

Office of Chief Counsel
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Memorandum

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(Procedure & Administration) CC:PA:02

subject: Divisibility of the penalty under section 6677

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether the penalty imposed by section 6677 for failure to file information with respect to foreign trusts is a “divisible tax” such that a taxpayer would need to pay only a portion of the penalty to meet the full payment rule established by Flora v. United States, 362 U.S. 145 (1960).

CONCLUSIONS

A penalty assessment pursuant to section 6677 is not a “divisible tax” within the meaning of Flora v. United States, 362 U.S. 145 (1960). A taxpayer must pay the full amount of the penalty to challenge the entire penalty assessment under section 6677 for a particular year. Notwithstanding that requirement, a taxpayer may pay that portion of the penalty assessment that relates to a separate filing requirement if the taxpayer wants to contest only that portion of the penalty. The taxpayer could not, however, challenge the merits of the remaining portions of the assessment absent prior payment of the remaining portions.

BACKGROUND

Under section 6048, the Service generally requires annual information reporting by U.S. persons with respect to contributions to, ownership of, and distributions from a foreign trust. Section 6677 generally imposes penalties on persons who fail to comply with section 6048.

You asked whether an assessment of a penalty under section 6677 for a failure to comply with section 6048 is a “divisible tax.” Normally, a taxpayer must pay the full amount of the tax at issue to provide a refund court jurisdiction over the taxpayer’s liability (the “full payment rule”). A divisible tax is one for which the taxpayer need only pay a “divisible” portion prior to bringing a suit for refund.

LAW AND ANALYSIS

1. Section 6048

Section 6048 contains three distinct and separate reporting obligations. First, under section 6048(a), a responsible party must inform the Service of each occasion upon which a U.S. person creates a foreign trust, transfers money or property to a foreign trust, or when a citizen or resident of the United States dies if the decedent owned a portion of a foreign trust. Second, under section 6048(b), a U.S. person treated as owning a foreign trust under the grantor trust rules (sections 671 through 679) must report information with respect to that trust and also must ensure that the trust itself reports information to the Service and to each U.S. person treated as owning, or receiving a distribution from, the trust. Lastly, under section 6048(c), any U.S. person who receives a distribution from a foreign trust during the taxable year must report information about that distribution to the Service.

Any U.S. person or responsible party who is required to report information under section 6048(a) or (c) or who is required to report information under section 6048(b) because he is treated as the owner of a foreign trust under the grantor trust rules, must file a Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts) by the due date (including extensions) for his U.S. tax return. Under section 6048(b), the U.S. owner of a foreign trust is required to file a Form 3520 for each taxable year even if there is no transaction with the foreign trust during the year. A separate Form 3520 is required with respect to each foreign trust for which the person is required to report information.

Any foreign trust with a U.S. owner is required to file a Form 3520-A (Annual Information Return of Foreign Trust with a U.S. Owner) by the 15th day of the 3rd month after the end of the trust’s tax year. The foreign trust also is required to give copies of the Foreign Grantor Trust Owner Statement (page 3 of Form 3520-A) and Foreign Grantor Trust Beneficiary Statement (page 4 of Form 3520-A) to the U.S. owners and U.S. beneficiaries by the same date. Form 3520 instructs a U.S. owner of a foreign trust who

has not received a Foreign Grantor Trust Owner Statement from the foreign trust to complete a substitute Form 3520-A to the best of his ability and attach it to his Form 3520.

2. Section 6677

The amount of the section 6677 penalty for a failure to file a correct and complete Form 3520 will depend upon which subsection of section 6048 is violated. Where a U.S. person or responsible party fails to report a transaction with a foreign trust under subsection (a) or (c), the person will owe an initial penalty equal to the greater of \$10,000 or 35 percent of the “gross reportable amount.”¹ “Gross reportable amount” for these purposes means the gross value of the property involved in the event reportable under section 6048(a), or the gross amount of the distributions in the case of a failure relating to section 6048(c). I.R.C. § 6677(c)(1), (3). For example, if a U.S. person files a Form 3520, but fails to report a transaction with the foreign trust valued at \$30,000, the U.S. person will owe a penalty (absent showing of reasonable cause) equal to \$10,500 (35% of \$30,000).

