

FOREIGN TRUSTS - DANCING THROUGH THE MINEFIELD

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FOREIGN TRUSTS - DANCING THROUGH THE MINEFIELD

I. NONTAX ISSUES.

A. Recognition of Existence and Validity Of Trusts.

1. Noncommon law jurisdictions (including civil law jurisdictions) often have no equivalent concept, or if they do, they may be creatures of statute.

a) Civil law concepts of community property and forced heirship may preclude the use of a trust.

2. English common law system also has differences from American system.

a) English statutory law the trustee has the power to sell, mortgage or lease the trust assets regardless of any restrictions in the terms of the trust instrument; a trustee is not entitled to compensation unless the instrument so provides; and trustees are given the power to appoint successor trustees.

b) The beneficiaries of a trust governed by English law have the power at all times to modify or terminate the trust even though one or more trust purposes have not been accomplished.

c) Spendthrift restraints on alienation of beneficial interests may not be valid.

3. Some civil law countries have trust-like devises.

a) Power of attorney

b) Usufruct.

(1) Splits life interest from a remainder interest.

(2) But does not split powers of management and enjoyment.

c) Fideicommissum or fideicommisso.

d) Treuhand (Germany)

e) Bewind (Netherlands)

f) Foundation

(1) Stiftung and anstalt.

B. Applicable Law.

1. Issues of what country's law to apply, and what country has jurisdiction to administer the trust and resolve disputes, can arise. This is especially so when trustees, beneficiaries, and assets are located in more than one country.

2. Problem concepts:

a) Choice of law.

b) Conflicts of law

c) Local tax law.

d) Property situs rules.

e) Succession laws.

C. Forced Heirship.

- 1. A trust may be used to avoid the application of forced heirship rules in a settlor's country of residence.**
- 2. Even if effective as to the trust assets, the settlor's country of residence may reallocate assets within its jurisdictions to compensate for transfers made under the law of the trust.**

D. Creditor Protection.

- 1. While many offshore jurisdictions are perceived as being favorable to creditor protection planning, the protections offered are not uniform.**
- 2. Misc. Issues and Considerations:**

- a) Statute of Elizabeth override
 - (1) As to issue of which future creditors cannot be exempted
 - (2) Disregard of "badges of fraud" - fraud needs to be proved by direct evidence
- b) Statute of Limitations for Fraudulent Conveyance
- c) Insolvency Definitions
- d) Attorneys Available
- e) Nonrecognition of foreign judgments
- f) Express provisions allowing grantor to be a beneficiary
- g) Standards of Proof in Fraudulent Conveyance Claim
- h) Who has burden of proof in fraudulent conveyance claim
- i) Protection for redomiciled trusts
- j) Favorable standards restricting freezing of assets
- k) Favorable statutory choice of law provisions

E. Political Stability.**F. Hague Convention On The Law Applicable To Trusts And On Their Recognition.**

- 1. Signed 1985, effective January 1, 1992.**
- 2. General Effect:**

- a) Each signatory recognizes the existence and validity of trusts. However, the Convention only relates to trusts with a written trust instrument. It would not apply trusts which arise (usually in common law jurisdictions) without a written trust instrument.
- b) The Convention sets out the characteristics of a trust (even jurisdictions with considerable legal history relating to trusts find this difficult).
- c) The Convention sets out clear rules for determining the governing law of trusts with a cross border element.

- 3. The U.S. is not a party.**

- 4. Current ratified signatories:**

- a) Australia, Canada (8 provinces only), China (Hong Kong only), Italy, Luxembourg, Liechtenstein, Malta, Monaco, the Netherlands (European territory only), San Marino, Switzerland and United Kingdom (including 12 dependent territories/crown dependencies)

G. Exchange Controls.**H. Common Law Jurisdiction.****II. FOREIGN VS. DOMESTIC TRUST - DEFINITION.**

A. RELEVANCY?

- 1. Different tax and reporting rules apply.**
- 2. An inadvertent or intentional conversion of a trust from domestic to foreign can trigger Code §684 gain recognition on appreciation.**

B. APPLICABLE RULE: All trusts are deemed to be FOREIGN unless both:**1. A court in the U.S is able to exercise primary supervision over the trust administration (the "Court Test"), and****a) Effect of a Flee Clause.**

(1) A trust does not meet the U.S. Court Test if the trust instrument contains a provision whereby the trust would be removed from the U.S. jurisdiction if a U.S. court attempted to assert jurisdiction or otherwise supervise the administration of the trust, directly or indirectly. Treas. Regs. §301.7701-7(c)(4)(ii).

(a) But a flee clause is permitted if activated only upon foreign invasion of the U.S. or widespread confiscation or nationalization of property within the U.S.

(2) DANGER: A domestic asset protection trust that provides for removal to outside of the U.S. in the event of creditor attack will be considered to be a foreign trust. Treas. Regs. §301.7701-7(c)(5), Ex. 2.

(a) Such clauses are often found in domestic creditor protection trusts so as to inhibit creditor attacks.

b) Regulatory Safe Harbor - Domestic Trust:

(1) Trust instrument does not direct administration outside the U.S.;

(2) Trust is in fact administered in the U.S.; and

(3) Trust is not subject to an automatic migration clause.

2. One or more U.S. persons have the authority to control all substantial decisions of the trust (the "Control Test").

a) EFFECT: If a foreign person has control over only one "substantial decision," foreign trust status results.

(1) Thus, have to watch for powers not just of trustees, but of protectors, beneficiaries, and other persons granted power or authority over the trust.

(2) Regulation examples allow for foreign person to serve, if can be "outvoted" by U.S. persons.

(a) Also, can give powers to foreign persons, so long as a U.S. fiduciary can veto it (and the U.S. fiduciaries are not foreclosed from making those decisions themselves - see Treas. Regs. §301.7701-7(d)(1)(iii) and (v) ex. 2, 3 and 4).

(i) "(iii) The term control means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions. To determine whether United States persons have control, it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries."

(ii) Example 1 provides the foreign trustee(s) cannot have veto power, and there cannot be a requirement for unanimity if there is a foreign trustee.

(iii) Example 2 importantly blesses a straight majority vote, where one of 3 trustees is foreign.

b) 12 month safe harbor if there is an inadvertent change.

(1) An inadvertent change means the death, incapacity, resignation, change in residency, or other change that would change the residency of the trust but was not intended to do so.

(a) What other "changes" might come within this rule?

(i) Perhaps the removal of a trustee for malfeasance or nonfeasance, or the bankruptcy of a corporate fiduciary.

(2) Thus, for example, if a sole U.S. trustee dies and the trust designates a foreign person to serve as successor, if that foreign person is replaced with a U.S. person within 12 months, then the trust will not have been converted to a foreign trust.

(3) An extension of the 12 month period can be requested from the IRS.

C. Traps!

1. Florida trust, Florida assets, two trustees - one situated in Florida and one in Canada.

a) Inadvertent foreign trust.

2. Same facts. Trust reports as a foreign trust.

a) Unfortunately, the trust officer/attorney did not know that this was a pre-1996 trust which had elected to remain/be treated as a domestic trust. Such electing trusts will be treated as domestic trusts.

3. Trust instrument says it is governed by Florida law. Trustee is a U.S. person who resides abroad. There are no Florida assets and the trustee spends no time in the U.S.

a) No adequate state ties to trigger Florida court jurisdiction - therefore, it is a foreign trust since the Court test is unlikely to have been met.

4. Client has a trust created with an eye towards asset/creditor protection. The drafting lawyer includes a creditor protection trust provisions that direct the administration of the trust be moved offshore in the event of creditor attack.

a) Flee provision results in a foreign trust - Court test flunked.

5. Trust with U.S. administrator, trustee, assets, and beneficiary. Non-U.S. protector has power to terminate a trust.

a) This is enough to establish non-U.S. control and thus a foreign trust.

6. Trust with U.S. administrator, trustee, assets, and beneficiary. Non-U.S. beneficiary has a power to appoint trust assets.

a) This is enough to establish non-U.S. control and thus a foreign trust.

7. Trust with U.S. administrator, trustee, assets, and beneficiary. Non-U.S. beneficiary has a power to remove a trustee, even though the trust says upon removal a U.S. successor must be appointed.

a) This is enough to establish non-U.S. control and thus a foreign trust.

8. Trust that is subject to U.S. court jurisdiction and with a U.S. trustee signs a one year contract with an investment advisor situated in the U.K., which advisor will be making the investment decisions for the trust.

a) This is enough to establish non-U.S. control and thus a foreign trust.

b) If contract was terminable at will, it would not be a problem.

III. FOREIGN NONGRANTOR TRUST ISSUES

A. General U.S. Income Taxation.**1. Common Types of Income - Taxation of Trust.****a) Foreign Source Income.**

(1) Similar to any non-U.S. person under the Code, the U.S. does not generally tax.

(a) Although U.S. beneficiaries may be taxed on distributions.

(2) However, again similar to other non-U.S. persons, a foreign trust will be taxed on its income that is effectively connected with a U.S. trade or business.

(a) Subject to treaty variations.

b) U.S. Source Income.

(1) Capital gains taxed at U.S. capital gains rates, if it is ECI.

(2) Gain from dispositions of U.S. real property interests are taxable under FIRPTA (Code §897).

(a) And such gains are subject to FIRPTA Code §1445 withholding rules.

(3) Other capital gains are not taxed.

(a) Under Code §641(b), a foreign trust is treated as a nonresident alien who "is not present in the United States at any time." Thus, the 183 days or more rule of Code §871(a)(2) which could tax capital gains is not applicable. See Code §641(b).

(4) Non-ECI FDAPI - 30% rate of tax (or lower treaty rate), and should be withheld by U.S. payors.

(a) Although a foreign trust can make a Code §871(d) election to treat passive income from U.S. real estate activities as effectively connected income.

(b) The payor is obligated to withhold even if all of the trust beneficiaries are U.S. persons. Treas. Regs. §§1.1441-1(c)(6)(ii)(D) & -5(e)(2).

(c) A U.S. payor of such income should withhold 30% unless the trust provides to the payor a Form W-8ECI with a taxpayer identification number.

