

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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CC:PA:02: TWCurtzman
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UILC: 6048.00-00, 6677.00-00, 6677.01-01, 6677.03-00

date: November 02, 2011

to: Samuel Berman
Special Counsel
(Small Business/Self-Employed)

from: Ashton P. Trice
Branch Chief
(Procedure & Administration)

subject: Applicability of Section 6677(a) and (b) Penalties

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

LEGEND

A =

B =

C =

D =

E =

Location F =

Location G =

Location H =

Location I =

\$W = \$

\$X = \$

\$Y = \$

\$Z = \$

Date 1 =

Date 2 =

Date 3 =

Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Date 10 =
Date 11 =
Date 12 =
Date 13 =
Date 14 =
Date 15 =
Date 16 =
Date 17 =
Date 18 =
Date 19 =
Date 20 =
Date 21 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Year 7 =
Year 8 =

ISSUES

- (1) Whether the Estate is responsible for the section 6677(a) and (b) “initial” penalties for the applicable tax years (Year 3 through Year 6) ending prior to the Decedent’s death.
- (2) Whether the Estate is responsible for the section 6677(a) and (b) “additional” penalties for the applicable tax years (Year 3 through Year 6) ending prior to the Decedent’s death.
- (3) Whether the Estate is responsible for the section 6677(a) and (b) “initial” penalties for the two short tax years within Year 7.

CONCLUSIONS

- (1) The Estate is responsible for the section 6677(a) and (b) “initial” penalties asserted against the Decedent for the applicable tax years (Year 3 through Year 6) ending prior to the Decedent’s death because the Forms 3250 and 3250-A were not filed timely.
- (2) The Estate is responsible for the section 6677(a) and (b) “additional” penalties asserted against the Decedent for the applicable years (Year 3 through Year 6) ending prior to the Decedent’s death, unless the Executor has a reasonable cause for filing the required section 6048 returns more than 90 days after the Service mailed notice that these returns were never filed.
- (3) The Estate may be responsible for the section 6677(a) “initial” penalty for the two short tax years within Year 7, if the two Forms 3520 filed were untimely, incomplete, or incorrect. The Estate is responsible for the section 6677(b) “initial” penalty for the short tax year ending Date 2 because the Form 3520-A for the short tax year ending Date 2 was filed untimely, unless the Executor has a reasonable cause for filing the Form 3520-A nearly one and a half years after its due date.

FACTS

We understand the following facts based upon the Executor’s counsel’s letter dated Date 21 (the “Executor’s Letter”), the Letter 3946 dated Date 12, and the subsequent Letter 3946 dated Date 12:

A (“A” or the “Decedent”) established a foreign grantor trust called the B sometime in Year 1, from which he would receive distributions during that and each subsequent year. The B’s bank accounts were located in Location F and Location G. Sometime at the end of Year 6, A instructed his accountant (“Preparer”) to prepare amended returns for tax years Year 4 through Year 5. None of these returns were completed or filed before A died.

A died on Date 2. C (“Executor”) and D were appointed as executors of A’s Estate.¹ On Date 5, the Preparer filed the Decedent’s Year 6 Form 1040. Between Date 6 and Date 13, Preparer filed the Decedent’s Forms 1040X for tax years Year 4 through Year 5, as previously instructed by the Decedent. The submission of these amended returns

¹ The Executor’s Letter claims that C and E were appointed as executors of the A Estate. However, Line 6a of the A Estate’s Form 706 (United States Estate (and Generation-Skipping Transfer) Tax Return) identifies C as an executor, and the Form 706 is signed by D as an executor. Accordingly, it appears likely that D was also appointed as an executor of the Estate before her death on Date 20. It is unclear whether E was actually appointed as an executor to the A Estate, but his name and signature do not appear on the Form 706. Thus it appears that C became the sole executor of the Estate sometime after Date 20. Regardless of E’s and D’s actual role as co-executors, there appears to be no dispute that C served as an executor during the Year 8 examination and remains the Executor of the A Estate to date.

prompted an examination of the Decedent's liabilities for these tax years. The Revenue Agent began the examination in Year 8.²

On Date 7, the Executor caused the B to provide a check for \$W. On Date 8, the Executor paid \$W in estimated estate taxes, and simultaneously requested an extension to file Form 706 (United States Estate (and Generation-Skipping Transfer) Tax Return) on Date 17. The Service granted this extension request.

