Information Reporting and Civil Penalties (in a Nutshell)

By

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I. In General

The Internal Revenue Code (the "Code")[1] generally imposes an income tax reporting requirement on all United States persons and certain foreign persons with sufficient nexus to the United States.[2] The term "United States person" generally includes citizens and residents of the United States, domestic partnerships and corporations, and domestic trusts and estates.[3] The term "resident" generally includes lawfully admitted permanent residents (*i.e.*, green card holders) and individuals meeting the substantial presence.[4]

Individuals who are citizens or residents of the United States are generally required to file annually a Form 1040 to report their worldwide income no matter where they reside.[5] Foreign persons, including foreign trusts, are generally required to file annually a Form 1040NR to report their fixed determinable and periodic ("FDAP") income from sources within the United States (*e.g.*, dividends, interest, rents and royalties) and income that is effectively connected with the conduct of a trade or business within the United States for the year ("effectively connected income" or "ECI").[6]

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[1] Unless otherwise noted, all section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

[2] I.R.C. § 6012.

[3] I.R.C. § 7701(a)(30).

[4] The "substantial presence test" measures the weighted average of days an alien is physically present in the United States over a three calendar year period. Specifically, if an individual is present in the U.S. for at least 31 days in the current year and the weighted average for the three year period totals 183 days or more, he generally will be treated as a resident alien of the United States as of the first day in the current year he is physically present in the United States. I.R.C. § 7701(b)(2)(A)(iii); Treas. Reg. § 301.7701(b)-4(a). The formula counts days present in the current year at full value, days present in the immediately preceding year at 1/3 value, and days present in the second preceding year at 1/6 value.

[5] I.R.C. § 6012(a); Treas. Reg. § 1.6012-1(a)(1); *see also* Instructions to Form 1040. I.R.C. § 6012 contains the exceptions for when an individual is not required to file a Form 1040.

In addition to income tax filings, U.S. persons and certain foreign persons may be subject to certain information reporting requirements. For example, the Code requires a foreign grantor trust with a U.S. owner to furnish to the IRS certain information regarding its identification, income and assets.[7] Reporting of such information is generally required on Form 3520-A, "Annual Information Return of Foreign Trust With a U.S. Owner." As discussed below in Section II, the failure to file such information can result in significant civil penalties imposed on the U.S. owner of the foreign grantor trust.

Contrary to foreign grantor trusts, foreign nongrantor trusts generally do not have an information reporting requirement. However, U.S. persons who maintain or engage in certain transactions with foreign grantor or nongrantor trusts during the year are generally required report such transactions to the IRS on a Form 3520, "Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts." Such reportable transactions include: (1) ownership of a foreign grantor trust; (2) transfer of property to a foreign trust (*i.e.*, the U.S. transferor must notify the IRS of the transfer and provide the IRS with the identity of the trustees and beneficiaries); and, (3) receipt of property or distribution from a foreign trust.[8] Reporting is also required for any testamentary transfer of property, as well as the death of a U.S. citizen or resident who was considered to own any portion of a foreign trust or in whose estate are included a foreign trust's assets.[9] In the case of testamentary transfers and the death of a U.S. owner of a foreign trust, notice must be furnished by the decedent's executor.[10] As discussed below in Section II, the failure to timely file a Form 3520, or filing an incorrect or incomplete form, can result in significant civil penalties.

Information reporting on Form 3520 is also required where a U.S. person receives, in the aggregate, gifts or bequests in excess of $100,000 from a nonresident alien or a foreign estate during the year.[11] While a foreign person is not subject to the U.S. gift tax on gratuitous transfers of foreign property, as discussed below in Section II, the failure on the part of the U.S. recipient to disclose such gift to the IRS can result in significant monetary penalties.

Additionally, if, during the year, a U.S. person, either directly or indirectly, (1) transfers property to a foreign corporation, (2) owns at least 10% of the vote or value of a foreign corporation which is owned, in the aggregate, more than 50% (by vote) by U.S.

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6 I.R.C. § 6012(a); Treas. Reg. § 1.6012-1(b)(1); *see also* Instructions to Form 1040NR.

