited. The commentator advocating this position believes that the current use by the IRS of Form 3520-A penalties is "heavy-handed to an abusive extreme." He further suggests that Form 3520-A "has become a cash cow which results in uninformed citizens and residents being forced to pay tens of millions of dollars of penalties every year for failing to report transactions to the government that substantively are completely tax free."[59]

VII. Conclusion

The situation regarding foreign trusts and gifts has been strained for a long time, and this article demonstrates that things have worsened lately. Indeed, the IRS launched a specialized Compliance Campaign, refused to extend the FTA policy to Forms 3520 and 3520-A, imposed the highest possible penalties against a taxpayer who belatedly reported his foreign gifts pursuant to the DIIRSP, stacked penalties against a taxpayer who played two roles with a foreign trust, adopted a policy of assessing maximum penalties automatically and without analyzing "reasonable cause" statements from taxpayers, neglected to issue guidance about the proper treatment of foreign retirement plans, and offered only limited relief for certain foreign trusts under Rev. Proc. 2020-17. Various organizations and professionals have recently submitted comments to the IRS, criticizing aspects of Form 3520, Form 3520-A, and related enforcement mechanisms. Taxpayers and practitioners with international issues will be watching closely to see whether, or to what extent, the IRS takes such input to heart.

ENDNOTES

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1 Code Sec. 6048(a)(1).
2 Code Sec. 6048(a)(4).
3 Code Sec. 6048(a)(3)(A). The "grantor trust rules" are located in Code Secs. 671-679.
4 Code Sec. 6048(b)(1); Notice 97-34, Section IV, IRB 1997-25, 22.
5 Code Sec. 6048(c)(1); Notice 97-34, Section V, IRB 1997-25, 22.
6 Code Sec. 6677(a).
7 Code Sec. 6677(b).
8 Code Sec. 6677(a).
9 Code Sec. 6677(c)(1); Code Sec. 6048(a).
10 Code Sec. 6677(c)(2); Code Sec. 6048(b).
11 Code Sec. 6677(c)(3); Code Sec. 6048(c).
12 Code Sec. 6677(d); Notice 97-34, Section VII, IRB 1997-25, 22.
13 *See, e.g.*, CCA 200645023 (Jun. 20, 2006); *James*, 100 AFTR 2d 2012-5587 (2012); *Moore*, 115 AFTR 2d 2015-1375 (2015); *In re Wyly et al.*, 117 AFTR 2d 2016-2058 (2016).
14 Code Sec. 6677(e).
15 Code Sec. 6039F(a); IRS Notice 97-34, Section VI, IRB 1997-25, 22.
16 Schedule B (Interest and Ordinary Dividends), Part III (Foreign Accounts and Trusts), Question 8 (2021); 2021 Instructions for Schedule B, pg. B-2; 2021 Instructions for Form 1040 and Form 1040-SR, pg. 23.
17 Code Sec. 6039F(c)(1)(B); IRS Notice 97-34, Section VI, IRB 1997-25, 22.
18 Code Sec. 6039F(c)(2); IRS Notice 97-34, Section VII, IRB 1997-25, 22; IRM § 20.1.9.10.5 (Jan. 29, 2021); IRM § 8.11.5.6.3 (Dec. 18, 2015).
19 Small Business Job Protection Act of 1996, U.S. House of Representatives, 104th Congress, 2nd Session, Report 104-737, Aug. 1, 1996, pg. 337 (stating that penalty determinations by the IRS will be subject to review by the courts under the "arbitrary and capricious standard, which provides a high degree of deference to [the IRS's] determination.").
20 Voluntary Disclosure Practice Examiner Guide Paper, 2022 Tax Notes Today Federal 138-24 (7/9/2022), pg. 44; *See also* IRS Chief Counsel, INFO 2013-0015 (March 29, 2013).
21 Frank Agostino *et al. Examination of Large Foreign Gifts and Inheritances: Code Sec. 6039F, Notice 97-34 and Form 3520*, 20 J. Tax Pract. Proc. 5 (2018).
22 *See, e.g.*, Kristen A. Parillo, "IRS Looking to Fix Problems with Some Automatic Assessments," Federal Tax Notes Today Doc. 2019-47399 (Dec. 16, 2019); Andrew Velvarde. "Practitioners Fault Accelerated Assessable Penalty Collection,"

Federal Tax Notes Today Doc. 2020-10055 (Mar. 28, 2020).