(5) ECI - graduated rates.

(a) The test of whether income of a foreign trust is effectively connected with a U.S. trade or business is generally applied at the trust level.

(i) Not the beneficiary level.

2. Taxation of U.S. Beneficiaries.

a) Generally apply normal Subchapter J rules.

b) DNI includes capital gains, unlike domestic trusts.

c) Special rules will create constructive distributions. Code § 643(i).

(1) Loans to beneficiaries, unless "qualified obligations."

(2) Free use by beneficiaries of trust property.

d) U.S. beneficiaries receive a credit against their U.S. tax liability of the trust's U.S. taxes.

(1) If taxes were withheld by the payor to the trust, the U.S. beneficiary includes the withheld taxes in income as a "gross up". Treas. Regs. §§1.1441-3(f), 1.1462-1(b).

3. Taxation of Non-U.S. Beneficiaries.

a) No withholding is required as to foreign source income distributed to NRA beneficiary and the foreign beneficiary should not be subject to U.S. tax (unless ECI).

b) U.S. source effectively connected income is taxable.

c) U.S. source FDAPI - 30% (or treaty rate).

d) The trustee is obligated to withhold 10% of the value of the distribution of any U.S. real property interest.

4. AMT

a) Applies to foreign trusts. Code §§55 & 59(c).

5. Foreign Tax Credits.

a) No explicit Code provision provides a credit for foreign income taxes incurred to a U.S. beneficiary receiving a CURRENT distribution from a foreign trust.

(1) Conduit principle of Code §652, which shifts the gross amount of the foreign income (unreduced by foreign taxes imposed on) arguably should treat the taxes as having been paid by the beneficiary.

(a) Such treatment is supported by Rev.Rul. 56-30, 1956-1 C.B. 646.

(b) Code §901(b)(5) indicates that a beneficiary may receive a credit (subject to Code §904 limitations) on his or her "proportionate share of the taxes" paid or accrued to a foreign country.

(c) See also GCM 36304 (1975) ("a United States beneficiary of a foreign trust could credit those foreign income taxes paid or accrued by the trust and attributable to certain foreign-source income of the trust that was included in the beneficiary's gross income under the predecessor of Code §662(a)(2)").

(2) It is unclear whether all foreign taxes are creditable, or there is some reduction in the amount of the credit due to less dollars being available to distribute to the beneficiary due to the trust's payment of foreign tax.

(a) Based on analogous issues raised in *American Chicle Co. v. U.S.*, 316 U.S. 450 (1942).

b) The Code does provide that a beneficiary who receives an ACCUMULATION distribution of foreign source income on which foreign income tax has been paid must "gross up" the distribution to include the taxes deemed distributed under Code §666(b). Code §667(a). The beneficiary can then claim a credit if the beneficiary elects the provisions of the foreign tax credit, or a deduction if no credit is claimed. Code §667(d).

(1) Because the credit does not arise under Code §901, the limitations thereunder should not apply.

c) Trusts are allowed the foreign tax credit for taxes not allocable to beneficiaries. Code §§901(m) & 642(a).

(1) Although foreign trusts will typically not be taxable directly by the U.S. on foreign source income.

6. Watch out:

a) Amounts paid to a U.S. person indirectly from a foreign trust of which the payor is not the grantor is treated as paid directly by the foreign trust. Code §§643(h)/665(c). This can trigger DNI distributions and throwback distributions.

(1) For example, a distribution to a foreign beneficiary, who then gifts the distribution to a U.S. person. Under Regulations, the recipient U.S. person need not even be a beneficiary.

(2) Interestingly, these rules do not apply to a distribution to the grantor, who then makes a gift to a U.S. person, although perhaps other tax principles can be applied to find a disguised distribution to a U.S. person in those circumstances.

b) Loans of cash or marketable securities to a U.S. person who is grantor or beneficiary is a distribution, as well as free use by beneficiaries of trust property. Code §643(i).

(1) But see Notice 97-34 exception for "qualified obligations."

c) Try to plan to get items that are nontaxable to nonresident alien beneficiaries to them and not to U.S. beneficiaries, if possible.

(1) For example, non-USRPI long-term capital gains could be distributed to NRA beneficiaries in one year, and then distributions of other types of income incurred in later years distributed to U.S. beneficiaries.

7. Traps!

a) Foreign nongrantor trust owns a Bahamas condominium with a value of \$1 million and a basis of \$500,000. The trust sells the condominium for \$500,000. Since the gain is not U.S. source income nor effectively connected with a U.S. trade or business, no U.S. taxes are paid. The trust terminates in the same year and distributes the sales proceeds to its U.S. beneficiaries. The trust has no other income in that year.

(1) If this was a U.S. trust, there would be no DNI and thus the beneficiaries would not have any income tax. However, since foreign trusts include capital gains in DNI, the beneficiaries pick up the capital gain for U.S. income tax purposes.

b) Same facts, except the condominium is situated in the U.S.

(1) Foreign trust subject to FIRPTA tax and withholding per its disposition of a U.S. real property interest. Sections 897 and 1445.

c) Foreign trust leases out a U.S. condominium. The tenant correctly withholds 30% of the gross rent payments.

(1) Foreign trust should consider a Section 871(d) net election to be taxed on a net basis (thus allowing for deduction of depreciation, taxes, and other expenses).

d) Foreign trust allows one of its U.S. beneficiaries to occupy its Bermuda condominium on a rent-free basis.

(1) Oops! That's a taxable distribution to the U.S. beneficiary. Section 654(i).

e) Foreign trust lends its U.S. beneficiary \$100,000.

(1) Oops! That's a taxable distribution to the U.S. beneficiary. Section 654(i).

f) Foreign trust distributes funds to nonresident alien son, which distributions involve non-U.S. source income. Son is not taxed since he is an NRA. Son makes a gift to sister of those proceeds - sister is a U.S. resident.

(1) Under Code §643(h), sister can be taxed as if she received a direct distribution from the trust, even if she is not a beneficiary of the trust.

B. Throwback Rules

1. Which trusts do the rules apply to?

a) The only trusts remaining subject to throwback are foreign trusts and domestic trusts that either (a) were at any time foreign trusts, or (b) were created before March 1, 1984, and would have been subject to the aggregation requirement of §643(f) if that provision had then applied.

b) Not applicable to grantor trusts.

2. What is happening here?

a) Undistributed DNI (reduced by applicable taxes) carries out in later years to beneficiaries.

3. Statutory Mechanics:

- a) Calculate UNI (undistributed net income) for years after 1969 on a year by year basis.
- (1) UNI = excess of DNI over (a) distributions to beneficiaries in that year under Code §661(a)(1) and (2), and (b) taxes imposed on trust allocable to the undistributed DNI. Code §665(a).
- (a) Essentially, undistributed DNI, less taxes on that undistributed DNI.
- (b) ALERT: Watch for unexpected sources of DNI (e.g., depreciation recapture, imputed income under Code §§ 482, 446, 551, 951, 7872).
- (c) If no records are available, assume UNI arose in earliest taxable years of trust. Code §666(d).
- (d) Foreign taxes can be included for this purpose. Code §665(d)(2).
- (2) But credit against UNI accumulation distributions previously made for that year. Code §665(a)(1) and Code §666(a).
- b) Calculate accumulation distribution for the current tax year. Code §666(a).
- (1) This is essentially the excess of Code §661(a) distributions over DNI for the current tax year. Code §665(b).
- c) Allocate the accumulation distribution amount to prior tax years with UNI. Code §666(a).
- (1) Apply to oldest tax year with UNI first, and then second oldest, etc.
- (2) Gross up the distribution amount for each such year with UNI by taxes previously imposed on the trust in that year. Code §666(b) & (c).
- d) The accumulation distribution is deemed to occur in each prior year and is included in the income of the recipient beneficiary when paid, credited, or required to be distributed as if it was a current year Code §662(a)(2) distribution. Code §667(a).
- (1) Thus, U.S. beneficiaries will include the distribution in income. Code §667(a)(2).
- (2) However, the rate of tax is determined by averaging formula applied over the 5 years preceding the current tax year. Code §667(b).
- (a) For the 5 preceding tax years, throw out the years with the highest and lowest taxable income amounts of the beneficiary.
- (i) Augmented by accumulation distributions that increased prior years' taxable income.
- (b) Then divide the accumulation distribution by the number of prior tax years to which the accumulation distribution is allocated.
- (i) However, this number of prior tax years may be reduced for years with low amounts of UNI allocated to them. Code §667(b)(3). Amounts accumulated in that year are still part of the total accumulation distribution.
- (c) Add that fractional amount of the total accumulation distribution to the taxable income of the remaining 3 preceding tax years and determine the resulting tax increases for those years, and then determine the average tax increase for those three years.
- (d) Multiply the average tax increase by the number of prior tax years to which the accumulation distribution is allocated.
- (e) Reduce that figure by the amount of taxes deemed distributed to the beneficiary under Code §§665(b) and (c).
- (i) The beneficiary may not obtain a refund where the credit for taxes paid by the trust exceeds the partial tax obligation. Code §666(e).
- (f) The remaining amount is the net tax imposed on the accumulation distribution.
- (i) Subject to adjustment for estate and GST taxes attributable to the partial tax. Code §667(b)(6).
- (a) For example, assume the trust sold property during the beneficiary's lifetime, but the beneficiary died before the gain was distributed so that the gain was included in the beneficiary's estate as income in

respect of a decedent. The ultimate recipients of the gain would be able to reduce their tax on the distribution by a ratable portion of the estate or generation-skipping taxes paid on the UNI of the trust.

(3) Are special rules for multiple trusts and foreign taxes. Code §§667(c) & (d).

(4) U.S. beneficiaries will thus be taxed on the accumulation distribution at ordinary income rates, since there is no provision for the pass-through of character.

(a) Foreign beneficiaries will get the benefit of a character pass-through. Code §667(e).

(b) Implications:

(i) No preferential capital gains rates.

(ii) Distribution will lose any applicable foreign income character and thus may reduce otherwise available foreign tax credits.