7 I.R.C. § 6048(b).

8 I.R.C. § 6048(a). In Notice 97-34, 1997-25 I.R.B. 22, the IRS clarified section 6048(a)'s notice requirements. The Form 3520, used to report transfers to foreign trusts, is filed with a U.S. transferor's annual income tax return.

9 I.R.C. § 6048(a)(3).

10 I.R.C. § 6048(a)(4).

11 I.R.C. § 6039F(a).

persons, or (3) acquires or disposes of certain amounts of ownership interests in a foreign corporation, such U.S. person must generally file an information return on a Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations," and, in the case of a transfer to a foreign corporation, also on Form 926, "Return by a U.S. Transferor of Property to a Foreign Corporation."[12] For purposes of Form 5471, certain beneficiaries of foreign trusts can be treated as indirectly engaging in the transaction with the foreign corporation.

Information reporting is also generally required for each year a U.S. person, who is a direct or indirect shareholder of a "passive foreign investment company" ("PFIC"),[13] (1) recognizes gain on a direct or indirect disposition of PFIC stock; (2) receives certain direct or indirect distributions from a PFIC; (3) is making a reportable election as outlined in Part 1 of the form; or (4) is including income under an election to remove the PFIC taint by currently recognizing income (*i.e.*, the so-called mark-to-market or "qualified election fund" elections).[14] Reporting is filed on Form 8621, "*Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*."

Finally, and importantly, each U.S. person having a financial interest in, or signature or other authority over, any foreign financial accounts with an aggregate value exceeding $10,000 at any time during the calendar year must report such relationship by filing Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* ("FBAR"), in addition to noting that they have such foreign account filing requirement on Schedule B of Form 1040 and including the income from these accounts on the United States person's U.S. federal income tax return.[15]

The following is a general discussion of certain information reporting requirements imposed on U.S. persons to disclose certain relationships and transactions with foreign trusts, foreign corporations and foreign financial accounts. A general discussion of the potential civil penalties which can apply for the failure to disclose such information is provided at the end thereof.

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[12] I.R.C. §§ 6038, 6038B; 6046.

[13] A foreign corporation is treated as a PFIC for a taxable year if it satisfies one of two tests: (1) at least 75% of the corporation's gross income for the year is passive or investment-type income; or (2) at least 50% of the average fair market value of its assets during the year are assets that produce or are held for the production of passive income. I.R.C. § 1297(a). If a foreign corporation satisfies either test, the corporation is a PFIC and any U.S. person owning an interest (directly or indirectly) in the corporation generally is subject to the PFIC rules, regardless of how large an ownership interest the person has in the foreign company. Unless the shareholder makes a special election to be taxed on a current basis, a distribution or sale of the shares may result in additional tax and interest charges. That is, the portion of a distribution from a PFIC that exceeds 125% of the average distributions made to the shareholder within the three preceding years included in the shareholder's holding period, or if the holding period is less than three years, the actual holding period itself. I.R.C. § 1291(b)(2).

[14] Prop. Treas. Reg. § 1.1291-1(i).

[15] *See* Instructions for Form TD F 90-22.1 (revised October 2008).

II. Form 3520-A Reporting

The trustee of a foreign grantor trust[16] with a U.S. owner must generally file an annual Form 3520-A.[17] Section 6048(b) provides that a U.S. grantor of a foreign grantor trust is "responsible for ensuring" that the trustee (i) files a return with the IRS for each taxable year of the trust setting forth a full and complete accounting of all trust activities and operations,[18] and (ii) furnishes specified income (*i.e.,* Schedule K-1's) and other information to each U.S. grantor and trust beneficiary who directly or indirectly receives a trust distribution for that year.[19]

The Form 3520-A discloses the trust assets and the identity of the settlor and the name, social security number and contact details of the trust's agent in the United States (if any). Form 3520-A is generally filed by the trustee or fiduciary of the foreign grantor trust.[20] To avoid penalties, a complete Form 3520-A must be filed by the 15th day of the 3rd month after the end of the trust's tax year.[21]

In addition to reporting on Form 3520-A, a foreign grantor trust with a U.S. owner generally files a Form 1040NR, indicating on Page 1 that (1) it is a grantor trust taxable under sections 671-679 of the Code and (2) that a statement of income taxable to the grantor is attached. This is similar to the way that Forms 1041 are completed for U.S. domestic grantor trusts.[22]

The Form 1040NR is due on June 15th of the year following the calendar year when the nonresident alien individual, estate or trust received the taxable income. The

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16 In addition to other applicable rules, where a U.S. person transfers property to a foreign trust, such U.S. transferor may be treated as the owner of the trust's assets for U.S. federal tax purposes if the foreign trust that has or could have one or more U.S. beneficiaries. I.R.C. § 679.

