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IMPLEMENTING THE NEW FOREIGN TRUST RULES

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BOTTOM LINE

- The Small Business Job Protection Act of 1996 (SBJPA '96) and its 1997 amendments significantly changed the tax and reporting requirements for trusts classified as foreign trusts for income tax purposes.

- U.S. persons who settle foreign trusts, have interests in foreign trusts, or receive gifts from foreign persons must carefully comply with the reporting requirements by completing Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. U.S. owners of foreign trusts also must ensure that the trustee of the foreign trust files Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner.

RELEVANCE

Estate and *wealth strategies* practitioners who utilize international trusts as part of their clients' overall estate or financial plans, or who have a U.S. citizen or resident that is a beneficiary of a foreign trust, must understand the information in this article. Accountants who prepare foreign trust filings also need to know these rules. By failing to comply with the reporting requirements set forth in this article, the advisor could subject the client to substantial penalties.

FUNDAMENTAL ISSUES

As a result of SBJPA '96, U.S. grantors and beneficiaries of foreign trusts, as well as U.S. recipients of large gifts from foreign sources, must file Form 3520. If these U.S. persons do not file Form 3520 timely and completely, absent reasonable cause, the Code imposes a 35% penalty on transfers to and from foreign trusts. The Code also levies a penalty equal to 5% of the total value of the trust against U.S. owners of foreign trusts who do not file Form 3520-A. Thus, grantors and beneficiaries of foreign trusts must understand and comply with the new reporting requirements.

Foreign trust owners—as determined under the grantor trust rules and as further defined in Notice 97-34—must file Form 3520 annually. U.S. persons who make transfers to or receive distributions from foreign trusts, or owners thereof, must file Form 3520. In addition, persons who receive transfers (*i.e.*, gifts or bequests) totaling more than $100,000 from any foreign source must report them on Form 3520.

PIVOTAL POINTS

Six classes of U.S. persons must file Form 3520. They are:

(1) grantors of foreign trusts (which includes both foreign non-grantor trusts and foreign grantor trusts);

(2) persons who make gratuitous transfers (money or property) to foreign trusts, or persons who transfer or exchange property at fair market value for an obligation issued by the foreign trust;

(3) executors of decedents' estates when (a) the decedent makes a testamentary transfer to a foreign trust; (b) any portion of a foreign trust's assets are included in the decedent's estate; or (c) a foreign trust loses grantor status as a result of the death of the decedent;

(4) grantors whose domestic trusts become foreign;

(5) beneficiaries who receive distributions from foreign trusts; and

(6) recipients of gifts or bequests from foreign sources.

Reporting Transfers to Foreign Trusts. Form 3520 requests information regarding transfers to a foreign trust in consideration of an obligation, qualified or not. Generally, a qualified obligation is a written loan for not more than five years, in U.S. dollars, with a yield to maturity of 100-130% of the applicable Federal rate in effect at issue. In addition, the U.S. person must agree (on Form 3520) to extend the limitations period for assessment of any income or transfer tax attributable to the transfer to three years after the loan matures. The U.S. person must also annually report the status of the note, including principal and interest payments. If the obligation loses qualified status, it will constitute a gratuitous transfer and must be so reported then. If the transfer is not a qualified obligation, it constitutes a gratuitous transfer, for which the transferor must complete Schedule B of Form 3520. The Code subjects unreported gratuitous transfers to the 35% penalty.

Reporting Distributions to Foreign Trust Beneficiaries. Any U.S. person who receives a distribution from a foreign trust must complete Part III of Form 3520. If a foreign trust lends money to a "U.S. person" who happens to be the grantor or a beneficiary of the trust, the recipient must fully disclose this transaction. If the loans do not meet the definition of a qualified obligation, the Service will treat the loans as a distribution to the recipient. Further, if the foreign trust is a non-grantor trust, such a deemed distribution would be subject to taxation. The Service scrutinizes these "loans" closely because some grantors have used foreign trust loans as a means to distribute cash or property in an attempt to avoid paying income tax.

