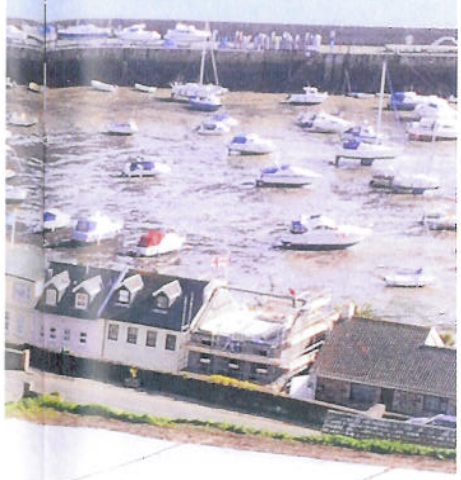

Potato plants grow in fields near Mont Orgueil Castle at Gorey Harbour in Jersey.
REUTERS/Toby Melville

The special tax regimes and compliance rules for U.S. persons with overseas activities or holdings are exceedingly complex and burdensome, with civil penalties for noncompliance often at punitive levels.

Planning for U.S. Persons Inheriting

OFFSHORE TRUST Structures

PAUL MARCOTTE, JR.

The Internal Revenue Code (Code) can greatly complicate matters for U.S. persons[1] with overseas activities or holdings. In particular, the failure of these persons to comply with various return filing requirements under federal law can produce harsh monetary penalties and possible criminal sanctions. This article discusses some of the more important of these requirements and applies them to the example that follows.

Example

Jean-Paul just learned that his Uncle Pierre in France has died, leaving him the sole beneficiary of the Gemini Trust. Jean-Paul, although born in France, came to the United States as a student, married a U.S. citizen, and in time became a naturalized citizen himself. Pierre established the Gemini Trust years ago in Jersey (one of the Channel Islands) since France does not recognize personal trusts. This structure allowed Pierre to avoid French forced heirship laws that otherwise limited his testamentary freedom. The Gemini Trust also allowed Pierre a means to shield his global wealth held outside of France from excessive taxation there, including the despised *impôt de solidarité sur la fortune* (French wealth tax). A private trust company in Jersey serves as trustee. The Gemini Trust owns bank and brokerage accounts in a Swiss bank and some private offshore holding companies, each of which owns prime commercial property in a major European city.

FBAR Reporting

The federal government has been intensifying enforcement efforts regarding U.S. persons with undisclosed foreign accounts. Recent front-page headlines detailed the government's ongoing court battle against UBS to compel compliance with an IRS summons seeking disclosure of the bank's U.S. customers. Criminal prosecutions are now underway against some of the account holders.[2]

In addition to the requirement on Form 1040, Schedule B (Part III), to indicate an interest in a foreign account, there is a separate reporting requirement outside the tax law. The Currency and Foreign Transactions Reporting Act (originally the Bank Secrecy Act), 31 U.S.C. section 5314 and, specifically, 31 C.F.R. section 103.24, imposes a requirement that U.S. persons make an

annual report separate from their tax return disclosing foreign accounts. Reporting is required for a financial interest or signature authority if the aggregate balance of the accounts at any time during the year exceeds $10,000.

The purpose of this reporting requirement is to make it easier for the government to detect and combat various nontax related criminal activities (e.g., money laundering, drug trafficking). This report is submitted on Treasury Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts (FBAR)) and is due June 30 of each year with no provision for an extension. This form is now filed with the IRS, which has been delegated overall enforcement power, and ends up in a central database with the Financial Crimes Enforcement Network (FinCEN) inside Treasury where multiple law enforcement agencies have access.

The definition of "financial account" includes not only bank deposit accounts, but also brokerage accounts and debit cards. The requirement to disclose accounts applies when one has mere signature authority over an account, such as a corporate officer, trustee, or agent under a power of attorney.

As a result of this broad application, multiple persons or entities may be required to report the same account. For example, if a U.S. person is a beneficiary of a trust and (1) has an interest in more than 50% of the trust assets, or (2) receives more than 50% of the trust income, that beneficiary must file an FBAR for any foreign accounts of the trust. The trustee in turn may have a similar requirement if the trustee is a U.S. person or the trust is domestic. In the above example, Jean-Paul is required to report any accounts held by the Gemini Trust since he is the sole beneficiary.