17 I.R.C. § 6048(b).

18 I.R.C. § 6048(b)(1)(A).

19 I.R.C. § 6048(b)(1)(B).

20 *See* Instructions for Form 3520-A; *see also* Rev. Proc. 2002-23, 2002-15 I.R.B. 744, section 3, for other eligible Canadian plans.

21 *See* Instructions for Form 3520-A.

22 *Cf.* A foreign nongrantor trust is treated as its own taxpayer, separate from the grantor or settlor. I.R.C. § 641(b). It is taxed as a foreign individual and therefore must file a Form 1040NR to report certain types of income from U.S.-source FDAP income, if not fully withheld at source, and effectively connected income. Treas. Reg. § 1.6012-1. The Form 1040NR is generally due on June 15th of the year following the calendar year when the foreign nongrantor trust received the taxable income. The form must be signed by the trustee.

form must be signed by the trustee or executor, if it is for a trust or estate, or by the individual taxpayer on the return showing his beneficial share of the income.

III. Form 3520 Reporting

The Code generally imposes an information reporting requirement on U.S. persons that engage in certain transactions with foreign trusts. In addition, U.S. persons who receive certain foreign gifts or bequests must disclose such gifts or bequests.

Form 3520 is filed separately from the personal income tax return of the U.S. settlor, transferor or recipient and is due on the date of such personal income tax return, including extensions. Generally, Part 1 covers transfers to a foreign trust by a U.S. person; Part II provides information on the owner of a foreign trust settled by a U.S. person; Part III covers distributions received by a U.S. person from a foreign nongrantor trust; and, Part IV is used to report large foreign gifts. Note that a trust distribution will not constitute a foreign gift and should be reported on Part III rather than Part IV.

A. Transfers to a Foreign Trust

The Code requires any U.S. person who gratuitously transfers property to a foreign trust to notify the IRS of the transfer and provide the IRS with the identity of the trustees and beneficiaries.[23] Reporting a transfer to a foreign trust is done on Form 3520 (Part I), which is attached to the U.S. transferor's Form 1040 for the year.[24]

For purposes of reporting on Form 3520, a gratuitous transfer is any transfer other than a transfer for fair market value (to an unrelated foreign trust) or corporate or partnership distributions.[25] The determination of whether a transfer is gratuitous is made without regard to whether the transfer is a gift for U.S. federal gift tax purposes.[26] Transfers to foreign trusts for fair market value include only transfers that are consideration for the fair market value of the property transferred to the foreign trust.[27] Thus, a sale of property by a U.S. person to a foreign trust must be reported as a transfer to a foreign trust unless the trust pays fair market value for the property.[28] A credit sale

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[23] I.R.C. § 6048(a); Notice 97-34, 1997-25 I.R.B. 1.

[24] Form 3520 is filed separately from Form 1040, but the Form is due on the date the individual's U.S. income tax return (Form 1040) is due (including extensions). Form 3520 must be filed timely to avoid penalties for failing to timely report. *See* Instructions for Form 3520.

[25] Treas. Reg. § 1.671-2(e)(2)(ii).

[26] Treas. Reg. § 1.671-2(e)(2)(i).

[27] Treas. Reg. § 1.684-3(d).

[28] I.R.C. § 679 provides for exceptions to the exception for transfers at fair market value to a foreign trust that is a related party (for transfers occurring after February 5, 1995.

to a trust will not be treated as a fair market value sale unless the obligation issued by the trust is a "qualified obligation."[29]

B. U.S. Beneficiary Receives a Distribution

Whenever a U.S. beneficiary receives a distribution, either directly or indirectly, from a foreign trust, the Code requires such U.S. beneficiary to file a Form 3520.[30] For this purpose, a distribution from a foreign trust includes: (i) any gratuitous transfer of money or property from a foreign trust, whether or not the trust is deemed to be owned by another U.S. person; (ii) the receipt of trust corpus and the receipt of a gift or bequest that is not otherwise subject to income tax; and (iii) a direct or indirect loan of cash or marketable securities to a U.S. grantor or U.S. beneficiary by a foreign trust. Note that a distribution is reportable whether is it actually or constructively received.