(iii) Distribution will lose passive activity income character and thus may not allow for offset by passive losses.

(c) However, tax-exempt municipal bond interest should keep its tax-free character. Code §643(a)(5).

4. Observations.

a) There can be no accumulation distribution in any year in which total distributions do not exceed trust accounting income. A "simple" trust generally avoids the problem.

b) Nonresident alien beneficiaries are subject, on items of income that are otherwise taxable to an NRA.

c) Since foreign trusts include capital gains in DNI, undistributed capital gains are included in undistributed income.

d) There is no minority exception for younger beneficiaries. Therefore, accumulation of income during minority is a problem.

5. Traps!

a) Beneficiary of foreign trust is a 5 year old U.S. person. The trustee accumulates the income of the trust until the beneficiary reaches age 18, and then distributes it.

(1) Throwback rules apply - there is no exception for accumulations while there is a minor beneficiary.

b) Foreign trust sells a condominium for a \$500,000 gain on 11/1/2010. On 6/30/2011, it distributes the proceeds of the sale to a U.S. beneficiary.

(1) Capital gain goes into DNI. In 2010 this DNI was not distributed, so there was an accumulation. In 2011, there is an accumulation distribution. As an accumulation distribution, the accumulated capital gain loses its character and is taxed as ordinary income to the U.S. beneficiary.

C. Interest Charge On Accumulation Distributions.

1. Interest is charged on accumulation distributions.

2. Rate of Interest.

a) Use rates and method of interest under Code §6621 applicable to underpayments of tax.

b) For portion of period which occurs before 1/1/96, use 6% (with no compounding).

3. Mechanics.

a) Identify the tax years that have undistributed net income.

(1) QUERY WHETHER 668*A(*5 HAS A DIFFERENT ALLOCATION FORMULA)

b) For each such year, multiply the UNI for that year by the number of years away that year is from the current year of distribution.

(1) But exclude years in which the beneficiary was a nonresident alien. Code §668(a)(4).

- c) Add up all those products.
- d) Divide that sum by the aggregate UNI of all years.
- e) Multiply the result by the partial tax under Code §667(b) (after tax credits) and the applicable Code §6621 interest rate.
- f) The result is the applicable interest charge.
- g) Effect: Creates a weighted number of years for which interest should be charged, based on the years with UNI and the relative amounts of UNI in each year.

4. Misc.

- a) Interest is not deductible.
- b) Maximum interest charge is limited so that interest and tax does not exceed 100% of the accumulation distribution.

5. Traps!

- a) Foreign trust accumulates foreign source for 15 years. It then distributes the income to a U.S. beneficiary.
 - (1) The interest charge is so high that between tax on the accumulation distribution and interest, almost all of the distribution is taxed away.

IV. GAIN ON FUNDING OF FOREIGN TRUST.

A. History.

1. In 1997 new Code § 684 replaces former Code §1491 excise tax.
2. New Code §684 applies to transfers after August 4, 1997.

B. Elements.

1. Transfer of property,

- a) Direct, indirect, or constructive transfer. Treas. Regs. §1.684-2(a).
 - (1) Example of "indirect:" transferring property first to an intermediary, and the intermediary makes the transfer to the trust. Treas. Regs. §1.684-2(b)(2), Ex. 1.
 - (2) Example of "constructive:" Termination of grantor trust status of a foreign trust when there was a U.S. grantor. Treas. Regs. §1.684-2(e)(2), Ex. 2.

2. By a U.S. person,

- a) Use regular Code §7701(a)(30) definition.
- b) Including Code §6013(g) election by NRA to be treated as a resident alien. Treas. Regs. §1.684-1(b)(1).

3. To a foreign estate or trust, and

4. Treated as a sale or exchange, and gain recognized.

C. Exceptions.

1. Transfer to a grantor trust to the extent a U.S. person is treated as the owner under Code §671 (including §679).
2. Code §501(c)(3) foreign trust.
3. Transfers at death that result in a basis step-up under Code §1014(a).

- a) Thus, while 2010 was a problematic year, with the restoration of estate taxes and basis step-up (absent an election out of estate tax), most transfers at death will not trigger gain recognition.

b) Since IRD items do not get a basis step-up, they can be triggered at death.

4. Transfers for fair market value to unrelated trusts.

5. Distributions to a trust by an entity other than a trust and certain other special forms of entities.

D. Nonobvious Applications.

1. Transfer by a U.S. estate.

2. Conversion of a domestic trust to a foreign trust.

a) Deemed to occur on same day, but immediately before, conversion to a foreign trust. Treas. Regs. §1.684-4(b).

b) Exception for "inadvertent migrations." Treas. Regs. §1.684-4(c).

3. Foreign grantor trust with U.S. grantor ceases to be a grantor trust (including death).

4. Transfers of property to entities owned by a foreign trust.

E. Observations.

1. Loss is not recognized.

a) Gain recognized on an asset by asset basis - no offset for losses. Treas. Regs. §1.684-1(a)(2).

2. Irrelevant whether the foreign trust has U.S. beneficiaries.

a) Except to the extent that it may create a grantor trust under Code §679.

3. Receipt of partial consideration will not usually change the result, nor the amount of gain.

a) A transfers property that has a fair market value of \$1000X to foreign trust in exchange for \$400X of cash. A's adjusted basis in the property is \$200X. A recognizes gain at the time of the transfer equal to \$800X. Treas. Regs. §1.684-1(d), Ex. 3.

4. Such deemed transfers are subject to reporting requirements under Code §6038.

F. Traps!

1. Joe, a U.S. person, sets up a revocable trust in Nevis for credit protection purposes. The trustee is a Nevis bank. Joe dies.

a) Gain triggered.

b) But subject to reduction for basis step-up at death.

2. U.S. domestic trust. U.S. trustee dies, and Uncle Jose, a resident of Panama, takes over as successor trustee.

a) Conversion of trust from a domestic trust to a foreign trust triggers gain recognition.

3. Foreign trust has a U.S. grantor and a U.S. mandatory income beneficiary, and is thus treated as a grantor trust under Section 679. U.S. beneficiary dies, and Mexican daughter of beneficiary succeeds as a beneficiary.

a) Conversion out of grantor trust status triggers gain recognition.

4. U.S. grantor gifts a portfolio of securities with \$1 million in accrued gains and \$1 million in accrued losses to a nongrantor foreign trust.

a) \$1 million in gains recognized. No offset permitted - losses not recognized under Section 684.

5. U.S. person sells a Bahamas condominium to a foreign trust. The property is worth \$1 million, and the U.S. person has a \$500,000 basis in it. The sales price is \$900,000.

a) All \$500,000 in gain is recognized.

V. GRANTOR TRUSTS

A. U.S. Grantors - When Is There A Grantor Trust?

1. Apply usual grantor trust rules to determine if one exists. Code §§671-8.

2. Foreign trust funded by a U.S. person with a U.S. beneficiary. Code §679.

a) Thus, trust need not otherwise meet the traditional grantor trust rules of Subchapter J.

b) When will a trust be considered to have a U.S. beneficiary?

(1) The test is made annually. Treas. Regs. §1.679-2(a)(1).

(2) It is defined in the negative. A U.S. beneficiary will be deemed to exist unless:

(a) Under the trust terms, no part of income or corpus may be paid or accumulated to or for the benefit of a U.S. person, and

(i) Income will be treated as being accumulated for a U.S. person even if that person's interest is contingent on a future event. Code §679(c)(1).

(a) Thus, merely contingent U.S. person beneficiaries will be enough (at least if income is being accumulated).

(ii) It does not matter if no income or corpus is actually distributed to a U.S. person. Treas. Regs. §1.679-2(a)(2)(i).

(iii) Exception for negligible interests.

(a) A person who is not named as a beneficiary and is not a member of a class of beneficiaries as defined under the trust instrument is not taken into consideration if the U.S. transferor demonstrates to the satisfaction of the Commissioner that the person's contingent interest in the trust is so remote as to be negligible. Treas. Regs. §1.679-2(a)(2)(ii).

(b) However, this exception is not applicable to such a person if they are also a discretionary beneficiary. Id.

(iv) The Regulations provide 13 examples of situations that provide guidance on when there is a potential beneficiary and the exception for negligible interests. Treas. Regs. §1.679-2(a)(2)(iii).

(b) If the trust were terminated at any time in the taxable year, no part of the income or corpus could be paid to or benefit a U.S. person. Code §679(c)(1); Treas. Regs. §1.679-2(a)(1).

(3) Attribution of ownership can occur through foreign corporations, foreign partnerships, foreign trusts, and foreign estates. Code §679(c)(2). A U.S. person beneficiary will be deemed to exist as to amounts paid to or accumulated for:

(a) A controlled foreign corporation,

(b) A foreign partnership with a U.S. person partner, or

(c) A foreign trust or foreign estate with a U.S. beneficiary.

(4) When a trustee or other person has discretion to determine beneficiaries (e.g., under a power of appointment), a U.S. beneficiary will be deemed to exist, unless:

(a) The trust terms specifically identify the class of persons, and none of those persons are U.S. persons in the taxable year. Code §679(c)(4).

(b) Thus, powers of appointment are a danger.

(c) Powers to amend the foreign trust to benefit a U.S. person, either under the instrument or applicable local law, may also trigger the existence of a U.S. beneficiary. Treas. Regs.

§1.679-2(a)(4)(ii).

(5) Oral or written agreements or understandings that effectively result in a U.S. person beneficiary will be treated as trust terms. Code §679(c)(5).

(a) Such as letters of wishes, or actual distributions that are made. Treas. Regs. §1.679-2(a)(4)(i).

(6) Loans of cash or property to U.S. persons will result in such person being treated as a U.S. beneficiary. Code §679(c)(6).

(a) Except for loans repaid at a market rate of interest within a reasonable period of time or fair market value rent being paid.

(7) If a U.S. person transfers property to a foreign trust, the IRS may presume there is a U.S. beneficiary absent the submission of satisfactory information or evidence to the contrary. Code §679(d).

(8) Can also extend to U.S. persons who are indirect beneficiaries via agent or nominee relationships. Treas. Regs. §679-2(b)(2).

c) Extended "transfers."

