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Tax Primer for Settlers of Foreign Asset Protection Trusts: Part Two

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The first part¹ of this article discussed planning issues and opportunities when establishing foreign trusts with asset protection objectives. This part discusses the reporting requirements to which the settlers, trustees, and beneficiaries of such trusts are subject — and the penalties for failing to report.

SETTLORS

Asset transfers to foreign trusts must be reported pursuant to §6048 and §684,² regardless of the nature of the assets. Reportable events for purposes of §6048 include

- creation of a foreign trust by a U.S. person;
- direct and indirect transfers of any money or property to a foreign trust, including transfers by reason of death; and
- death of the U.S. person who settled the foreign trust if

o that person was treated as the owner of any portion of the foreign trust under the grantor trust rules of §671 to §679 (other than §678) at the time of death; or

o any portion of the foreign trust was included in the gross estate of the decedent.³

The obligation to disclose the reportable events to the Internal Revenue Service falls upon the “responsible person” as identified by the statute. Section 6048 identifies the responsible person depending upon the reportable event:

- the grantor in the case of creation of an inter vivos foreign trust,
- the transferor in the case of the transfer of money or property to a foreign trust, and
- the executor of a decedent’s estate in any other case in which the decedent was involved in a reportable event.

Reporting under §6048(a) is accomplished by timely completion and submission of a Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*. The Form 3520 is due with the filing of the settlor’s U.S. income tax return. Transfers to a foreign trust may be direct, indirect, or constructive. Gratuitous and non-gratuitous transfers of money or property to a foreign trust are both reportable events.

As under §679 and §684, there is an exception from reporting under §6048 for fair market value sales to a foreign trust.⁴ Guidance from the IRS confirms the exception is more limited than may be assumed. “[A]ny direct or indirect transfer that is structured with a principal purpose of avoiding the application of §679 or §6048” is regarded as a gratuitous transfer without the receipt of fair market value.⁵ Rents, royalties, and compensation paid to a trust are regarded

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¹ Ward, *Tax Planning and Compliance for Settlers of Foreign Asset Protection Trusts, Part One*, 50 Tax Mgmt. Int’l J. 366 (July 2, 2021).

² All section references are to the Internal Revenue Code, as amended (“the Code”), or the Treasury regulations thereunder, unless otherwise indicated.

³ §6048(a)(3)(A). Instructions to Form 3520 provide that a person who is regarded as a grantor by application of §678 is not subject to the Form 3520 filing requirements that otherwise apply to grantors of foreign trusts.

⁴ §6048(a)(3)(B)(i), invoking the rules of §679(a)(3).

⁵ Notice 97-34 (June 23, 1997), §III.B.

as transfers for fair market value only if the payments reflect an arm's-length price for the use of the property of, or services rendered by, the trust.⁶ Receipt of a beneficial interest in the trust as consideration for a transfer of property to the foreign trust is disregarded in determining whether fair market value was received for the transfer.⁷ A distribution from one trust to another trust that is a beneficiary of the first trust is a gratuitous transfer without the receipt of fair market value.⁸ If the foreign trust issues a note or other obligation to the transferor, in exchange for property transferred to the trust, the obligation will not be taken into account to determine if the transferor received fair market value unless the trust's obligation satisfies the definition of a "qualified obligation,"⁹ as described in Part One of this article. Despite recognition of qualified obligations for purposes of determining transfers for fair market value, such obligations must nonetheless be disclosed on a Form 3520, and the statute of limitations for assessment of any income or transfer tax attributable to the transfer to the foreign trust must be extended for each year that the obligation is outstanding to a date three years after the maturity date of the qualified obligation.¹⁰

