Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: May 1, 2006

to:

Supervisory Revenue Agent
(Small Business/Self Employed)

from: Joseph P. Dewald
General Attorney
(Small Business/Self-Employed)
CC:SB:7:SF:2

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subject: Assertion of Penalties for Failure to File Information Returns with Respect to Certain Foreign Entities

This memorandum is in response to your request for legal advice dated January 20, 2006, in the audit involving (“taxpayer”). You have requested our advice on the assertion of penalties under sections 6048, 6677, and 6038 of the Internal Revenue Code (“Code”).

<u>LEDGEND</u>

A =

B =

C =

D1	=
D2	=
D	=
E	=
F	=
G	=
H	=
J	=
K	=
L	=
M	=
N	=
O	=
P	=
Q	=
R	=
S	=
T	=
U	=
V	=
W	=
$a	=

\$b	=
\$c	=
\$d	=
\$e	=
\$f	=
\$g	=
\$h	=
\$i	=
\$j	=
\$k	=
\$l	=
\$m	=
\$n	=
aa	=
bb	=
cc	=
dd	=
ee	=
ff	=
gg	=
hh	=
Country A	=

Country B	=
Country C	=
Country D	=
Country E	=
Country F	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
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 =

ISSUES

(1) Whether taxpayer was required to file information returns under section 6048 for A for Year 2 through Year 7?

(2) If taxpayer was required to file information returns for A, what amounts should be taken into account to compute the failure to file penalties under sections 6677?

(3) Whether taxpayer was required to file information returns under section 6038 for D for Year 2 through Year 7?

CONCLUSIONS

(1) As owner of A and as transferor of the assets to A, taxpayer was required to file information returns under section 6048(a) and (b) for Year 2 through Year 7.

(2) Pursuant to section 6677(a) and (c)(1), the 35 percent penalty for failure to report transfers of money or property to A under section 6048(a) is computed each year based on the gross value of the property that taxpayer transferred to A or to any of A's assets during the applicable year. The Service should take into account all of the transfers involving the premium payments to the Policy, C stock to D, and funds from C that settled in D's account because taxpayer either made these transfers or caused other entities to make these transfers. Pursuant to section 6677(b) and (c)(2), the 5 percent penalty for failure to report information on A under section 6048(b) is computed each year based on the gross value of A's assets that are treated as owned by taxpayer at the close of the applicable tax year. The gross value amount of the assets of A should include the value of all assets held by A, the Policy, and D.

(3) As grantor of B and A, taxpayer has more than 50 percent control, based on vote and value, of D pursuant to section 1.6038-2(b) and (c) of the Income Tax Regulations ("Regulations"). Taxpayer is, therefore, subject to penalties under section 6038(a) for failing to file Forms 5471 for Year 2 through Year 7.

FACTS

Introduction

Taxpayer is the President and Chairman of the Board of C. In Year 2, taxpayer entered into a tax avoidance arrangement. The arrangement was designed to save taxes and transfer assets offshore. The arrangement consisted of settling B and A, transferring stock of C to D, and creating an offshore deferred compensation arrangement ("OEL"). See Notice 2003-22, 2003-1 C.B. 851.

The Domestic and Foreign Trusts and the International Business Corporation

On Date 3, taxpayer settled B. There were two successive trustees of B who were subject to taxpayer's control. The first trustee was L who was the Vice President of C and was taxpayer's immediate subordinate at C. L retired from C in late Year 2 and ceased being the trustee of B in Date 7. At that time, taxpayer named M as the trustee of B. M was a longtime acquaintance of taxpayer, was a tenant of taxpayer, and provided professional architectural services to taxpayer. B was initially unfunded but subsequently obtained domestic bank accounts in which taxpayer made deposits. The beneficiaries of B have been taxpayer's spouse and children, all of whom are U.S. persons.

On Date 4, B settled A located in Country A. The trustee of A is E. L was named as A's protector. However, after L retired, taxpayer named M as A's protector. The actions of E, as trustee of A, were subject to the written consent of the protector. However, taxpayer retained the power to appoint a new protector at his own discretion. The beneficiaries of A have been taxpayer's spouse and children.