(1) "Transfers" include indirect transfers if there is a principal purpose of tax avoidance. Treas. Regs. §1.679-3(c).

(2) They will also include an assumption or satisfaction by a person of a foreign trust's obligation to third party. Treas. Regs. §1.679-3(d)(1).

(3) Guarantees of trust obligations by a related U.S. person can constitute a transfer. Treas. Regs. §1.679-3(e)(1).

(4) Transfers by a related U.S. person to an entity owned by the foreign trust may constitute a transfer. Treas. Regs. §1.679-3(f).

d) Exceptions

(1) Excluding deferred compensation and charitable trusts. Code §§6048(a)(3)(B)(ii).

(2) Transfers by reason of death of transferor. Code §679(a)(2).

(3) Transfers by sale/exchange for fair market value. Code §679(a)(2)(B).; Treas. Regs. §1.679-4(b).

(a) In testing consideration, obligations of, and obligations guaranteed by, the trust, any grantor, owner, or beneficiary, or certain related persons, will not be counted unless they are "qualified obligations." Code §679(a)(3); §1.679-4(c).

(4) Not applicable to any transfer of property by reason of a beneficiary becoming a U.S. person more than 5 years after the transfer. Code §679(c)(3); Treas. Regs. §1.679-2(a)(3)(i).

e) Late entries to grantor trust status.

(1) Foreign grantor later becomes a U.S. person.

(a) If residency starting date is within 5 years of the date the grantor transferred property to the trust, such transfer will be deemed to have occurred on the residency starting date (and thus may trigger grantor trust status). Code §679(a)(4); §1.679-5(a).

(b) Determine residency start date using Code §7701(b)(2)(A) rules. Code §679(a)(4)(C).

(c) Property deemed transferred includes undistributed income. §1.679-5(b)(2).

(2) U.S. trust becomes a foreign trust.

(a) If there is a U.S. grantor and a U.S. beneficiary, the grantor will be treated as having made the transfer as of the day the trust becomes foreign, thus triggering grantor trust status. Code §679(a)(5).

(i) Property transferred includes undistributed net income. §1.679-6(b).

(3) Foreign trust with U.S. grantor acquires a U.S. beneficiary.

(a) This will trigger the operation of the grantor trust rules in the year it acquires a U.S. beneficiary, including by reason of a beneficiary becoming a U.S. person. Code §679(a)(1); Treas. Regs. §1.679-2(a)(3).

(i) But note above exception as to transfers that occurred more than 5 years before a foreign person becomes a U.S. person.

(b) Interestingly, if there was no U.S. beneficiary in the prior year, any undistributed income at the end of the year will be income to the U.S. grantor in the next year when there is a U.S. beneficiary. Code §679(b); Treas. Regs. §1.679-2(c)(1).

(i) This will trigger an accumulation distribution interest charge on the undistributed net income. Treas. Regs. §1.679-2(c)(1).

3. Traps!

a) U.S. grantor establishes an irrevocable foreign trust for his two grandchildren - one of whom is a U.S. citizen. The grantor retains no rights, powers, or interests over or in the trust.

(1) Grantor trust, even though it would not be if it was a domestic trust.

b) U.S. grantor establishes an irrevocable foreign trust for his two grandchildren - both of whom are foreign. The grantor retains no rights, powers, or interests over or in the trust. The grantor allows the grandchildren to use a trust condominium rent free - the parents of the grandchildren (who are U.S.) stay at the condominium with the grandchildren.

(1) Possible exposure to grantor trust treatment for rent-free use of trust property by a U.S. person.

c) Foreign trust established by foreign grandpa for his U.S. grandchildren. Trust borrows funds and U.S. child of grandpa guarantees repayment.

(1) Creates a U.S. "grantor" or transferor.

d) Foreign trust established by foreign grandpa for his U.S. grandchildren. Grandpa moves to the U.S. and becomes a U.S. resident alien by spending too many days in the U.S. under the substantial presence test.

(1) Grandpa now becomes a U.S. grantor if he moved to the U.S. within 5 years.

e) U.S. father establishes an irrevocable foreign trust for his child who has a green card. When the child reaches age 21, he gives up the green card and moves abroad.

(1) Trust was a grantor trust, but when child ceased to be a U.S. person, the grantor trust status ended. The father is treated at that time as having transferred all of the trust property to a foreign trust, thus subjecting himself to Section 684 gain on any appreciation.

B. Foreign Grantors.

1. Code §672(f) imposes limits on when a foreign person can be treated as owner under the grantor trust rules. Thus, a trust may appear to be a grantor trust under other Subchapter J rules, but will not be treated as such unless it meets the requirements for grantor trust status that apply when the grantor is foreign.

a) The situations where grantor trust will be allowed to operate with a nonresident alien grantor are:

(1) Revocable trust, or

(a) Power to revest absolutely in grantor; and

(i) Power to revest must be held for at least 183 days. Treas. Regs. §1.672(f)-3(a)(2).

(b) Revocation power exercisable solely by grantor (or, in the event of the grantor's incapacity, by a guardian or other person who has unrestricted authority to exercise such power on the grantor's behalf) (a) without approval or consent of any person, or (b) with consent of related or subordinate party who is subservient to grantor. Treas. Regs. §1.672(f)-3(a)(1).

(i) "Related or subordinate party" is defined under Treas. Regs. §1.672(c)-1. Treas. Regs. §1.672(f)-3(a)(1).

(ii) A related or subordinate party is subservient to the grantor unless the presumption in the last sentence of §1.672(c)-1 is rebutted by a preponderance of the evidence. Treas. Regs. §1.672(f)-3(a)(1).

(iii) See Treas. Regs. §1.672(f)-3(a)(4) examples for IRS interpretations of these general rules.

(2) Benefit trust, or

(a) Distributions (income or corpus) during lifetime of grantor can only be made to grantor or the grantor's spouse.

(i) A distribution in satisfaction of a legal obligation of the grantor or the grantor's spouse is considered a distribution to the grantor/grantor's spouse, but subject to some restriction for related party obligations. Treas. Regs. §1.672(f)-3(b)(2).

(3) Compensatory trust.

(a) A trust whose distributions are taxable as compensation for services rendered. See Treas. Regs. §1.672(f)-3(c).

b) Trusts that are not treated as a grantor trust by reason of Code §672(f) are taxed as regular trusts, subject to accumulation distribution and interest charge rules for accumulation distributions to U.S. beneficiaries. Treas. Regs. §1.672(f)-1(a)(1).

c) Code §672(f) applies to trusts for which the grantor is not a U.S. citizen or resident or a domestic corporation.

d) Code §672(f) applies to both domestic and foreign trusts.

e) Special Rules:

(1) A CFC is treated as a domestic corporation for this purpose. Code §672(f)(3)(A).

(2) A PFIC is treated as a domestic corporation for this purpose. Treas. Regs. §1.672(f)-2(a).

(3) These rules do not apply for purposes of Code §1297 PFIC rules in determining whether a corporation is a PFIC. Code §672(f)(3)(B). Treas. Regs. §1.672(f)-2(c)(1).

(4) Once a trust fails to be treated as a grantor trust under these rules, later qualification under these rules will not then allow grantor trust status. Treas. Regs. §1.672(f)-3(a)(3).

f) Grandfathered trusts.

(1) These limits on grantor trust status do not apply to any portion of a trust that was treated as owned by the grantor under Code §§676 and 677 on September 19, 1995, as long as the trust would continue to be so treated thereafter. However, the preceding sentence does not apply to any portion of the trust attributable to gratuitous transfers to the trust after September 19, 1995. Treas. Regs. §§ 1.672(f)-3(a)(3) and -3(b)(3).

2. If foreign owner under grantor trust rules, and trust has a U.S. beneficiary, such beneficiary is treated as grantor to the extent such beneficiary has made gratuitous transfers of property to such foreign grantor. Code §672(f)(5).

a) A 1996 amendment to Code §901(b)(5) states that the Treasury will promulgate regulations that deem such U.S. beneficiaries to have paid, for foreign tax credit

purposes, any foreign taxes paid by the grantor or the trust on the income that the U.S. beneficiaries are deemed to have received personally. Any resulting foreign tax credits would be subject to the appropriate limitations under Code §904(d). Regulations have not yet been promulgated.

3. Traps!

a) Foreign grandfather sets up a foreign trust for his family members, some of them are U.S. persons. The trust invests in real estate in Panama. On the advice of counsel, grandfather retains the right to change the beneficiaries of the trust, so as to create a grantor trust and thus have himself treated as the owner of the trust for U.S. tax purposes. He does this so any gains on the investments will be taxable to him, and not the trust (or its U.S. beneficiaries).

(1) Since such grantor trust power is not one of the 3 required powers, the trust will not be a grantor trust for U.S. tax purposes. The U.S. beneficiaries will be subject to U.S. income tax on any distributions they receive of investment gains (either in the year of the gains or under the accumulation distribution rules).

C. Conversion From Grantor Trust To Nongrantor Trust With U.S. Beneficiaries At Death Of Grantor.

1. Regular foreign trust taxation rules - including throwback rules, interest charge on accumulation distributions, and special DNI rules.

a) Consideration should be given to domesticating the trust to avoid these rules.

2. Unlikely that the throwback rules will apply to prior accumulations.

a) Code §671 says that only the portion of trust not taxable to the grantor is subject to subparts A through D, which subparts include the throwback provisions, etc.

3. If grantor was U.S., and then the grantor dies, this can be a Code §684 deemed transfer to the foreign trust that triggers gain recognition.

a) Treas. Regs. §1.684-2(e)(2), Ex. 2.

(1) Treas. Regs. §1.684-3(c) indicates that a Code §1014 basis adjustment will be permitted to apply, even though the Regulations treat the conversion as occurring immediately before death.

b) Can this be avoided by having trust become a domestic trust at death of grantor?

(1) Treas. Regs. §1.684-2(e)(1) can be read that this won't work because the conversion is deemed to occur "immediately before" the death of the grantor. However, policy would dictate this should not be a trigger, the "immediately before" is not found in the statute or committee report, and an argument could be made that there is "foreign trust" at the time of the death of the grantor so the Regulation may not apply by its language.

