

## US Owners Of Foreign Trusts Face Increased IRS Scrutiny

By **Arielle Borsos and Victor Jaramillo** (June 21, 2018, 2:52 PM EDT)

On May 21, 2018, the Internal Revenue Service Large Business and International division added foreign trust information reporting to its “compliance campaigns,” signaling that the IRS sees a “compliance risk” in this area that requires a targeted response to achieve compliance objectives. LB&I first announced its use of compliance “campaigns” in January 2017 as part of its move toward issue-based examinations. Since its initial rollout, LB&I has identified a total of 35 campaigns it believes present compliance risks and corresponding “treatment streams” it will employ to improve taxpayer compliance. Such “treatment streams,” include issue-focused examinations, soft notices or letters, voluntary self-correction, practitioner outreach and, in certain instances, published guidance. With respect to the foreign trust campaign, LB&I indicated that it will take a “multifaceted approach” to improving compliance, including through the use of “examinations and penalties assessed by the campus when forms are late or incomplete.” Accordingly, individuals who have foreign trust reporting requirements now face an increased risk of IRS audit, as well as the assessment of penalties, which can be quite substantial in this area, and should be sure they are in compliance with the complex reporting obligations associated with foreign trusts.



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Form 3520-A is an annual information return required of a foreign trust with a U.S. owner.[1] Whether a U.S. person that is a settlor or beneficiary of a foreign trust is an “owner” generally depends on the types of powers held by that person with respect to the trust assets. Such powers include, among other things, the right to revoke the trust, direct the beneficial enjoyment of the trust fund, borrow trust assets without adequate security or withdraw trust income or corpus without another party’s approval.[2] A U.S. person may also be treated as an owner if he or she creates a trust with current or future U.S. beneficiaries.[3] The IRS may look not only to the terms of the trust but also to the conduct of the parties and even foreign law to determine whether a U.S. person has sufficient powers over a trust to be treated as its owner.



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The Form 3520-A reports information about the trust, including its income statement, distributions made during the year (whether to U.S. or foreign beneficiaries), its balance sheet, as well as information about its U.S. beneficiaries and U.S. owners on foreign grantor trust beneficiary statements and foreign grantor trust owner statements (which must be provided to the U.S. beneficiaries and owners in turn). The trust deed and other underlying trust documents (e.g., letters of wishes, variances to trust documents, memoranda, etc.) must also be provided with the Form 3520-A unless the foreign trust appoints a U.S. agent for purposes of responding to an IRS request or summons pursuant to code Sections 7602, 7603 and 7604 to examine trust records or produce testimony. The foreign trustee must sign and file the Form 3520-A. However, because the penalties for failing to file the form are imposed on the U.S. owners, each U.S. owner is effectively responsible for ensuring that the foreign trust files Form 3520-A and furnishes annual statements to its U.S. owners and beneficiaries.[4] To avoid those penalties, if the trustee is unwilling to sign and file the Form 3520-A, the U.S. owner may do so instead.

Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, must be filed by any U.S. person who creates or transfers property to a foreign trust, receives a distribution (including both actual and constructive distributions, loans, and use of trust assets for less than fair market value) from a foreign trust, or who is deemed an owner of all or any part of a foreign trust, to report such transactions or ownership.[5] In general, if there is a U.S. owner of a foreign trust, a beneficiary receiving a distribution from the trust will not be subject to U.S. tax on the distribution and instead will be treated as having received a gift from the owner of the trust; however, a beneficiary who receives a distribution from a foreign trust with no U.S. owner is subject to U.S. tax on the distribution. Beneficiaries who receive distributions from foreign trusts must ensure they receive either a foreign grantor trust beneficiary statement (if there is a U.S. or foreign owner) or a foreign nongrantor trust beneficiary statement (if there is no U.S. or foreign owner), that shows the appropriate taxation (if any) of the distribution in order to avoid application of a "default" regime that taxes the entire distribution at ordinary rates and includes a punitive interest charge.[6] The foreign grantor (or nongrantor) trust beneficiary statement must be attached to the beneficiary's Form 3520, and the appropriate taxation of the distribution is reflected on Schedule A of Form 3520.

Form 3520-A is due on March 15, with an extension available until September 15, of each year, and Form 3520 is due on April 15 of each year, with an extension available until October 15. Both forms must be filed with the IRS service center in Ogden, Utah. The failure to timely file or accurately complete either the Form 3520-A or Form 3520 can come at a steep cost. With respect to the failure to file Form 3520-A, the penalty is imposed on the U.S. owner and is equal to 5 percent of the value of the trust assets treated as owned by the U.S. owner at the close of each taxable year.[7] With respect to a failure to file Form 3520, the IRS can impose a penalty equal to 35 percent of the gross value of the property transferred to or received from a foreign trust if the transfer is not reported.[8] The failure to timely file a complete and correct Form 3520-A or Form 3520 may result in an additional penalty of \$10,000 per 30-day period for failing to comply within 90 days of notification by the IRS that the information return has not been filed.[9] The total penalty for failure to report a trust transfer, however, cannot exceed the amount of the property transferred.[10] Additional accuracy-related penalties may also apply if there is understatement of tax attributable to the taxpayer's failure to report ownership over or distributions from a foreign trust. Pursuant to Section 6662(j), those penalties equal 40 percent of the underpayment of tax.

Individuals may argue against the imposition of penalties by demonstrating that their failure to comply with their reporting obligations was due to reasonable cause and not willful neglect.[11] A reasonable cause determination is based on the facts and circumstances of each case, though it generally exists if a taxpayer "exercised ordinary business care and prudence but was nevertheless unable to [file or pay] within the prescribed time.[12] Reasonable cause exists when a taxpayer's reporting error is based on an honest misunderstanding of fact or law that is reasonable under the facts and circumstances, including the experience, knowledge, and education of the taxpayer. [13] One may also satisfy the reasonable cause standard by establishing that the taxpayer in good faith relied upon the advice of a qualified tax adviser, including an accountant, to whom disclosure of the pertinent facts were made.[14]

If, prior to the initiation of an IRS examination, an individual discovers he or she had any foreign trust information reporting noncompliance (but has no unreported income), he or she may file Forms 3520-A or 3520, with a reasonable cause statement, through the delinquent international information return submission procedures to potentially avoid the imposition of penalties. It remains to be seen how LB&I's announcement that it will assess penalties for late or incomplete Forms 3520-A or 3520 "by the campus" will interact with the delinquent international information return submission procedures, as forms filed pursuant to those procedures are filed at the same IRS campus as timely filed returns. Individuals who have, or believe they may have, foreign trust reporting requirements should therefore take action to determine their obligations and the appropriate compliance options.

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[1] I.R.C. § 6048(b).

[2] I.R.C. §§ 673-678.

[3] I.R.C. § 679.

[4] See I.R.C. § 6677(b).

[5] I.R.C. § 6048(a), (c).

[6] I.R.C. § 6048(c).

[7] I.R.C. § 6677(b).

[8] I.R.C. § 6677(a).

[9] I.R.C. § 6677(a).

[10] Id.

[11] I.R.C. §§ 6677(d), 6664(c).

[12] See Treas. Reg. § 301.6651-1(c)(1).

[13] Treas. Reg. § 1.6664-4(b)(1).

[14] Treas. Reg. § 1.6664-4(c).

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