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Estate Penalized for Undisclosed Foreign Trust

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In Chief Counsel Advice 201208028 (the “CCA”) the [IRS](#) provided guidance to executors and administrators of estates of decedents who died having a beneficial interest in a previously unreported foreign trust. The general rule is that if a U.S. person transfers assets to a foreign trust the trust is considered a “Grantor Trust” under IRC Sec. 6048 and the transfer needs to be reported on Form 3520. In addition a report of receipt of annual distributions from the trust must be made on Form 3520 and the trust must file Form 3520-A. If the trust does not file timely Form 3520-A then the U.S. recipient of the distribution must file a substitute Form 3520-A. The failure to file Form 3520 and/or Form 3520A on a timely basis subjects the U.S. taxpayer to Civil Penalties. The initial penalties stated in IRC Sec. 6677 (a) for failure to timely file Form 3520 are the greater of \$10,000, or 35% of the “gross reportable amount”, and (b) for failure to timely file Form 3520-A or a substitute are the greater of \$10,000 or 5% of the “gross reportable amount”. A U.S. taxpayer can be subject to both penalties depending on the circumstances under which the penalty is imposed. The question presented in the CCA is whether the estate of a decedent who failed to file either Form 3520 or Form 3520-A can be penalized for not filing the forms once the decedent’s interest in the foreign trust was discovered and the sums received determined.

The facts described in the CCA are that an individual U.S. taxpayer established a foreign grantor trust from which he would receive annual distributions. The taxpayer died without ever filing Forms 3520 or substitute Form 3520-A and the [IRS](#) informed his Executor that no Forms 3520 or 3520-A had been filed for various years. Under IRC Sec. 6903(a), as the administrator of the estate the Executor assumes the responsibility of administering the Decedent’s Estate, including paying any outstanding tax liabilities of the estate. The letter from the [IRS](#) to the Executor notified the Executor that as the Executor he was now the person responsible for filing the unfilled forms and that the estate could be subject to initial penalties under Code Sec. 6677(a) and Code Sec 6677(b) and may be subject additional penalties of \$10,000 per month if the forms were not filed within 90 days of the letters date.

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In addition to the Code Sec. 6677(a) and (b) penalties, under the Estate of Rau v. Comm'r, 301 F2d 51 (9th Cir. 1962) Federal penalties assessable against a decedent, including the civil fraud penalty, are collectible from decedents estates. The Federal penalties assessable against a decedents estate, may include the penalties assessable for failure to timely file a Report of Foreign Bank Account (FBAR). The FBAR penalty for a "willful" violation is the greater of \$100,000 or 50% of the highest account balance per year.

The implications of the CCA are many fold. Because of the potential penalties U.S. taxpayer's who have undeclared interests in foreign trusts or executors who discover that decedents had such and interests should consider entering the Offshore Voluntary Disclosure Initiative (OVDI) as a method of mitigating all penalties. The OVDI requires a single "miscellaneous civil penalty" in lieu of all other civil penalties and criminal prosecution. The "miscellaneous civil penalty" is 27.5 % of the highest single year account balance for unreported offshore accounts. The potential combination of penalties described above can well exhaust any estate.

It should also be noted that beginning for tax year 2011 a new disclosure Form 8938 will required U.S. taxpayers to disclose "specified foreign financial asset" if the combined value of those assets \$50,000 or more. Form 8938 will be part of Form 1040. The Form 8938 disclosure do not require duplicate reporting of information from Form 3520 or Form 3520-A but require disclosure of whether those forms were filed. Tax return preparers are likely to be particularly sensitive to disclosures required for foreign held assets as they face increasing scrutiny and penalties. Tax return preparers should note that recent appellate court decisions, including Edwards v. U.S. (9th Cir.) severely limit claims of taxpayer-tax preparer communication privilege.

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