

## Case Claims IRS Failed To Comply With Penalty Rules On A Foreign Trust

*Social:* The IRS faces a legal challenge for a penalty collection for failing to file an information return for a foreign trust. Did the IRS itself fail to comply with requirements for written supervisory penalty approval?

A California taxpayer has filed in the United States Tax Court to challenge an Internal Revenue Service collection determination for a penalty, under Sec. 6677, for failing to file an information return for a foreign trust.

The petitioner, Ching Tzu Lu, and counsel argue that the IRS did not comply with Sec. 6751(b), which stipulate that supervisory penalty approval must be in writing.

According to [case background](#), four years ago the IRS assessed a \$50,000 penalty for a late filing of Form 3520-A, “Annual Information Return of Foreign Trust With a U.S. Owner,” calculated at 5% of the \$1 million gross reportable value of Lu’s ownership in the foreign trust. That was later subject to an 80% abatement.

In December 2021, the IRS seized \$8,062 of Lu’s 2020 state tax refund, which prompted a formal request of a Collection Due Process Hearing. When appeal failed, Lu and counsel filed that the IRS has violated procedure for managerial approval of the penalty.

### **In writing**

The petitioner’s argument hinges on the need for immediate managerial approval of the penalty being *in writing*.

The IRS maintains, as one settlement officer affirmed, “I reviewed the Internal Revenue Code Section 6751(B) subsequently which does not state that the managerial approval required under IRC 6751(B) must be on a specific form or document, it just says you need managerial approval.

“There is sufficient evidence to show that managerial approval was secured prior to the assessment of the penalty under IRC 6677,” the officer added.

“There is no requirement that this approval must be on a specific form such as form 8278 as your representative suggested.

On petition documentation filed with the Tax Court in early July, Lu and counsel maintained:

“Both the Commissioner’s Appeals Officer and Appeals Settlement Officer erred in concluding that the Commissioner adequately complied with the legal requirement under I.R.C. Section 6751(b) that the immediate supervisor of the individual making the determination (or a higher-level official the Secretary may designate) must personally approve the assessment in writing. Accordingly, the Office of Appeals erred in its conclusion to sustain the levy and any portion of the penalty assessed under I.R.C. Section 6677.

“I.R.C. Section §6751(b) not only requires that there be managerial approval, but most importantly, that such approval must be in writing, even if not on a specific form or document,” Lu’s counsel added in case papers, further maintaining that the approval had not been specific or formal enough.

Citing the 2020 case *McCarthy v. Commissioner*, Lu and counsel maintain that “a mere notation in an IRS reporting system [e.g., the Accounts Management System which stated ‘Penalty Approved’ was held by the Tax Court to be insufficient and the Government’s argument was unavailing when considering “that document did not expressly show approval of ... penalty. And IRS failed to establish which of its employees made initial determination of any ... penalty, who that employee’s immediate supervisor was, or that penalty was approved timely in writing by that immediate supervisor.”

### **‘Reasonable duration’**

Lu and counsel also maintain that despite being timely and responsive throughout “the catalogue of Notices and Petitioners’ responses related to the underlying penalty” beginning in with the Commissioner’s first notice in late 2018, they were provided with no “meaningful reply or opportunity to engage in dialogue” until May 2022.

“This 3½ -year timespan does not appear to be a reasonable duration of time to wait for a meaningful response or opportunity to engage,” Lu’s counsel added in case papers.

Lu seeks dismissal of the Sec. 6677 penalty and a refund of what’s already been paid or, if the IRS wins, that the Court require the Commissioner abate part of the interest charged.

Observers note that the case, if Lu wins, will strengthen requirements that the IRS adhere strictly to its own policies of documentation.

Your tax specialist needs to stay on top of this and many other issues of wealth, foreign income and tax enforcement. If we can help, please let us know.