TRUSTEES

In addition to reporting obligations imposed on settlors of foreign trusts, the foreign trust itself is also subject to reporting obligations. Trust reporting obligations are satisfied by timely completion and submission of a Form 3520-A, *Annual Information Return of a Foreign Trust with a U.S. Owner*. Section 6048(b)(1) requires any U.S. person treated as the owner of trust income and corpus under the grantor trust rules to "ensure that" the foreign trust submits a return each year which sets forth "a full and complete accounting of all trust activities and operations for the year, the name of the United States agent for such trust, and such other information as the Secretary may proscribe."¹¹ If the trustee of the foreign trust fails to file Form 3520-A, the settlor of the foreign trust who is treated as the owner of trust income and corpus under the grantor trust rules must complete and attach a substitute Form 3520-A for the foreign trust to the grantor's Form 3520 by the due date of the U.S. owner's Form 3520 in order to avoid penalties. Otherwise, the Form 3520-A is completed by the trustee and filed by 15th day of the third month after the end of the trust's taxable year.

In addition to reporting on Form 3520-A, the information required by §6048(b) must be furnished to each U.S. person

- who is the owner of a portion of any such trust under the grantor trust rules, by providing a Foreign Grantor Trust Owner Statement (page 3 of Form 3520-A); or
- who receives (directly or indirectly) any distribution from the foreign trust, by providing a Foreign Grantor Trust Beneficiary Statement (page 5 of Form 3520-A).¹²

Foreign trusts which are grantor trusts are required to appoint a U.S. person to act as the trust's "limited agent only for purposes of applying §§7602, 7603, and 7604. . . ."¹³ Generally, these Code provisions require the U.S. agent to respond to inquiries from the IRS, make available to the IRS "any books, papers, records, or other data which may be relevant or material" in determining the correctness of information provided to the IRS, and receive summons from the IRS. The U.S. agent must be appointed prior to the due date for the grantor's Form 3520.¹⁴ The grantor of the foreign trust, one of the trust beneficiaries, or a domestic corporation controlled by the grantor or a beneficiary may act as the U.S. agent. In order to be authorized to act on behalf of the foreign trust, the agent must enter into a binding agreement with the trustee of the foreign trust conforming to the "Authorization of Agent" set forth in Notice 97-34. Unless the name, address, and taxpayer identification number of the agent is provided on a Form 3520-A, appointment of the agent will be ignored. Failure to appoint the U.S. agent and provide the necessary information will allow the Secretary of the Treasury to determine the amounts required to be taken into account for purposes of computing the grantor's income from the foreign trust.¹⁵ Despite appointment of the U.S. agent, the grantor of the foreign trust remains liable for penalties under §6677(a) and §6677(b) if U.S. the agent fails to comply with its obligations under the Authorization of Agent.¹⁶

BENEFICIARIES

In addition to the reporting obligations imposed on settlors of foreign trusts (generally satisfied by filing Form 3520) and the reporting obligations imposed on trustees of foreign trusts (generally satisfied by filing Form 3520-A), beneficiaries of foreign trusts are also

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ Form 3520 instructions.

¹¹ §6048(b)(1)(A).

¹² §6048(b)(1)(B). The trust reporting obligations are satisfied by timely completion and submission of a Form 3520-A.

¹³ §6048(b)(2)(B).

¹⁴ Notice 97-34.

¹⁵ §6048(b)(2)(A).

¹⁶ Notice 97-34.

subject to independent reporting requirements. Any U.S. person who received a distribution from a foreign trust is required to file a Form 3520 to report the name of the trust and the aggregate amount of distributions received during the taxable year. Settlers of foreign trusts (including settlers treated as owners of trust income and corpus under the grantor trust rules) are subject to the same beneficiary reporting requirements as persons who are not settlers if distributions are made from the foreign trust to the settlor. There is no de minimis threshold by which modest distributions may remain unreported. However, reporting is excused if the U.S. beneficiary does not know or have reason to know that the distribution came from a foreign trust. Generally, creation of a foreign trust and transfers to it are not subject to reporting by U.S. beneficiaries unless they receive a distribution the same year. Such a distribution is deemed to occur if the beneficiary held a right of withdrawal (customarily described as a “Crummey power”).¹⁷