Forms 3520, "Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts," and 3520-A, "Annual Information Return of Foreign Trust With a U.S. Owner," were filed for A for Year 2 and Year 3 but none of the Forms were signed, with the exception of the Year 2 Form 3520. The Year 2 Form 3520 is signed M. However, in a taped interview on Date 12, M stated that his signature on the Year 2 Form 3520 was forged. There is no evidence of any subsequent Form 3520 or Form 3520-A filings for A.

Upon its formation, A secured a flexible premium variable life insurance policy ("Policy") on taxpayer from F, which was subsequently exchanged with G. The premium payments made on the Policy ranged from approximately $a to $b per year. Taxpayer would transfer money to B bank account, and the trustee of B would pay the premiums to F or G.

The Policy owned the stock of D1, which was formed in Country B and was reincorporated under Country C law as D2 in Year 4. Under the reincorporation, the assets and liabilities of D1, were assigned to D2.[1] All of the stock of D is titled to H. On Date 5, D opened a bank account at the Country C branch of E. D appears to have closed the E bank account in Date 10 and opened bank accounts at J and K in Date 9 and Date 8, respectively.

C Stock Transfer to D

[1] D1 and D2 are referred to hereafter as D.

In a transfer made effective on Date 2, taxpayer entered into a private annuity agreement with D. In exchange for an unfunded and unsecured private annuity policy ("annuity") from D, taxpayer transferred aa shares of C stock to D, which constituted bb of C. The annuity was valued at $c. See Private Annuity Agreement. The exchange suggests a value of $d per share of the C stock transferred. However, taxpayer signed a personal financial statement and a residential loan application in Year 1 providing that the value of C stock was $e per share. The terms of the annuity agreement provide that annuity payments are deferred until Date 13.

<u>The OEL Arrangement</u>

Effective Date 1, taxpayer entered into an OEL arrangement. Prior to entering into the OEL arrangement, taxpayer was a longtime employee of C. In the year prior to the OEL arrangement, taxpayer's salary from C was $f. However, taxpayer's salary in every year involving the OEL arrangement never exceeded $g. Neither L, N, nor O, all of whom were listed as Officers and Directors in the Corporate minutes of C, were aware of the OEL arrangement until many years after taxpayer entered into the arrangement.

The OEL arrangement consisted of three separate contractual arrangements. The first consisted of an employment contract that taxpayer entered into with P, which was located in Counrty D. Under this contract, taxpayer agreed to provide his worldwide personal services to P in exchange for an annual salary of $g, an unenforceable deferred compensation program, and fringe benefits that were not provided by P or enforced by taxpayer.

In the second contractual arrangement, P entered into a subcontract with Q. Q was a domestic employee leasing company. Under this subcontract, Q had the right to contract out taxpayer's services in the United States. In exchange for this right, Q paid taxpayer's annual salary of $g and paid P cc of the post-salary proceeds received for the use of taxpayer's services. In addition, Q assumed the obligation to provide the fringe benefits provided in the contract between taxpayer and P. The only fringe benefit Q provided to taxpayer was automobile expenses, which C reimbursed to Q.

The third contractual arrangement consisted of a business consultation agreement between Q and C. This agreement required C to pay Q a first year incentive fee of $h and an annual payment of $i for the use of taxpayer's services. C was also required to pay P a yearly bonus of dd of C's income before taxes but after deducting reasonable business expenses and after excluding the $i annual payment. Other than C, no other United States entities were contacted for the use of taxpayer's services.

After the OEL arrangement was in place, P entered into two revolving lines of credit. One was with R in which R would provide P with up to $j in return for a note payable to R. The other was with D in which P would provide D with up to $j in return for a note payable to P.

In Year 3, Country D law changed so the OEL structure was moved from Country D to the Country A. Effective on Date 6, the employment contract between taxpayer and P was assigned to S, which was located in Country E. S entered into a revolving line of credit with D in which S would provide D with up to $j in return for a note payable to S. There is no known revolving line of credit from another entity to S.

In Year 4, the subcontract between S and Q (formerly between P and Q) was assigned to T, which was a domestic corporation. The business consultation agreement between Q and C was also assigned to T.