C. U.S. Donee Receives a Certain Foreign Gift or Bequest

If the aggregate value of foreign gifts or bequests received by a U.S. person from a nonresident alien or foreign trust exceeds $100,000 ("large foreign gift"), or more than $12,760 from a foreign corporation or foreign partnership, such U.S. person must report the receipt of the gift or bequest to the IRS on Part IV of Form 3520.[31] Reporting of a large foreign gift is required unless, (1) the U.S. donee is a tax-exempt entity, (2) the gifts are "qualified tuition or medical payments," or (3) the gifts are distributions to a U.S. beneficiary of a foreign trust which are otherwise properly disclosed.[32]

D. Exceptions

There are several exceptions to the general requirement of reporting certain transactions with foreign trusts, including the following: (i) transfers to certain employee benefit plans; (ii) transfers to foreign trusts having a current determination letter from the IRS recognizing their status as tax exempt under section 501(c)(3); (iii) transfers to, ownership of or distributions from a Canadian registered retirement savings plan or a Canadian registered retirement income fund , where the U.S. citizen or resident alien is

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[29] Notice 97-34. To be treated as a "qualified obligation," an obligation must: (i) be reduced to writing by an express written agreement; (ii) have a term not exceeding five years including options to renew and rollovers; (iii) be denominated in U.S. dollars; (iv) have a yield to maturity of between 100% and 130% of the applicable AFR on the date the obligation was issued; (v)have a U.S. person willing to extend the statute of limitations for assessment of any income or transfer tax changes attributable to the transfer to three years beyond the maturity date of the obligation; and (vi) have a U.S. person report on the status of the obligation and the interest and principal payments on Form 3520.

[30] I.R.C. § 6048(c)

[31] I.R.C. § 6039F(a); *see also* Instructions for Form 3520.

[32] Notice 97-34; Instructions for Form 3520.

eligible to file Form 8891; and, (v) distributions taxable as compensation and which have been reported as compensation on the applicable tax return.[33]

IV. Report of Foreign Financial Acccounts

A. In General

Each U.S. person having a financial interest in, or signature or other authority over, any foreign financial accounts with an aggregate value exceeding $10,000 at any time during the calendar year must report such relationship by filing Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* ("FBAR"), in addition to noting that they have such foreign account filing requirement on Schedule B of Form 1040 and including the income from these accounts on the United States person's U.S. federal income tax return.[34]

Reporting on Form TD F 90-22.1 is required for each calendar year that a U.S. person maintains such interest or authority over foreign financial accounts.[35] The Form TD F 90-22.1 must be filed on or before June 30 each calendar year. An extension for filing one's U.S. income tax return does not extend the deadline for making a TD F 90-22.1. That is, there is no extension of time available for the late filing.[36]

The Form TD F 90-22.1 was recently revised in October 2008. The revised form is effective for tax years starting on January 1, 2009. The revised form provides additional definitions and clarifications. It also generally expands the class of individuals and companies required to make annual reports, including certain foreign persons in and doing business in the United States (including a branch of a foreign entity) and certain trusts with U.S. settlors. There are also more detailed rules regarding consolidated reports for corporate parents and subsidiary corporations. The revised form confirms that there is no extension of time for filing the form.

B. Definitions

For purposes of FBAR, the term "United States person" means a citizen or a resident of the United States, or a person in and doing business in the United States.[37] A foreign subsidiary of a U.S. person is not required to file this report, although its U.S.

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33 I.R.C. § 6048(a)(3)(B)(ii); Notice 97-34.

34 *See* Instructions for Form TD F 90-22.1 (revised October 2008).