VI. FOREIGN CORPORATIONS OWNED BY A FOREIGN TRUST WITH U.S. BENEFICIARIES

A. Can Create A Controlled Foreign Corporation (CFC).

1. Code §958(a)(2) - stock owned through a foreign trust shall be considered as being owned proportionately by its beneficiaries. See also Treas. Regs. §1.958-1(b) & (c).

2. But query whether these rules are appropriate where discretionary beneficiaries have no voting rights. An argument can be made that it is okay to use Code §958(a) for purposes of testing for the "more than 50% in value by U.S. persons" test, but

still otherwise have to find a 10% or more U.S. shareholder that has true voting control.

B. Can Create A Passive Foreign Investment Company (PFIC).

1. Prop. Regs. §1.1291-1(b)(8)(iii)(C) attributes stock from trusts to beneficiaries on a "proportional" basis.

VII. MAJOR REPORTING REQUIREMENTS

A. Forms 3520.

1. Who must file Forms 3520?

a) U.S. beneficiaries (including grantor) who receive, directly or indirectly, any distribution from a foreign trust.

(1) A distribution is any gratuitous transfer of money or other property.

(a) It does not matter whether the trust is owned by another person under the grantor trust rules.

(b) It does not matter whether the recipient is a person designated as a beneficiary under the trust instrument.

(c) A distribution includes the receipt of a specific bequest under Code §663(a).

(2) Distributions include indirect and constructive transfers.

(a) Charges made on a credit card that are paid by foreign trust or guaranteed are secured by the assets of the foreign trust.

(b) Checks written by the US person on a foreign trust's bank account.

(c) Payments from a foreign trust in exchange for property or services in excess of the fair market value of the property or services.

(d) Loans from foreign trusts to a U.S. beneficiary, U.S. grantor, or any U.S. person related to the beneficiary or grantor, that are not qualified obligations. See Code §643(i); Notice 97-34.

(e) Use of trust property without fair market value consideration is considered a constructive distribution under the 2009 HIRE Act revisions. Code §643(i).

(f) Amounts paid to a U.S. person indirectly from a foreign trust of which the payer is not the grantor is treated as paid directly by the foreign trust. Code §§643(h)/665(c).

b) U.S. person creates a foreign trust or who directly or indirectly transfers money or other property during the tax year to a foreign trust.

(1) If a partnership or corporation makes a gratuitous transfer to a trust the partners or shareholders are generally treated as the grantors of the trusts unless the transfer is made for a business purpose. See instructions to Form 3520.

(2) If a trust makes a gratuitous transfer to another trust, the grantor of the transferor trust is treated as the grantor of the transferee trust except as to certain exercises of powers of appointment. See instructions to Form 3520.

c) U.S. owner of all or a portion of a foreign trust at any time during the tax year under the grantor trust rules.

d) Estate of a U.S. decedent if:

(1) Decedent makes a transfer to a foreign trust by reason of death, or

(2) The decedent was treated as the owner of any portion of a foreign trust immediately prior to death, or

(3) The decedent's estate included any portion of the assets of a foreign trust.

e) Foreign trust makes a loan of cash or marketable securities during the year to U.S. person who is a grantor or beneficiary of the trust that is reported as a "qualified obligation" - such U.S. person must file.

(1) See 1.679-4(d) and form instructions for definition of a qualified obligation.

f) U.S. owner of an outstanding obligation of a related foreign trust (or a person related to the trust) issued during the current tax year that was reported as a "qualified obligation."

(1) See 1.679-4(d) and form instructions for definition of a qualified obligation.

g) While not related to foreign trusts, U.S. persons who receive certain gifts or bequests from a foreign trust must also file.

2. Exceptions.

a) Transfers to foreign trusts described in Code §§402(b), 404(a)(4), or 404A.

b) Most fair market value transfers to a foreign trust.

(1) Unless transfers in exchange for obligations that are qualified obligations.

(2) Unless US transferor does not immediately recognize all of the gain on the property transferred.

(3) Unless it involves transfers with a US transferor that is related to the foreign trust.

(4) See Notice 97-34.

c) Transfers to foreign trusts that are recognized Code §501(c)(3) organizations.

d) Transfers to Canadian registered retirement savings plans or income funds under certain circumstances.

e) Distributions taxable as compensation for services rendered it reported as compensation income.

f) Transfers from foreign trusts to domestic trusts that are recognized Code §501(c)(3) organizations.

g) Domestic trusts that become foreign trusts to the extent the trust is treated as owned by one person after application of Code §672(f).

3. When?

a) On due date of income tax return (with extensions).

b) For US decedents, on due date of estate tax return (or the date such return would have been required if a return is not actually do).

4. Penalties?

a) Statute of limitations for assessment of any tax imposed with respect to any event or period to which the information required to be reported relates will not expire before the date that is three years after the date on which the required information is reported. Code §6501(c)(8).

b) For failure to report a transfer, penalty of 35% of the value of the property transferred.

c) For failure to report a distribution, penalty of 35% of the value of the distribution.

d) For failure of the US owner under the grantor trust rules to report trust activities and income, 5% of the value of the property deemed owned.

e) Additional penalties for continuing failures after IRS notice. See Code §6677.

f) However, no penalties will be imposed if the taxpayer can demonstrate reasonable cause and not willful neglect.

(1) The fact that a foreign country would impose penalties for disclosing the required information is not reasonable cause.

5. Misc.

- a) A separate Form 3520 must be filed for transactions with EACH foreign trust.
- b) Joint returns may be allowed if the filers file joint income tax returns.
- c) The returns must be consistent with any Form 3520-A filed by the foreign trust unless the inconsistency is reported on a Form 8082.

6. Traps!

a) Foreign grandfather has a revocable trust in the Bahamas. The trust makes a distribution to U.S. grandson.

(1) Reporting required - grantor trust status is irrelevant.

b) Foreign grandfather sets up a foreign trust for his grandchildren, some of whom are U.S. He gives credit cards to all the grandchildren, the bills of which are paid by the trust, even though they are not beneficiaries.

(1) Indirect/constructive transfer to U.S. person - reporting required.

c) Foreign grandfather sets up a foreign trust, which owns a house in Bermuda. The Bermuda house is used by the U.S. grandchildren on the college breaks.

(1) Rent-free use of trust property by a U.S. person triggers reporting.

d) U.S. grantor of a revocable foreign trust dies. The assets are included in his estate for estate tax purposes.

(1) Reporting required.

B. Forms 3520-A.

1. Annual return filed by a foreign trust with a U.S. owner under the grantor trust rules.

a) Each U.S. person that owns a part of the trust under the grantor trust rules is responsible for assuring compliance with filing requirements.

2. Purpose is to provide information to the U.S. owner so it can satisfy its annual reporting requirements.

3. Exception for Canadian registered retirement savings plans and Canadian registered retirement income funds.

4. Due by the 15th day of the third month after the end of the trust's tax year.

a) Unless an extension is granted. See Form 7004.

5. Penalties.

a) The US owner is subject to a penalty equal to 5% of the gross value of the portion of the trust's assets treated as owned by the US person. Code §6677(b).

b) Exception for reasonable cause and not willful neglect.

(1) The fact that a foreign country would impose penalties for disclosing the required information is not reasonable cause.

6. Allows for appointment of U.S. agent to respond to IRS requests to examine records or produce testimony or IRS summonses.

a) Alternatively, the trustee can attach all written and oral agreements and understandings relating to the trust, the trust instrument, and gives IRS right to determine how much of the trust assets must be taken into account by the u.s. owner.

7. Requires income statement and balance sheet along with statement providing income attributable to the U.S. owner

8. Includes preparation and distribution of Foreign Grantor Trust Owner Statement, which is delivered to each U.S. person owner.

a) Deliver by the 15th day of the third month after the end of the trust's tax year.

9. Includes preparation and distribution of Foreign Grantor Trust Beneficiary Statement which is distributed to each U.S. beneficiary who receives a distribution from the foreign trust during the tax year.

a) But not for any portion of the trust for which that U.S. person is treated as the owner under the grantor trust rules.

b) Deliver by the 15th day of the third month after the end of the trust's tax year.

C. Beneficiary Reporting To Properly Report, Or Avoid Accumulation Distributions - Foreign Grantor Trust Beneficiary Statements And Foreign Nongrantor Trust Beneficiary Statements And Form 4970.

1. Under Code §6048(c)(2), any distribution of income or principal from a foreign trust to a U.S. beneficiary is treated as an accumulation distribution includible in the gross income of the recipient unless adequate records are provided to determine the proper treatment of the distribution. Thus, absent a proper submission from a beneficiary, a distribution from a foreign trust will be taxable to the beneficiary under Code §§665–668, together with the interest charge under Code §668. See Notice 97-34.

2. A U.S. beneficiary who receives a complete Foreign Grantor Trust Beneficiary Statement with respect to a distribution should treat the distribution as a nontaxable gift from the owner of the trust. Such a Statement is prepared with the Form 3520-A.

3. A U.S. beneficiary who receives a complete Foreign Nongrantor Trust Beneficiary Statement that provides adequate information to determine the U.S. tax consequences of the distribution from the foreign trust may determine the tax consequences of the distribution on the basis of the actual status of the income as DNI or undistributed net income (UNI), without regard to the default rule. A U.S. beneficiary may not, however, rely on a beneficiary statement that he or she knows or has reason to know to be incorrect.

a) This Statement is not part of any return and must be prepared independently. It is attached to the beneficiary's Form 3520 filing. See the Line 30 instructions to Form 3520 for what must be contained in the Statement.

(1)

b) See Code §6048(c) and IRS Notice 97-34. The foreign trust is supposed to prepare this statement. No penalties are imposed on the foreign trust for failure to provide it, but the U.S. beneficiary may be subject to penalties if he or she does not obtain it.

c) The Statement will also assist U.S. beneficiaries in determining the amount of any available foreign tax credits.