From the beginning of the OEL arrangement, P transferred the money it received from Q to a Country F bank account titled to U. P transferred ee of these funds to U. In almost every transaction, the transfer of funds into P was followed within 24 hours by the transfer of funds out of P into U. The ff difference represented P's service fee. The Service cannot trace the funds after they were transferred to U due to bank secrecy laws. Also due to bank secrecy laws, the Service cannot trace the funds that T transferred to S after S received those funds. However, large amounts of money settled in D's bank accounts through the revolving lines of credit to D that D never repaid. Apparently, the revolving lines of credit were the vehicle for transferring the funds from P and S to D. The main promoter of this tax shelter, V, explained in a court reported interview on Date 11, that P would receive the money from Q and, pursuant to a lending agreement, would transfer the money to D at D's request. A cover letter enclosing D's balance sheet stated that D received $k on its line of credit with P. The D Manager, W, signed correspondence providing that the balance of the principal amount borrowed by D on the revolving line of credit with S was $l, $m, and $n for Year 4, Year 5, and Year 6, respectively.

The OEL arrangement resulted in C claiming deductions for the use of taxpayer's services and taxpayer omitting reportable income. The arrangement also resulted in assets being indirectly transferred to A through: (1) premium payments to the Policy owned by A; (2) the transfer of aa shares of C stock to D in exchange for a deferred, unfunded, unsecured private annuity; and (3) transfers of funds from C, under the business consultation agreement, through various entities to D's bank accounts.

LAW AND ANALYSIS

Burden of Proof on Assessed Penalties

Penalties under sections 6677 for failure to file under section 6048 and penalties under section 6038(b) are assessable penalties and are not subject to deficiency procedures. See I.R.C. §§ 6677(e) and 6671; IRM Exhibit 20.1.9-3. Assessments of tax, additions to tax, and penalties are given a presumption of correctness, and introduction of an assessment establishes a prima facie case. Welch v. Helvering, 290 U.S. 111 (1933); United States v. Stonehill, 720 F.2d 1288 (1983); United States v. Molitor, 337 F.2d 917

(9th Cir. 1964); United States v. Gavett, 94 AFTR2d 2004-5499 (E.D. Pa. 2004). However, the assessment must be supported by a minimal evidentiary foundation for the presumption of correctness to arise. Stonehill, 702 F.2d 1288, 1293 (citing Weimerskirch v. Commissioner, 596 F.2d 358, 360 (9th Cir. 1979)). This evidentiary foundation requires the introduction of some substantive evidence. Stonehill, 720 F.2d 1288, 1293 (citing Edwards v. Commissioner, 680 F.2d 1268, 1270 (9th Cir. 1982); Weimerskirch, 596 F.2d 358, 360; United States v. Janis, 428 U.S. 433, 441-442 (1976); Suarez v. United States, 582 F.2d 1007, 1010 n. 3 (5th Cir. 1978); Carsen v. United States, 560 F.2d 693, 696-698 (5th Cir. 1977); Gerardo v. Commissioner, 552 F.2d 549, 552 (3d Cir. 1977)). When a presumptively correct assessment is introduced, the burden of proof shifts to the taxpayer to prove that the assessment is arbitrary or erroneous. Helvering v. Taylor, 293 U.S. 507, 515 (1935); Stonehill, 702 F.2d 1288, 1294; Cohen v. Commissioner, 266 F.2d 5, 11 (9th Cir. 1959); Kersting v. United States, 206 F.3d 817, 820 (9th Cir. 2000).

Under section 7491(c) of the Code, the Secretary has the burden of production for any penalty or addition to tax. For the presumption of correctness to apply to penalties that the Service imposes on taxpayer under sections 6048, 6677, and 6038, the Service must have some minimal evidentiary foundation for the assessment. This will shift the burden of proof to taxpayer to prove the assessment erroneous. Higbee v. Commissioner, 116 T.C. 438, 446-447 (2001). To the extent that the Service possesses some evidence that taxpayer caused transfers to be made to A, the Service can impose penalties under sections 6048 and 6677 either by treating B as a grantor trust under section 677 of the Code, or by applying the doctrine of economic substance to not give economic effect to the transactions of B, and by applying the doctrine of economic substance to the transactions involved in the OEL arrangement and the sale of C stock for the annuity. With respect to the C transfers into the OEL arrangement, the Service should treat taxpayer as causing these transfers because: (1) taxpayer had gg control over the C stock at the time C entered into the OEL arrangement; (2) taxpayer was the only Officer and Director of C to ratify the OEL arrangement on behalf of C as none of the other Officers and Directors knew of the OEL agreement; and (3) taxpayer retained control over the funds paid into the OEL arrangement at all times.