35 31 CFR § 103.24. Such persons will be required to provide detailed information concerning each account when so requested by the Secretary or his delegate. *Id.*

36 *See id.*

37 *See id.*

parent corporation may be required to do so.[38] A branch of a foreign entity that is doing business in the United States is required to file this report even if not separately incorporated under U.S. law.[39]

The term "financial account" generally includes any bank, securities, securities derivatives or other financial instrument accounts, including any accounts in which the assets are held in a commingled fund, and the account owner holds an equity interest in the fund.[40] The term also means any savings, demand, checking, deposit, time deposit, or any other account (including debit card and prepaid credit card accounts) maintained with a financial institution or other person engaged in the business of a financial institution.[41] Individual bonds, notes, or stock certificates held by the filer are a financial account, nor is an unsecured loan to a foreign trade or business that is not a financial institution.[42]

Any of the financial accounts described above is considered to be a foreign financial account for purposes of FBAR, if it is located outside the United States, Guam, Puerto Rico, and the Virgin Islands.[43] However, an account maintained with a military banking facility[44] is not considered to be a foreign financial account for purposes of FBAR, even if the military banking facility is located in a foreign country.[45] The geographical location of the account, not the nationality of the financial entity institution in which the account is founds determines whether it is in an account in a foreign country.[46] That is, the situs of a financial account is determined by the location where the branch is, not the location of the institution's home office. Thus, for example, an account maintained at a German branch of a U.S. bank is a foreign financial account, but an account maintained at a U.S. branch of a German bank is not a foreign financial account.

C. Ownership of Accounts

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38 *See id*.

39 *See id*.

40 *See id*.

41 *See id*.

42 *See id*.

43 *See id*.

44 Such facilities are generally known as a "United States military banking facility" or a "United States military finance facility" that are operated by a U.S. financial institution designated by the U.S. government to serve U.S. government installations abroad.

45 *See id*.

46 *See id*.

The instructions to Form TD F 90-22.1 explain that a U.S. person has a financial interest in a bank, securities, or other financial account in a foreign country under either of the following circumstances:

1. A U.S. person is the owner of record or has legal title, whether the account is maintained for his or her own benefit or for the benefit of others including non-U.S. persons. If an account is maintained in the name of two persons jointly, or if several persons own a partial interest in an account, each of those U.S. persons has a financial interest in that account.[47]

2. A U.S. person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is:

    a. A person acting as an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person;

    b. A corporation in which the U.S. person owns directly or indirectly more than 50 percent of the total value of shares of stock or more than 50 percent of the voting power of all shares of stock;

    c. A partnership in which the U.S. person owns an interest in more than 50 percent of the profits (distributive share of income) or more than 50 percent of the capital of the partnership; or

    d. A trust in which the U.S. person either has a direct or indirect present beneficial interest in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income.[48]

3. A U.S. person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is a trust, or a person acting on behalf of a trust, that was established by such U.S. person and for which a trust protector has been appointed.[49]

D. Signature Authority

For purposes of Form TD F 90.22-1, a U.S. person is considered to have signature authority over a foreign financial account if such person can control the disposition of money or other property in the account by delivering his or her signature (or his or her signature and that of one or more other persons) to the bank or other person maintaining

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47 *See id.*

48 *See id.*

49 *See id.*

the account. In addition, a U.S. person has "other authority" subject to FBAR reporting if such person can exercise comparable power over an account by direct communication to the bank or other person maintaining the account, either orally or by some other means.

E. Exceptions

Notwithstanding the general rules, Form TD F 90.22-1 is not required to be filed under the following circumstances:

1. An officer or employee of a bank which is currently examined by Federal bank supervisory agencies for soundness and safety need not report that he or she has signature or other authority over a foreign bank, securities or other financial account maintained by the bank, if the officer or employee has NO personal financial interest in the account.[50]

2. An officer or employee of a domestic corporation whose equity securities are listed upon U.S. national securities exchanges or which has assets exceeding $10 million and 500 or more shareholders of record need not file such a report concerning the other signature authority over a foreign financial account of the corporation, if he has NO personal financial interest in the account and he has been advised in writing by the chief financial officer of the corporation that the corporation has filed a current report, which includes that account.[51] There are additional exceptions for domestic and foreign subsidiaries.

