Foreign Reporting: Get It Right

Even savvy advisors fail to recognize that a trust is, in fact, foreign—and that can be catastrophic. Penalties are stiff and the IRS is increasingly unforgiving. A guide to doing it right

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As estate planners, we love helping people, and as attorneys, we need to bill hours. So when we can help people and bill hours at the same time, you'd think that we would be elated. Not necessarily.

A large part of our practice in recent years has been devoted to fixing clients' foreign trust and entity tax reporting problems. It usually begins when a new client comes to us for what's ostensibly going to be a quick review of the foreign trust structure that some advisor set up for them. But what we often find is that even sophisticated lawyers have failed to realize that a trust will be considered foreign for tax purposes, which in turn leads to mishandled (or simply neglected) foreign tax and information reporting for the structure. Forensic accounting is needed to figure out what must be revealed to the government, and we have to beg the Internal Revenue Service for forgiveness and penalty abatement—which lately it is much less inclined to give. And be warned: Penalties and interest can be so severe that, after a relatively short period of noncompliance, they will outstrip the total value of the foreign structure (one client was faced with nearly $1 million in penalties as a result of only two years of missed reporting and another owed more in penalties and interest than the total value of the structure after only seven years of missed reporting.)

It's such a mammoth waste of time, energy and money that we wish foreign trust reporting was handled properly in the first place.

Because many of the mistakes that we see are those made in the context of a U.S. client who creates a foreign trust, invests in a foreign fund, or establishes a foreign entity, most of the requirements that we'll point out are from the perspective of a typical "outbound" foreign trust and/or entity structure. That is, one in which a U.S. person settles a foreign trust that is treated as a grantor-owned trust under Internal Revenue Code Section 679, the transfer to the trust is considered incomplete for gift tax purposes,[1] and the trust invests in foreign entities or foreign bank accounts. To be complete, though, we'll also look at the reporting requirements that arise (in a trust or non-trust context) when cross-border investments or monetary transfers occur, whether outbound or inbound.

HISTORY

Before 1976, income earned within a foreign trust created by a U.S. person (the grantor) was not taxable in the United States until it was distributed to its U.S. beneficiaries (unless one of the other grantor-trust rules of IRC Sections 671 through 678 applied to cause the income to be taxed each year to the grantor). Accordingly, before 1976, foreign trusts provided an attractive opportunity for a U.S. investor to achieve tax deferral on otherwise taxable income.

To stop this practice, Congress enacted IRC Section 679 in 1976. This section causes any trust created by a U.S. person with U.S. beneficiaries (even if those beneficiaries are merely a theoretical possibility) to be treated for income tax purposes as if the U.S. grantor directly owns the trust assets. This means that the trust itself is disregarded for income tax purposes, and the trust's income is treated as if the grantor earned it directly. We refer to these as "U.S.-grantor foreign trusts."

Section 679 applies only to foreign trusts created after May 21, 1974, and to transfers of property to foreign trusts after May 21, 1974.[2] As a result, pre-1974 trusts are classified as "foreign nongrantor trusts" (unless of course another grantor-trust rule applies). It's possible to achieve tax deferral with foreign nongrantor trusts, because income earned within them is not taxable in the United States (unless it is U.S.-sourced) until it's distributed to the trust's U.S. beneficiaries. But this tax deferral for foreign nongrantor trusts is neither as beneficial nor uncomplicated as it may seem.

Congress wants its tax money sooner rather than later. It therefore created the so-called "throwback rules" to reduce the incentive to accumulate income within foreign nongrantor trusts. The throwback rules are designed to capture the income tax that would have been paid if amounts accumulated by a trust and paid to a beneficiary in later years (known as "accumulation distributions") had instead been distributed and taxed in the years that they were earned.[3] The throwback rules accomplish this by allocating an accumulation distribution to the beneficiary's prior years in which there is undistributed net income (UNI) in the trust.[4] The UNI is then added to the beneficiary's income in those years, and the resulting additional throwback tax is calculated and assessed to the beneficiary.[5] And, as if the throwback tax were not enough, in the same year that Congress enacted IRC Section 679 (which now causes most foreign trusts created by U.S. persons to be grantor trusts), it also enacted an extra tax (that is to say, a penalty) in the form of an interest charge on the throwback tax, compounded daily over a specially determined number of years.[6]

Let's stop here and dispossess you of the thought that just popped into your head: "So, if I have a client who is a beneficiary of a pre-1974 foreign trust, then that trust is grandfathered, the trust is a foreign nongrantor trust rather than a U.S.-grantor foreign trust, and the pre-1976 throwback rules (*sans* interest charge) will apply. My client can get the benefit of some tax deferral because he doesn't have to pay the punitive interest charge on the throwback tax."

Wrong.

A pre-1974 trust that is not otherwise treated as a U.S.-grantor foreign trust under Sections 671 through 678 can actually be an unexpectedly bad thing. That's because unlike the grandfathering available under Section 679 for trusts created before May 21, 1974, there's no grandfathering for the interest charge enacted by the 1976 act.[7] So all foreign nongrantor trusts, regardless of when created

To stop the practice of deferring taxation in foreign trusts, Congress enacted IRC Section 679 in 1976.

or whether the grantor was foreign or U.S., are subject to the interest charge on the throwback tax on accumulation distributions for years beginning on or after Jan. 1, 1976. Therefore, it may be desirable to force a pre-1974 foreign trust to be a U.S.-grantor foreign trust by amending the document (if possible), or causing the trust to be a U.S. trust rather than a foreign trust, or to begin distributing all of the trust's income each year (to prevent further accumulation), or to invest the trust's principal and accumulated income in a tax-free investment (such as a private-placement life insurance policy).

SURPRISES

Clearly, it's important to know whether your client has a foreign trust under U.S. tax law. But even the most sophisticated advisor may misclassify a trust. How can this be?

The IRC defines a "foreign trust" as any trust that is not a "U.S. trust." For a trust to be classified as a U.S. trust, it must meet both the "court test" and the "control test" under IRC Section 7701(a)(30)(E).[8] And that's the rub: If a trust fails just one of these tests, it is a foreign trust for U.S. tax purposes.[9] Moreover, these tests have an implicit bias towards a trust being classified as a foreign trust, and in our experience, given the current state of globalization, it's not uncommon for a trust to unexpectedly be classified as a foreign trust under these rules. Of course, if an advisor or grantor fails to realize that a trust is foreign, they'll also fail to file the required IRS returns, causing the U.S. grantor to be liable for applicable failure-to-file penalties.

Before 1996, the classification of a trust as "foreign" turned upon whether the trust was "comparable to a nonresident alien individual."[10] In other words, the extent of a trust's nexus with the United States or with a foreign jurisdiction (the location of the trustee, the *situs* of the trust *corpus*, the trust's governing law, etc.) determined whether the trust was "foreign" or "domestic." Other than a few revenue rulings and cases, there was not a lot of guidance.[11]

This subjective analysis left practitioners with a lot of wiggle room to argue that trusts that actually were foreign should have been considered domestic, thereby avoiding the tax treatment and filing requirements that come with foreign status.

So Congress devised a more helpful, objective means to determine whether a trust was foreign or domestic: the court test and the control test.

Of course, it's sometimes desirable for a trust to be governed by foreign law, but to be classified as a U.S. trust for tax purposes. If structured properly, these "hybrid trusts" can satisfy both the court and control tests and thus have the benefit of foreign law without the burden of foreign-trust reporting.

COURT TEST

To satisfy the court test, a U.S. court must be able to exercise primary supervision over the trust's administration. A U.S. court is able to do this if, upon petition by a proper party, it can render orders or judgments resolving substantially all issues regarding the administration of the entire trust.[12] For purposes of this test, "administration" means carrying out duties imposed by the trust's terms and applicable law, including maintaining books and records, filing tax returns, managing and investing the trust assets, defending the trust against suits by creditors, and determining the amount and timing of distributions.[13]

The Treasury regulations contain a safe-harbor provision to address complications in determining a court's supervisory authority over the administration of a trust when the trust has never appeared before a court. Under this provision, a trust will satisfy the court test if:

(1) the trust instrument does not direct that the trust be administered outside of the United States;

(2) the trust is in fact administered exclusively in the United States; and

(3) the trust is not subject to an "automatic migration provision" that causes it to migrate from the United States if a U.S. court attempts to assert jurisdiction or otherwise supervise its administration.[14]

The regs also allow a trust to satisfy the court test if a U.S. court and a foreign court are both able to exercise primary supervision over the administration of the trust—as long as the trust instrument does not contain an automatic migration provision that would snatch it out of the U.S. judge's hands.[15]

With proper drafting, a hybrid trust can satisfy the safe-harbor requirements for the court test. First, it's important to note that a requirement that a trust be administered in a particular jurisdiction is not the same as a "governing law" provision. A trustee may *administer* a trust in the United States, yet *apply the law* of a foreign country to the trust. Accordingly, a hybrid trust should easily satisfy this prong of the safe harbor, because the trust instrument must simply be drafted without a requirement that the trust be administered outside the United States.