Penalties for noncompliance with the FBAR requirements are severe.[3] For an unintentional failure to file, the penalty is $10,000 per violation, although a reasonable cause exception applies. If the taxpayer intentionally fails to file, the civil penalty is the greater of $100,000 or one-half the account balance for each year's violation in addition to any criminal sanction. Multiple years of noncompliance can result in total penalties that can easily consume or exceed the entire account balance.

Practice note. When reviewing an estate planning questionnaire for a new client who has recently immigrated to

The Mont Orgueil Castle is seen behind an island flag at Gorey Harbour in Jersey.
REUTERS/Toby Melville

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this country, any overseas holdings, including interests in foreign trusts or prospective future inheritances from overseas relatives should be reviewed to determine whether FBAR or other reporting is required.

U.S. Beneficiaries of Foreign Trusts—Throwback Rules and Compliance Requirements

A trust in which no person is considered the owner for income tax purposes (i.e., a nongrantor-type trust) is treated as conduit-type entity for U.S. tax purposes; the trust or the beneficiary pays tax on any income/gains generated by the trust. The statutory mechanism for allocating this tax burden between the trust and beneficiary is distributable net income (DNI), which measures the potential income that can be allocated (and thus taxed) to the beneficiary. This basic statutory framework assumes that the trust is subject to full U.S. income taxation. Thus, if income is not distributed (or required to be distributed) currently to the beneficiaries so that they bear the tax burden on these amounts, the trust will bear the burden. With an offshore trust, however, the trust generally is not subject to U.S. tax, so the Code provides a special tax regime to account for the potential tax deferral in these circumstances.

Where a foreign nongrantor-type trust does not distribute all of its income currently (including capital gains that are included in DNI for this purpose), a rather complex and draconian set of rules ("throwback rules") applies when principal distributions are made in later years.[4] Without these special rules, a later principal distribution would not be taxable to a U.S. beneficiary since it normally would not carry out prior-year DNI under regular U.S. fiduciary tax rules. As a result, that previously earned but undistributed trust income would never be taxed in the United States.

In highly simplistic terms, the throwback rules can be thought of as treating part or all of the later principal distribution as comprising this previously undistributed DNI (an "accumulation distribution") and this amount is then carried or "thrown" back to the earlier tax years of the beneficiary when the income was originally generated by the trust. A tax computation is then applied to reflect that the tax rates in effect during those years may have been higher than the rates in effect for the year of distribution.

A rather onerous feature of these rules is that the character of the income making up an accumulation distribution, such as long-term capital gains, is not preserved in the hands of the beneficiary. Further, the tax liability is then subjected to an interest charge to reflect the time value of money from the tax deferral. If the trust has been in existence for several years, the combined tax and interest charge can often come close to equaling the entire distribution, resulting in confiscatory taxation.

Due to the practical difficulties that the Service has in obtaining information offshore, the Code presumes that 100% of any distribution will be treated as an accumulation distribution unless the beneficiary has received sufficient information from the subject trust to show otherwise (beneficiary has burden of proof).[5] If a beneficiary cannot comply, the Service provides limited administrative relief through a shortcut (default) calculation method whereby only the excess of the current-year distribution over the average of the distributions for the prior three years (using 1.25 times those distributions) is deemed to be an accumulation distribution. The interest charge is then computed based on one-half of the total years that the trust has been in existence. Distributions from foreign trusts are reported on IRS Form 3520 (Annual Return to Report Transactions with Foreign Trusts). The initial penalty for failure to file this return is 35% of the amount of the distributions, with further escalating penalties if noncompliance continues after notice from the Service.

Any attempt to circumvent these rules by structuring a transfer of funds to a U.S. beneficiary as a loan must meet the requirements for a "qualified loan." Otherwise the transaction will be characterized as a distribution.[6]