On Date 11,³ the Executor filed Form 706, which reflected a total estate tax liability of \$X. The facts are unclear as to whether the Executor paid over the remaining net liability of \$Y upon filing the Form 706.

On Date 12, the Revenue Agent mailed the Decedent (c/o the Executor) a Letter 3946 advising him that no Forms 3520 or 3520-A had been filed with respect to the foreign trust for tax years Year 2 through Year 5, and no Form 3520-A had been filed for tax year Year 6. The letter also notified the Decedent and the Executor that the person responsible for filing these forms may be subject to the initial penalties under section 6677(a) and (b) for failing to file these forms, and may be subject to the respective "additional" penalties of \$10,000 per month if the forms were not filed within 90 days of the letter's date. The letter did not provide notice of potential penalties under section 6677(a) or (b) for tax year Year 7.

On Date 16, the Executor filed Forms 3520 and 3520-A for tax years Year 3 through Year 5, Form 3520-A for tax year Year 6, and Forms 3520 and 3520-A for the short tax year from Date 1 through Date 2. It is unclear when the Executor filed the Form 3520 for the short tax year from Date 3 through Date 9. The Executor filed these forms more than 90 days after the Service mailed its Date 12 notice of failure to file the forms for years Year 2 through Year 6.⁴

On Date 18, the Service proposed assessing the following section 6677 penalties against the Estate: section 6677(a) "initial" penalties for tax years Year 3 through Year 5, and Year 7; section 6677(a) "additional" penalties for tax years Year 3 through Year

² The Executor's Letter claims that the Service began an examination of the Decedent's Year 6 tax year on Date 10. Ostensibly, the examinations for the other tax years at issue began on or after this date as well.

³ The Executor's Letter claims that the Form 706 was filed on Date 14, although IDRS reflects the Service received the Form 706 on Date 11. For the issues discussed in this memorandum, the difference in dates is immaterial.

⁴ It is unclear from the facts whether any Forms 3520 or 3520-A were filed for tax year Year 2 as initially indicated by the Date 12, Letter 3946. However, no penalties were asserted by the Service for this tax year, therefore they are outside the scope of this memorandum.

5; section 6677(b) “initial” penalties for tax years Year 3 through Year 7; and section 6677(b) “additional” penalties for tax years Year 3 through Year 6.⁵

The Estate, through the Executor, has requested that Appeals review the applicability of the section 6677(a) and (b) penalties to the Estate.

LAW AND ANALYSIS

- (1) The Estate is responsible for the section 6677(a) and (b) “initial” penalties asserted against the decedent for the applicable tax years (Year 3 through Year 6) ending prior to the Decedent’s death because the Forms 3250 and 3250-A were not filed timely.

The Executor does not dispute that for the applicable tax years prior to the Decedent’s death (tax years Year 3 through Year 6), the Decedent was responsible for filing Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts). Furthermore, where the foreign trust failed to file Form 3520-A (Annual Information Return of Foreign Trust with a U.S. Owner), the Decedent, as the U.S. owner of the trust, was responsible for completing and attaching a substitute Form 3520-A for the foreign trust. The Executor does dispute, however, that the related section 6677(a) and (b) penalties are applicable against the Estate.

- (a) *The Decedent’s Requirement to File Form 3520 under Section 6048(a) or (c).*

Section 6048(a)(1) generally requires a “responsible party” to provide written notice of a “reportable event” to the Secretary. This written notice is provided on Form 3520, as discussed below.

