

Reproduced with permission from Daily Tax Report, 207 DTR J-1, 10/27/17. Copyright © 2017 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

## Foreign Income

Robert M. Adler of Nossaman LLP discusses the dubious grounds relied on by the IRS to impose the greater of two alternative penalties for the late filing of Form 3520 reporting offshore trust transactions.

### Questionable IRS Penalties for the Late Reporting of Offshore Trust Transactions

BY ROBERT M. ADLER

For taxpayers not participating in the Offshore Voluntary Disclosure Program, the Internal Revenue Service has aggressively assessed penalties for the late filing of information returns required for the reporting of offshore assets and income, the funding of offshore trusts, and transfers made from those trusts to U.S. beneficiaries. The legal support is dubious, at best, for the IRS' assessment of onerous penalties of 35 percent of the amounts distributed under tax code Section 6048(c) when a distribution is made to the trust's grantor/owner who is also a named beneficiary.

#### A. The Statutory Framework

Section 6677(a) provides for a civil penalty if any return required by Section 6048 is not timely filed. Section 6677(a) provides for a penalty equal to the greater of \$10,000 or 35 percent of the "reportable amount." At the same time, Section 6677(b) provides that, where a return is required to be filed by the owner under Section 6048(b), a much-reduced penalty of 5 percent is as-

*Robert Adler is a partner at Nossaman LLP in the Washington, D.C. office. He has four decades experience as a litigator, specializing in complex litigation and white collar defense. Recently, he has represented clients involved in the non-reporting to the IRS of offshore accounts and their earnings. Prior to joining Nossaman, Mr. Adler served in the Criminal Tax Section of the Tax Division of the U.S. Justice Department and later as a civil trial attorney in that Division.*

sessable. Section 6048(c) provides that, if a U.S. person receives, during any taxable year, a distribution from a foreign trust, that person must file a return providing the required information with respect to such distribution. Failure to timely file this information return results in a penalty of 35 percent of the amount distributed. This penalty will obviously represent a sizeable sum in many cases.

The tax code is not a model of clarity in determining whether a 5 percent versus a 35 percent penalty applies when a trust distribution is made to a beneficiary who is *also* treated as the owner under Section 6048(b). If that individual fails to timely file Form 3520 reporting that distribution, then which penalty applies? The IRS uniformly, but incorrectly, takes the position that the 35 percent penalty applies on the ground that the trust distribution was made to a "beneficiary" under Section 6048(c).

In taking this position, the IRS ignores the uncertainty that stems from two alternative penalties in Sections 6048(b) and (c). There is no language in the statute or in case law to support the IRS position. The statute is *silent* as to which penalty applies when the owner of the trust and the trust beneficiary are the *same* individual. The IRS has not promulgated regulations that might clarify these uncertainties; and there is no case law on point that resolves this issue or even discusses it.

#### B. The Problems with the IRS Position

The IRS position is wrong for four reasons: it is contrary to the legislative history of Section 6048; it is contrary to the grantor trust rules; it is contrary to the well-established judicial principle that ambiguities in a statute are to be resolved in favor of the taxpayer; and it is

contrary to the IRS' own guidance to taxpayers applying the statute.

### 1. Legislative history

The legislative history of Section 6048 reflects that the 35 percent penalty imposed by Section 6048(c) was not intended to be applied when the distribution was made to a U.S. owner who was also the sole beneficiary.

Congress amended Section 6048(c) in 1996. The reasons for the amendments were explained by the Joint Committee on Taxation in its staff report. See, General Explanation of Tax Legislation Enacted in the 104<sup>th</sup> Congress, JCS-12-96, Dec. 18, 1996. As set forth on pages 269-273 (Reasons for Change), Congress believed that the U.S. grantor trust rules (under Sections 671-678) were being used as a vehicle to avoid tax by the use of a foreign trust. As explained in the report, under the prior grantor trust rules, only the owner of the trust (not the trust beneficiary) was subject to U.S. tax on the trust's income. Thus, if a non-resident alien created a foreign trust with a U.S. beneficiary, the prior grantor trust rules did not tax a distribution to the U.S. beneficiary. If the alien's home country did not tax the trust's income, the income would not be subject to tax either in the foreign country or the U.S. For this reason, Congress amended Section 6048(c) to require annual reports by the beneficiary for any distribution received and to provide that the amount of any distribution from a foreign trust was includable in the beneficiary's gross income as an accumulation distribution (unless adequate records were provided to determine the proper treatment of the distribution).

In circumstances where a distribution is made to a beneficiary who is also the trust's grantor/owner, the underlying rationale for this amendment to Section 6048(c) did not apply. A U.S. grantor/owner was required to include all of the trust income in his taxable income in the first instance and this requirement made any amendment to the tax code unnecessary in order to ensure that trust income was included in gross income for U.S. tax purposes.

### 2. Grantor trust rules

A distribution to a grantor is non-taxable in the first place because under Section 671, the owner of a grantor trust is required to include all of the trust's earnings in his/her gross income even if there was no actual distribution from the trust. Accordingly, the trust itself is effectively ignored for income tax purposes, and the trust does not shield the grantor/owner from including the trust's gross income in his/her own reportable income. This treatment also means that, for income tax reporting purposes, the fact that the owner is also the beneficiary is irrelevant. The income is reported by the owner in that capacity and not in the capacity of beneficiary.