[23] "Appeals Guidance Issued on Abatement for International Penalties," 2022 Tax Notes Today International 248-23 (Dec. 7, 2022).

[24] "Appeals Guidance Issued on Abatement for International Penalties," 2022 Tax Notes Today International 248-23 (Dec. 7, 2022); IRM § 8.11.5.1(3) (Dec. 18, 2015); IRM § 8.11.5.1(12) (Dec. 18, 2015).

[25] *See*, *e.g.*, "AICPA Calls for More Transparency from IRS on Backlog," 2022 Tax Notes Federal Today 135-19 (Jul. 11, 2022).

[26] Notice 2022-36, Section 2, IRB 2022-36, 188.

[27] Notice 2022-36, Section 3(A), IRB 2022-36, 188.

[28] *Wrzesinski*, Case No. 2:22-cv-03568, Eastern Dist. of Penn, Complaint, Sep. 1, 2022; Andrew Veldarde, "Son of Polish Lottery Winner Challenges Foreign Gift Penalty," 2022 Tax Notes Today Federal 174-26 (Sep. 7, 2022).

[29] *Wilson*, 124 AFTR 2d 2019-6693 (D.C. NY 2019).

[30] *Wilson*, 128 AFTR 2d 2021-XXXX (2nd Ct. 2021); *See also* Andrew Velarde, "Second Circuit Hands Government Win on Foreign Trust Penalties," 2021 Tax Notes Today Federal 144-3 (Jul. 29, 2021).

[31] *Wilson*, 128 AFTR 2d 2021-XXXX (2nd Ct. 2021), Slip Opinion, pg. 9 (referencing Code Secs. 6048(c), 6677(a) and 6677(c)).

[32] *Wilson*, 128 AFTR 2d 2021-XXXX (2nd Ct. 2021), Slip Opinion, pg. 13 (emphasis added).

[33] U.S. Government Accountability Office. Workplace Retirement Accounts: Better Guidance and Information Could Help Plan Participants at Home and Abroad Manage Their Retirement Savings. GAO-18-19 (Jan. 2018); *See also* Veena K. Murthy, *Selected Cross-Border Equity and Deferred Compensation Issues with Fund Foreign Plans*, 42 Compensation Planning J. 67 (Apr. 2014); Lawrence J. Chastang and Steve Yeager, *Foreign Pensions and Florida Practitioners*, Fl. CPA Today, May/June 2013; Cynthia Blum, *Migrants with Retirement Plans: The Challenge of Harmonizing Tax Rules*, 17, 1 Fl. Tax Rev. 2015.

[34] U.S. Government Accountability Office. Workplace Retirement Accounts: Better Guidance and Information Could Help Plan Participants at Home and Abroad Manage Their Retirement Savings. GAO-18-19 (Jan. 2018), pg. 37.

[35] *Id.*, pgs. 38 and 39.

[36] "Remedy Sought for Taxation of Retirement Funds in Australia," 2016 Tax Notes Today 178-29; Document 2016-18374 (Aug. 26, 2016); "Dual Citizen Concerned about Australian Superannuation Funds," 2014 Tax Notes Today 166-14; Document 2014-21016 (Aug. 11, 2014).

[37] "IRS Releases OVDP, Streamlined Program Hotline Guide," 2017 Worldwide Tax Daily 160-16; Document 2017-66433.

[38] Rev. Proc. 2020-17, IRB 2020-12, 539; Annagabriella Colon. "IRS Guidance Eases U.S. Taxpayers' Information Reporting Duty," 2020 Tax Notes Today Federal 42-3, Document 2020-8022 (Mar. 3, 2020).

[39] Rev. Proc. 2020-17, Section 1, IRB 2020-12, 539.

[40] Rev. Proc. 2020-17, Section 2.01, IRB 2020-12, 539 (referencing Code Sec. 6048(d)(4)).