Section 6048(a)(4) defines “responsible party” for purposes of section 6048(a) as:

- (A) the grantor in the case of the creation of an inter vivos trust,
- (B) the transferor in the case of a reportable event described in section 6048(a)(3)(A)(ii) other than a transfer by reason of death, and

⁵ A confirmation of the calculation of the penalties is outside the scope of this memorandum. For the tax years at issue, the section 6677(a) “initial” penalty is a one time penalty per required section 6048 return equal to 35% of the gross reportable amount as defined in section 6677(c). The “initial” penalty under section 6677(b) is a modification of the section 6677(a) “initial” penalty where the penalty amount is reduced from 35% of the gross reportable amount to 5% of the gross reportable amount. For the sake of convenience we will call this a “section 6677(b) ‘initial’ penalty.” The “additional” penalty tacks on an additional \$10,000 for each 30-day period (or fraction thereof) during which the failure to file the required return continues for more than 90 days after the day on which the Service mails notice of the failure to file the required section 6048 return.

(C) the executor of the decedent's estate in any other case.

The Decedent is both the grantor and transferor under section 6048(a)(4)(A) and (B) of the reportable events that occurred before his death (*i.e.*, creation of the trust and transfers of money or property to the trust under section 6048(a)(3)(A)(i)-(ii)). Thus, the Decedent is a "responsible party" under section 6048(a) for reportable events that occurred prior to death. The Decedent created the trust prior to the tax years at issue, and we cannot confirm whether the Decedent transferred money or property to the trust during the tax years at issue.

We understand, however, that the Decedent received approximately \$Z per year in distributions from the trust. Section 6048(c)(1) generally provides that if any U.S. person receives (directly or indirectly) any distribution from a foreign trust during any taxable year of such person, such person shall make a return with respect to such trust for such year which includes certain information. This person should report those distributions on Part III of Form 3520 for each tax year.⁶

Section 6677(a) generally imposes an "initial" penalty where the person required to file a notice or return under section 6048 does not timely file such notice or return or files an incomplete or incorrect return. Section 6677(a) provides that these "initial" penalties are assessed against "the person required to file such notice or return." This phrase refers back to the "responsible party" under section 6048(a), or the U.S. person who receives distributions under section 6048(c), as described above. Because there is no dispute that the Decedent was the "responsible party" under section 6048(a) and/or the U.S. person who received distributions from the trust under section 6048(c), the Decedent should have filed Forms 3520 for tax years Year 3 through Year 6, and is therefore "the person required to file such notice or return" for the purposes of the "initial" penalty under sections 6677(a).

(b) *The Decedent's Requirement to File Form 3520-A under Section 6048(b).*

Section 6048(b)(1) generally requires that if, at any time during any taxable year of a U.S. person, such person is treated as the owner of any portion of a foreign trust under the rules of sections 671-79, such person shall complete Part II of Form 3520 and be responsible to ensure that the trust files an annual return (*i.e.*, Form 3520-A). Part II of Form 3520 tells the U.S. owner that if the foreign trust did not file Form 3520-A for the current year, the U.S. owner must, to the best of his or her ability, complete and attach a substitute Form 3520-A for the foreign trust. If the trust failed to file Form 3520-A and the U.S. owner failed to provide a substitute Form 3520-A, section 6677(a) imposes a penalty on the U.S. owner as modified by section 6677(b).

⁶ There does not appear to be a dispute that reportable events occurred as defined in section 6048(a)(3), or the Decedent received a distribution provided for in section 6048(c)(1), during tax years Year 3 through Year 6.

Section 679(a)(1) generally provides that a U.S. person who directly or indirectly transfers property to a foreign trust (except by reason of death or for FMV consideration) shall be treated as the owner for his taxable year of the portion of such trust attributable to such property if for such year there is a U.S. beneficiary of any portion of such trust.

The Decedent established the trust by depositing money to the trust's Location F and Location G bank accounts beginning in Year 1. The Decedent was the primary beneficiary during all years of the trust's existence prior to his death on Date 2. The Decedent is a U.S. person, thus he is treated as an owner of the trust under section 679(a)(1). Under section 6048(b), the Decedent was responsible to ensure that the trust filed Form 3520-A during each of the years of the trust's existence. As noted above, Part II of Form 3520 tells U.S. owners of foreign trusts that did not file Form 3520-A to complete and attach substitute Forms 3520-A for the foreign trust.

Section 6677(b) reduces the amount of the penalty under section 6677(a) on the foreign trust's U.S. owner in the case of a return required under section 6048(b) (i.e., Form 3520-A) that is not timely filed or is incomplete or incorrect. Because there is no dispute that the Decedent was the U.S. owner of the foreign trust under section 679, he is "the United States person referred to in [section 6048(b)]" for purposes of the initial penalty under section 6677(b).