3. As noted above, a U.S. person is not required to report any account maintained with a branch, agency, of other office of a foreign bank or other institution that is located in the United States, Guam, Puerto Rico, and the Virgin Islands.[52]

V. Form 5471

Form 5471 is generally used by certain U.S. citizens and residents who are officers, directors, or shareholders in certain foreign corporations to satisfy the reporting requirements of sections 6038 (reporting with respect to certain foreign corporations) and 6046 (returns relating to organizations and reorganizations of foreign corporations). A separate Form 5471 and applicable schedules for each foreign corporation must be attached to the U.S. Federal income tax return of the U.S. person obligated make the information return.

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50 *See id.*

51 *See id.*

52 *See id.*

Generally, there are five categories of U.S. taxpayers that are required to complete a Form 5471 for each taxable year of certain foreign corporations:

- Category 1 Filer: This filing requirement has been repealed by the "American Jobs Creation Act of 2004." Prior to this repeal, U.S. citizens or residents who were officers, directors, or 10 percent shareholders of a foreign personal holding company were required to file a Form 5471 as Category 1 Filers.

- Category 2 Filer: U.S. citizen or resident who is an officer or director of a foreign corporation in which a U.S. person has acquired: (1) 10% of stock of the total value of the corporation's stock or of the total combined voting power of all classes of stock with voting rights ("10% requirement"); or (2) an additional 10% or more (in value or vote) of the outstanding stock of the foreign corporation.[53]

- Category 3 Filer: (1) U.S. person who acquires stock in a foreign corporation which, when added to any stock owned on the acquisition date, meets the 10% requirement; (2) U.S. person who acquires stock which, without regard to stock already owned on the date of acquisition, meets the 10% requirement; (3) a person treated as a U.S. shareholder in a captive insurance company situation (as defined in section 953(c)(1)); (4) a person who becomes a U.S. person while meeting the 10% requirement; or (5) U.S. person who disposes of sufficient stock in the foreign corporation to reduce interest to less than the ownership requirement (*i.e.*, less than 10%).[54]

- Category 4 Filer: U.S. person who had "control" (more than 50% of vote or value) of a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the foreign corporation (exception for consolidated returns) ending with or within the taxable year of the U.S. person.[55]

- Category 5 Filer: U.S. shareholder who owns, directly or indirectly, at least 10 percent of a controlled foreign corporation ("CFC") and who owns stock in the CFC for an uninterrupted period of 30 days or more during any tax year of the foreign corporation, and who owned the stock on the last day of that year.[56]

  A CFC is a foreign corporation that has U.S. shareholders that own (either directly, indirectly or constructively within the meaning of sections 958(a) and (b)) on any day of the tax year of the foreign corporation, more than 50 percent

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53 I.R.C. § 6046(a)(1)(A).

54 I.R.C. § 6046(a)(1)(B).

55 I.R.C. § 6038(a)(1).

56 I.R.C. § 6038(a)(4).

of: (1) the total combined voting power of all classes of its voting stock; or (2) the total value of the stock of the corporation.[57]

For purposes of Form 5471 reporting, a U.S. taxpayer can own shares of a CFC directly or indirectly. Stock owned (directly or indirectly) by or for a portion of a trust of which a person is considered the owner under the grantor trust rules is considered to be owned by such person.[58] Under the indirect ownership rules, if an individual has an interest in a foreign corporation, foreign partnership, foreign estate, or foreign trust that own shares in a foreign corporation, the individual will be deemed to "indirectly" own a proportionate share of the foreign entity's shares in the foreign corporation.[59] Accordingly, if a U.S. taxpayer has a beneficial interest in a foreign nongrantor trust that owns shares in a foreign corporation, the taxpayer will be deemed to "indirectly" own a proportionate share of the foreign trust's shares in the foreign corporation.[60]

VI. Potential IRS Penalties

The failure to file the required tax returns and information returns may result in civil and criminal penalties, as discussed below.

A. Income Tax Returns

1. Section 6651, Failure to File Tax Returns or to Pay Tax

   In addition to the tax due, if a taxpayer fails to file a return, there may be imposed a penalty of 5% per month of the amount of tax required to be shown on a tax return. The amount of the penalty is not to exceed 25% of the amount of tax in the aggregate. There is an exception if the failure was due to reasonable cause, not willful neglect.