B as a Grantor Trust

Section 671 of the Code provides that where it is specified in sections 671 through 679 that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 677(a)(3) of the Code provides that the grantor shall be treated as the owner of any portion of a trust whose income without the approval or consent of an adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.

Article II of B Trust Agreement authorizes the trustee to purchase life insurance on taxpayer. There does not appear to be any limit on the amount the trustee may apply to the payment of premiums. Therefore, pursuant to section 677(a)(3), taxpayer is treated as the owner of B. Because taxpayer is the grantor and the owner of B, B is a grantor trust, which is generally disregarded for Federal income tax purposes. See Revenue Ruling 85-13, 1985-1 C.B. 184 (providing that, if a grantor is treated as the owner of an entire trust, the grantor is considered to be the owner of the trust's assets for Federal income tax purposes).

The Doctrine of Economic Substance

To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits, which were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 2001) aff'g 113 T.C. 254 (1999); United States v. Wexler, 31 F.3d 117, 122 (3d Cir. 1994); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Weller v. Commissioner, 31 T.C. 33 (1958), aff'd, 270 F.2d 294 (3d Cir. 1959); Nicole Rose Corp. v. Commissioner, 117 T.C. No. 27 (2001); ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3d Cir. 1998).

Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). This determination turns on whether the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. Cherin v. Commissioner, 89 T.C. 986, 993-94 (1987); ACM Partnership, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. Yosha, 861 F.2d 494; ACM Partnership, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231.

In determining whether a transaction has economic substance to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership, 157 F.3d at 247; Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363. Courts have recognized that circular cash flows, offsetting legal obligations, or anticipated pre-tax economic return that is insignificant compared to the anticipated after-tax net return may effectively eliminate any real economic significance of the transaction. See Knetsch v. United States, 364 U.S. 361 (1960); ACM Partnership, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3d Cir. 1998); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), aff'g 44 T.C. 284 (1965); Nicole Rose Corp. v. Commissioner, 117 T.C. No. 27 (2001); Sheldon v. Commissioner, 94 T.C. 738 (1990).

The transactions involving B, which include creating A and making premium payments on the Policy owned by A, appear to have no purpose or economic substance other than to place an entity between taxpayer and A to avoid the Service treating taxpayer as the owner of A under section 679 and including the income of A in the income of taxpayer under section 671. Therefore, the transactions of B should be recharacterized as transactions between taxpayer and A and the Policy.

The OEL arrangement also does not appear to have any economic substance separate and distinct from the economic benefit achieved by tax reduction. The result of the arrangement is to provide C with deductions for the use of taxpayer's services while taxpayer omits reporting a majority of the C payments as income. The effect of the arrangement is to send a majority of taxpayer's wages, or other form of compensation, from C to D to avoid paying tax on those wages or compensation. Even if there was some economic substance and business motivation for the OEL arrangement, the OEL arrangement did not have sufficient substance, apart from its tax consequences, to be respected for tax purposes. The OEL arrangement achieved nearly the same result as if C continued to pay taxpayer's full compensation directly to taxpayer, except that taxpayer reported less income on his tax return.

Finally, taxpayer's purpose for the transfer of C stock in exchange for the annuity is not clear. One possibility is that taxpayer wanted to avoid all tax on the sale of the C stock. Another possibility is that taxpayer wanted to defer payment of tax on the sale of the C stock until D makes payments on the annuity. As an unfunded and unsecured private annuity with payments deferred for over hh years from the sale of C stock, there is a substantial issue regarding whether D will have the assets to pay the annuity. In addition, considering taxpayer's overall tax avoidance plan, there is no reason to believe that the annuity is valid and that taxpayer expects to receive any payments from the annuity. There does not appear to be any economic substance separate and distinct from the economic benefit achieved by tax reduction. See Melnik v. Commissioner, T.C. Memo 2006-25 (2006) (the Tax Court found that there was no economic substance to a transaction involving the petitioners sale of stock of their corporation to an International Business Corporation held by a foreign trust in exchange for an unsecured, deferred private annuity payable by the International Business Corporation).