(c) *The Estate's Assumption of the Decedent's Liabilities.*

Based on the correspondence between the Executor and the Revenue Agent, we understand that the Executor had notified the Service of his role as the Estate's executor and fiduciary in a timely manner after the Decedent's death. As a fiduciary, the Executor assumes the "rights, duties, and privileges of such other person in respect of a tax imposed by this title." I.R.C. § 6903(a). This means that the Executor assumes the responsibility of administering the Decedent's Estate, including paying any outstanding liabilities of the Decedent. Id.; see also IRS Pub. 559 (Survivors, Executors and Administrators).

The Executor's responsibility to resolve the Estate's liabilities is a common aspect of state probate law. Indeed, it is well-established in Location H,⁷ as it is elsewhere, that an unpaid tax liability of a deceased taxpayer is collectible from that taxpayer's estate. See . Federal law mirrors this state law requirement. Treas. Reg. § 301.6903-1(a) ("The amount of the tax or liability is ordinarily not collectible from the personal estate of the fiduciary but is collectible from the estate of the taxpayer[.]"). Federal penalties assessable and assessed against a decedent, including the civil fraud penalty, are also collectible from the estate. See,

⁷ Because the Decedent was a resident of Location I, Location H when he died, it is most likely that Location H probate law will be applied to the Estate.

e.g., Estate of Rau v. Commissioner, 301 F.2d 51 (9th Cir. 1962) (civil fraud penalty for decedent's wrongful actions prior to death, yet assessed after his death, upheld as valid). The Estate assumes the role of the Decedent upon his death, and the Estate is administered by the Executor. Because the Decedent was a "person required to file [a Section 6048] notice or return" under the penalty provisions of section 6677(a) and (b), the Estate, as administered by the Executor, assumes the role of the Decedent with respect to any outstanding liabilities and also satisfies the same role under sections 6677(a) and (b). Accordingly, the Estate assumes the liability for Decedent's "initial" section 6677(a) and (b) penalties for the Forms 3520 and 3520-A not filed by the Decedent during his lifetime.

- (2) The Estate is responsible for the section 6677(a) and (b) "additional" penalties asserted against the Decedent for the applicable years (Year 3 through Year 6) ending prior to the Decedent's death, unless the Executor has a reasonable cause for filing the required section 6048 returns more than 90 days after the Service mailed notice of the failure to file.

The "initial" penalty for failing to file the section 6048 returns or notices timely or correctly is not the only assessable penalty under section 6677. Section 6677(a) and (b) also provide for an "additional" penalty until the proper section 6048 return is filed. For the "additional" penalty to apply, the Service must first "mail[] notice of such failure to the person required to pay such penalty[.]" I.R.C. § 6677(a). If the person required to pay the "initial" penalty fails to properly submit the section 6048 return "more than 90 days after the day on which the Service mails" this notice, he must pay "\$10,000 for each 30-day period (or fraction thereof) during which such failure continues" after the 90th day. Id.

As explained above, the Executor – acting on behalf of the Estate – is required to pay the section 6677(a) and (b) "initial" penalties for the Decedent's failure to timely file the Forms 3520 and 3520-A. On Date 12, the Service mailed a notice of failure to file (Letter 3946) to "the person required to pay such penalty," the Estate. This started the 90-day safe harbor period during which the "additional" penalties did not accrue. The Executor did not submit the missing returns for tax years Year 3 through Year 6 on behalf of the Estate until Date 16, more than 90 days after the Service mailed him the Letter 3946.⁸ Accordingly, the "additional" penalties assessed against the Estate and attributed to the untimely Forms 3520 and 3520-A were proper.