Because a hybrid trust typically will have a foreign co-trustee, it would seem difficult to satisfy the second requirement that a trust must "in fact" be administered exclusively in the United States. But all that is required is for the U.S. co-trustee to:

(1) maintain trust books and records;

(2) file trust tax returns;

(3) manage and invest the trust assets (or hire an investment advisor to do so);

(4) defend the trust against suits by creditors; and

(5) determine the amount and timing of distributions.[16]

(Note that if a hybrid trust properly meets the control test, the trust's administration is occurring onshore.)

Finally, simple drafting can help a hybrid trust satisfy the final prong of the safe-harbor test: The trust document must not have an automatic migration provision that would cause the trust to migrate from the United States if a U.S. court attempted to assert jurisdiction or otherwise supervise the trust's administration.[17]

It is important to elaborate on the concept of "primary supervision" set forth in the regs because it's easy to lose sight of this concept after focusing on the "exclusively administered in the United States" prong of the safe-harbor provision. The court test itself does not require trust administration to occur exclusively in the United States. In fact, the court test does not even require a U.S. court to determine all issues regarding the trust's administration, but only *substantially* all issues.[18] If nine out of 10 of the administrative tasks are performed by a U.S. person, it can be said that a U.S. court would be able to determine "substantially all" issues regarding the administration of the trust, and would be able to exercise primary supervision over the trust's administration.

The difficulty with the court test is that you never know if it has been satisfied until the trust is in front of a U.S. court attempting to exercise supervision over its administration. Accordingly, the best approach to the court test is to ensure that as much of the trust's administration is actually performed by a U.S. person with the understanding that it will be necessary for the trustees to submit to the jurisdiction of the U.S. court. Contesting jurisdiction based on an argument that the trust is foreign could jeopardize the previous years' filing positions.

One question that may arise with a hybrid trust in particular is whether a foreign court's ability to exercise jurisdiction over the trust's administration causes the trust to fail the court test. But the Treasury Regulations make it clear that, if both a U.S. court and a foreign court are able to exercise primary supervision over the administration of the trust, it still meets the court test.

CONTROL TEST

The control test is more clear cut. It provides, in no uncertain terms, that one or more U.S. persons must control *all* substantial decisions of the trust, with no foreign person having the power to veto any of the substantial decisions.

Under the Treasury Regulations, "substantial decisions" include those determining:

(1) whether, when, and how much income or *corpus* to distribute;

(2) whether a receipt is allocable to income or principal;

(3) whether to terminate the trust;

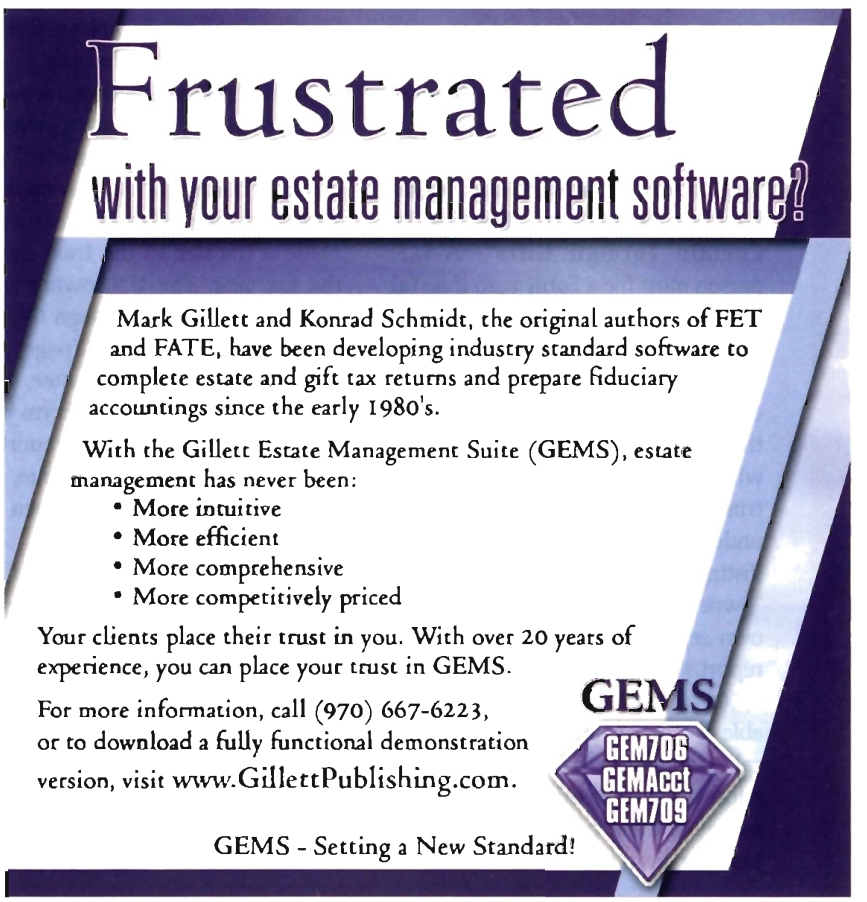
(4) whether to compromise, arbitrate or abandon claims of the trust, and whether to sue on behalf of the trust or to defend claims of the trust;

(5) whether to remove, add or replace a trustee, and whether to appoint a successor trustee to succeed a trustee who has died, resigned or otherwise ceased to act; and

(6) investments.[19]

With a hybrid trust, a U.S. person should make all of the trust's substantial decisions (make sure you document these decisions), and no foreign person in any capacity (as a trustee, protector, trust consultant, etc.) should be given the power to make or veto such decisions.

Still, a foreign fiduciary does not have to be completely inactive. The regs allow foreign persons to execute a U.S. person's substantial decisions (for example, sign



investment agreements at the U.S. person's direction, communicate the U.S. person's instructions to the trust's foreign attorneys, etc.).[20] A foreign person can even make substantial decisions—as long as such decisions are subject to the approval or veto power of a U.S. person, and the U.S. person can make substantial decisions on his own.[21] But beware: If a foreign person is to play an active role in a hybrid trust, it's paramount to document the fact that the U.S. person is calling the shots (for example, by way of correspondence between the U.S. person and the foreign person).

Now that it is clear which trusts are foreign and require reporting, let's look at who must file exactly which forms.

THE GRANTOR

The U.S. grantor of a foreign trust must file two key forms: Form 3520, an annual return to report the grantor's ownership of the foreign trust and to report any other transactions with the trust during the year; and Form 709, to report transfers to the foreign trust as complete or incomplete gifts.

(1) Form 3520: "Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts"—A U.S. person must file a Form 3520 if he (a) engaged in a reportable event with regard to a foreign trust during the year, or (b) was treated as the owner of a foreign trust at any time during the year. (Although a U.S. person who transfers property to a foreign trust will be treated as its owner under IRC Section 679, Form 3520 distinguishes between "transfers" and "ownership," each of which carry their own separate penalties for failure to report.)

(a) Reportable Event—A reportable event occurs when, during a calendar year, a U.S. person creates a foreign trust or otherwise transfers money or other property to a foreign trust for less than fair market value. Simply receiving a promissory note from the trust in exchange for the transferred property doesn't necessarily prevent the transfer from being for "less than fair market value" for purposes of the reporting requirement.[22]

(b) Owner of a Foreign Trust—In general, a U.S. person who creates or transfers property to a foreign trust is treated as the "owner" of that trust if it has U.S. beneficiaries. This is so even if the U.S. person did not retain any benefits from, or powers over, the trust that would cause him to be its owner under other IRC provisions.[23] Also, if a U.S. person who is "related"[24] to the foreign trust transfers property to the trust in exchange for a promissory note, that person is treated as owning the portion of the foreign trust that is attributable to the property transferred for each year that the note is outstanding, unless the loan is in the form of a "qualified obligation."[25] The requirements of a "qualified obligation" are set forth in the instructions to Form 3520.