If a U.S. person fails to file a Form 3520 when required by section 6048(b)² or a foreign trust that is treated as owned by a U.S. person fails to file Form 3520-A and that U.S. person does not file a substitute Form 3520-A, the U.S. person will owe an initial penalty under section 6677(b) equal to the greater of \$10,000 or 5 percent of the “gross reportable amount.”³ Here, “gross reportable amount” means the value of the foreign trust’s assets at the close of the year treated as owned by the U.S. person. I.R.C. § 6677(c)(2). For example, if a foreign trust with a U.S. owner and assets of \$250,000 fails to file a complete and correct Form 3520-A and the U.S. owner fails to file a substitute Form 3520-A, the U.S. owner will owe an initial penalty (absent showing of reasonable cause) equal to \$12,500 (5% of \$250,000).

In all cases, an additional \$10,000 penalty is imposed for each 30-day period during which the failure to file an information return continues (beginning 90 days after notification of the failure). The total amount of the penalties cannot exceed the gross reportable amount.

Section 6677(d) provides that no penalty will be imposed by section 6677 on any failure that is shown to be due to reasonable cause and not due to willful neglect. The fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the required information does not constitute reasonable cause.

¹ Prior to 2010, the initial penalty was 35% of the gross reportable amount.

² A U.S. person treated as the owner of a foreign trust who fails to file Form 3520 when required under section 6048(b) will be subject to a penalty for such failure only with respect to tax years beginning after March 18, 2010.

³ Prior to 2010, the initial penalty was 5% of the gross reportable amount for failure to file Form 3520-A.

3. Divisibility

Prior to bringing a suit for refund in a federal district court or the Court of Federal Claims, a taxpayer must pay the full amount of tax that will be at issue before the court. See Flora v. United States, 362 U.S. 145 (1960) (Flora II); Boynton v. United States, 566 F.2d 50 (9th Cir. 1977). In Flora, the Supreme Court considered a suit for refund in which the taxpayer only paid a small portion of the tax at issue. Analyzing the structure of 28 U.S.C. § 1346(a)(1) (the statute granting jurisdiction over tax refund suits), its legislative history, and related jurisdictional statutes, the Court found “full payment of an assessed tax . . . a condition precedent to the right to sue the collector for a refund.” Flora v. United States, 357 U.S. 63, 68 (1958) (Flora I), *aff’d on reh’g*, 362 U.S. 145 (1962) (Flora II). Accordingly, the Court concluded the taxpayer’s suit for refund could not proceed because the court lacked jurisdiction under 28 U.S.C. § 1346 absent full payment of the tax. The Court did recognize, however, that in some instances full payment may not be necessary, for example, in the case of excise taxes which “may be divisible into a tax on each transaction or event.” Flora, 362 U.S. at 171 n. 37, 38 (1960).

From that recognition was born the “divisible tax” exception to the full payment rule. Where a tax is considered a “divisible tax,” the taxpayer need only pay a portion of the tax before instituting suit (assuming other jurisdictional prerequisites are met). “A divisible tax . . . is one that represents the aggregate of taxes due on multiple transactions (e.g., sale of items subject to excise taxes).” Rocovich v. United States, 933 F.2d 991, 995 (Fed. Cir. 1991) (citing Flora II). It is a tax the assessment of which reflects the cumulation of several separable assessments based on separate transactions. See Fidelity Bank, N.A. v. United States, 616 F.2d 1181, 1182 n.1 (10th Cir. 1980). Certain courts have found that the “divisible tax” exception only applies in two types of situations: “(1) a suit challenging unpaid excise taxes; or (2) a suit challenging a 100% penalty pursuant to [section] 6672 for failure to withhold and pay over employment taxes.” Ardalan v. United States, 748 F.2d 1411, 1414 (10th Cir. 1984); see also Bell Capital Mgmt. v. United States, 207 U.S. Dist. LEXIS 82085, *11-12 (N.D. Ga. 2007); Thorton v. United States, 1992 U.S. Dist. LEXIS 6819 (S.D. Fla. 1992). Other courts, however, have recognized the exception can apply in additional situations. See, e.g., Hankin v. United States, 891 F.2d 480, 481 (3rd Cir. 1989) (acknowledging penalties imposed under sections 6700 and 6701 are “divisible into separate portions or transactions”); Nordbrock v. United States, 173 F.Supp.2d 959 (D. Ariz. 2000), *aff’d* 248 F.3d 1172 (9th Cir. 2001) (finding penalty on tax return preparers pursuant to section 6695 divisible).⁴