The Executor argues that the Executor could not be responsible for the section 6677(a) and (b) "additional" penalties because he was not a "responsible person" required to file any section 6048 return, and therefore not a "person required to file" under section 6677(a). This argument reflects the Executor's confusion about the difference between

⁸ The 90th day after the Date 12 notice was Date 15. If the Executor filed the Forms 3520 and 3520-A on Date 16, as he claims, then the forms were filed 72 days after the expiration of the 90-day safe harbor period.

the “initial” and “additional” section 6677 penalties. Whereas the section 6677 “initial” penalty is assessed against the “person *required to file* [the applicable section 6048 return],” the section 6677 “additional” penalty is assessed 90 days after the Service mails notice to the “person *required to pay* [the ‘initial’] penalty” if the applicable section 6048 returns are not filed. Section 6677(a) (emphasis added). As explained above, the Decedent was the “person required to file” the applicable section 6048 returns during his lifetime under section 6677. For the purposes of section 6677(a) and (b) “initial” penalties, the Estate steps into the shoes of the Decedent and assumes the penalty liability for the Decedent’s failure to file during his lifetime.⁹ The Service then notified the Estate as the “person required to pay” the section 6677(a) and (b) “initial” penalties that it had 90 days to file those section 6048 returns not filed by the Decedent during his lifetime, or else the “additional” penalties would be assessed against it. Because the Executor, acting on behalf of the Estate as its fiduciary, failed to file within 90 days of the notice the applicable section 6048 returns that the Decedent should have filed during his lifetime, the Estate was liable for the section 6677(a) and (b) “additional” penalties as well as the section 6677(a) and (b) “initial” penalties.

This does not mean that imposing section 6677’s “additional” penalty is appropriate in every circumstance. Section 6677(d) provides some flexibility by offering a reasonable cause exception to any penalty identified in the section. Section 6677(d) does specify, however, that the “fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer” for disclosure of the required information is not reasonable cause. Notice 97-34, 1997-25 I.R.B. 22, expands on this by providing that refusal of a foreign trustee to provide the required information – including not doing so based upon “difficulty in providing the required information” – is not reasonable cause. Nonetheless, read in accordance with the discussion of reasonable cause for the accuracy-related and fraud penalties under Treas. Reg. § 1.6664-4(b), such a determination is dependent on the unique facts and circumstances of the case.

As opposed to the section 6677 “initial” penalties that carried over from the Decedent to his Estate, removing the section 6677 “additional” penalties for reasonable cause may be more understandable, for example, if the facts showed that the existence of the foreign trust or accounts were only recently discovered by the Executor after the Decedent’s death, and that a prompt filing of the Forms 3520 and 3520-A within 90 days of the Service’s notice would require some sort of forensic accounting. Appeals should consider all of the available facts to determine whether the reasonable cause exception for the section 6677 “additional” penalties are appropriate in this case.¹⁰

⁹ The Internal Revenue Code not only defines an individual as a “person,” but an estate is a “person” as well. Section 7701(a)(1) (“The term ‘person’ shall be construed to mean and include an individual, a trust, *estate*, [etc.]”) (emphasis added).

¹⁰ By only referencing the reasonable cause exception in our discussion of the section 6677(a) and (b) “additional” penalties, we do not intend to indicate that the exception is only available for the “additional” penalties. The reasonable case exception to the section 6677 penalty applies for the “initial” and “additional” penalties under sections 6677(a) and (b) as well, provided that the facts and circumstances merit its invocation.

- (3) The Estate may be responsible for the section 6677(a) “initial” penalty for the two short tax years within Year 7 if the Forms 3520 were untimely, incomplete, or incorrect. The Estate is responsible for the section 6677(b) “initial” penalty for the short tax year ending Date 2 because the Form 3520-A for the short tax year ending Date 2 was filed untimely, unless the Executor has a reasonable cause for filing the Form 3520-A nearly one and a half years after its due date.

The section 6677(a) and (b) “initial” penalties asserted against the Estate for the untimely filing of the Forms 3520 and 3520-A for Year 7 differ from those relating to prior tax years because these Forms were due after the Decedent’s death. Also, unlike the previous tax years, the Service did not provide the predicate notice for application of the “additional” penalties under sections 6677(a) and (b). Because it provided no prior notice under section 6677 the Service did not assert the “additional” penalties against the Decedent’s Estate. Nonetheless, the Estate may be responsible for section 6677(a) and (b) “initial” penalties for the Executor’s untimely, incomplete, or incorrect filing of the required Form 3520 for short tax year ending Date 2 and for the short tax year Date 3 through Date 9. Furthermore, the Estate may be responsible for section 6677(a) and (b) “initial” penalties for the Executor’s untimely, incomplete, or incorrect filing of the Form 3520-A for the short tax year ending Date 2.