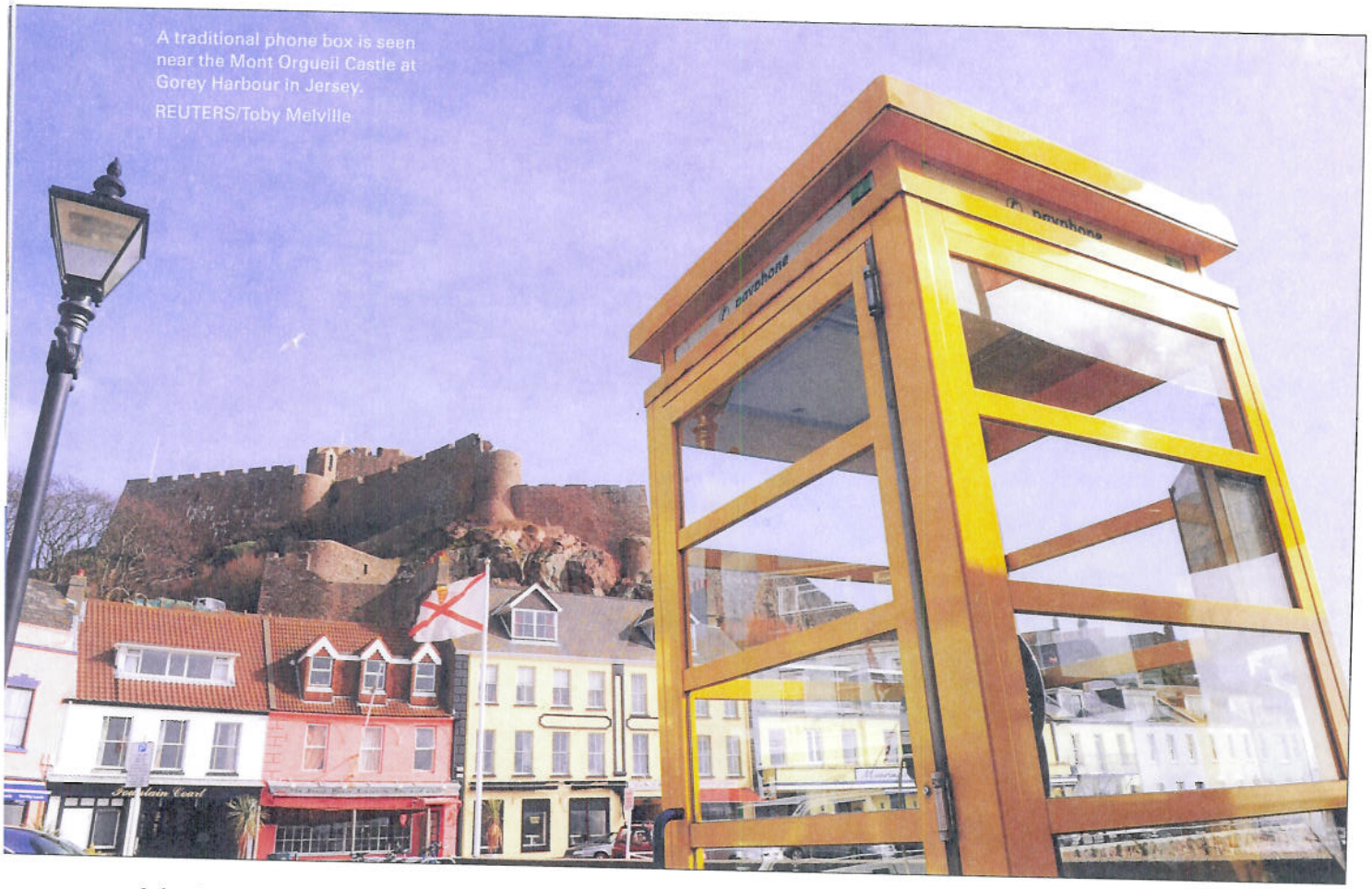
Practice note. The throwback rules apply notwithstanding that the foreign trust may have been formed in a non-tax haven country or for legitimate purposes. The major compliance problem here is obtaining adequate reliable information from overseas trustees to determine the exact throwback liability. It is not uncommon for a foreign trust to have been in existence for many years and that trust records are not well maintained or do not exist for all periods, or the trustee is secretive or uncooperative. As a result, the throwback rules can often present a real compliance nightmare.

MULTIPLE YEARS OF NONCOMPLIANCE CAN RESULT IN TOTAL PENALTIES THAT CAN EASILY CONSUME OR EXCEED THE ENTIRE ACCOUNT BALANCE.

In the example, Jean-Paul needs to be aware of the state of trust records and receive full and timely cooperation from the trustee.