A Treated as Owned by Taxpayer

Section 679(a)(1) of the Code generally provides that a U.S. person who directly or indirectly transfers property to a foreign trust (other than a trust described in sections 402(b), 404(a)(4), or 404A, or a trust determined by the Secretary to be described in section 501(c)(3)) shall be treated as the owner for his taxable year of the portion of the trust attributable to the property transferred if for that year there is a U.S. beneficiary of any portion of the trust. Section 1.679-1(a) of the Regulations provides in general that a U.S. transferor who transfers property to a foreign trust is treated as the owner of the portion of the trust attributable to the property transferred if there is a U.S. beneficiary of any portion of the trust, unless an exception in section 1.679-4 applies to the transfer.[2]

Section 1.679-3(f)(1) of the Regulations provides that if a U.S. person is a related person (as defined in section 1.679-1(c)(5)) with respect to a foreign trust, any transfer of property by the U.S. person to an entity in which the foreign trust holds an ownership interest is treated as a transfer of the property by the U.S. person to the foreign trust followed by a transfer of property from the foreign trust to the entity owned by the foreign trust. Section 1.679-1(c)(5) of the Regulations provides that a person is a related person if, without regard to the transfer at issue, the person is a grantor of any portion of the trust (within the meaning of section 1.671-2(e)(1)) or an owner of any portion of the trust under sections 671 through 679. Section 1.671-2(e)(1) of the Regulations provides that a grantor includes any person to the extent that person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to the trust.

If the Service treats B as a grantor trust, B is disregarded for Federal tax purposes. If the Service applies the doctrine of economic substance to the transactions involving B, B is also disregarded for Federal tax purposes. Therefore, under either approach, taxpayer, as owner of B, is treated as creating A and is a related person to A. Because taxpayer is a related person to A and the beneficiaries of A are U.S. beneficiaries, any transfer of property by taxpayer to an entity in which A holds an ownership interest is treated as being made by taxpayer to A. Pursuant to sections 679(a)(1), 1.679-1(a), and 1.679-(3)(f)(1), taxpayer will be treated as the owner of A to the extent of any property taxpayer caused to be transferred to A or to any entity in which A holds an ownership interest.

The investment by the Policy in D stock indicates direction by the policy holder to the manager of the insurance policy on how to fund the Policy. The investor control doctrine dictates that because A, as the policy holder, is directing how to fund the policy, A owns the assets held by the Policy. See Rev. Rul. 2003-91, 2003-2 C.B. 347. Through this ownership of the assets held by the Policy, A is treated as receiving the C

[2] In general, although the regulations under section 679 of the Code apply with respect to transfers occurring after August 7, 2000, the Service has always taken the position that the regulations reflect the law in effect prior to their publication in final form. See the Preamble to the proposed regulations, 65 Fed. Reg. 48185 (Aug. 7, 2000).

stock transferred to D and the funds transferred to D's accounts that resulted from the OEL arrangement. Under section 679 and the regulations, these transfers are treated as being made as follows: (1) from taxpayer to A, (2) from A to the Policy, and (3) from the Policy to D. A is also treated as receiving the premium payments for the Policy. Under section 679 and the regulations, these payments are treated as being made by taxpayer to A and from A to the Policy.

Section 6048(a) Penalties

Section 6048(a) generally provides that any U.S. person who directly or indirectly transfers money or other property to a foreign trust must report the transfer at the time and in the manner prescribed by the Secretary. However, under section 6048(a)(3)(B)(ii), transfers to foreign trusts described in sections 402(b), 404(a)(4), or 404A, or trusts determined by the Secretary to be described in section 501(c)(3) are not reportable. In addition, under section 6048(a)(3)(B)(i), transfers involving fair market value sales are not reportable. Therefore, section 6048(a) generally requires a U.S. person to report gratuitous transfers to a foreign trust. See Notice 97-34, 1997-1 C.B. 422. For this purpose, a gratuitous transfer is any transfer other than: (1) a transfer for fair market value, or (2) a corporate or partnership distribution. Id. U.S. persons are required to report gratuitous transfers to foreign trusts on Form 3520. Under section 6677(a), a person who does not comply with the reporting requirements of section 6048(a) will be subject to a penalty equal to 35 percent of the gross value of the transferred property.