The same principles should carry over to the penalty provisions of Sections 6048(b) and (c). Because both the reporting obligation and tax liability fall on the owner—as the owner—there is no remaining reporting obligation for the beneficiary which would fall under Section 6048(c).

### 3. Judicial precedent: Ambiguity is resolved in the taxpayer's favor

The Supreme Court and numerous circuit courts have held that, where a statute is not clear as to whether

a penalty may be imposed or on whom it may be imposed, the ambiguity must be resolved against the government.

The Supreme Court held in *Gould v. Gould*, 245 U.S. 151, 153 (1917):

In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen. (citation omitted)

The Supreme Court's later decision in *Commissioner v. Acker*, 361 U.S. 87 (1959), involved the interpretation of a tax statute imposing a penalty. At issue was whether separate tax penalties could be asserted for both the failure to timely file a declaration of estimated income tax and for the filing of a return that substantially underestimated the estimated tax. The tax code did not answer this question. However, the Treasury Regulations provided that both penalties could be assessed. Relying on those regulations, the IRS assessed both penalties. The Supreme Court did not find any express or implied language in the statute that authorized both penalties. *Acker*, *supra* at 91. The Court proceeded to hold: "the law is settled that 'penal statutes are to be construed strictly.'" (citation omitted). *Id.* It further stated: "... one 'is not to be subjected to a penalty unless the words of the statute plainly impose it.'" (citation omitted). *Id.*

This long-standing principle that ambiguous tax penalty provisions should be interpreted in the taxpayer's favor, as enunciated in *Gould* and *Acker*, was recently followed in a decision involving the interpretation of Section 6048(c). In *In re Wyly*, 552 B.R. 338, 562 (N.D. Tex. 2016), the Court stated: "another principle of statutory construction supports the Debtors' reading of 6048(c)—i.e., the canon of resolving ambiguities in tax statutes, and especially tax statutes imposing penalties, in the taxpayers' favor." *Id.* The court proceeded to state, quoting *Acker*: "one 'is not to be subjected to a penalty unless the words of the statute plainly impose it.'" *Id.* at 578. Further, the court, quoting from a recent Fifth Circuit decision, *United States v. Marshall*, 798 F.3d 296, 318 (5th Cir. 2015), stated: "if 'the words of a tax statute are doubtful, the doubt must be resolved against the government and in favor of the taxpayer.'" *Id.*

The Fifth Circuit's decision in *Marshall*, *supra*, is representative of a host of similar decisions in other Circuits. See, e.g., *Bradley v. United States*, 817 F.2d 1400, 1402-1403 (9th Cir. 1987) ("a tax provision which imposes a penalty is to be construed strictly; a penalty cannot be assessed unless the words of the provision plainly impose it"); *Christensen v. Qwest Pension Plan*, 462 F.3d 913, 918 (8th Cir. 2006) ("We agree with the District Court's decision that this is a statutory penalty that may not be imposed 'unless the words of the statute plainly impose it'; citing *Acker*"); *United States v. Frame*, 885 F.2d 1119, 1142 (3d Cir. 1989) ("if this charge were an additional penalty imposed by the Secretary, it would be invalid" (quoting from *Acker*); and *Railway Labor Executives' Association v. Interstate Comm.*, 735 2d. 691, 701 n.2 (2d Cir. 1984): ("If the Congress wishes to impose a tax or penalty upon a citizen, it must act, not simply talk.")

Tax Court decisions have similarly held that ambiguities in tax statutes imposing penalties are to be resolved in favor of the taxpayer. For example, in *Rand v Commissioner*, 141 T.C. 376, 393 (2013), an issue was presented whether a penalty should be imposed on a tax return preparer. The Court applied the “rule of lenity,” stating:

The rule of lenity is an ‘ancient maxim’ that is perhaps not much less old than construction itself. It is founded on the tenderness of the law for the rights of individuals; and on the plain principal that the power of punishment is vested in the legislative, not in the judicial department. It is the legislature, not the Court, which is to define a crime, and ordain its punishment (citation omitted). Thus, under the rule of lenity statutes that impose a penalty are to be construed in favor of the more lenient punishment (citation omitted). And although often considered in the criminal context, the rule of lenity has been applied in the civil context and specifically with regard to civil tax penalties.

The Tax Court proceeded to hold:

Here, the words of the relevant statutes do not plainly impose a penalty on . . . because the penalty is not plainly imposed. . . the rule of lenity further confirms what we have already concluded that [I.R.C. 6662 ] does not impose a penalty . . . *Id.*

U.S. Claims Court decisions have followed the same “strict construction” rule when the Government has attempted to impose a penalty. For example, *Pender Peanut Corp. v. United States*, 20 Cl. Ct. 447, 453 (1990) involved a penalty imposed by the U.S. Department of Agriculture. The court stated: “A statute must plainly authorize an agency’s power to impose penalties” (quoting from *Tiffany v. National Bank of Missouri*, 85 U.S. 409, 410 (1874) and *Acker*.) The Court continued: “‘Consistent with the Supreme Court’s mandate, the Claims Court carefully construes language which imposes a penalty: It is a venerable rule of statutory interpretation that a statute imposing a penalty, ‘must receive a strict, that is, a literal construction.’” (citation omitted).

