Internal Revenue Code – Assessed Penalties

Proportionality of Penalties for Failure to File Information Tax Returns to Amounts of Unpaid Tax

26 USC §6677(a); 26 USC §6677(d) 26 USC §6679(a)(1); 26 USC §6679(c)

Proposed change:

The remainder of the first sentence in flush language of 26 USC 6677(a) following 26 USC 6677(a)(2) is amended to read as follows:

… the person required to file such notice or return shall pay a penalty equal to the amount of the understatement of tax liability attributable to the items of income shown on said notice or return, but in no event less than $500.

26 USC 6677(d) is amended by adding a final sentence to read as follows:

No penalty shall be imposed by this section on any failure which is shown to be due to reasonable cause and not due to willful neglect. Reasonable cause shall be presumed if the taxpayer files any information tax return required hereunder prior to being contacted by the Internal Revenue Service concerning the information tax return or any other matter concerning the tax year for which the said return was required to be filed.

26 USC 6679(a)(1) is amended to read as follows:

In addition to any criminal penalty provided by law, any person required to file a return under section 6046 or 6046A who fails to file such return or who files a return which does not show the information required pursuant to such section shall pay a penalty equal the amount of the understatement of tax liability attributable to the items of income shown on said notice or return, but in no event less than $500 nor more than $10,000.

26 USC 6679(c) is added to read as follows:

No penalty shall be imposed by this section on any failure which is shown to be due to reasonable cause and not due to willful neglect. Reasonable cause shall be presumed if the taxpayer files any information tax return required hereunder prior to being contacted by the Internal Revenue Service concerning the information tax return or any other matter concerning the tax year for which the said return was required to be filed.

Reason for change:

Current section 6677 imposes a statutory penalty of 35% of the value of a foreign grantor trust or 35% of all amounts received by a United States person from a foreign person who has not filed an information tax return on Form 3520. The statutory penalty is imposed regardless of whether the amount received had been previously taxed, was not subject to taxation or constituted previously undeclared taxable income.

The distinction has become important in recent years with this penalty being applied on the same basis to: 1) individuals who diverted income properly taxable in the United States to Swiss bank accounts set up in the names of foreign trusts or corporations; 2) individuals who inherited or become entitled as beneficiaries to non-taxable funds from non-United States parents in foreign bank accounts; and 3) United States taxpayers who funded foreign trusts or corporations with previously taxed income when they took up residence outside of the United States or for legitimate business reasons. In the first case, the result has been a penalty appropriate to the actions of the taxpayers, but potentially excessive when combined with a penalty for failure to file foreign bank account report forms. In the second and third cases, the result has been a forfeiture that pushes up to, if not exceeding, constitutional prohibitions on excessive fines and forfeitures and is wrong as a matter of policy.

We are representing a taxpayer in a case where the United States taxpayer received the entire inheritance from his parents for reasons unrelated to taxation, subject to an obligation to pay half to his non-resident alien sister, her children, or as she may direct. The taxpayer met his obligation by transferring assets to a trust that his sister requested he form a number of years later in which he had no interest whatsoever. The transaction was documented in writing and based on legal advice. Upon audit, the Internal Revenue Service asserted that the taxpayer was required to file a Form 3520 to report the transfer. When the audit was closed on the basis of no change in the liability of the taxpayer and the Form 3520 was sent by the IRS auditor to the IRS Service Center, the taxpayer was assessed a penalty of approximately $750,000 under section 6677 for 35% of the amount transferred. In this case, the revenue loss to the United States was nil. The entire penalty, even if valid, is for failure to file a form.

In like vein, we have represented taxpayers who have regularly filed Form 5471 to report information about foreign controlled corporations, but then failed to file the form for one year due to an error by their accountants. All of the income representing distributions from the foreign controlled corporation was properly reported on their tax returns. The IRS Service Center automatically assessed a $10,000 penalty under section 6679. The taxpayer ended up paying half that amount, $5,000, in professional fees to have the penalty abated. Once the assessment is made, the taxpayer is incurring substantial cost regardless of whether or not reasonable cause exists.

The American tax system recognizes that the Internal Revenue Code is complicated and that taxpayers may make mistakes. The system encourages taxpayers to correct mistakes when they discover them so that they correctly meet their tax and filing obligations. The penalty amounts imposed when taxpayers

attempt to correct mistakes results in taxpayers not correcting mistakes and playing an audit lottery, because the penalty cost of correcting the error or oversight is so material.

We represent taxpayers who were beneficiaries of foreign trusts who legitimately believed that they were not required to report amounts received. In some cases, they had received professional advice to that effect from professional advisors who were not well informed about the United States tax law. We represent taxpayers who established foreign trusts or corporations for reasons completely unrelated to United States taxation. The funds involved are not income or gains on which these individuals should have paid United States taxes. These individuals do not believe that they should be required to pay a substantial portion of their assets to the United States on which they have either already paid tax or which they are receiving as an inheritance that the Internal Revenue Code provides is not subject to income tax. These individuals in many cases filed amended tax returns when they became aware that they were not compliant. They are now being faced with the assertion of substantial penalties by the Internal Revenue Service, placing them in the same category as those who diverted or hid income and did not even attempt to meet their United States tax obligations.

A better penalty approach would be to tie the amount of the penalty to the amount of unpaid tax that relates to the items of income that would have been reported on the information tax returns. If the amount of unpaid tax is substantial, the penalty will be substantial. A taxpayer who has diverted untaxed money into a foreign bank account will owe a substantial amount of tax, and will owe a substantial penalty under this proposal. If the amount of unpaid tax is small or nil, as would be the case in the result of administrative error or where the assets held abroad were properly declared prior to transfer or were not subject to United States taxation , the penalty would likewise be small.

Such an approach encourages compliance, while still providing for substantial penalties for those who seek to cheat on their tax obligations. If a taxpayer learns that they have not been compliant, they should be encouraged to become compliant, and not fear that if they do become compliant, they will be subject to onerous penalties and forfeiture of their assets.