- (a) *The Estate may be responsible for the section 6677(a) “initial” penalty for the two short tax years within Year 7, unless the Forms 3520 were untimely, incomplete, or incorrect.*

As described above, section 6048(a)(1) generally requires the “responsible party” to provide written notice of a “reportable event” to the Secretary, and the executor of a decedent’s estate is one such “responsible party.” Under section 6048(a)(4)(C), the Executor is the responsible party for reporting the death of the Decedent, which is a reportable event under section 6048(a)(3)(A)(iii). Under Treas. Reg. § 1.684-2(e)(1), because the Decedent was the owner of the foreign trust when he died, the Decedent is treated as having transferred – on the date of death but immediately before his death – the assets to a foreign trust. See Treas. Reg. § 1.684-2(e)(2), Example 2. Under the plain language of section 6048(a)(4)(B) and (C), the Executor is also the responsible party for reporting this transfer of money or property to the foreign trust by reason of decedent’s death. Under the facts of this case, the Decedent’s death and related transfer should be reported on both page 1 and Part I of Form 3520 for the tax year beginning Date 1 and ending Date 2 (the date of death).

Although section 6048(a)(1) requires that the triggering event be reported “on or before the 90th day (or such later day as the Secretary may prescribe) after any reportable event,” the Service provided a more generous reporting requirement in its instructions

for Form 3520 with respect to the reporting triggered by a death under section 6048(a)(3)(iii). These instructions provide that in the case of a Form 3520 filed with respect to a U.S. decedent, Form 3520 is due on the date that the estate tax return is due (or would be due if the estate were required to file a return), including extensions.

Under the extension granted by the Service, the Estate had until Date 17 to file its Form 706, and accordingly, the Form 3520 for the short tax year ending Date 2. If the Form 3520 for the short tax year ending Date 2 were indeed filed on Date 16, as claimed by the Executor, then it was filed timely.

This is not, however, the Estate's only reporting requirement for Year 7 with respect to a Form 3520. Section 6048(c)(1) generally provides that if any U.S. person receives (directly or indirectly) during any taxable year of such person any distribution from a foreign trust, such person shall make a return with respect to such trust for such year which includes certain information. Section V of Notice 97-34 states that "a distribution is reportable if it is either actually or constructively received. For example, if a U.S. beneficiary uses a credit card, and charges on that credit card are paid or otherwise satisfied by a foreign trust ... the amount charged on that credit card will be treated as a distribution to the U.S. beneficiary that must be reported under § 6048(c) for the year in which the charge occurs." 1997-25 I.R.B. 22.

On Date 7, Executor caused the Location G bank with which the foreign trust had an account to make a payment to the U.S. Treasury for estimated estate taxes. This is analogous to the credit card example in Notice 97-34 in that the foreign trust directly paid off a debt of an estate. Likewise, the amount paid to the U.S. Treasury on behalf of the Estate is treated as a distribution to the Estate. Thus, the Executor, on behalf of the Estate, is required to report that distribution on Part III of Form 3520 for the tax year beginning Date 3 and ending Date 9.

The instructions to Form 3520 also provide that the form is due on the date that your income tax return is due, including extensions. In this case, the income tax return referred to in the instructions is the Estate's Year 7 Form 1041. This would apply to the estate's Form 3520 for the short tax year beginning Date 3 and ending Date 9. Thus, the estate's Form 3520 for the short tax year beginning Date 3 and ending Date 9 is due on the date that its Form 1041 is due, including extensions. Because it is unclear from the facts as to what the due date is for the Estate's Form 1041, we cannot say whether the Form 3520 for this period was filed timely.