4. A U.S. beneficiary who receives an accumulation distribution from a nongrantor foreign trust should file Form 4970, as an attachment to the Form 3520 to compute the tax and interest charge.

D. Form TD F 90-22.1

1. Filings relating to foreign trusts.

a) A U.S. beneficiary of a foreign trust with a beneficial interest in more than 50% of the assets or income of a trust that owns foreign financial accounts must file an annual Form TD F 90-22.1 Report of Foreign Bank and Financial Accounts.

(1) Thus, the presence of multiple beneficiaries (2 or more) with equal interests presumably will avoid meeting the more than 50% threshold.

b) A U.S. grantor of a foreign trust with foreign accounts if there is a trust protector.

c) Proposed 31 CFR §103.24(e)(2)(iii) would provide that a U.S. person who is the settlor of a trust and has an ownership interest in a trust account for U.S. income tax purposes under Code §§671 - 679 has a financial interest in the account for purposes of these rules.

2. A financial account includes any bank, securities, derivatives, mutual fund, or other financial instruments account.

3. The account must exceed \$10,000.

4. Due by June 30 of the following year.

5. Watch for additional, similar filings under HIRE Act foreign reporting rules - Form 8938.

6. Watch for need to also report accounts held by any entities controlled by the foreign trust.

E. Form 56.

1. A trustee should notify the IRS of the commencement of a trusteeship by filing a Form 56. Code §6903.

2. There are no penalties for nonfiling. However, if not filed, the IRS will send correspondence to the last known address of the trust and the trustee may be bound by notices not actually received by it.

a) As a practical matter, these are not always filed.

F. Form 1040NR.

1. If a foreign trust has income taxable by the U.S. it is obligated to file the return.

2. Due by the 15th day of the fourth month after the end of the trust's taxable year, or the sixth month if the trust has no office in the U.S.

G. HIRE Act Disclosures - Form 8938.**1. Form 8938 Reporting**

a) Introduction.

(1) Enacted under FATCA.

(2) First active for 2011 tax years.

(3) Does not eliminate FBAR reporting.

(4) Code provisions - Code §6038D.

(5) Regulations

(a) Issued in TD 9567, 12/14/2011.

b) Who Must Report.

(1) Any individual who holds an interest in a "specified foreign financial asset (SFFA)" that exceeds the filing threshold. Code §6038D(a). Regulations provide reporting applies to "specified persons" with such an interest. [Treas. Regs. §1.6038D-2T(a)(1)]

Restatement: (a) a specified person, (h) has an interest, (c) in specified foreign financial assets, (d) that exceed the filing threshold

(2) (a) a "specified person"

(a) A "specified individual" or a "specified domestic entity" [Treas. Regs. §1.6038D-1T(a)(1)]

(i) "specified individual" [Treas. Regs. §1.6038D-1T(a)(2)]

(a) U.S. citizen, resident alien, nonresident alien with election under Code §6013(g) or (h), or nonresident alien who is a bona fide resident of Puerto Rico or a section 931 possession

(b) Resident aliens who elect to be taxed as a resident of a foreign country under the provisions of an income tax treaty are STILL specified individuals who must report [Instructions for Form 8938, November 2011]

(b) Presently, restricted to individuals. Domestic entities covered only to extent provided in future regulations, which are anticipated to be issued for domestic entities formed or availed of to hold SFFA's that exceed the filing threshold. [Instructions for Form 8938, November 2011]

(i) Query whether can avoid reporting through use of domestic entities until then

(a) Proposed regulation indicates they will apply to tax years starting after 2011, so risky

(3) (b) has an "interest"

(a) General Rule: If any income, gains, losses, deductions, credits, gross proceeds, or distributions attributable to the holding or disposition of the specified foreign financial asset are or would be required to be reported, included, or otherwise reflected by the specified person on an annual return [Treas. Regs. §1.6038D-2T(a)(1)]

(i) But not necessarily in the current tax year

(ii) Including by reason of a parent making an election under Code §1(g)(7) to include a child's unearned income in the parent's gross income [Treas. Regs. §1.6038D-2T(b)(1)]

(b) Interests owned through a disregarded entity are treated as owned by the tax owner [Instructions for Form 8938, November 2011]

(c) Generally, a person is not treated as having an interest in any foreign financial asset held by a corporation, partnership, trust or estate solely by reason of being a shareholder, partner, or beneficiary [Treas. Regs. §1.6038D-2T(b)(3)]

(i) Except if owner of a trust under grantor trust rules or certain other trusts [Treas. Regs. §1.6038D-2T(a)(3)]

(a) Note that Treas. Regs. §1.6038D-7T(a)(2) (discussed below) provides an exception for Form 8938 reporting of the trust SFFA's at times. However, it would appear that the SFFA's of the trust are still counted for purposes of the filing threshold.

(ii) But consult Treas. Regs. §1.6038D-3T(c) to determine whether an interest in a foreign trust or foreign estate is itself a specified foreign financial asset that would need to be reported

(d) No interest exists as to SFFA's held in a financial account [Instructions for Form 8938, November 2011]

(i) **OBSERVATIONS:**

(a) Thus, it appears that SFFA's held through a U.S. financial account do not have to be reported. This is consistent with the Committee Reports, but a more explicit confirmation of this in the Instructions or regulations would be helpful.

(b) SFFA's held through a foreign financial account do not have to be reported, either. Of course, this does not relieve the taxpayer from reporting as to the foreign account itself.

(4) (c) in specified foreign financial assets (SFFA)

(a) See the definition of an SFFA below.

(5) (d) that meet or exceed the filing threshold

(a) If the aggregate of such assets exceeds \$50,000 (or such higher prescribed value). Code §6038D(a).

(i) Contrast this \$50,000 threshold with the \$10,000 FBAR threshold.

(ii) Regulations require filing if aggregate value exceeds \$50,000 on the last day of the taxable year, OR \$75,000 at any time during the taxable year [Treas. Regs. §1.6038D-2T(a)(1)]

(iii) Married filing jointly: \$100,000 on the last day of the year or \$150,000 during the year [Treas. Regs. §1.6038D-2T(a)(2)]

(iv) Qualified individual under Code §911(d)(1): \$200,000 (\$400,000 if married and filing jointly) on the last day of the year or \$300,000 (\$600,000 if married filing jointly) at any time during the year [Treas. Regs. §1.6038D-2T(a)(3)]

(a) Higher threshold granted due to expectation that such persons will have higher assets abroad

(v) Special rules if married filing joint return [Treas. Regs. §1.6038D-2T(a)(2) & (4)]

(vi) Married filing separately if living in the U.S. - use \$50,000/\$75,000 threshold [Instructions for Form 8938, November 2011]

(vii) Include in these totals assets that are exempt from reporting under Treas. Regs. §1.6038D-7T [Treas. Regs. §1.6038D-2T(a)(6)]

(a) But exclude assets excluded from reporting under Treas. Regs. §1.6038D-7T [Treas. Regs. §1.6038D-2T(a)(6)]

(b) Selling specified foreign assets before the end of the year will not avoid the filing requirement, if the "during the year" threshold was exceeded [Instructions for Form 8938, November 2011, Examples]

(c) If the IRS determines that an individual has a specified foreign financial asset, it can presume the \$50,000 threshold is met if insufficient proof is provided otherwise. Code §6038D(e).

(d) For purposes of calculating reporting thresholds, include 100% of value of property held jointly with others, with special rules for married persons. [Treas. Regs. §1.6038D-2T(c)(1)]

(i) But see Treas. Regs. §1.6038D-2T(c)(1)(ii) for special counting rules for married persons

(e) IRS can presume that filing threshold is exceeded if a specified person does not provide sufficient information on aggregate value of an account upon request by the IRS [Treas. Regs. §1.6038D-8T(d)]

(6) Exception - no annual return

(a) Filing not required if the specified person is not required to file an annual return [Treas. Regs. §1.6038D-2T(a)(7)]

(i) "Annual return" means an annual federal income tax return of a specified individual or an annual federal income tax return or information return of a specified domestic entity filed with the Internal Revenue Service under section 876, 6011, 6012, 6013, 6031, or 6037, and the regulations. [Treas. Regs. §1.6038D-1T(a)(11)]

(7) Reporting required even if none of the reported assets affect the taxpayer's tax liability for that year.

c) How to Report

(1) Attach Form 8938 to the individual's income tax return. Code §6038D(a).

(a) Married individuals who file a joint return must file a single Form 8938 reporting all specified foreign financial assets in which either have an interest [Treas. Regs. §1.6038D-2T(c)(2)(i)].

(2) Instructions refer to the "annual return" of the specified person

(a) Forms 1040, 1120, 1065, 1041, 1120-S, and 1040NR.

d) What Gets Reported - "Specified Foreign Financial Assets" Defined [Code §6038D(b)]

(1) SFFA includes:

(a) A "financial account" (FA) (using Code §1471(d)(2) definition) maintained by a "foreign financial institution" (FFI) (using Code §1471(d)(4) definition) [Treas. Regs. §1.6038D-3T(a)(1)]

(i) FA/financial account: [Instructions for Form 8938, November 2011]