In short, a U.S. person who is treated as the owner of all or any portion of a foreign trust under these rules at any time during the tax year must file Form 3520 regardless of whether he made a transfer to the trust during the tax year. The U.S. owner must obtain a copy of the Foreign Grantor Trust Owner Statement (page 3 of Form 3520-A) from the trustee, to be attached to the Form 3520. Form 3520 is due on the date that the reporting party's income tax return is due, and is extended automatically when the taxpayer's return is extended.

Penalties—The penalty for failure to file a Form 3520 to report transfers to a foreign trust is equal to 35 percent of the gross value of the property transferred; and the penalty for failure to file a Form 3520 for any year in which a U.S. person is treated as the owner of a foreign trust is equal to 5 percent of the gross value of the portion of the trust's assets treated as owned by the U.S. person. If the person responsible for filing Form 3520 receives a failure-to-file notice from the IRS and does not file the form within 90 days, an additional penalty of $10,000 will be imposed for every subsequent 30-day period until the form is filed.[26]

(2) Form 709: "United States Gift (and Generation-Skipping Transfer) Tax Return"—All transfers to foreign trusts are reportable as gifts on Form 709. Even if a transfer to a trust is incomplete for gift tax purposes (which will be the case, for example, when the grantor of a foreign trust retains a special power of appointment over the property in the trust), the transferor must file a Form 709 to advise the IRS of the incomplete gift. The transferor must disclose all relevant facts relating to the incomplete gift and attach a copy of the trust document to the Form 709.[27] The Form 709 is a calendar-year return that is due by April 15 following the year of the transfer.

Penalties—The penalty for failure to file is based on the amount of tax required to be shown on the return,[28] which will be zero in the case of an incomplete gift (and, therefore, the penalty would presumably not apply). Form 709 is extended automatically with the transferor's income tax return, but can be extended separately with Form 8892 if extension of the transferor's tax return is not desired.

THE TRUSTEE

Trustees of foreign trusts must file various U.S. returns, based on whether or not the trust is classified as a U.S.-grantor foreign trust and depending on the events that occur with respect to the trust in a given year.

(1) Form SS-4: "Application for Employer Identification Number"—The trustee of a foreign trust with a U.S. grantor is required to file certain tax and information returns on behalf of the trust, and so it must obtain an Employer Identification

Number (EIN) for the trust. The EIN can be obtained by filing Form SS-4 with the IRS' Philadelphia Service Center. For foreign trusts, Form SS-4 can be filed over the phone, but it cannot be filed over the Internet. If it is filed over the phone by a third-party designee, the designee must have the Form SS-4 signed by the trustee ready to fax to the IRS representative while on the phone before the IRS will issue the EIN to the trust.

(2) Form 56: "Notice Concerning Fiduciary Relationship"—Trustees must file Form 56 to notify the IRS of the creation, termination, or change in a fiduciary relationship held by the trustee. This form should be filed at the time the fiduciary relationship is created, terminated, or changed, but a fiduciary who is required to file a return (for example, Form 1041) may file Form 56 with the first return filed after the fiduciary relationship is created, terminated or changed. There is no specific penalty for failure to file Form 56.

(3) Form 3520-A: "Annual Information Return of Foreign Trust With a U.S. Owner"—The trustee of a foreign trust with a U.S. owner must file Form 3520-A each year by March 15, unless the deadline is extended with Form 7004.

Penalties—Although this filing requirement is imposed on the trustee, the penalty for failure to file is imposed on the U.S. grantor. The penalty is equal to 5 percent of the value of the trust assets that are treated as owned by the U.S. grantor. If the trustee receives a failure-to-file notice from the IRS and does not file the form within 90 days, an additional penalty of $10,000 will be imposed on the grantor for every subsequent 30-day period until the form is filed.[29]

(a) Foreign Grantor Trust Owner Statement—If a U.S. person is treated as the owner of any portion of a foreign trust, the trustee must provide him with a copy of the Foreign Grantor Trust Owner Statement (page 3 of Form 3520-A) at the time the trustee files Form 3520-A, so that the U.S. owner can attach it to his Form 3520.

If the U.S. grantor fails to notify the IRS of any inconsistency between the information reported on his income tax return and the information contained in the Foreign Grantor Trust Owner Statement, the IRS may assess additional tax and treat such assessment as "arising out of a mathematical or clerical error on the return" under IRC Section 6213(b). As such, the IRS would not be subject to the usual restrictions on assessment, and the U.S. owner would have no right to file a petition with the Tax Court to dispute the assessment.[30]

> The penalty for failing to file Form 3520 is 35 percent of the gross value of the property transferred to the foreign trust.

(b) Foreign Grantor or Nongrantor Trust Beneficiary Statement—A U.S. beneficiary of a foreign trust must file Form 3520 to provide information to the IRS regarding any distributions received from the trust during the tax year. For this purpose, the trustee of a foreign trust that is a grantor trust as to a U.S. person under IRC Sections 671 through 679 should give a copy of the Foreign Grantor Trust Beneficiary Statement (page 4 of Form 3520-A) to any U.S. beneficiary who received a trust distribution during the year so that the beneficiary may attach the statement to his Form 3520 (the trustee should not complete this statement for a U.S. grantor who receives a distribution from the trust). In the case of a foreign trust that does not have a U.S. or foreign grantor (a "foreign nongrantor trust"), the trustee should provide a Foreign Nongrantor Trust Beneficiary Statement to any U.S. beneficiary who received a distribution from the trust during the year so that the beneficiary may attach the statement to his Form 3520 (the information to be included in a Foreign Nongrantor Trust Beneficiary Statement is set forth in the instructions to Form 3520).

If the U.S. beneficiary of a foreign trust fails to notify the IRS of any inconsistency between his income tax return and the information contained in a Foreign Grantor or Nongrantor Trust Beneficiary Statement, the IRS may assess additional tax and treat such assessment as "arising out of a mathematical or clerical error on the return" under IRC Section 6213(b). As such, the IRS would not be subject to the usual restrictions on assessment, and the U.S. beneficiary would have no right to file a Tax Court petition to dispute the assessment.[31]

(c) Appointment of U.S. Agent for Tax Reporting Purposes—If the trustee of a foreign trust with a U.S. grantor fails to authorize a U.S. person to act as the trust's limited agent for purposes of applying IRC Sections 7602, 7603 and 7604 (relating to the examination of records and the service and enforcement of a summons for the examination of such records), the IRS has the authority to unilaterally determine the amount of the trust's income to be included on the U.S. grantor's income tax return.[32] To avoid this, the trustee must appoint a U.S. agent under an agreement substantially in the form of the sample agency agreement set forth in the instructions to Form 3520-A. In addition, the name, address and tax ID number of the U.S. agent must be set forth both on the trust's Form 3520-A and on the grantor's Form 3520, and a copy of the agency

agreement must be attached to the Form 3520-A.

(4) Form 1041: "U.S. Income Tax Return for Estates and Trusts"—Current Treasury Regulations provide that the trustee of a foreign trust with a U.S. owner must file a Form 1041 and must include a statement (a "grantor trust information letter") with the Form 1041 to report the income of the trust to be included on the U.S. owner's income tax return.[33] The Form 1041 and the grantor trust information letter generally must be filed by April 15 each year. Form 1041 can be automatically extended for six months with Form 7004.

Penalties—The penalty for failure to file Form 1041 is based on the amount of tax required to be shown on the return, which is zero in the case of a wholly owned U.S.-grantor foreign trust (and, therefore, the penalty would presumably not apply).[34]

(5) Form 1040NR: "U.S. Nonresident Alien Income Tax Return"—The trustee of a foreign trust that is not a U.S.-grantor foreign trust for U.S. income tax purposes but has U.S.-source income must file a Form 1040NR if the U.S. tax attributable to such income was not withheld by the payor. Because Form 1040NR is designed to report income attributable to nonresident alien individuals, as opposed to nonresident trusts, the trustee must make appropriate adjustments on the form.[35] Form 1040NR generally must be filed by June 15 each year (or by April 15, if the trust has a U.S. office).

Penalties—The penalty for failure to file is 5 percent of the amount of tax required to be shown on the return for each month or partial month during which such failure continues (usually up to a maximum penalty of 25 percent of the tax due). [36]

(6) Form 2848: "Power of Attorney and Declaration of Representative"—Occasionally, a foreign trustee will want to authorize a U.S. attorney or certified public accountant (CPA) to communicate directly with the IRS on the trustee's behalf. If so, the foreign trustee must file a Form 2848 with the IRS' Philadelphia Accounts Management Center authorizing the attorney or CPA to represent the trustee for the specific tax matters set forth in the form.

THE EXECUTOR

In some circumstances, the executor of a U.S. person's estate must file a Form 3520 to report transfers to a foreign trust or to report the U.S. decedent's ownership of a foreign trust.