Taxpayer is treated as making gg of the transfers to A. All of the transfers are gratuitous transfers because taxpayer did not receive any consideration in exchange for the transfers. Taxpayer is therefore subject to reporting under section 6048(a) and subject to the penalties under section 6677(a) for failing to report under section 6048(a). The Forms 3520 that were filed for A for Year 2 and Year 3 are not valid information returns because the Forms were either forged or not signed. See Beard v. Commissioner, 82 T.C. 766, 777 (1984), aff'd per curiam, 793 F.2d 139 (6th Cir. 1986) (providing that one criteria for a valid return is that the taxpayer execute the return under penalties of perjury); See also I.R.C. §§ 6061 and 6065. Because no valid Forms 3520 have been filed for A, taxpayer is subject to the 35 percent penalty on the transfers to A from Year 2 to Year 7. These transfers include the premium payments on the Policy, the transfer of C stock, and the transfers to D's accounts that resulted from the OEL agreement.

Section 6048(b) Penalties

Section 6048(b)(1) provides that if a U.S. person is treated as the owner, or partial owner, of a foreign trust under section 671 through 679, the U.S. person is responsible for ensuring that the foreign trust files an annual return setting forth a full and complete accounting of all trust activities, trust operations, and other relevant information. Under section 6048(b)(1)(B), the U.S. person is also responsible for ensuring that the trust annually furnishes such information as the Secretary prescribes to U.S. owners and U.S. beneficiaries of the trust. This information is to be furnished on Form 3520-A. Under section 6677(b) and (c)(2), if a trust does not furnish this information, the U.S. owner is subject to a penalty equal to 5 percent of the gross value of the portion of the trust's assets at the close of the year treated as owned by the U.S. person.

Taxpayer is treated as owning gg of A. Taxpayer is, therefore, subject to reporting under section 6048(b) and subject to the penalties under section 6677(b) for failing to report under section 6048(b). The Forms 3520-A that were filed for A for Year 2 and Year 3 are not valid information returns because the Forms were not signed. See Beard, 82 T.C. 766, 777, aff'd per curiam, 793 F.2d 139 (providing that one criteria for a valid return is that the taxpayer execute the return under penalties of perjury); See also I.R.C. §§ 6061 and 6065. Because no valid Forms 3520-A have been filed for A, taxpayer is subject to the 5 percent penalty on the gross value of A's assets at the close of each year from Year 2 to Year 7.

Imposing Penalties under Section 6038

Section 6038(a)(1) provides that every U.S. person furnish such information as the Secretary may prescribe by regulations with respect to any foreign corporation that the U.S. person controls. This includes a U.S. person who had control of a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the foreign corporation. Treas. Reg. § 1.6038-2(a). Control means the ownership of stock having over 50 percent of the voting power or value of all the stock of the foreign corporation. Treas. Reg. § 1.6038-2(b). For purposes of determining control, the constructive ownership rules of section 318(a) apply. Treas. Reg. § 1.6038-2(c).

The information required under section 6038(a) is to be furnished on a Form 5471, "Information Return of U.S. Persons With Respect To Certain Foreign Corporations." Under 6038(b)(1), a person who fails to timely furnish the information required by section 6038(a)(1) will be subject to a $10,000 penalty for each accounting period in which the failure exists. If the failure continues for more than 90 days after the Secretary mails notice of the failure, the penalty is increased by $10,000 for each 30-day period during which the failure continues but shall not exceed $50,000.

Taxpayer, as grantor of B and A, is the indirect owner of the assets of B and A. As grantor of B and A, taxpayer has more than 50 percent control, based on vote and value, of D pursuant to section 1.6038-2(b) and (c) of the Regulations. Taxpayer is, therefore, subject to penalties under section 6038(a) for failing to file Forms 5471 for Year 2 through Year 7.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

If you have any questions, please contact me at .

By: ______________________________
Joseph P. Dewald
General Attorney
(Small Business/Self-Employed)