U.S. beneficiaries should attach either a Foreign Grantor Trust Beneficiary Statement or a Foreign Nongrantor Trust Beneficiary Statement, received from the trustee, to avoid the presumption that the distribution is an accumulation distribution. With respect to a distribution from a foreign grantor trust (where the grantor is either a U.S. person or a foreign person, under certain circumstances), if the U.S. beneficiary attaches a completed statement, the distribution will constitute a non-taxable gift directly from the grantor. However, without the statement, the instructions to Form 3520 require the beneficiary to calculate accumulated distributions using the "default distribution calculation." This computation, as explained below, may result in the recognition of income by the beneficiary of a grantor trust.

All U.S. persons with interests in foreign trusts must file Form 3520 or risk severe penalties.

U.S. beneficiaries of non-grantor foreign trusts with completed statements may apply either the default distribution method or the actual distribution method. However, if they chose the default distribution method, they must use it in all future years. Under that calculation, to the extent a distribution in the present year (Y) exceeds the average distribution in the

previous three years (A), Y constitutes an accumulated distribution, while A constitutes a current distribution, subject to taxation as such. Thus, if annual distributions are constant, this rule will not create tax problems for the beneficiary. However, if distributions vary substantially from year to year, a throwback tax, together with interest, could be due. If so, the beneficiary must complete Form 4970, Tax on Accumulation Distribution of Trusts, and attach it to Form 3520.

Part IV of Form 3520 applies to U.S. persons who receive gifts or bequests from foreign persons totaling $100,000 or more. If the beneficiary does not report the transfer(s) in this section, the Code imposes a penalty equal to 35% of the gross amount of the transfer. .

Miscellaneous Issues. If grantors, transferors, or beneficiaries of the same foreign trust file joint income tax returns, they may file a joint Form 3520. However, practitioners should exercise caution when jointly filing Form 3520. The Code authorizes severe reporting penalties for errors or omissions on Form 3520, for which filing jointly presumably creates joint and several liability.

Form 3520 (and Form 3520-A) requests the identity of the U.S. agent, as well as his, her, or its address and tax identification number (SSN or EIN). All foreign grantor trusts should appoint a U.S. agent to comply with (1) requests by the Service to examine trust books and records and (2) summons from the Service for such records or testimony. If a U.S. agent is not appointed, the Secretary has the authority to determine the amounts of income that will be includible in the U.S. owner's return. The language in the agency agreement should mirror that in the instructions to Form 3520-A. In other words, the trustee and agent must enter into a written agreement, which should contain language similar to that set forth in the Agency Agreement provided as a practice tool for this review.

Further, if the trustee of a foreign trust does not appoint a U.S. agent, the person completing Form 3520 must provide additional information, including various trust documents and financial statements. If that person cannot obtain the documents, he or she is subject to substantial penalties, absent reasonable cause. Form 8082, Notice of Inconsistent Treatment, places the burden on the filer to demonstrate that he or she is having difficulty or is being treated in an inconsistent manner by the foreign trustee. However, if the person complaining of the difficulties is also the trust's grantor, the Service will likely impose the penalties.

PRACTICE APPLICATIONS

While many (if not most) practitioners question the validity of foreign tax motivated structures utilizing a foreign trust, for purposes of this review, the issue is disclosure. A purported fair market value exchange of property for an obligation (*i.e.*, a promissory note or a private annuity) issued by a foreign trust requires disclosure by the transferor on Form 3520. Otherwise, a U.S. transferor faces a 35% penalty.

