

Abatement of Foreign Pension Trust Penalties

March 31, 2020

For more than a decade, the IRS has engaged in a vigorous enforcement campaign involving U.S. taxpayers with unreported foreign accounts and assets. The breadth of the cases has been wide – the IRS has pursued U.S. persons who have hidden money in foreign accounts, failed to report their affiliation with foreign companies and foreign trusts, and failed to report large gifts from non-U.S. persons. The IRS has assessed, and collected, substantial civil penalties (and sometimes recommended criminal prosecution) in many of these cases.

U.S. taxpayers who participate, through their employment or individually, in foreign pension programs and retirement trusts and who failed to file required reports have been swept up in this enforcement wave. The rules for filing are complex, and almost every one of these cases involves innocent mistakes or at worst, only a degree of negligence. Relief for many of these individuals is finally on the way.

On March 2, 2020, the IRS released Revenue Procedure 2020-17. It relieves certain U.S. citizens and resident individuals from the requirement to file information returns with respect to their transactions with, and ownership of, certain tax-favored foreign retirement trusts and certain tax-favored foreign nonretirement savings trusts. As to prior years in which required reports may not have been filed, the IRS guidance permits an eligible individual to request abatement of penalties assessed, or a refund of penalties paid (subject to statutory refund claim limitations). **While this is welcome news to many, the requirements to qualify as a “tax-favored foreign retirement trust” or “tax-favored foreign nonretirement savings trust” can exclude many plans, including some in the United Kingdom.**

Many U.S. citizens and resident individuals are unaware that they may be subject to tax and/or information reporting requirements in the United States with respect to their transactions with, or ownership of, tax-favored foreign retirement plans. Failing to comply with the various information reporting requirements can create an exception to the standard three-year statute of limitations during which the IRS can audit a tax return and assess additional tax and penalties. And, perhaps more importantly, many of these foreign plans are classified as “trusts” for U.S. tax purposes. Therefore, the foreign trust penalty regime – which can be quite punitive – can often come into play.

This recent IRS guidance allows an “eligible individual” who has been assessed a penalty for failing to comply with information reporting requirements with respect to an “applicable tax-favored foreign trust” (i.e., Form 3520 and/or Form 3520-A) to request an abatement of the penalties assessed, or a refund of the penalties paid. Under the guidance, an eligible individual is a U.S. citizen or resident individual who is compliant, *or comes into compliance*, with all requirements for filing a U.S. federal income tax return(s) covering the period such individual was a U.S. citizen or resident, including, if necessary, reporting as income any contributions to, earnings of, or distributions from, an applicable tax-favored foreign trust. An applicable tax-favored foreign trust is defined as a “tax-favored foreign retirement trust” (generally, a foreign trust that provides pension or retirement benefits) or a “tax-favored foreign non-retirement savings trust” (generally, a foreign trust that provides medical, disability, or educational benefits).

If a taxpayer seeking the benefits of the guidance needs to come into compliance with respect to

contributions to or unreported income from the tax-favored foreign trust, he or she will generally need to file three years of amended returns. If the taxpayer has compliance issues in addition to the foreign pension matters covered in the recent IRS notice, there are a variety of other compliance programs that may provide a taxpayer with relief from the various penalties that may be imposed for past non-compliance.

Careful review of the foreign country's laws is necessary before seeking relief under this IRS guidance. The requirements to qualify as an applicable tax-favored foreign trust can cause such trusts to fail, thus excluding a taxpayer from penalty protection. For example, the requirement that the foreign country's laws allow only contributions with respect to income earned from the performance of personal services may inadvertently lead to the exclusion of many retirement savings plans. Note also that the United States is party to a number of income tax treaties with foreign countries that may affect the tax treatment of contributions to, earnings of, or distributions from an applicable tax-favored foreign trust.

Caplin & Drysdale has been advising taxpayers with foreign reporting issues for decades. Our tax controversy team has particular experience guiding taxpayers through the myriad of reporting regimes and compliance programs offered by the IRS. If you have received a notice from the IRS informing you that it has assessed penalties under section 6677 for failing to file information returns with respect to a tax-favored foreign trust, if you have recently paid a penalty for such failure, or if you wish to consider rectifying prior non-compliance even if you have not yet heard from the IRS, please contact us to discuss your eligibility for the recently-announced relief.

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