(1) Form 3520: "Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts"—When the death of a U.S. person results in a transfer to a foreign trust, the executor of the U.S. decedent's estate must report this transfer on Form 3520. Also, if a U.S. decedent was treated as the owner of any portion of a foreign trust under the grantor trust rules prior to death, or if any portion of a foreign trust was included in the U.S. decedent's gross estate, the executor of this person's estate must report the person's death to the IRS on Form 3520. Although the instructions to Form 3520 do not specify a due date, it should probably be filed by the same date (including extensions) as the decedent's final U.S. income tax return.

Penalties—The penalty for failure to file Form 3520 is equal to 35 percent of the value of the property transferred to the trust by reason of the U.S. person's death, or 35 percent of the value of the portion of the trust treated as owned by the U.S. person or included in the U.S. person's gross estate (as the case may be). If the executor receives a failure-to-file notice from the IRS and does not file the Form 3520 within 90 days of such notice, an additional penalty of $10,000 will be imposed for each 30-day period thereafter that the executor fails to file the form.[37]

THE BENEFICIARIES

The beneficiaries of a foreign trust (whether a U.S.-grantor foreign trust or a foreign nongrantor trust) must file a Form 3520 to report distributions from the trust. A beneficiary of a foreign nongrantor trust also must calculate the throwback tax on Form 4970 attached to his Form 3520.

(1) Form 3520: "Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts"—A U.S. beneficiary of a foreign trust must file Form 3520 to provide information to the IRS regarding distributions received from the foreign trust during the tax year. Failure to provide adequate information to the IRS regarding distributions may result in unfavorable tax treatment of the distribution. The beneficiary can avoid such treatment by obtaining from the trustee whichever statement is appropriate, either a Foreign Grantor Trust Beneficiary Statement or a Foreign Nongrantor Trust Beneficiary Statement, and attaching it to his Form 3520. Form 3520 is due on the same date as the beneficiary's income tax return, and is extended automatically when the beneficiary's return is extended.

Penalties—The penalty for failure to file Form 3520 is equal to 35 percent of the amount of the distribution. Additionally, if the beneficiary receives a failure-to-file notice from the IRS and does not file the form within 90 days, an additional penalty of $10,000 will be imposed for each 30-day period thereafter that the beneficiary fails to file the form.[38]

(2) Form 4970: "Tax on Accumulation Distribution of Trusts"—A U.S. beneficiary of a foreign nongrantor trust who receives an accumulation distribution from the trust must calculate the throwback tax on such distribution on Form 4970 and attach it to his Form 3520. An accumulation distribution occurs when the distribution exceeds the

trust's distributable net income (DNI) for the year of the distribution, and the trust had DNI in prior years that was not distributed. The throwback rules are designed to capture the incremental amount of U.S. taxes, if any, that would have been collected if amounts accumulated by the trust and later paid to a beneficiary had instead been distributed (and taxed) in the years that the income was earned. The throwback tax is also subject to a nondeductible interest charge, which some view as a penalty.

In general, a U.S. person who created a foreign trust with U.S. beneficiaries prior to May 21, 1974, will not be treated as the trust's owner under IRC Section 679. Accordingly, such grandfathered foreign trusts are considered foreign nongrantor trusts to which the throwback rules apply. However, the additional interest charge on accumulation distributions from such trusts will apply only to years beginning on or after Jan. 1, 1976, so that only the throwback tax, not the interest charge, applies to prior years.[39]

WITHHOLDING

Many times, a foreign trust will hold investment accounts or interests in entities that generate U.S.-source income. In this case, the payor of the income (called a "withholding agent") will need to obtain information that will allow it to properly determine the amount of tax to withhold on such income.

(1) Form W-8IMY: "Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding"—In general, payments of U.S.-source income to a foreign person (or to a foreign trust) are subject to special U.S. tax withholding rules. These rules obligate the withholding agent to withhold U.S. tax at a rate of 30 percent and remit the withheld amounts to the U.S. government. However, if a U.S. person is treated as the owner of a foreign trust's assets under the grantor trust rules, U.S.-source income from such assets will not be subject to these withholding rules. A withholding agent need not withhold tax on a payment to a foreign trust with a U.S. owner if it receives from the trust: (a) an "intermediary withholding certificate" (Form W-8IMY) that includes a "withholding statement," and (b) the U.S. owner's Form W-9.[40] The instructions to Form W-8IMY set forth the information that must be included on the "withholding statement."

A Form W-8IMY and withholding statement must be completed for each intermediary that stands between the assets and the ultimate beneficial owner of those assets. For example, if a foreign LLC that is owned by a foreign trust with a U.S. owner holds an investment account that generates U.S.-source income, a Form W-8IMY and withholding statement must be completed for both the trust and for the LLC. This series of Forms W-8IMY and withholding statements must ultimately be backed up by the U.S. grantor's Form W-9. (In the case of a foreign trust with a foreign grantor, the series of Forms W-8IMY would end with the foreign person's W-8BEN, and payments of U.S.-source income to such a trust would be subject to 30 percent withholding.)

(2) Form W-9: "Request for Taxpayer Identification Number and Certification"—If a U.S. person is treated as the owner of a foreign trust's assets under the grantor trust rules, U.S.-source income from such assets should not be subject to the 30 percent withholding tax typically imposed on payments of such income to foreign trusts. To achieve this result, the withholding agent must obtain a Form W-8IMY and withholding statement from the trust that is backed up by the U.S. grantor's Form W-9. The Form W-9 identifies the U.S. person as the ultimate beneficial owner of the assets for tax purposes so that the withholding agent may apply the appropriate withholding tax rate to the income paid to the intermediary foreign trust.

(3) Form 8802: "Application for United States Residency Certification"—Non-U.S.-source income from a foreign trust's offshore investments may be subject to a reduced rate of tax (and tax withholding) pursuant to a double-income-tax treaty between the foreign jurisdiction in which the investments are made and the United States (as the tax jurisdiction of the grantor or the beneficiary of the trust). To benefit from a reduced treaty withholding rate, the foreign trustee or its money manager is frequently asked to produce proof that the grantor or beneficiary is in fact a U.S. taxpayer. This proof is provided via a Form 6166 (Certification of Filing a Tax Return), which the U.S. taxpayer obtains by filing Form 8802.[41] Form 6166 is a letter from the IRS certifying that the grantor, beneficiary, or trust[42] has filed the type of income tax return that is required of U.S. citizens and residents. The trustee or money manager can then use Form 6166 to justify the reduced treaty rate requested of the foreign withholding agent.[43] Although it is possible to seek a refund from the foreign taxing authorities, it's preferable to obtain the reduced rate in advance. Therefore, Form 8802 should be filed at least 60 days before the certification is needed.

Depending on where the trust's assets are invested, a Form 6166 should be obtained either for the U.S. grantor or beneficiary, or for the trust itself (or both). If a foreign trust's investments are located in a treaty country that is a civil law jurisdiction that does not recognize trusts (such as Switzerland), the jurisdiction will require information regarding the person who is the grantor or beneficiary of the trust

(as its "ultimate beneficiary.") In this case, the individual U.S. grantor or beneficiary would need certification from the IRS that he is a U.S. taxpayer. On the other hand, if the trust invests in a common law jurisdiction that recognizes trusts, the trust itself should also be certified as a U.S. taxpayer in addition to the U.S. grantor or beneficiary.

ENTITIES

There are numerous filing requirements relating to U.S. ownership of, and transfers to, foreign entities. In general, a U.S. owner of a foreign trust will be treated as if he directly owns the trust's interest in any foreign entity, and as if he directly transferred any assets that the trust transferred to the entity. In addition, U.S. beneficiaries of a foreign nongrantor trust may be treated as owning investments held by the trust in proportion to their beneficial interests, in certain situations.[44]

These filings may be required when a foreign trust invests in or through a foreign corporation or foreign partnership (note: this discussion is generally limited to investment entities that do not generate income that is effectively connected with the conduct of a U.S. trade or business).

(1) Form 926: "Return by a U.S. Transferor of Property to a Foreign Corporation"—A U.S. person who transfers property to a foreign corporation in an exchange described in IRC Sections 332, 351, 354, 355, 356 or 361 must report such transfer on Form 926.[45] Transfers of cash to a foreign corporation are also reportable in certain instances.[46]

Penalties—Form 926 is attached to the U.S. transferor's tax return for the year of the transfer, and the penalty for failure to file is equal to 10 percent of the fair market value of the property transferred to the foreign corporation, with a maximum penalty (except in the case of intentional disregard) of $100,000.