2. Section 6662, Substantial Underpayment of Tax

   In addition to the tax due and the penalty imposed under section 6651, a taxpayer could be subject to a penalty of 20% of the amount of the underpayment. This penalty is imposed on both (a) negligence or disregard of rules or regulations, and (b) any substantial underpayment of tax (understatement of greater than 10% or $5,000).

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57 I.R.C. § 957(c).

58 IRC § 318(a)(2)(B)(ii).

59 IRC § 958(a)(2).

60 IRC §§ 958(a)(1) and 318(a)(2)(B)(i); Treas. Reg. §1.958-2(c)(ii)(a).

a. EXCEPTION 1: There is a reasonable cause exception whereby the substantial underpayment of tax penalty may be alleviated if there was a reasonable cause for the underpayment (*i.e.*, there is "substantial authority" for or adequate disclosure of the position and the position is not a tax shelter) and the taxpayer acted in good faith with respect to the underpayment.

b. EXCEPTION 2: If the taxpayer is subject to the (worse) fraud penalty under section 6663, then the substantial underpayment penalty does not apply. Generally, pursuant to section 6663, if the underpayment is based on fraud, in addition to the tax due, taxpayer could be subject to a penalty of 75% of the portion of the underpayment attributable to fraud. However, the Code provides an exception for reasonable cause.

B. Certain Information Returns (Forms 3520, 3520-A and 5471)

1. Forms 3520 and 3520-A

Section 6677, Failure to File Information with Respect to Certain Foreign Trusts

(i) If a U.S. transferor fails timely file a Form 3520 to report the transfer of property to a foreign trust, or files the form incorrectly or incompletely, the IRS may impose a penalty equal to 35% of the gross value of the property transferred to the foreign trust.[61]

(ii) Similarly, if a U.S. beneficiary fails to timely file a Form 3520 to report the receipt of a distribution from a foreign trust, or files the form incorrectly or incompletely, there may imposed a penalty equal to 35% of the gross value of the distribution received from the foreign trust.[62]

(iii) Finally, if a U.S. donee fails to timely file a Form 3520 to report the receipt of a large foreign gifts, or files the form incorrectly or incompletely, such donee may be subject to a penalty equal to 5%, not to exceed 25%, of the value of the gift or bequest received in the relevant year.

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[61] *See also* Instructions for Form 3520.

[62] *See id*.

(iv) If a foreign grantor trust that fails to timely file a Form 3520-A, or fails to furnish all of the required information, the U.S. owner may be subject to a penalty equal to 5% of the gross value of the portion of the trust's assets treated as owned by the U.S. person at the close of the taxable year.[63]

(v) The failure to timely file a complete and correct Form 3520 or Form 3520-A may result in an additional penalty of $10,000 per 30-day period for failing to comply within 90 days of notification by the IRS that the information return has not been filed.[64] The total penalty for failure to report a trust transfer, however, cannot exceed the amount of the property transferred.[65] The monetary penalty is in addition to any applicable criminal penalty.[66] If the person responsible for reporting can demonstrate that the failure to timely file was due to reasonable cause, and not willful neglect, the IRS can abate the penalty under section 6677(a) or 6677(b).[67]

2. Form 5471: Category 2 and Category 3 Filers

Section 6038(b), Information Reporting with Respect to Certain Foreign Corporations and Partnerships

The IRS may impose a penalty of $10,000 for each failure to timely file a Form 5471, or filing a Form 5471 which does not show the information required under section 6038. If the information is not filed within 90 days after the IRS has mailed a notice of the failure to the U.S. person, an additional $10,000 penalty (per foreign corporation) can be imposed for each 30-day period, or fraction thereof, during which the failure continues after the 90-day period has expired. The additional penalty is limited to $50,000. There is no reasonable cause exception for either the initial or additional penalty.