Notice 97-34 confirms that distributions may be actually or constructively received. For example, if the U.S. beneficiary uses a credit card, and charges on the credit card are paid or otherwise satisfied by the foreign trust or secured or guaranteed by assets of the foreign trust, the amount charged to the credit card will be treated as a distribution to the U.S. beneficiary and must be reported. Similarly, if a beneficiary draws a check on an account of the foreign trust or otherwise incurs a debt charged to the foreign trust, the amount incurred will be treated as a distribution to the U.S. beneficiary and subject to reporting. If the U.S. beneficiary receives a distribution from the foreign trust in exchange for services rendered by the beneficiary to the foreign trust or in exchange for property owned by the beneficiary, the difference between the fair market value of the services rendered or the property transferred to the trust and the amount of distribution will be subject to reporting on a Form 3520.

With a limited exception, loans from foreign trusts are treated as distributions when made directly or indirectly to a grantor or beneficiary of the foreign trust or to a U.S. person who is related to a grantor or beneficiary of that trust.¹⁸ A person is related to the grantor or beneficiary if the relationship is described in §267 or §707(b).¹⁹ The exception is when the loan takes the form of a qualified obligation satisfying all

the requirements set forth in the regulations.²⁰ Nonetheless, the qualified obligation loan must be reported on must be reported on a Form 3520 by the grantor or beneficiary.

PENALTIES

The reporting obligations imposed by §6048 should be taken seriously inasmuch as failure to satisfy the statute’s requirements subjects settlers and beneficiaries of foreign trusts to severe penalties under §6677. Penalties apply to Forms 3520 and 3520-A filed late or with incomplete or inaccurate information.²¹ In each case the penalty is equal to the greater of \$10,000 or a percentage of the gross reportable amount. The “gross reportable amount” for purposes of §6677 is defined as

- 35% of the gross value of any property transferred to the foreign trust in the case of a failure by the U.S. transferor to report the creation of the foreign trust or a transfer of assets to the foreign trust,
- 35% of the gross distributions received from the foreign trust in the case of a failure by a U.S. person who is a beneficiary of the foreign trust to report the distribution from the trust, or
- 5% of the gross value of the portion of the foreign trust treated as grantor trust if the foreign trust fails to timely file a Form 3520-A or provides incomplete or inaccurate information.

Gross value is determined relying on the valuation principles of §2512 and the regulations thereunder “without regard to any prohibitions or restrictions on a person’s interest in the property.”²² Penalties may be avoided if the taxpayer can show that the failure to report was due to reasonable cause and not willful neglect.²³ Settlement of the trust in a foreign jurisdiction which imposes civil and criminal penalties on the taxpayer who fails to provide the required information is not reasonable cause for a failure to report.²⁴

As noted above, if the foreign trust does not provide a Form 3520-A, the 5% penalty may be avoided if the grantor prepares, completes, and attaches a substitute Form 3520-A to the U.S. grantor’s Form 3520 by the due date of the Form 3520.

In addition to the above-mentioned penalties, additional penalties will be imposed if the non-compliance continues more than 90 days after the IRS mails a notice for failure to report.

¹⁷ Notice 97-34. A beneficiary holding a Crummey power will be treated as the grantor of that portion of the trust subject to the beneficiary’s right of withdrawal. Rev. Rul. 81-6. See also Rev. Rul. 67-241. Crummey powers are frequently included in trust agreements so as to enable the settlor to make gifts to the trust which qualify for the annual exclusion under §2503(b).

¹⁸ §643(i)(1).

¹⁹ §643(i)(2)(B)(i). Section 267(c)(4) is applied as if the family

of an individual includes spouses of family members.

²⁰ Notice 97-34. See Reg. §1.679-4(d).

²¹ §6677(a).

²² Notice 97-34.

²³ §6677(d).