(2) Section 351 Information Statement—Both the recipient of stock and the corporation issuing stock in a Section 351 exchange must file information statements with their respective income tax returns. The information that must be included in this statement is set forth in Treasury Regulations Section 1.351-3. Presumably, the parties to a Section 351 transaction that is reportable on Form 926 would not also be required to file this information statement.

> The penalty for failing to file Form 8858 is $10,000, and if the IRS notifies the taxpayer, an additional $10,000 penalty applies.

(3) Form 5471: "Information Return of U.S. Persons With Respect to Certain Foreign Corporations"—In general, if the foreign trust's investment in a foreign personal holding company (FPHC) or a controlled foreign corporation (CFC) reaches 10 percent of the equity ownership of such company, the U.S. beneficial owner(s) (and, in some instances, any U.S. officer or director) of the company must file Form 5471 with his income tax return, with a copy to the Philadelphia Service Center.

Penalties—These reporting requirements are generally set forth in IRC Sections 6035, 6038 and 6046, each of which contains its own penalty provisions for failure to comply with their requirements.

(4) Form 5472: "Information Return of a 25 % Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business"—A U.S. corporation that has at least one direct or indirect foreign shareholder who holds 25 percent of the corporation's total voting power or 25 percent of all classes of the corporation's stock at any time during the year must file Form 5472 to report certain transactions between the corporation and the foreign owner (or other foreign or domestic related party within the meaning of IRC Sections 267(b), 707(b)(1), or 482 and the related regulations).[47] A U.S. corporation that is owned by a foreign trust with a U.S. grantor generally is not required to file Form 5472, because the constructive ownership rules of IRC Section 318 treat the U.S. grantor as the owner of the corporation's stock, and, therefore, the corporation is not "foreign-owned."[48] Likewise, these constructive ownership rules treat the non-U.S. grantor of a foreign grantor trust as owning stock in a U.S. corporation owned by the trust, thereby making the U.S. corporation "foreign-owned" for purposes of the Form 5472 filing requirement.

Penalties—The penalty for failure to file Form 5472 is $10,000. In addition, if the IRS issues a failure-to-file notice and the failure continues for more than 90 days after such notice, an additional penalty of $10,000 will be imposed for each 30-day period thereafter that the failure continues.[49]

(5) Form 8621: "Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund"—If the foreign trust invests in a passive foreign investment company (PFIC), the U.S. beneficial owner must file Form 8621 with his tax return each year by the due date of his return, including extensions. (In general, a foreign corporation is a PFIC if either (a) 75 percent or more of its gross income is passive, or (b) 50 percent or more of its assets are held for the production of passive income.)[50]

Penalty—There is no specific penalty for failure to file Form 8621. However, a U.S. beneficial owner of a PFIC will typically want to file Form 8621 to elect "qualified electing fund" (QEF) status for the PFIC. A QEF election allows the beneficiary to avoid interest charges on certain distributions from the PFIC by including in gross income his *pro rata* share of the company's ordinary income and net capital gain each year (regardless of whether the beneficiary actually received distributions from the PFIC). This election should be made no later than the due date (including extensions) for filing the beneficiary's income tax return for the first year during which the foreign company qualifies as a PFIC. The beneficiary must continue to file Form 8621 for each subsequent year in which he holds a beneficial interest in the PFIC.[52]

(6) Form 1120-F: "U.S. Income Tax Return of a Foreign Corporation"—A foreign corporation must file Form 1120-F if during the year the corporation either engaged in a U.S. trade or business (whether or not it had income from that trade or business) or had income from any U.S. source (even if the income was exempt under a treaty or U.S. law.) A foreign corporation that did not engage in a U.S. trade or business during the year and whose U.S.-source income was withheld at source does not have to file Form 1120-F for that year. If the foreign corporation has a U.S. office, the form is due on the fifteenth day of the third month after the end of its tax year. If the corporation does not have a U.S. office, the form is due on the fifteenth day of the sixth month after its tax year.

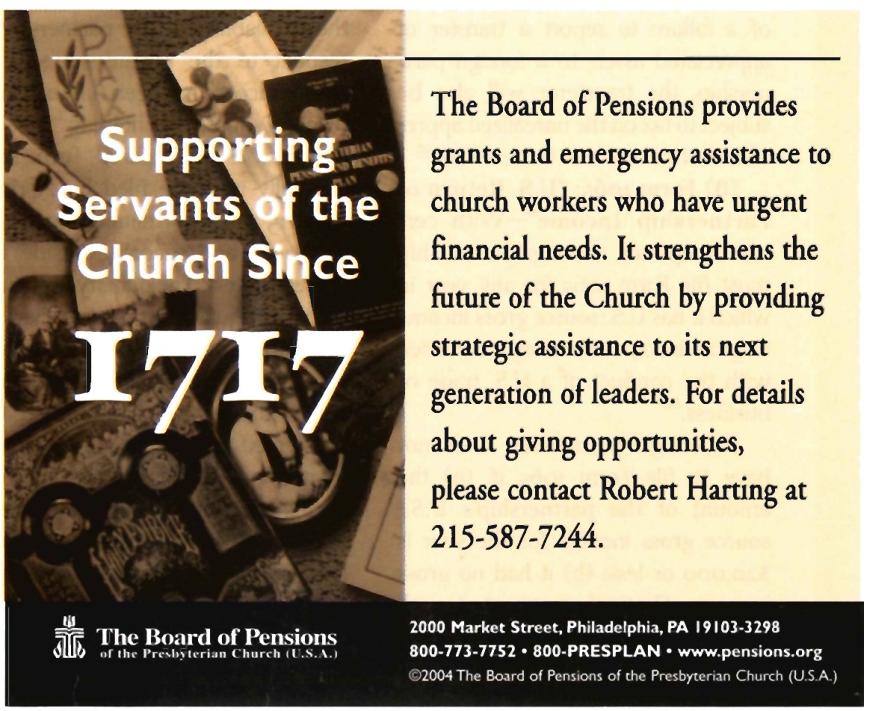
Penalties—The penalty for failure to file the Form 1120-F is generally 5 percent of the amount of tax required to be shown on the return, with an additional 5 percent penalty for each month or partial month during which such failure continues (up to a maximum penalty of 25 percent of the unpaid tax).[53] The penalty for failure to pay any tax when due is generally 0.5 percent of the unpaid tax, with an additional 0.5 percent penalty for each month or partial month during which the tax remains unpaid (up to a maximum penalty of 25 percent of the unpaid tax).[54]

(7) Form 8865: "Return of U.S. Persons With Respect to Certain Foreign Partnerships"—Form 8865 is used to report the information required under IRC Sections 6038 (reporting with respect to controlled foreign partnerships), 6038B (reporting transfers to foreign partnerships), and 6046A (reporting acquisitions, dispositions, and changes in foreign partnership interests). The requirements of these sections are, in summary:

(a) IRC Section 6038—A U.S. partner holding a 10 percent or greater interest in a foreign partnership must file Form 8865 if the partnership is "controlled" (using a 50 percent or more standard) by U.S. persons each owning a 10 percent or greater interest in the partnership. However, the 10 percent U.S. partners need not file Form 8865 if another U.S. partner owns a 50 percent or greater interest in the partnership.[55] In this case, only the 50 percent U.S. partner must file Form 8865. If the foreign partnership is required to file Form 1065, certain schedules from the Form 1065 will satisfy corresponding information requirements under IRC Section 6038.[56]

(b) IRC Section 6038B—Capital contributions to foreign partnerships must be reported if either (i) the U.S. person contributing such property either directly or indirectly holds a 10 percent interest in the partnership immediately after the transfer, or (ii) the value of the property contributed to the partnership exceeds $100,000 (when added to the value of any other property contributed to the partnership by the U.S. person or a related person during the previous 12-month period).

A U.S. person who makes a reportable contribution of appreciated assets also must report the partnership's subsequent disposition of those assets on Form 8865 if the U.S. person is a direct or indirect partner on the date of the subsequent disposition. In general, the Form 8865 on which



a transfer (or subsequent disposition) is reported must be attached to the partner/transferor's income tax return for the tax year that includes the date of transfer or subsequent disposition.