3. Form 5471: Category 4 and Category 5 Filers

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63 *See id.*

64 I.R.C. § 6677(a).

65 *Id.*

66 I.R.C. § 7203.

67 I.R.C. § 6677(d).

Section 6679, Failure to File Returns, Etc. with Respect to Foreign Corporations or Foreign Partnerships

The IRS may impose a penalty of $10,000 for each failure to timely file a Form 5471, or filing a Form 5471 which does not show the information required under section 6046. If the information is not filed within 90 days after the IRS has mailed a notice of the failure to the U.S. person, an additional $10,000 penalty (per foreign corporation) can be imposed for each 30-day period, or fraction thereof, during which the failure continues after the 90-day period has expired. The additional penalty is limited to $50,000. There is a reasonable cause exception for the initial $10,000 penalty; however, there is no such exception for the additional penalty.

4. Form 926

Section 6038B(c), Notice of Certain Transfers to Foreign Persons

If a U.S. person fails to timely provide information regarding certain transfers to foreign corporations as required under section 6038B, the IRS may impose a penalty equal to 10% of the fair market value of the property transferred at the time of the exchange. There is a reasonable cause exception. Additionally, the amount of the penalty imposed under this section is limited to $100,000, unless the failure was due to intentional disregard.

5. Information Returns Generally

(i) Section 6721, Failure to File Correct Information Return

There may be imposed an additional penalty of $50 for *each* return (not to exceed $250,000 per year) which fails to include all of the required information or includes incorrect information. There is an exception to this penalty if the failure is corrected within 30 days after the required filing date. However, if the failure is based on intentional disregard, then no exception applies (including the $250,000 cap) and the amount of the penalty is the greater of $100 or 10% of the aggregate amount of the items required to be reported. There is no reasonable cause exception.

(ii) Section 6723, Failure to Comply with Other Information Reporting Requirements

There may be imposed an additional penalty of $50 for each failure to comply with a required information reporting (not to exceed $100,000 per year). There is no exception, including a reasonable cause exception.

C. Form TD F 90.22-1

A willful violation of the Form TD F 90.22-1 requirements (*i.e.*, failure to file Form TD F 90.22-1, failure to supply information on the report, or filing a false or fraudulent report) could result in the imposition of civil and/or criminal penalties.[68]

For example, if any U.S. person willfully violates the Form TD F 90.22-1 filing requirement, such person may be liable to the U.S. government for a civil penalty of not more than $25,000[69], in addition to the following criminal penalties:

1. If a U.S. person willfully violates the reporting requirement, such person may be subject to a fine of not more than $250,000, or imprisoned for not more than 5 years, or both;[70] and

2. If a U.S. person willfully violates the reporting requirement while violating another law of the United States, or as part of a pattern of any illegal activity involving more than $100,000 in a 12-month period, such U.S. person may be subject to a monetary fine of not more than $500,000, or imprisoned for not more than 10 years, or both.[71]

In addition, if a U.S. person, with respect to Form TD F 90.22-1, (1) falsifies, conceals, or covers up by any trick, scheme, or device a material fact, (2) makes any materially false, fictitious, or fraudulent statement or representation, or (3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent

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[68] The instructions for Form TD F 90.22-1 specifically provide that criminal penalties for failing to comply with FBAR are provided in 31 U.S.C. § 5322(a) and (b), and 18 U.S.C. § 1001. In addition, civil penalties for failure to comply with the BSA or regulations issued under the authority of the BSA are generally provided in 31 U.S.C. § 5321.

[69] 31 U.S.C. § 5321. Section 5321 generally provides that if a U.S. person willfully violates a provision of the BSA or a regulation issued under the BSA, such person may be liable for a civil penalty of not more than the greater of the amount (not to exceed $100,000) involved in the transaction (if any) or $25,000. With respect to reporting on Form TD F 90.22-1, a U.S. person is not reporting a transaction but, rather, reporting his interest or signature authority over a foreign financial account. Thus, the maximum amount of potential civil penalty is $25,000.

[70] 31 U.S.C. § 5322(a).

[71] 31 U.S.C. § 5322(b).

statement or entry, such person may be fined, or imprisoned for not more than 5 years, or both.[72]

D. Criminal Penalties

In addition to the above, criminal penalties under sections 7203 (monetary and penal penalties for willful failure to file supply information), 7206 (monetary and penal penalties for fraud and false statements) and 7207 (monetary and penal penalties for fraudulent statements) may apply.

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[72] 18 U.S.C. § 1001.