U.S. Owners of Foreign Corporations—CFCs and PFICs

It is becoming increasingly common for clients to have an ownership interest (direct or indirect) in a privately held offshore corporation that in turn owns real estate investments. These types of interests potentially involve two different anti-



A traditional phone box is seen near the Mont Orgueil Castle at Gorey Harbour in Jersey.
REUTERS/Toby Melville

deferral tax regimes that can trigger some fairly extensive reporting requirements.

The first set of rules applies to a controlled foreign corporation (CFC), which is basically a foreign corporation in which one or more U.S. persons own more than 50% of the stock.[7] A passive foreign investment company (PFIC) is basically a foreign corporation that derives 75% or more of its income from mostly passive sources (i.e., dividends, interest, or rents from passive rental activities) or has 50% or more average assets that are passive-type holdings (e.g., securities, passive rental real estate).[8] Unlike the definition for a CFC, there is no minimum level of ownership by U.S. persons that can trigger PFIC status. As a result, PFIC status occurs often and unexpectedly.

The CFC and PFIC rules were enacted to discourage U.S. persons from conducting activities or owning certain types of property through a foreign corporation that otherwise would permit deferral of profits from U.S. tax until the funds were repatriated to the U.S. owner in the form of dividends. The anti-deferral regime for a CFC requires that certain types of passive income (Subpart F items as defined in Section 952 and offshore earnings reinvested in U.S. assets) be taxed currently to 10%-or-more U.S. shareholders as an imputed dividend whether or not actual distributions are made.[9]

For a PFIC, there is no current imputed income, but when a dividend is later made or shares in the entity sold, an interest charge must be added to any regular tax liability to reflect the tax deferral.[10] Moreover, dividends from a PFIC (and imputed dividends from a CFC) are generally not entitled to the preferential tax rate for qualified dividends (15% for dividends received before 2011). Further, on any disposition of stock in a CFC or PFIC by 10%-or-more stockholders, Section 1248(a) denies the preferential tax rates for long-term capital gains to the extent that any gain represents accumulated but undistributed income of the entity. Elections are available for a PFIC to minimize the effect of some of these rules, but at a price—current income inclusion with the risk of insufficient cash distributions to pay any tax due.

Reporting of these interests is usually made annually on IRS Form 5471 (Information Return of U.S. Persons With

1 For purposes of this article, a "U.S. person" generally means a citizen or resident alien as defined in Section 7701(b)(1)(A).

2 There has also been a recent flurry of administrative activity related to FBAR, discussed below. See "FinCEN Proposes Revised Regs. on Reporting Requirements of Foreign Financial Accounts," 21 JOIT 7 (May 2010); "FBAR Filing Deadline Extended for Certain Individuals," 21 JOIT 8 (May 2010); "IRS Continues Suspension of FBAR Filing Requirements for Non-U.S. Citizens, Residents, Domestic Entities," 21 JOIT 9 (May 2010).

3 See Georgiev, "IRS Clarifies Foreign Bank and Financial Accounts Report Penalty," 17 JOIT 61 (May 2006).

4 See generally Sections 665-668.

5 Section 6048(c)(2).

6 Section 643(i).

7 Sections 951-965.

8 Sections 1291-1298.

9 Section 951.

10 Section 1291.

11 See "IRS Announces Voluntary Compliance Initiative for Taxpayers With Unreported Offshore Income," 20 JOIT (June 2009) (Checkpoint only).

12 Note 2, *supra*. See also McArthur, Castro, Harris, and Ashford, "Recent U.S. Tax Bills Target Offshore Tax Abuse," 21 JOIT 24 (April 2010); "International Tax Reform Proposals: Treasury's Green Book," 20 JOIT 6 (August 2009); Anson, Harter, Fischl, Urge, Lyon, Merrill, and Lubkin, "First Obama Budget Proposes Revising Check-the-Box Rules, Deferring Deductions on Unrepatriated Foreign Earnings, Limiting Foreign Tax Credits," 20 JOIT 57 (July 2009).

13 See O'Donnell and Parets, "FATCA: An Analysis," 21 JOIT 24 (June 2010).

NOW THAT THE VOLUNTARY DISCLOSURE INITIATIVE HAS EXPIRED, IRS LIKELY WILL SHOW NO MERCY IN PURSUING TAXPAYERS WITH THESE TYPES OF UNDISCLOSED HOLDINGS

Respect To Certain Foreign Corporations (for a CFC) and Form 8621 (Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund) (for a PFIC); other forms may also be required. As an example of the steep penalty structure for noncompliance, the failure to file Form 5471 results in an initial $10,000 penalty, and the subsequent failure to file after notice from the Service generates an additional $10,000 penalty per month up to $50,000. A reasonable cause exception applies. These penalties are imposed even though no income tax liability may be due with the filing.

