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Mon Dieu!

Your Client is Now the Beneficiary of an Offshore Trust

COMPLIANCE REQUIREMENTS FOR U. S. CITIZENS INHERITING OFFSHORE TRUST STRUCTURES – COMMON TRAPS AND PITFALLS

By Paul Marcotte

Your client, Jean-Paul, just learned that a relative in France (Uncle Pierre) has died, leaving him the sole beneficiary of the Gemini Trust. Jean-Paul, although born in France, came to the US as a student, married a US 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 which 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*, the 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 a prime commercial property in a major European city.

For purposes of this article, a "US person" generally means a citizen or resident alien as defined in § 7701 (b) (1)(A) of the Internal Revenue Code ("Code"). As Jean-Paul will soon see, the Code can greatly complicate life for US persons with overseas activities or holdings. In particular, the failure of US 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.

Foreign Bank Account [FBAR] Reporting

The federal government has been intensifying enforcement efforts regarding US persons with undisclosed foreign accounts. Recent front page headlines detail the government's ongoing court battle against a prominent Swiss bank to compel compliance with an Internal Revenue Service ("Service") summons seeking disclosure of the bank's US customers. Criminal prosecutions are now underway against some of the account holders.

In addition to the requirement that one indicate on Schedule B of Form 1040 whether one has an interest in a foreign account, there is a separate requirement outside the tax law to report these. The Currency and Foreign Transactions Reporting Act (originally the Bank Secrecy Act), 31 U.S.C. § 5314 and specifically, 31 C.F.R. § 103.24, imposes a requirement that US persons make an annual report, separate from their tax return, disclosing the existence of foreign accounts. Reporting is required where one has a financial interest or signature authority and the aggregate balance of such accounts at any time during the year exceeds $10,000.

The purpose behind this reporting requirement is to make it easier for the government to detect and combat various non-tax related criminal activities (e.g., money laundering, drug trafficking, etc.). This report is submitted on Treasury Form TD F 90-22.1 (commonly known as "FBAR") and is due June 30 of each year, with no provision for an extension. This form is now filed with the Service, which has been delegated overall enforcement power, and ends up in a central database with FinCen (Financial Crimes Enforcement Network) inside the Treasury Department 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 where one has mere signature authority over an account (e.g., a corporate officer, a 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 US person is a beneficiary of a trust (i) with an interest in more than 50 percent of the trust assets or (ii) receives more than 50 percent of the trust income, that beneficiary has to file an FBAR for any foreign accounts of the trust. The trustee in turn may have a similar requirement if the trustee is a US person or if 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 non-compliance with the FBAR requirements are severe. In case of 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 non-compliance can result in total penalties that can easily consume or exceed the entire account balance.

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

US Beneficiaries of Foreign Trusts; Impact of Throwback Rules and Compliance Requirements

A trust where no person is considered the owner for income tax purposes (i.e., a non-grantor type trust) is treated as a conduit type entity for US 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 or 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 US income taxation so that if income is not distributed (or required to be distributed) currently to the beneficiaries so that they bear the tax burden on such amounts, then the trust will bear the tax burden. With an offshore trust, however, the trust generally is not subject to US tax so the Code provides for a special tax regime to account for the potential tax deferral in such circumstances.

Where a foreign non-grantor type trust does not distribute all of its income (including capital gains which are included in DNI for this purpose) on a current basis, a rather complex and draconian set of rules (the "throwback rules") apply when principal distributions are made in later years. See generally Code §§ 665-668. Without these special rules, a later principal distribution would not be taxable to a US beneficiary since it normally would not carry out prior year DNI under regular US fiduciary tax rules. As a result, that previously earned but undistributed trust income would never be taxed in the US.

In highly simplistic terms, the throwback rules can be thought of as treating part or all of the later principal distribution as being comprised of this previously undistributed DNI (an "accumulation distribution") and such amount is then carried or "thrown" back to the earlier tax years of the beneficiary when such income was originally generated by the trust. A tax computation is then applied to reflect that the tax rates in effect during such 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 a number of years, the combined tax and interest charge can often come close to equaling the entire distribution resulting in confiscatory taxation.

Due to practical difficulties the Service has in obtaining information offshore, the statute 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). See Code § 6048(c)(2). 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 on the basis of one-half of the total years 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 percent of the amount of the distribution(s), with further escalating penalties if non-compliance continues after notice from the Service.

Any attempt to circumvent these rules by structuring any transfer of funds to a US beneficiary as a loan must meet the requirements for a "qualified loan" as otherwise the transaction will be characterized as a distribution. See Code § 643 (i).