²⁴ *Id.*

Accuracy-related penalties under §6662 may also apply. In the case of any grantor who is subject to the 20% accuracy penalty on underpayments under §6662(a), the penalty increases to 40%²⁵ to the extent the understatement arises from information required to be reported on Form 3520 or Form 3520-A.²⁶

Any financial accounts held by a foreign trust with respect to a U.S. person will also be subject to Foreign Bank and Financial Account reporting (“FBAR”) requirements. Reportable accounts for FBAR purposes include bank accounts, security accounts, accounts with institutions that are in the business of accepting other accounts, insurance or annuity policies with cash value, accounts with brokers or dealers for futures or options transactions in any commodity, and accounts with mutual funds which offer shares available to the general public and have a regular net asset value determination and regular redemptions.²⁷ Reporting is required by any person with either signature authority over the foreign account or a financial interest in the foreign account. Signature authority is defined as “the authority of an individual (alone or in conjunction with another) to control the disposition of money, funds, or other assets held in a financial account by direct communication (whether in writing or otherwise) to the person whose financial account is maintained.”²⁸ Trustees customarily have such signature authority. However, FBAR reporting is only required of U.S. persons. Foreign trustees are rarely subject to FBAR.

The grantor of a foreign trust is deemed to have a financial interest in all financial accounts of the foreign trust.²⁹ Even if the settlor of a foreign trust were not treated as the owner of trust income and corpus under the grantor trust rules, the settlor nonetheless has an FBAR reporting obligation inasmuch as the foreign trustee acts as an agent or nominee of the set-

tlor who is a U.S. person.³⁰ Thus, the foreign financial accounts of a foreign trust settled by a U.S. person or with respect to which the U.S. person is regarded as the grantor will be aggregated with the other foreign financial accounts of the grantor to determine if the \$10,000 threshold for annual FBAR reporting has been satisfied.

As with respect to Forms 3520 and 3520-A, penalties for failure to meet FBAR and Form 8938 reporting obligations must be taken seriously. Willful FBAR failures are subject to a penalty equal to the greater of \$100,000 or 50% of the account balance(s). Negligent FBAR penalties are subject to fines of \$10,000 per year per account.³¹

As explained in the first part of this article, a foreign trust established for asset protection purposes will almost inevitably be a grantor trust. Under the attribution rules of §318, the grantor is treated as owning the assets of the trust. Consequently, if the foreign trust owns specified financial assets subject to Form 8938 reporting, shares of a foreign corporation subject to Form 5471 or 8621 reporting, interests in foreign partnerships or disregarded entities subject to reporting under Forms 8865 and 8858, the grantor will have additional information return filing obligations. At least in the case of the Form 8938, assets reported on Form 3520 do not also have to be reported on Form 8938.³²

CONCLUSION

Whatever protection foreign trusts offer against creditor claims, they clearly provide no way to avoid U.S. income taxes. However, with proper planning and some degree of caution, there may be opportunities to minimize the rate at which U.S. taxes are imposed. In any and all events, careful attention to the information reporting obligations imposed on settlors and beneficiaries of foreign trusts is essential to avoid creation of a new creditor.

³⁰ 31 C.F.R. §1010.350(e)(2)(i).

³¹ The district courts are divided on whether the negligent FBAR penalty is limited to \$10,000 per year or \$10,000 per account per year. *See generally* Ward, *United States v. Boyd: Ninth Circuit Sides with Taxpayer for Single Late Penalty on FBAR Reporting Multiple Financial Accounts*, 50 Tax Mgmt. Int'l J. 256 (May 7, 2021).

³² Form 8938 Instructions.

²⁵ §6662(j)(3).

²⁶ §6662(j)(2).

²⁷ 31 C.F.R. §1010.350(c).

²⁸ 31 C.F.R. §1010.350(f).

²⁹ 31 C.F.R. §1010.350(e)(2)(iii).