⁴ One section of the Code explicitly defines a “divisible tax” as any tax imposed by subtitle C (employment taxes) and the penalty imposed by section 6672 with respect to such taxes. I.R.C. § 6331(i)(2). This definition only applies, however, in a situation in which the Service levies with respect to an unpaid divisible tax during the pendency of a court proceeding challenging that tax. Moreover, this definition lacks any reference to excise taxes. See Nakano v. United States, 2009 U.S. Dist. LEXIS 130862 (D. Ariz. 2009) (noting and holding that an excise tax is not a divisible tax within the meaning of section 6331(i)(2)). Because it fails to encompass excise taxes, which the Supreme Court has specifically

Payment of the divisible part of a tax or penalty that constitutes a “divisible tax” satisfies the full payment rule established by Flora. Accordingly, where a taxpayer pays the divisible portion of a “divisible tax” prior to bringing a suit for refund, the court in which the suit is brought will have jurisdiction over the entire amount of, and the liability for, the “divisible tax” at issue. See, e.g., Nielson v. United States, 976 F.2d 951 (5th Cir. 1992).

In Nielson, the Fifth Circuit considered the scope of a district court’s jurisdiction where a taxpayer, pursuant to section 6703, pays only 15 percent of the penalty at issue prior to bringing suit. Section 6703 authorizes partial payment of penalties imposed under sections 6700, 6701, and 6702 (without explicitly calling those penalties “divisible taxes”). Although the taxpayer contended the court’s jurisdiction was limited to determining liability for the 15 percent paid, the district court found the taxpayer liable for the entire amount of the penalty (i.e., the 15 percent paid plus the 85 percent unpaid). The Fifth Circuit agreed with the district court’s finding. Analogizing section 6703 to section 6694 (which also provides for 15 percent partial payment) and relying on the legislative history of both sections, the Fifth Circuit found that where a taxpayer makes partial payment of the penalty under those sections, he is suing for a determination of his liability for the entire penalty, not just the amount paid.

While neither section 6703 or 6694 explicitly refers to these penalties as “divisible taxes,” they do create an exception for these penalties from the full payment rule akin to the “divisible tax” exception. Because of that similarity, we conclude that the reasoning in Nielson guides our analysis here. In addition, the conclusion in Nielson (that the court had jurisdiction over the entire penalty assessment) finds support in cases adjudicating liability under section 6672, a penalty traditionally labeled a “divisible tax.” See Steele v. United States, 280 F.2d 89 (8th Cir. 1960) (allowing corporate officers to pay as to one employee, institute a suit for refund, and have the court “sett[le] the question of the right of the government to have made the penalty assessment against them”). Therefore, a determination that the penalty under section 6677 constitutes a “divisible tax” would enable a person liable for that penalty to partially pay, satisfy the full payment rule, and trigger a refund court’s jurisdiction over the entire penalty amount. Based on the precedent above and for the reasons below, however, we conclude that the penalty under section 6677 does not constitute a “divisible tax,” and therefore a court could not exercise jurisdiction over any amount of the penalty not paid.

As stated above, section 6048 imposes three distinct and separate reporting obligations on the following parties: (1) U.S. persons that create, or transact with, a foreign trust (or in the case of a decedent who is a U.S. resident or citizen treated as owning a foreign trust, the responsible party); (2) U.S. persons that are treated as owning a foreign trust

identified as being subject to the “divisible tax” exception, and because of the limiting language of section 6331(i)(2), this definition cannot control for purposes of determining whether a tax is “divisible” in the context of the Flora rule.