(c) IRC Section 6046A—Any U.S. person (i) who acquires or disposes of an interest in a foreign partnership and directly[57] holds at least a 10 percent interest in the foreign partnership either before or after such acquisition or disposition or (ii) whose percentage interest in a foreign partnership changes by the U.S. person or by at least 10 percentage points (for example as a result of additional capital contributions by other partners) must file Form 8865. However, if an event is reportable under both IRC Section 6038B (capital contributions to foreign partnerships) and IRC Section 6046A, the U.S. person need only report the event under IRC Section 6038B.[58]

Penalties—Form 8865 must be filed with the U.S. partner's income tax return, and the penalty for failure to file is $10,000, with additional $10,000 penalties (up to a maximum additional penalty of $50,000) every 30 days for continuing failure to file after notice from the IRS. In the case of a failure to report a transfer of appreciated assets to a foreign partnership, the transferor will also be subject to tax on the unrealized appreciation attributable to those assets.[59]

(8) Form 1065: "U.S. Return of Partnership Income"—With certain exceptions, a foreign partnership must file Form 1065 for any year in which it has U.S.-source gross income or gross income effectively connected with the conduct of a U.S. trade or business.[60]

A foreign partnership does not have to file Form 1065 if: (a) the amount of the partnership's U.S.-source gross income for the year is $20,000 or less; (b) it had no gross income effectively connected with the conduct of a U.S. trade or business; (c) at no time during the year is one percent or more of any item of partnership income, gain, loss, deduction, or credit allocable in the aggregate to direct U.S. partners; and (d) it is not a "withholding foreign partnership" under the U.S. tax withholding rules.[61]

In addition, a foreign partnership with U.S.-source gross income but no U.S. partners is not required to file Form 1065 if: (a) the partnership had no gross income effectively connected with a U.S. trade or business; (b) it is not a "withholding foreign partnership" under U.S. tax withholding rules; (c) the reporting requirements under the withholding rules are satisfied;[62] and (d) the tax liability of the partners with respect to its U.S.-source income has been fully satisfied through source withholding.[63]

Finally, a foreign partnership with U.S. partners and no U.S.-source gross income need not file Schedule K-1 for purely foreign partners if: (a) the partnership had no gross income effectively connected with a U.S. trade or business; (b) it is not a "withholding foreign partnership" under the withholding rules; (c) the reporting requirements under the withholding rules are satisfied; and (d) the tax liability of the partners with respect to the partnership's U.S.-source income has been fully satisfied through source withholding.[64]

Penalties—If required, Form 1065 generally must be filed by April 15 (June 15 if the partnership maintains its books and records outside the United States). The penalty for failure to file is equal to $50 multiplied by the number of people who were partners in the partnership during any part of the taxable year. This penalty is assessed for each month or partial month (not to exceed five months) during which such failure continues.[65] In addition, partners of a foreign partnership whose tax-matters partner resides outside of the United States, or the books of which are maintained outside of the United States may not take into account deductions, losses and credits derived from the partnership if it is required to file Form 1065 and fails to do so.[66] Failing to file this form also will cause the period of limitations on assessment of tax attributable to partnership items to remain open indefinitely.[67]

(9) Form 8858: "Information Return of U.S. Persons With Respect To Foreign Disregarded Entities"—Each U.S. person who directly, indirectly, or constructively owns a "foreign disregarded entity" must disclose its financial interest in that entity by the annual filing of Form 8858. A "foreign disregarded entity" (FDE) is an entity that was not created or organized in the United States and that is disregarded as separate from its owner for U.S. income tax purposes. If the U.S. person directly owns the FDE or is treated as directly owning the FDE (as is the case with an FDE held beneath a grantor trust), Form 8858 will be filed with that U.S. person's income tax return (Form 1040, 1041, 1065, or 1120). If, instead, the U.S. person owns an interest in a controlled foreign corporation (CFC) or controlled foreign partnership (CFP) that is the tax owner of the FDE, then Form 8858 should be filed with the U.S. person's Form 5471 or Form 8865 filed with respect to its interest in the CFC or CFP. U.S. persons must file Form 8858 annually starting with the accounting period of the FDE's tax owner that begins on or after Jan. 1, 2004.

Penalties—The penalty for failing to file Form 8858 is $10,000 per annual accounting period; and, if the IRS notifies the U.S. person of its failure, an additional $10,000 penalty (up to a maximum additional penalty of $50,000) applies to each 30-day period that the failure to file persists after expiration of the 90-day period following the IRS notice.[68] In addition, persons failing to timely file Form 8858 are subject to a 10 per-

cent reduction of the foreign taxes available for credit; and, if the IRS notifies the U.S. person of its failure, then an additional 5 percent reduction applies to each three-month period that the failure persists after the 90-day period has expired.[69]

(10) Form 8832: "Entity Classification Election"—A foreign entity (other than certain *per se* corporations[70]) may elect to be treated for U.S. tax purposes as (a) either a corporation or a partnership, in the case of an entity with more than one owner; or (b) either a corporation or a disregarded entity, in the case of an entity with one owner. If no election is made on Form 8832, a foreign entity will be treated by "default" as: (a) a partnership if it has two or more members and at least one member has unlimited liability; (b) a corporation if all members have limited liability (even if it is a single-member entity); and (c) a disregarded entity if it has a single owner with unlimited liability. It is important to emphasize that "unlimited liability" refers to the owners' liability with respect to the entity's debts and obligations under the legislation governing a particular type of entity, (for example, a limited liability company or a company limited by shares). Therefore, the default rules will result in most foreign entities being treated as corporations for tax purposes. It is equally important to note that an existing foreign entity that elects to change its classification will be treated as having undergone a liquidation, which may have adverse tax consequences for any U.S. beneficial owners of such entity.[71] An entity electing to be classified using Form 8832 must obtain an EIN, even if the filing of Form 8832 is the only reason the entity will need the EIN.

An election under Form 8832 will be effective on the date filed or on the date that the entity specifies on the election form.[72] However, if the effective date specified on the form is more than 75 days prior to, or more than 12 months after, the filing date, the effective date of the election will be either 75 days prior to, or 12 months after, the filing date, as the case may be. A late classification election may be made if certain requirements are met.[73]

(11) Form 8833: "Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)"—If a foreign individual or foreign corporation benefits from a reduced rate of withholding (or an exemption from withholding) under an income tax treaty with the United States, the taxpayer must file a Form 1040NR or a Form 1120-F, as applicable, and attach Form 8833 to the return to claim such benefit. Note that the applicability of a treaty may be precluded by a "limitation on benefits" provision contained in the treaty. For instance, Article 22 of the 1996 U.S. Model Income Tax Treaty generally requires that residents of the respective treaty countries own at least 50 percent of the beneficial interests of a company seeking benefits under the treaty as a tax resident of the treaty country.

Penalties—The penalty for failure to disclose a treaty-based position in this manner is $10,000 for corporations and $1,000 for all other taxpayers.[74]

FOREIGN ACCOUNTS

Many times, a foreign trust structure will include one or more foreign accounts, which will give rise to an additional annual filing requirement with the U.S. Treasury Department.

(1) Treasury Department Form (T DF) 90-22.1: "Report of Foreign Bank and Financial Accounts"—A U.S. person who has a financial interest in, or signature or other authority over, one or more foreign financial accounts worth more than $10,000 (in the aggregate) must report such accounts on the U.S. person's federal income tax return (Schedule B) and must file TDF 90-22.1 with the U.S. Treasury Department in Detroit.[75] A "financial interest" for these purposes includes being the owner of record or having legal title to a bank or brokerage account, whether the account is maintained for the U.S. person's benefit or for the benefit of others. It also includes situations in which the owner of record or the legal owner of a foreign account is: (a) a person acting as the U.S. person's agent, (b) a corpo-

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ration in which the U.S. person owns more than 50 percent of the shares, (c) a partnership in which the U.S. person owns more than 50 percent of the profit interests, or (d) a trust with respect to which the U.S. person either has a greater than 50 percent present beneficial interest in the assets or receives more than 50 percent of the current income. The TDF 90-22.1 must be filed with Treasury on or before June 30 of the year following the close of the taxable year of the U.S. person. Failure to file may result in civil and criminal penalties.

ANTI-MONEY LAUNDERING

In 1990, the U.S. Treasury Department formed the Financial Crimes Enforcement Network (FinCEN) in an effort to safeguard the U.S. financial system from money laundering, terrorist financing and other illicit financial activity. FinCEN achieves this goal by gathering financial information through various forms and maximizing the sharing of this information among law enforcement agencies and FinCEN's partners in the regulatory and financial communities.