Section 958(a)(2) provides that shares in a foreign corporation held by a foreign trust are deemed held proportionally by the beneficiaries. Thus, in the example above, each of the holding companies will be treated as a CFC in relation to Jean-Paul since Gemini Trust's 100% ownership of each company will be attributed to him. This situation will trigger an annual Form 5471 filing requirement for each entity. Alternatively, if Gemini Trust had a noncontrolling interest that otherwise could escape classification as a CFC, the entity might still be classified as a PFIC if the underlying rental property is passively managed.

Practice note. If a client is a U.S. person and beneficiary of an offshore trust that has one or more privately held foreign corporations as holdings or specialized investment vehicles, such as foreign mutual funds, it is prudent to inquire as to the nature of the holdings and the identity of any other owners to determine whether these additional reporting obligation apply.

IRS Offers Short Window for Offshore Voluntary Disclosure

On March 23, 2009, the Service announced an offshore voluntary disclosure initiative that was effective for six months.[11] The deadline for participating in the initiative was subsequently extended to October 15, 2009. The program was designed to encourage noncompliant taxpayers to come forward and make full disclosure of offshore accounts and entities (including trusts) with the potential reward of avoiding criminal prosecution. The Service will collect back taxes, interest, and the accuracy or delinquency penalty for the preceding six years with no reasonable cause exception applicable. The Service will also impose a 20% penalty based on the highest balance or value in an offshore account or entity during the prior six years in lieu of all other penalties. The penalty is reduced to 5% if all taxes have been paid with respect to the account or entity and the taxpayer did not open or establish the account or entity and no activity transpired while the taxpayer was in control. This reduced level of penalty is especially attractive in situations where an innocent taxpayer, such as Jean-Paul, recently inherited one of these structures.

What's Next?

As discussed above, the whole area involving international tax compliance and offshore trusts/accounts is receiving increased attention by several branches of government. Now that the Service's offshore voluntary disclosure initiative has expired, it can be expected that the Service will show no mercy in pursuing taxpayers with these types of undisclosed holdings.

Congress and the Administration may well enhance the Service's arsenal. At this writing, there is pending legislation, the Stop Tax Haven Abuse Act (S. 506 and H.R. 1265), that would, among other changes, expand the reporting requirements for FBARs to include all accounts in a jurisdiction that Treasury determines to be a tax haven regardless of the balance on hand during the year. President Obama in May 2009 announced his own package of international tax proposals that included (1) increasing the level of penalties for violations of the FBAR and foreign trust reporting requirements; (2) creating a rebuttable presumption that any failure to file the FBAR is willful where the account balance is more than $200,000; and (3) extending the statute of limitations.[12]

On March 18, 2010, the President signed the Hiring Incentives to Restore Employment (HIRE) Act (P.L. 111-147), which includes significant provisions for additional information disclosure for persons with foreign financial interests.[13] For tax years beginning after March 18, 2010, the Act provides that individuals with an interest in a "specified foreign financial asset" during the tax year must attach a disclosure statement to their income tax return for any year in which the aggregate value of all such assets is greater than $50,000. Individuals who fail to make the required disclosures are subject to a penalty of $10,000 for the tax year. An additional $10,000 penalty per each 30 days of failure to disclose (or fraction of the 30-day period) applies if the failure to disclose continues for more than 90 days after IRS notifies an individual by mail of the failure to disclose, up to a $50,000 maximum penalty. No penalty is imposed where an individual can establish that the failure was due to reasonable cause and not willful neglect. A foreign law prohibition against disclosure of the required information is not reasonable cause.

Conclusion

The special tax regimes and compliance rules in this area are exceedingly complex and burdensome, with civil penalties for noncompliance often at punitive levels. Not much distinction is made between hardcore tax dodgers who intentionally exploit the offshore world and honest taxpayers like Jean-Paul who have the misfortune of inheriting one of these structures. In Jean-Paul's case, an exit strategy may be in order for him to try to bail out of this structure and reduce the ongoing compliance headaches. ●