- (a) A depository or custodial account, or
- (b) An equity or debt interest in a foreign financial institution (other than interests that are publicly traded)
- (c) Includes a FA in a financial institution organized in a possession [Treas. Regs. §1.6038D-3T(a)(2)]
- (ii) FFI/foreign financial institution, generally means a non-U.S. financial institution that: [Instructions for Form 8938, November 2011]
 - (a) Accepts deposits in the ordinary course of a banking or similar business, or
 - (b) Holds financial assets for the account of others as a substantial part of its business, or
 - (c) Engaged in business of investing, reinvesting, or trading in securities, partnership interests, commodities, or interests in such items
- (iii) Exceptions
 - (a) FA maintained by a U.S. payor [Treas. Regs. §1.6038D-3T(a)(3)(i)]
 - (I) A FINANCIAL ACCOUNT MAINTAINED BY A U.S. PAYOR, SUCH AS A DOMESTIC FINANCIAL INSTITUTION. [INSTRUCTIONS FOR FORM 8938, NOVEMBER 2011]
 - (II) INCLUDES DOMESTIC BRANCH OF A FOREIGN BANK OR FOREIGN INSURANCE COMPANY AND A FOREIGN BRANCH OR FOREIGN SUBSIDIARY OF A U.S. FINANCIAL INSTITUTION
 - (III) COMMENT: THIS IS A MAJOR EXCEPTION
 - (b) Mark-to-market election applies to all the holdings in the account [Treas. Regs. §1.6038D-3T(a)(3)(ii)]
 - (I) INSTRUCTIONS DESCRIBE THIS AS AN ACCOUNT MAINTAINED BY A DEALER OR TRADER IN SECURITIES OR COMMODITIES
- (iv) The account gets reported, not the specific assets within the account [Treas. Regs. §1.6038D-3T(a)(1)]
- (v) Items specifically included as an FFI:[Instructions for Form 8938, November 2011]
 - (a) Foreign mutual funds
 - (b) Foreign hedge funds
 - (c) Foreign private equity funds
- (b) An asset not held in an account of a financial institution, if held for investment, and one of: [Treas. Regs. §1.6038D-3T(b)(1)]

 - (i) Stock or securities issued by a non-U.S. person
 - (ii) Financial instrument or contract with an non-U.S. issuer or counterparty
 - (a) Includes a note, bond, or other form of indebtedness issued by a foreign person
 - (b) Includes swaps with foreign counterparties
 - (c) Includes options and derivative instruments for currency or commodities if a foreign counterparty or issuer
 - (iii) An interest in a non-U.S. entity
 - (a) Thus, ownership of the following are reportable:
 - (I) STOCK IN A FOREIGN CORPORATION
 - (II) PARTNERSHIP OR MEMBER INTEREST IN A FOREIGN PARTNERSHIP OR LLC
 - (III) INTEREST IN A FOREIGN TRUST OR FOREIGN ESTATE
 - (IV) COMMENT: DOES THIS ONLY APPLY TO CURRENT BENEFICIARIES ONLY, OR DOES IT INCLUDE REMAINDERMEN AND CONTINGENT OR MORE REMOTE BENEFICIARIES?
 - (V) INTEREST IN AN OFFSHORE FOUNDATION
 - (b) But as to foreign trusts and estates, an interest is a SFFA only if the person knows or has reason to know based on readily accessible information [Treas. Regs. §1.6038D-3T(c)]
 - (I) RECEIPT OF A DISTRIBUTION CONSTITUTES KNOWLEDGE
 - (II) COMMENT: THUS, THIS PROVISION PRESUMABLY PROTECTS A BENEFICIARY OF A FOREIGN TRUST FROM HAVING TO REPORT IF THE INDIVIDUAL IS NOT AWARE IT IS A BENEFICIARY
 - (c) The instructions also include an interest in a foreign pension plan or foreign deferred compensation plan.
 - (iv) Exceptions
 - (a) Mark-to-market election applies to the asset [Treas. Regs. §1.6038D-3T(b)(2)]
 - (b) Interest in a social security, social insurance or other similar program of a foreign government [Instructions for Form 8938, November 2011]
 - (v) "Held for investment" means not used or held for use in a trade or business of the specified person [Treas. Regs. §1.6038D-3T(b)(3)]
 - (a) Thus, trade or business use is an exception from reporting
 - (b) Nontraditional definition - defined by exclusion

(c) "Trade or business" use includes: [Treas. Regs. §1.6038D-3T(b)(4)]

(I) FOR PROMOTING A TRADE OR BUSINESS

(II) ACQUIRED AND HELD IN THE ORDINARY COURSE OF BUSINESS, SUCH AS AN ACCOUNT OR NOTE RECEIVABLE

(III) OTHERWISE HELD IN A DIRECT RELATIONSHIP TO THE BUSINESS

(IV) FOCUS ON "PRESENT NEED" IN THE BUSINESS

(V) NO "PRESENT NEED" IF HELD FOR FUTURE BUSINESS, PLANT REPLACEMENT OR FUTURE CONTINGENCIES

(VI) STOCK IS NEVER HELD FOR "PRESENT NEED"

(VII) PRESUMED WITHIN THIS IF THE ASSET WAS ACQUIRED WITH FUNDS GENERATED BY THE BUSINESS (OR AFFILIATED GROUP BUSINESS), THE INCOME FROM THE ASSET IS RETAINED OR REINVESTED IN THE BUSINESS, AND BUSINESS PERSONNEL EXERCISE SIGNIFICANT MANAGEMENT AND CONTROL OVER THE INVESTMENT

(VIII) COMMENT: TREASURY IS APPARENTLY CONCERNED ABOUT THE SCOPE OF THIS EXCEPTION AND HAS DEVOTED MUCH INK TO IT. UNFORTUNATELY, TO USE THE EXCEPTION THE PREPARER WILL HAVE TO UNDERTAKE A JUDGMENT CALL ON WHETHER THE ASSET FITS THE CRITERIA.

(2) It does not matter if the assets have no positive value. [Treas. Regs. §1.6038D-2T(a)(5)]

(3) Exceptions

(a) Duplicative Reporting - SFFA is reported on one of these forms by the specified person in that tax year: [Treas. Regs. §1.6038D-7T(a)(1)]

(i) Form 3520, "Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts" (in the case of a specified person who is the beneficiary of a foreign trust);

(ii) Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations";

(iii) Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund";

(iv) Form 8865, "Return of U.S. Persons With Respect to Certain Foreign Partnerships"; or

(v) Form 8891, "U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans

(vi) But FBAR not included

(vii) BUT must report on the Form 8938 on which form the asset is reported [Treas. Regs. §1.6038D-7T(a)(1)(ii)]

(viii) But still counted towards filing threshold [Instructions for Form 8938, November 2011]

(b) Owner of a foreign grantor trust, as to SFFA's owned by the trust, if: [Treas. Regs. §1.6038D-7T(a)(2)]

(i) The specified foreign person reports the trust on a timely filed Form 3520 for the tax year;

(ii) The trust timely files Form 3520-A for the tax year; and

(iii) The specified person reports the filing of the Forms 3520 and 3520-A on its Form 8938

(c) Owner of a domestic grantor trust is not required to report SFFA's of the domestic trust if: [Treas. Regs. §1.6038D-7T(b)]

(i) The trust is a widely-held fixed investment trust under Treas. Regs. §1.671-5, or

(ii) A bankruptcy liquidating trust.

(iii) Thus, SFFA's of other, more typical domestic grantor trusts, are reportable

(d) Bona fide residents of a U.S. possession can exclude reporting of certain assets [Treas. Regs. §1.6038D-7T(c)]

(4) Questions

(a) Foreign real estate

- (i) Directly owned interests do not appear to be reportable.
 - (a) But indirect reporting if held in a reportable foreign entity
 - (b) Foreign issuer life insurance or annuities.

 - (i) Does appear to be "a financial instrument or contract with an non-U.S. issuer or counterparty"
 - (a) But is it always "held for investment?" Probably, per limited definition of "held for investment" meaning not held in a trade or business.
 - (c) Gold

 - (i) Direct ownership in a foreign safe deposit box would appear not to be covered.
 - (ii) More murky if held in a shared allocation account or other type of "account" with a non-U.S. institution.
- e) Information to Include on the Report. Code §6038D(c).
- (1) For an "account," the name and address of the financial institution in which such account is maintained and the number of such account [Treas. Regs. §1.6038D-4T(a)(1)]
 - (2) For a "stock or security," the name and address of the issuer and such information as is necessary to identify the class or issue of which such stock or security is a part [Treas. Regs. §1.6038D-4T(a)(2)]
 - (3) For a financial instrument or contract— [Treas. Regs. §1.6038D-4T(a)(3)]

 - (a) Such information as is necessary to identify such instrument, contract, or interest, and
 - (b) The names and addresses of all issuers and counterparties with respect to such instrument, contract, or interest.
 - (4) For an interest in a foreign entity, information that identifies the interest, including the name and address of the entity [Treas. Regs. §1.6038D-4T(a)(4)]
 - (5) The maximum value of the SFFA during the year while held by the specified person [Treas. Regs. §1.6038D-4T(a)(5)]
 - (6) Depository or custodial accounts under Code §1471(d)(2), info whether the account was opened or closed [Treas. Regs. §1.6038D-4T(a)(6)]
 - (7) Date of acquisition or disposition of nonaccount assets. [Treas. Regs. §1.6038D-4T(a)(7)]
 - (8) Amount of income, gain, loss, deduction or credit recognized with respect to the SFFA and the schedule on which it is reported [Treas. Regs. §1.6038D-4T(a)(8)]
 - (9) The foreign currency exchange rate and the source of rate, used to calculate maximum reported value [Treas. Regs. §1.6038D-4T(a)(9)]
 - (10) For SFFA's excepted from reporting under Treas. Regs. §1.6038D-7T(a), the number of Forms 3520, 5471, 8621, 8865, 8891 or other similar forms [Treas. Regs. §1.6038D-4T(a)(10)]
 - (11) NOTE: Per the Committee Report, an individual is not required to identify separately any stock, security instrument, contract, or interest in a foreign financial account disclosed under the provisions.
 - (12) Form 8938 Comments

 - (a) If all SFFA's are reported on other forms, still need to fill out the Form 8938, but only Part IV.
 - (b) Copy Part's I and II for as many separate accounts and assets to report.
- f) Valuation Aspects
- (1) Need values to determine filing thresholds and reported maximum values.
 - (2) General rule - report values at "fair market value" [Treas. Regs. §1.6038D-5T(a)]

(3) Not as rigorous as Form 706 or 709 - can use a "reasonable estimate" [Treas. Regs. §1.6038D-5T(b)(1)]

(a) Can rely on annual periodic account statements if no knowledge or reason to know they are not a reasonable estimate of value [Treas. Regs. §1.6038D-5T(d)(1)]

(i) COMMENT: This will be of benefit only to brokerage and similar type statements

(b) Instructions specifically provide that an appraisal by a third party is not necessary.

(i) COMMENT: This is very helpful

(ii) Preamble to regulations indicate that can rely on publicly available information from reliable or verifiable sources, but still no need for an appraisal if such sources are not available.