(1) **Form 8300: "Report of Cash Payments Over $10,000 Received in a Trade or Business"**—U.S. persons (other than casinos, which are required to file FinCEN Form 103, and certain financial institutions, which are required to file FinCEN Form 104) who, in the course of a trade or business, receive $10,000 or more in cash in one or more related transactions are required to report such cash receipts to the IRS on Form 8300.[76] This form must be filed with the IRS Detroit Computing Center within 15 days of the transaction. Additionally, a written statement must be provided to each person named on the form stating that the information was reported to the IRS. This statement must be furnished by Jan. 31 of the year following the calendar year in which the cash is received. Failure to file the form or to provide the written statement may result in civil and criminal penalties. The requirement to file Form 8300 is imposed on lawyers and accountants, and the IRS' right to require this reporting has been upheld against taxpayer challenges based on right to counsel, privilege against self-incrimination, attorney-client privilege, and professional responsibility rules.[77]

> Our most recent dealings with the IRS on behalf of clients in this situation indicate that the Service is adopting a less forgiving stance.

(2) **FinCEN Form 104: "Currency Transaction Report"**[78]—Financial institutions subject to U.S. jurisdiction must report each transaction, or set of transactions made by the same person in a single day, involving currency worth $10,000 or more by filing FinCEN Form 104 with the IRS Detroit Computing Center.[79] This form must be filed by the fifteenth calendar day after the day of the transaction. Failure to report may result in civil and criminal penalties.

(3) **FinCEN Form 105: "Report of International Transportation of Currency or Monetary Instruments"**[80]— Subject to certain exceptions, any person who physically transports, mails or ships currency or other monetary instruments worth more than $10,000 across U.S. borders (or is the recipient of such a shipment) must file FinCEN Form 105 with the appropriate U.S. Customs Office to report such transfers.[81] The party transporting the currency or other monetary instruments must file this form on or before the date of transport, and a recipient must file the form within 15 days of receipt. Failure to report may result in civil and criminal penalties.

INVESTMENT REPORTING

Whether a U.S. person directly invests abroad, or a foreign national directly invests in the United States, reports to the federal government must be made.

(1) **Form BE-11: "Annual Survey of U.S. Direct Investment Abroad"**—A U.S. person who directly or indirectly owns 10 percent or more of the voting power in a foreign business enterprise must report his investment annually to the U.S. Department of Commerce's Bureau of Economic Analysis on Form BE-11. For purposes of this reporting requirement, a trust's beneficiaries are considered to be the owners of the trust's interests in a foreign business enterprise.[82] Therefore, the U.S. beneficiaries of a foreign trust that owns a 10 percent interest in a foreign business enterprise is generally required to file Form BE-11.

Instructions to the form provide circumstances in which a U.S. person's investment in a foreign company may not have to be reported (as determined on a case-by-case basis.) These circumstances include: (a) the foreign company conducts business abroad only for the U.S. person's account, not its own; (b) the foreign company pays no foreign income taxes; and (c) the foreign company has limited physical assets or few employees permanently located abroad.

Also, the following explicit exceptions to filing the Form BE-11 apply: (a) none of the foreign company's total assets, sales, or gross operating revenues excluding sales tax, and net income (loss) after provision for foreign income taxes exceeds $30

million (positive or negative); (b) the foreign company is less than 20 percent owned, directly or indirectly, by U.S. investors; (c) the "U.S. person" invested in the foreign company is a bank; or (d) the foreign company is a bank.

The "case-by-case circumstances" and explicit exceptions exempt a majority of U.S. persons from the filing requirement.

Penalties—Penalties for failure to file the Form BE-11 range from $2,500 to $25,000.

(2) Form BE-15: "Annual Survey of Foreign Direct Investment in the United States"—Form BE-15 must be filed annually with the U.S. Department of Commerce's Bureau of Economic Analysis by any 10 percent foreign-owned U.S. business enterprise. (Note that the filing requirement is for the U.S. company, not for the foreign owner.) For this reporting requirement, the instructions to Form BE-15 state that "Beneficial, not record, ownership" controls, and the regulations provide that the beneficiaries of a trust are considered to be the owners of the trust's investments;[83] therefore, a U.S. business enterprise that is 10 percent owned by a foreign trust with U.S. beneficiaries should not be required to file this form as a result of the trust's investment in the company.

Penalties—Penalties for failure to file the Form BE-15 range from $2,500 to $25,000.

IRS HARDENS STANCE

The reporting requirements for U.S. persons' interests in foreign trusts and entities (and for other cross-border financial activities) are extensive, the nuances of these reporting requirements can be complicated, and the penalties for non-compliance can be severe. Lately, the IRS' attitude seems to have hardened toward U.S. taxpayers who've failed to properly report their interests in foreign trusts and entities. Until recently, the IRS was very interested in bringing taxpayers back into the fold through various amnesty programs that provided a waiver of certain penalties for taxpayers who 'fessed up, paid tax on any unreported income, and promised to comply in the future.[84] But our more recent dealings with the IRS on behalf of clients in this situation indicate that the Service is adopting a less-forgiving approach to penalty abatement. IRS agents have supported this observation, informally telling us that their new directive is toward compliance, rather than amnesty.

For the IRS, this stance is shortsighted—if taxpayers are more fearful of coming clean, the government will, in the long run, lose revenue. For advisors, though, the message is clear: It is more important now than ever to help clients get their tax reporting right the first time. ■

Endnotes

1. We also see many inadvertent "completed gift" foreign trusts. A discussion of the appropriate drafting of a foreign trust to avoid a taxable transfer is outside the scope of this article.
2. Public Law (P.L.) 94-455. Title X, Section 1013(f).
3. The general rule is that an accumulation distribution does not include amounts accumulated before the beneficiary's birth or before the beneficiary reaches the age of 21, but this exception does not apply to foreign trusts. Internal Revenue Code Section 665(b).
4. IRC Section 666(a). If the trust's records are not sufficient to establish which years have undistributed net income, the accumulation distribution will be allocated to the earliest year in which the trust was in existence. IRC Section 666(d).
5. Until 1997, the throwback rules applied to both foreign and domestic trusts. But after 1997, the rules were generally

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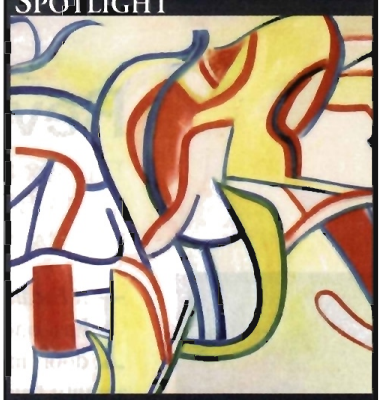
repealed for domestic trusts, with very limited exceptions. The throwback rules were repealed as to domestic trusts, mainly because the tax rates applicable to trusts were increased so much that income accumulation within trusts subject to U.S. tax was undesirable and therefore did not need to be discouraged through the throwback rules.