> **Practice Pointer:** 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 that a foreign trust may have been in existence for many years and trust records are not well maintained or do not exist for all periods or the trustee is secretive or uncooperative. As a consequence, the throwback rules can often present a real compliance nightmare.

In the earlier example, Jean-Paul will need to be concerned with the state of trust records and receiving full and timely cooperation from the trustee.

US Owners of Certain Foreign Corporations - CFCs and PFICs.

It is becoming increasingly commonplace to find clients who have an ownership interest (direct or indirect) in a privately held offshore corporation which in turn owns real estate investments. These types of interests potentially involve two different anti-deferral tax regimes which can trigger some fairly extensive reporting requirements.

The first set of rules apply to a controlled foreign corporation or CFC, which can be generally described as a foreign corporation where one or more US persons own more than 50 percent of the stock. See Code §§ 951 to 965. A passive foreign investment company or PFIC can be generally described as a foreign corporation which derives 75 percent or more of its income from mostly passive sources (i.e., dividends, interest or rents from passive rental activities) or has 50 percent or more average assets which are passive type holdings (e.g., securities, passive rental real estate, etc.). See Code §§ 1291 to 1298. Unlike the definition for a CFC, there is no minimum level of ownership by US persons that can trigger PFIC status. As a result, PFIC status occurs often and unexpectedly.

The CFC and PFIC rules were enacted to discourage US persons from conducting activities or owning certain types of property through a foreign corporation which otherwise would permit deferral of profits from US tax until such funds were in fact repatriated to the US owner in the form of dividends. The anti-deferral regime for a CFC requires that certain types of passive income (so-called Subpart F items as defined in Code § 952 and offshore earnings which are reinvested in US assets) be taxed currently to 10 percent or more US shareholders as an imputed dividend whether or not actual distributions are made. See Code 951.

In the case of 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. See Code Section § 1291. Moreover, dividends from a PFIC (and imputed dividends from a CFC) are generally not entitled to the preferential tax rate for qualified dividends (15 percent in 2009). Further, on any disposition of stock in a CFC or PFIC by 10 percent or more stockholders, Code § 1248(a) denies the benefit of the preferential tax rates for long-term capital gains to the extent that any gain represents accumulated but undistributed income of the entity. There are certain elections available in the case of a PFIC to minimize the effect of some of these rules, but with the price being current income inclusion with the risk of insufficient cash distributions to pay any tax due.

Reporting of such interests is usually made annually on IRS Forms 5471 (for a CFC) and 8621 (PFIC); other forms may also be required. As an example of the steep penalty structure in case of non-compliance, the failure to file Form 5471 attracts 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. Note that these penalties are imposed even though no income tax liability may be due with the filing.

Code § 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 discussed above, each of the holding companies will be treated as a CFC in relation to Jean-Paul since the Gemini Trust's 100 percent ownership of each company will be attributed to him. This situation will trigger an annual Form 5471 filing requirement for each entity. Alternatively, if the Gemini Trust had a non-controlling interest that could otherwise escape classification as a CFC, then the entity might still be classified as a PFIC if the underlying rental property is passively managed.

> **Practice Pointer:** If a client is a US 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 such holdings and identity of any other owners to determine whether these additional reporting obligations apply.

Service Offers Short Window for Offshore Voluntary Disclosure

On March 23, 2009, the Service announced an offshore voluntary disclosure initiative which is effective for six months. This program is designed to encourage non-compliant 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 percent 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 percent 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.

Preview of Coming Attractions

As discussed above, the whole area involving international tax compliance and offshore trusts/accounts is receiving increased attention by several branches of government. Once the Service's offshore voluntary disclosure initiative expires, it can be expected that the Service will show no mercy going forward 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 known as the Stop Tax Haven Abuse Act (S.B. 506 and H.R. 1265) which would among other changes expand the reporting requirements for FBARs to include all accounts in a jurisdiction that the Treasury determines to be a tax haven regardless of the balance on hand during the year. The President in early May announced his own package of international tax proposals which includes: (i) increasing the level of penalties for violations of the FBAR and foreign trust reporting requirements; (ii) creating a rebuttable presumption that any failure to file the FBAR is willful where the account balance is more than $200,000; and (iii) extending the statute of limitations.

In summary, the special tax regimes and compliance rules in this area are exceedingly complex and burdensome, with civil penalties for non-compliance often at punitive levels. Not much distinction is made as to 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. In the meantime, wish him *bonne chance* (good luck).

Mr. Marcotte is a partner in the Bethesda law firm of Paley Rothman, co-chairs its Tax Department and is a member of its Estate Planning and Estate/Trust Administration Departments. He can be reached at pmarcotte@paleyrothman.com.