[41] Rev. Proc. 2020-17; Section 5.02, IRB 2020-12, 539. The IRS expressly states that in determining the open period taxpayers do not need to consider the limitless assessment-period rule in Code Sec. 6501(c)(8) applicable when taxpayers fail to file certain international information returns.

[42] Rev. Proc. 2020-17, Section 1, IRB 2020-12, 539 (explaining that "[o]nly eligible individuals … (generally U.S. individuals who have been compliant with respect to their income tax obligations related to such trusts) may rely on" the new IRS guidance").

[43] Rev. Proc. 2020-17; Section 5.01, IRB 2020-12, 539.

[44] Rev. Proc. 2020-17; Section 5.03, IRB 2020-12, 539.

[45] Rev. Proc. 2020-17; Section 5.04, IRB 2020-12, 539.

[46] Rev. Proc. 2020-17, Section 3, IRB 2020-12, 539.

[47] Rev. Proc. 2020-17, Sections 6.01 and 7, IRB 2020-12, 539.

[48] Rev. Proc. 2020-17; Section 5.02, IRB 2020-12, 539. The IRS expressly states that in determining the open period taxpayers do not need to consider the limitless assessment-period rule in Code Sec. 6501(c)(8) applicable when taxpayers fail to file a long list of international information returns.

[49] Rev. Proc. 2020-17, Section 2.02, IRB 2020-12, 539; Rev. Proc. 2020-17, Section 3, IRB 2020-12, 539 (stating that Rev. Proc. 2020-27 "does not affect any reporting obligations under Code Sec. 6038D or under any other provision of U.S. law, including the requirement to file FinCEN Form 114 imposed by 31 USC section 5314 and the regulations thereunder.")

[50] Code Sec. 6402.

[51] U.S. Government Accountability Office. Workplace Retirement Accounts: Better Guidance and Information Could Help Plan Participants at Home and Abroad Manage Their Retirement Savings. GAO-18-19 (Jan. 2018), pg. 53.

[52] FR Vol. 87, No. 241, pg. 77167, Dec. 16, 2022.

[53] *See* "Texas CPAs Object to IRS's Foreign Trust Penalty Practices," 2023 Tax Notes Today Federal 38-41 (Feb. 24, 2023); "AICPA Requests Reforms for Foreign Trust Penalty Assessments," 2023 Tax Notes Today Federal 38-42 (Feb. 13, 2023); "Changes Needed for Foreign Trust Reporting, Florida Bar Argues," 2023 Tax Notes Today Federal 38-43 (Feb. 13, 2023); "Foreign Trust Transacting Reporting Must Be Improved, Firm Says," 2023 Tax Notes Today Federal 38-44 (Feb. 9, 2023); Michael J.A. Karlin, "Attorney Condemns Requirement to Report Foreign Gifts," 2023 Tax Notes Today Federal 45-42 (Mar. 6, 203); Andrew Velarde, "Commentators Line Up to Critique Foreign Trust Penalty Operation," 2023 Tax Notes Today Federal 43-11 (Mar. 6, 2023).

[54] Aggregation is appropriate because many of the comments by the four participants are duplicative.

[55] "Texas CPAs Object to IRS's Foreign Trust Penalty Practices," 2023 Tax Notes Today Federal 38-41 (Feb. 24, 2023).

[56] "Changes Needed for Foreign Trust Reporting, Florida Bar Argues," 2023 Tax Notes Today Federal 38-43 (Feb. 13, 2023).

[57] Part III to Schedule B of Form 1040 presents the following guidance about foreign accounts: "At any time during [relevant year], did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? *See* instructions. If "Yes," are you required to file [FBAR] to report that financial interest or signature authority? *See* [FBAR] and its instructions for filing requirements and exceptions to those requirements." Likewise, Part III to Schedule B presents the following question and warning about foreign trusts: "During [the relevant year], 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. *See* instructions." *See* Form 1040 (*U.S. Individual Income Tax Return*) for 2022.

[58] "AICPA Requests Reforms for Foreign Trust Penalty Assessments," 2023 Tax Notes Today Federal 38-42 (Feb. 13, 2023).

[59] Michael J.A. Karlin, "Attorney Condemns Requirement to Report Foreign Gifts," 2023 Tax Notes Today Federal 45-42 (Mar. 6, 2023).