6. IRC Section 667(a)(3); *see also* the instructions to Form 3520.
7. P.L. 94-455, Title X, Section 1014(d).
8. IRC Section 7701(a)(31)(B); IRC Section 7701(a)(30)(E).
9. These provisions generally apply to taxable years beginning after Dec. 31, 1996. However, certain trusts (other than grantor trusts) that were treated as domestic under prior law may elect to retain domestic status notwithstanding the bright-line test of IRC Section 7701. *See* Treasury Regulations Section 301.7701-7(e) and (f).
10. Revenue Ruling 87-61, 1987-2 C.B. 219 (July 13, 1987).
11. *See, for example,* Rev. Rul. 60-181, 1960-1 C.B. 257; Rev. Rul. 81-112, 1981-1 C.B. 598; *B.W. Jones Trust v. Commissioner,* 46 B.T.A. 531 (1942), *aff'd* 132 F.2d 914 (4th Cir. 1943).
12. Treasury Regulations Section 301.7701-7(c)(3)(iii) and (iv).
13. Treas. Regs. Section 301.7701-7(c)(3)(v).
14. Treas. Regs. Section 301.7701-7(c)(1).
15. Treas. Regs. Section 301.7701-7(c)(4)(D).
16. Treas. Regs. Section 301.7701-7(c)(3)(v).
17. In addition to administering a hybrid trust in such a way as to satisfy the court test and the control test, it is also helpful to include certain provisions in the trust document that track the Treas. Regs. under IRC Section 7701(a)(30)(E), which will shore up the U.S. characterization of the trust.
18. Treas. Regs. Section 301.7701-7(c)(3)(iv).
19. Treas. Regs. Section 301.7701-7(d)(1)(ii).
20. Treas. Regs. Section 301.7701-7(d)(1)(ii).
21. Treas. Regs. Section 301.7701-7(d)(1)(v), Example 4.
22. IRC Section 6048. Transfers to foreign trusts were formerly reportable on Form 926 as well. This reporting requirement was eliminated with the repeal of IRC Section 1491, effective Aug. 5, 1997.
23. IRC Section 679.
24. IRC Section 267(b) set forth the relationships that will cause a person to be "related" to a foreign trust.
25. Treas. Regs. Section 1.679-4(d); for these purposes, any assumption, satisfaction, or guarantee of a third-party loan to a related foreign trust is also treated as a transfer. Treas. Regs. Section 1.679-3(d) and (e); principal payments on the obligation will reduce the portion of the trust treated as owned by the U.S. person. IRC Section 679(a)(3)(B).
26. The penalties may not exceed the "gross reportable amount," which, in the case of a wholly owned grantor trust, could equal 100 percent of the value of the trust property. IRC Section 6677(a).
27. Treas. Regs. Section 25.6019-3(a).
28. IRC Section 6651.
29. The penalties may not exceed the "gross reportable amount," which, in the case of a wholly owned grantor trust, could equal 100 percent of the value of the trust property. IRC Section 6677(a).
30. IRC Sections 6048(d)(5) and 6034A(c).
31. IRC Sections 6048(d)(5) and6034A(c).
32. IRC Section 6048(b)(2).
33. Treas. Regs. Sections 1.671 4(a) and 1.671-4(b)(6)(ii) and the instructions to Form 1041. No income or expenses are reportable on the Form 1041. Rather, the grantor trust information letter contains all income and expense information from the trust's books to be reported on the grantor's U.S. tax return. Several years ago, the IRS was reportedly developing a new form (Form 1041NR) to be used by foreign trusts for U.S. tax reporting purposes; however, the IRS representative specializing in foreign trusts recently informed us that the IRS is no longer considering the development of such a form.
34. IRC Section 6651.
35. *See* the instructions to Form 1040NR. Several years ago, the IRS was reportedly developing a new form (Form 1041NR) to be used by foreign trusts for tax reporting purposes; however, the IRS representative specializing in trusts recently informed us that the IRS is no longer considering the development of such a form.
36. IRC Section 6651(a)(1).
37. The penalties for failure to file may not exceed the "gross reportable amount," which, in the case of a U.S. decedent who was treated as owning the entire trust, could equal 100 percent of the value of the trust property. IRC Section 6677(a).
38. The penalties for failure to file may not exceed the gross amount of distributions received from the trust. IRC Section 6677(a).
39. PL 94-455, Title X, Sections 1013 and 1014.
40. *See* Treas. Regs. Sections 1.1441-1(b)(1), 1.1441-1(d)(4), 1.1441-5(e)(5)(iii) and (iv), and 1.1441-1(e)(3)(iv).
41. For more information on claiming treaty benefits, *see* Internal Revenue Service Publication 686.
42. While the trust is not in fact the entity that pays the U.S. tax on the income earned on assets held by the trust, it does file a U.S. tax return (Form 1041 with a "grantor trust information letter"), as prescribed in Treas. Regs. Section 1.671-4(a), which reports the income of the trust to the U.S. grantor. Therefore, the trust should be considered a U.S. taxpayer for those purposes.
43. It should be noted that the reduced treaty rate may not be available if the treaty does not specifically provide that a "third country" pass-through entity (such as a trust) with a U.S. beneficial owner is eligible for treaty benefits.
44. For example, in the context of controlled foreign corporations (CFCs) and passive foreign investment companies (PFICs), Treasury regulations provide that the beneficiaries' interests in a purely discretionary nongrantor trust will be determined actuarially by all the "facts and circumstances." Treas. Regs. Section 1.958-1(c)(2) and Proposed Regulation Section 1.1291-1(b)(8)(i). In the context of foreign personal holding companies (FPHCs), the IRS has more fully described these "facts and circumstances" in Private Letter Ruling 9024076, which could be applicable by analogy to the CFC and PFIC regimes.
45. IRC Section 6038B(a)(1)(A).
46. Treas. Regs. Section 1.6038B-1(b)(3); see also instructions to Form 926.
47. IRC Section 6038A; *see also* the instructions to Form 5472.
48. Treas. Regs. Section 1.6048A-1(b); IRC

Section 318(a)(2)(B)(ii); *see also* the instructions to Form 5472.

49. IRC Section 6038A(d); 6038C(c).
50. IRC Section 1297(a).
51. A non-electing shareholder/taxpayer may, in certain instances, make a retroactive Qualified Electing Fund (QEF) election (*see* Treas. Regs. Section 1.1295-3 and the instructions to Form 8621); however, this retroactive election requires the taxpayer to make certain showings, such as the taxpayer reasonably believed that the company was not a PFIC, or the taxpayer reasonably relied on the advice of a qualified tax professional (*See* Treas. Regs. Section 1.1295-3).
52. *See* the instructions to Form 8621.
53. IRC Section 6651(a)(1).
54. IRC Section 6651(a)(2).
55. Treas. Regs. Section 1.6038-3(a)(2).
56. Treas. Regs. Section 1.6038-3(j).
57. Final regulations issued on Dec. 29, 1999 make the IRC Section 6046A reporting requirement apply only to direct ownership interests in foreign partnerships and only to events occurring on or after Jan. 1, 2000. Treas. Regs. Section 1.6046A-1. However, the constructive ownership rules of IRC Section 267(c) still apply to deem beneficiaries of trusts that directly own partnership interests to be "direct owners" for purposes of this reporting requirement.
58. Treas. Regs. Section 1.6046A-1(f)(1).
59. IRC Section 6038B(c)(1).
60. A foreign partnership filing Form 1065 solely to make an election (such as an election to amortize organizational expenses) must obtain an employer identification number (EIN) if it does not already have one. See the instructions to Form 1065.
61. Treas. Regs. Section 1.6031(a) 1(b)(2); This exception applies to taxable years beginning on or after Jan. 1, 2000. Treas. Regs. Sections1.6031(a) 1(f).
62. That is to say Forms 1042 and 1042-S are filed by the appropriate withholding agent. *See* Treas. Regs. Section 1.1461-1.
63. Treas. Regs. Section 1.6031(a)-1(b)(3)(i) and (ii). This exception applies to taxable years beginning on or after Jan. 1, 2001. Treas. Regs. Section 1.6031(a)-1(f)(1).
64. Treas. Regs. Section 1.6031(a)-1(b)(3)(i) and (ii). This exception applies to taxable years beginning on or after Jan. 1, 2001. Treas. Regs. Section 1.6031(a)-1(f)(1).
65. IRC Section 6698.
66. IRC Section 6231(f).
67. IRC Section 6229(c)(3).
68. IRC Section 6038(b).
69. IRC Section 6038(c).
70. Listed in Treas. Regs. Section 301.7701-2(b)(8).
71. *See* Treas. Regs. Section 301.7701-3(g).
72. *See* Treas. Regs. Section 301.7701-3(c)(1)(ii).
73. Revenue Procedure 2002-59.
74. Treas. Regs. Section 301.6712-1.
75. 31 Code of Federal Regulations (C.F.R.) Section 103.24.
76. IRC Section 6050I.
77. *See U.S. v. Ritchie*, 15 F.3d 592 (6th Cir. 1994); *Lefcourt P.C. v. U.S.*, 125 F.3d 79 (2d Cir. 1997), *cert. denied*, 513 U.S. 868 (1998); *but see U.S. v. Gertner*, 873 F. Supp. 729 (D. Mass. 1995), *aff'd*, 65 F.3d 963 (1st Cir. 1995) (holding that the information demanded by the government was privileged under the legal advice exception when there was a "strong possibility" that disclosure of a large unexplained cash income could be considered incriminating evidence in a pending narcotics prosecution).
78. Formerly Treasury Department Form 4789.
79. This does not include a transfer of funds by bank check, bank draft, wire transfer or other written order that does not involve the physical transfer of currency.
80. Formerly Treasury Department Form 4790. In April of 2004, the Financial Crimes Enforcement Network proposed changes to this form that would involve converting this report into two documents: Form 105 (Report of International Transportation of Currency and Monetary Instruments—Accompanied by an Individual) and Form 106 (Report of International Transportation of Currency and Monetary Instruments—Shipment, Mailing, or Receipt).
81. A transfer of funds through normal banking procedures that does not involve the physical transport of currency or monetary instruments need not be reported.
82. 15 C.F.R. Section 806.11(b).
83. 15 C.F.R. Section 806.11(b).
84. One of the most widely publicized of these amnesty programs was the Offshore Voluntary Compliance Initiative in 2003.

SPOTLIGHT



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