Accordingly, the only basis for the Service's section 6677(a) "initial" penalty against the Estate would be if either Form 3520 were incomplete or incorrect, or additionally in the case of the Form 3520 for the short tax year beginning Date 3 and ending Date 9, if the Form 3520 were untimely. Furthermore, as with the Year 3 through Year 6 section 6677(a) and (b) "additional" penalties assessed for tax years Year 3 through Year 6, Appeals should consider all of the available facts to determine whether the reasonable

cause exception for the Year 7 section 6677(a) "initial" penalty is appropriate in this case.

- (b) *The Estate is responsible for the section 6677(b) "initial" penalty for the short tax year Date 1 through Date 2 because Form 3520-A was filed untimely, unless the Executor has a reasonable cause for filing the Form 3520-A nearly one and a half years after its due date.*

Section 6048(b)(1) generally requires that if, at any time during any taxable year of a U.S. person, such person is treated as the owner of any portion of a foreign trust under the rules of sections 671-79, such person shall complete Part II of Form 3520 and be responsible to ensure that the trust files an annual return (i.e., Form 3520-A). Part II of Form 3520 tells the U.S. owner that if the foreign trust did not file Form 3520-A for the current year, the U.S. owner must, to the best of his or her ability, complete and attach a substitute Form 3520-A for the foreign trust. If the trust failed to file Form 3520-A and the U.S. owner failed to provide a substitute Form 3520-A, section 6677(b) imposes a penalty on the U.S. owner as the person required to file.

Section 679(a)(1) generally provides that a U.S. person who directly or indirectly transfers property to a foreign trust (except by reason of death or for fair market value consideration) shall be treated as the owner for his taxable year of the portion of such trust attributable to such property if for such year there is a U.S. beneficiary of any portion of such trust. Sections 671-79 and 6048(b) no longer apply as of the date of death. Section 679(a)(2)(A) provides that section 679(a)(1) does not apply to a transfer by reason of the death of the transferor. Treas. Reg. § 1.684-2(e)(1) provides that when the decedent was the owner of the foreign trust at the time of death, decedent is treated as having transferred, on the date of death but immediately before his death, the assets to a foreign trust.

In this case, the Decedent established the foreign trust by depositing money to the trust's Location F and Location G bank accounts in Year 1. The Decedent was the primary beneficiary during all years of the trust's existence before he died on Date 2. The Decedent is a U.S. person, thus he is treated as an owner of the trust under section 679(a)(1). Under section 6048(b), the Decedent was responsible to ensure that the trust filed Form 3520-A during each of the years of the trust's existence up until Date 2, his date of death. As explained above, if the trust did not file Form 3520-A for the tax year beginning Date 1 and ending Date 2 (the date of death), then the Executor, on behalf of the Decedent, must provide a substitute Form 3520-A for this tax period to avoid penalties under section 6677(b). However, upon the Decedent's death on Date 2, the grantor trust terminated and became a complex trust. See Year 8 Form 1041 for the A Administrative Trust.

Although section 6048(a)(1) requires that the triggering event be reported "on or before the 90th day (or such later day as the Secretary may prescribe) after any reportable

event,” the Service provided a more generous reporting requirement in its instructions for Form 3520-A. These instructions provide that a Form 3520-A is due on the 15th day of the third month after the end of the trust’s tax year. For Year 7, the end of the foreign grantor trust’s tax year was Date 2, the date of the Decedent’s death. Therefore, the Form 3520-A was due on Date 4. Because the foreign grantor trust terminated and became a complex trust after the Decedent’s death, there was no longer a requirement to file a Form 3520-A for any tax period after Date 2.

The Executor filed the 2007 Form 3520-A on Date 16, nearly a year and a half after its Date 4 due date. Accordingly the Year 7 Form 3520-A was untimely. To the extent that the Year 7 section 6677(b) “initial” penalty was assessed against the Estate on behalf of the Decedent, the trust’s U.S. owner, for the tax year beginning Date 1 and ending Date 2 the Estate is responsible for the section 6677(b) “initial” penalty. Furthermore, as with the section 6677(a) and (b) “additional” penalties assessed for tax years Year 3 through Year 6, Appeals should consider all of the available facts to determine whether the reasonable cause exception for the Year 7 section 6677(b) “initial” penalty is appropriate in this case.

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Please call (202) 622-4940 if you have any further questions.