Finally, the Court of Appeals for the Federal Circuit said in *Berkshire Hathaway Inc. v. United States*, 802 F.2d 429, 431 n.6 (Fed. Cir. 1986): “We agree with the Claims Court that [Code] § 6655 imposes a penalty and, therefore, the strict construction rule would apply.”

#### 4. IRS guidance

The fact that the reporting requirement in these circumstances falls on the owner is evidenced by the IRS’ own interpretation of Section 6048, as reflected by the reporting requirements in Form 3520 (and its companion Form 3520A) and the instructions to those forms.

Section 6048(b)(1) provides that the owner of a foreign trust “shall submit such information as the Secretary may prescribe with respect to such trust for such year” (emphasis supplied). Thus, Form 3520 and its instructions were derived from the statutory authority granted by Congress to the Secretary of the Treasury.

In interpreting a tax statute, case law has appropriately relied on the IRS’ own interpretation of the statute as embodied in IRS returns as well as their instructions. In *Wilkes v. United States*, 50 F. Supp. 2d 1281 (M.D. Fla. 1999), *aff’d without op.*, 210 F.3d 394 (11th Cir. 2000), at issue was whether an election under Section 2210 discharged the executor and the estate from liability. According to the court, the issue before it was “the proper reading of § 2210.” *Wilkes, supra* at 1284-85.

The court proceeded to rely on the IRS instructions for completing the form, stating at 1285:

Having examined the statutory language, the Court concludes that Plaintiff’s reading of the statute is correct. Although not dispositive, the legislative history as well as instructions which the IRS issued to aid in the preparation of a form necessary to exercise the Section 2210 election are consistent with this reading.

In so holding, the court rejected the government’s argument that the instructions had no legal effect. *Wilkes, supra*, at 1287. As explained by the court, prior case law properly held that while instructions to IRS Forms were not elevated to “to the level of statutes, regulations, or judicial decisions, [earlier cases] have given them substantially more weight than Defendant’s (the government’s) reading. . . would allow.” The Court held that “general principles of equity dictate that the IRS should not be allowed to issue instructions for completing its forms and later disavow those instructions.” *Id.* at 1287.

Form 3520 and its instructions (as well as the companion Form 3520A and its instructions) are clear that the reporting obligation for trust distributions fall on the taxpayer as the owner under Section 6048(b) and not as the beneficiary under Section 6048(c) where the beneficiary is the same individual as the grantor/owner. Here is how the reporting requirements work:

- The instructions for Form 3520, appearing on page 1, para. no. 2, state that the owner of any part of the assets of a foreign trust must complete the identifying information on page 1 of Form 3520 as well as Part II. The “Penalties” section of the instructions, appearing on page 2, provides that if a U.S. owner fails “to report the U.S. owner information”, the owner is subject to a 5 percent penalty of the gross value of trust assets. The “owner information” includes distributions by the trust. Line 22 of Form 3520 asks whether the foreign trust filed Form 3520A for the current year. The instructions for Form 3520A (page 1) specify that a foreign trust for the U.S. owner must file Form 3520A in order for the U.S. owner to satisfy his/her annual reporting requirements under Section 6048(b). If for whatever reason the trust did not file Form 3520A, Line 22 of Form 3520 requires that the owner file a “substitute” Form 3520A. In either event, Form 3520A, lines 5 and 17, require the reporting of any trust distribution. Line 17b requires information on “Distributions to U.S. Owners,” including the date of distributions and their fair market value. Those disclosure obligations fall squarely on the owner—not the beneficiary.

- A beneficiary has no obligation to file a Form 3520A. As is clear from the introductory paragraph to the instructions for Form 3520A (“Who Must File”), the owner was “. . . responsible for ensuring that the foreign trust files Form 3520A and furnishes the required annual statements to its U.S. owners and U.S. beneficiaries.” As discussed above, if the trust does not file Form 3520A, Form 3520 requires the owner to file a “substitute” Form 3520A. In both cases, the reporting obligation is the owner’s. Part I, Line 5, asks whether the trust transferred any property to another person during the tax year. The instructions for Line 5 (page 5) require that there be an attached “statement” if there was any such transfer. The “statement” must include a general description of the property transferred as well as the estimated fair market value and the adjusted basis of the property.

Forms 3520 and 3520A, and their respective instructions, reflect the IRS' interpretations of Section 6048(b) and (c). Those interpretations should be followed by the IRS, as well as by the courts, in concluding that a 35 percent penalty should not apply.

### **Conclusion**

Contrary to the IRS position, the Supreme Court, case law from other courts and the IRS guidance set out

in its forms make it clear that a penalty should be limited to 5 percent of the trust distribution when a distribution is made by an offshore trust to a beneficiary who is also the grantor/owner.