(as well as the trust itself); and (3) U.S. persons that receive a distribution from a foreign trust. Section 6677 imposes a penalty for each failure to meet the requirements of section 6048. Accordingly, where there are multiple, unreported transactions during the taxable year, the U.S. person will owe a penalty for each unreported transaction. Similarly, where a U.S. person is treated as the owner of multiple foreign trusts for which no Forms 3520-A have been filed, the U.S. person will owe a penalty with respect to each foreign trust. The amount of each penalty will depend on the gross amount of the unreported transaction or the amount of the assets in the unreported trust. A penalty assessment under section 6677, therefore, can reflect an aggregate of penalties imposed for multiple failures to meet any of the reporting obligations imposed by section 6048. Because that single assessment can in actuality be a cumulation of separable penalties specific to each failure, the penalty assessment would appear to be a “divisible tax.”

In Christian Laymen in Partnership, Ltd. v. United States, 1989 WL 168769 (W.D. Okla. 1989), the refund claimant (a partnership) contested an assessment of the penalty under section 6698 for failure to file a partnership return. Section 6698 imposes a penalty for each month, not to exceed five months, that the partnership fails to file its return. Even though the partnership failed to file for over five months, it only paid a portion equal to one month’s worth of the penalty, contending the “divisible tax” exception applied. At the urging of the government, the court disagreed and found that the penalty under section 6698 was not divisible, noting: “[t]here is only one failure to file. The penalty is increased for the continuing failure to file, but is not increased as a result of separate acts or transactions.” Id. at *2. The court concluded that because the penalty is for a single act (the failure to file the return) and not based on separate acts, the partnership needed to pay the full penalty amount before successfully bringing suit. A section 6677 penalty shares characteristics with the section 6698 penalty when the assessment is based on additional penalties for failure to file the required information return after notice from the Service. In each case, there is only one failure to file. The penalty assessment under section 6677, however, may also be tied to multiple acts, i.e., the failure to file a separate, complete and correct Form 3520 for each separate trust or the failure to report each separate transaction. Accordingly, unlike the penalty under section 6698, the penalty may increase based on the number of violations of section 6048’s requirements, again lending credence to the argument that a penalty assessment under section 6677 is a “divisible tax” with respect to each unreported transaction or trust.

The conclusion that payment of a portion of the penalty could afford jurisdiction over the entire assessment covering multiple penalties is difficult to reconcile, however, with the reasonable cause defense to the penalty. Section 6677(d) states that no penalty shall be imposed on any failure which is shown to be due to reasonable cause and not due to willful neglect. An assessment under section 6677 may actually be a cumulation of failures to file multiple Forms 3520 or report multiple transactions because of the multiple obligations imposed by section 6048, each with its own unique “gross reportable amount.” Because a taxpayer can show reasonable cause for “any failure”

under section 6677, a taxpayer could have different reasonable cause defenses for different failures that make up the penalty. It follows that were the section 6677 penalty a “divisible tax,” it could create a potential situation in which the taxpayer pays one portion of the penalty and because, assuming it were a “divisible tax,” the court would have jurisdiction over the entire penalty assessment, the taxpayer could present different reasonable cause defenses to different portions of the penalty, including portions that are not paid prior to suit. That result does not square with the purpose behind the “divisible tax” exception to the full payment rule.

In addition, unlike other assessable penalties under sections 6700, 6701, 6702 and 6694, the penalty under section 6677 does not have a statutory provision authorizing partial payment prior to a refund suit. I.R.C. §§ 6703, 6694(c). While this factor is not dispositive, it does stand the penalty here in stark contrast with other assessable penalties. See Rocovich v. United States, 933 F.2d 991 (Fed. Cir. 1991) (noting the lack of statutory authority for deeming the estate tax a “divisible tax”).

Therefore, because of the multiple reporting obligations under section 6048 that could apply and the possibility of multiple reasonable cause defenses to those reporting obligations, we conclude that the penalty under section 6677 is not a “divisible tax” for the purposes of the full payment rule. We reach this conclusion even in light of the fact that the penalty assessment, in certain circumstances, can constitute an aggregate of separable assessments for failures related to separate transactions or trusts. Notwithstanding that conclusion, we also conclude that if a taxpayer chooses only to contest a portion of the penalty relating to one or more particular failures to report, but not all failures, the taxpayer may pay that portion and sue for refund. If the taxpayer desires to challenge the entire penalty assessment, however, the taxpayer must pay the entire tax under dispute prior to bringing a refund suit.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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