With offshore trusts established for asset protection purposes, the issue is whether the Service will classify the trust as a "foreign trust" for tax purposes. In February 1999, the Treasury Department promulgated final regulations that set forth the tests the Service will use to determine whether an offshore trust is "foreign" or domestic for tax purposes. Based on these regulations, many practitioners draft offshore trusts, at least initially, as domestic trusts for tax purposes because they have at least one domestic trustee with all substantial decisions vested in the U.S. trustee(s). As such, these trusts avoid the foreign trust reporting requirements. On the other hand, with trusts that are not initially designed so that the Service will classify them as a domestic trust for tax purposes, and with "domestic" offshore asset protection trusts that later become a "foreign" trust for tax purposes, responsible persons must comply with the reporting requirements set forth in this article.

Naming an agent does not make a trust domestic. In fact, naming an agent is only necessary under the Code when the trust is a "foreign grantor trust." Moreover, naming an agent does not compromise asset protection features. The Code specifically limits an agent's duties, and the agreement between the trust and the agent should similarly be specific.

Generally, consider appointing the grantor's attorney, accountant, or financial advisor as the agent. Such an individual likely knows what is required. Moreover, the attorney-client privilege provides the grantor's attorney with an additional layer of protection if the client is subsequently sued, and a plaintiff's attorney seeks information from the agent. When the agent is the grantor's attorney or accountant, he may also have a better chance of fending off the Service. Note that for these purposes, the agent is the agent of the trustee, not the grantor/beneficiary.

COMMENTARY

Form 3520 and Form 3520-A are just two of the forms that are related to the establishment and maintenance of a foreign trust structure. If the asset protection structure employs other foreign entities, the U.S. person may be required to file additional forms.

Filing these forms annually may appear daunting at first, but once gathered, much of the information remains the same and is easy to replicate. Generally, the only changes are the value of the assets and distributions. However, preparers must cross-check these forms carefully, particularly when calculating accumulated distributions. Practitioners who are neither experienced tax attorneys nor CPAs should not attempt to complete these forms because clients who owe penalties as a result of untimely or inaccurate filings will likely raise malpractice claims against the advisor. Given the complexity and risks, practitioners new to the offshore arena should co-counsel with someone who knows the field.

PRACTICE ALTERNATIVES

Most practitioners agree that there are no magic income tax savings just because a trust is "offshore," despite claims to the contrary. A few practitioners opine that international trusts and other international entities may be utilized to defer taxes, but generally that goes to the nature of the assets owned rather than the trust itself. However, irrespective of whether there is any tax savings or a tax deferral associated with an offshore trust structure, the foreign reporting requirements must be met, especially for transfers to or distribution from foreign trusts.

Offshore asset protection trusts are great tools for asset protection under the proper circumstances. In almost all circumstances, these tools are tax neutral. However, as noted above, the practitioner has the option of drafting the offshore asset protection trust to be either a "foreign" or "domestic" trust for tax purposes. By naming a U.S. person or entity as co-trustee, by providing that all substantial decisions should be made by U.S. fiduciaries, and by making it subject to the U.S. court system, the offshore asset protection trust will be classified as a "domestic" trust for tax purposes. In this case, the trust need only file Forms 1041 and SS-4.

Although the trust can contain a "flee clause," by which the trust drops the U.S. trustee for asset protection reasons, the flee clause should be discretionary. A trust containing a mandatory flee clause will be treated as a foreign trust unless the mandatory flee occurs only in the case of foreign invasion or nationalization of property in the U.S. If the trust must "flee" for asset protection reasons, it will become "foreign" once the U.S. co-trustee is dropped. From that point forward, all of the filing requirements discussed above apply.

THE LAW

IRC §§ 679, 684, 6048, 6677, 7602, 7603, 7604, 7701(a)(30)(E)(i) and (ii), 7701(a)(31)
Treas. Reg. § 301.7701-7 (Feb. 2, 1999)
Notice 98-25, 1998-18 I.R.B. 11
Notice 97-34, 1997-1 C.B. 422

ADDITIONAL REFERENCES

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PRACTICE TOOLS

99-02-24: Agency agreement for appointment of foreign trust agent

99-02-25: Authorization of agent