(4) Must convert foreign currency values to dollar values. [Treas. Regs. §1.6038D-5T(b)(2)]

(a) Use U.S. Treasury Department's Financial Management Service foreign currency exchange rate. [Treas. Regs. §1.6038D-5T(c)(1)]

(i) [Http://www.fms.treas.gov/intn.html](http://www.fms.treas.gov/intn.html)

(b) Use the rate on the last day of the year. [Treas. Regs. §1.6038D-5T(c)(4)]

(i) Even if the asset was sold or disposed of during the year. [Instructions for Form 8938, November 2011]

(5) Encumbrances?

(a) Not mentioned, but presumably use gross values, without reduction for encumbrances and pledges

(6) Value cannot be treated as less than zero. [Treas. Regs. §1.6038D-5T(a)(b)(3)]

(7) Special rules.

(a) Except for certain special assets, can use value as of last day of the year, unless reason to know it is not a reasonable estimate. [Treas. Regs. §1.6038D-5T(f)(1)]

(i) For example, if readily available price information is available for publicly traded foreign stock, you should use the highest value during the year and not the value on the last day of the year. [Instructions for Form 8938, November 2011]

(b) Beneficial interest in a foreign trust. [Treas. Regs. §1.6038D-5T(f)(2)]

(i) "Maximum value" is sum of:

(a) FMV on last day of the year of all currency and other property distributed during the year to the specified person, and

(b) Value as of the last day of beneficiary's right to receive mandatory distributions as determined under Section 7520.

(I) THUS, NEED TO DO AN ACTUARIAL COMPUTATION USING IRS TABLES.

(II) AND TO DO THIS COMPUTATION, YOU WILL NEED VALUE OF UNDERLYING ASSETS OF THE TRUST.

(ii) Thus, if no mandatory distribution rights, it appears you are off the hook to do a valuation based on all underlying trust assets.

(a) But still need to otherwise determine full value of beneficial interest as far as computing filing thresholds, unless specified person does not know or have reason to know based on readily accessible information the FMV of the interest (in which case they can use the first "maximum value rule" rule relating to amounts distributed only). [Treas. Regs. §1.6038D-5T(f)(2)(ii)]

(I) THUS, IF THIS IS THE ONLY SFFA AND IT HAS DISCRETIONARY INTERESTS ONLY, PRESUMABLY NO REPORTING. BUT PERHAPS REPORT ANYWAY TO BE SAFE.

(c) Interests in estates, pension plans, and deferred compensation plans. [Treas. Regs. §1.6038D-5T(b)(3)]

(i) If the specified person does not know or have reason to know based on readily accessible information such fair market value, the "maximum value" to be reported is the fair market value, determined as of the last day of the taxable year, of the currency and

other property distributed during the taxable year to the specified person as a beneficiary or participant.

- (a) Same rule for determining value for filing threshold computations
- (b) If no distributions and no knowledge based on readily accessible information, use a zero value [Instructions for Form 8938, November 2011]

g) Penalties. Code §6038D(d); Treas. Regs. §1.6038D-8T.

(1) \$10,000 penalty.

(a) Married persons filing a joint return are treated as a single person, with joint and several liability. [Treas. Regs. §1.6038D-8T(b)]

(2) For continuing failure 90 days after IRS mails a notice of failure to file, \$10,000 for each subsequent 30 day failure, up to \$50,000 maximum.

(3) Code §662(j) imposes an accuracy-related penalty in the case of any portion of an underpayment attributable to any undisclosed foreign financial asset understatement. [Treas. Regs. §1.6038D-8T(f)(1)]

(a) 40% of the underpayment

(b) 75% if fraud

(c) Examples: Shares of foreign corporation not reported and a dividend was paid or the shares were disposed of for a gain

(4) IRS can presume that filing threshold is exceeded if a specified person does not provide sufficient information on aggregate value of an account upon request by the IRS [Treas. Regs. §1.6038D-8T(d)]

(5) There is a reasonable cause exception.

(a) However, foreign law prohibitions against disclosure of the required information cannot be relied upon to establish reasonable cause.

(6) Extended statute of limitations if SFFA's not reported

(a) Indefinite Suspensions [Code §6501(c)]

(i) Summary.

(a) Generally, taxes are required to be assessed within 3 years after a taxpayer's return is filed.

(b) However, under prior law the statute of limitations did not run as to certain foreign transactions if certain required information returns were not filed

(c) Instead, such statute of limitations did not expire until 3 years after the required information was furnished to the IRS.

(d) FATCA added Code §6038D reporting to the list of failures that suspends the statute of limitations

(I) ELECTION BY A PFIC SHAREHOLDER TO HAVE THE PFIC TAXED AS A QUALIFYING ELECTING FUND (QEF) (CODE § 1295(B));

(II) ANNUAL REPORT BY U.S. PERSON THAT IS A PFIC SHAREHOLDER (NEW UNDER THE ACT) (CODE §1298(F));

(III) SELF-REPORTING OF SPECIFIED FOREIGN FINANCIAL ASSETS (NEW UNDER THE ACT) (CODE §6038D).

(e) The Act now clarifies that the suspension of the statute of limitations applies with respect to any "tax return, event, or period" to which the information relates.

(I) HOWEVER, PURSUANT TO AN AMENDMENT BY THE EDUCATION JOBS ACT OF 2010, IF THE FAILURE TO REPORT WAS DUE TO REASONABLE CAUSE AND NOT WILFUL NEGLIGENCE, ALL ITEMS ON THE RETURN ARE NOT SUBJECT TO THE EXPANDED STATUTE - ONLY ITEMS RELATED TO THE FAILURE.

(II) SUCH RELATED ITEMS INCLUDE (1) ADJUSTMENTS MADE TO THE TAX CONSEQUENCES CLAIMED ON THE RETURN WITH RESPECT TO THE TRANSACTION THAT WAS THE SUBJECT OF THE INFORMATION RETURN; (2) ADJUSTMENTS TO ANY ITEM TO THE EXTENT THE ITEM IS AFFECTED BY THE TRANSACTION EVEN IF IT IS OTHERWISE UNRELATED TO THE TRANSACTION; AND (3) INTEREST AND PENALTIES THAT ARE RELATED TO THE TRANSACTIONS OR THE ADJUSTMENTS MADE TO THE TAX CONSEQUENCES.

(ii) Code.

(a) .

(iii) Comments.

(a) Thus, the filing of an income tax return by the taxpayer will not result in the standard 3 year statute of limitation, if one of the enumerated foreign reporting requirements are not met.

(b) The Act revision, by insertion of the term "tax return" as to items for which the suspension applies, suspends the statute of limitations for all items reported on the taxpayer's income tax return - even those unrelated to the missing foreign reporting.

(I) EXCEPT IF THE FILING WAS DUE TO REASONABLE CAUSE.

(c) Incomplete filings may trigger these rules.

(d) Note the retroactive effective date.

(iv) Effective Date.

(a) For returns filed after March 18, 2010, and returns filed before then if the assessment period specified in Code §6501 hadn't expired as of March 18, 2010.

(b) 6 Year Statute [Code §6501(e)(1)]

(i) Summary:

(a) A new six-year limitations period for assessment of tax on understatements of income attributable to foreign financial assets. Code §6501(e)(1).

(I) ESSENTIALLY IS AN EXTENSION OF THE EXISTING 6 YEAR STATUTE OF LIMITATIONS FOR 25%+ OMISSIONS FROM GROSS INCOME.

(b) Applies to returns filed if the taxpayer omits from gross income an amount properly includible if:

*(I) THE AMOUNT IS ATTRIBUTABLE TO ONE OR MORE ASSETS WHICH SHOULD HAVE BEEN REPORTED UNDER CODE §6038D (OR WOULD HAVE BEEN REQUIRED BUT FOR THE \$50,000 DOLLAR THRESHOLD IN CODE §6038D(A) AND WITHOUT REGARD TO CERTAIN OTHER EXCEPTIONS IN CODE §6038D RELATING TO DUPLICATIVE REPORTING), AND**(II) THE AMOUNT IS IN EXCESS OF \$5,000.*

(ii) Effective Date.

(a) Returns filed after March 18, 2010, and returned filed before that if the assessment period specified in Code §6501 had not expired as of March 18, 2010.

(7) Criminal penalties may apply [Instructions for Form 8938, November 2011]**h) Effective Date.****(1) For tax years beginning after Mar. 18, 2010.**

(a) Due with 2011 individual income tax return

(2) Notice 2011-55 provides that the Code Sec. 6501(c)(8) limitations period for tax assessments for periods for which reporting is required under Code Sec. 6038D won't expire before three years after the date on which the IRS receives Form 8938

(3) The temporary regulations generally apply to taxable years ending after 12/19/11, and the regulations expire on 12/12/14

i) Misc.(1) IRS webpage of updated information is at www.IRS.gov/form8938.

(2) Still need to file Form TD F 90-22.1 (FBAR) if otherwise required. [Instructions for Form 8938, November 2011]

(3) What impact does value have on later transfer tax values?

j) Special Discussion on Trust and Estate Issues**(1) Specific Issues**

(a) 1. At this point in time, domestic trusts are not reporting taxpayers – only individuals need to report. At some point in the future, domestic entities that are availed of to avoid reporting will also need to report.

(b) 2. In counting SFFAs to see if the filing threshold is exceeded, or in actually reporting SFFAs, a beneficiary is not treated as owning the assets of a trust or estate. However, owners

of an interest in a grantor trust will report the SFFAs of the trust attributed to them, subject to some exceptions.

(c) 3. An interest of a beneficiary in a foreign trust or a foreign estate is itself an SFFA. However, the beneficiary needs to know or have reason to know about the foreign trust or estate based on readily accessible information before it will be considered an SFFA. A receipt of a distribution from the estate or trust constitutes knowledge for this purpose.

(d) 4. In determining the "maximum value" of a beneficial interest in a foreign trust, the maximum value is the sum of (a) the fair market value on the last day of the year of all cash and property distributed to the beneficiary, and (b) the actuarial value on the last day of the year of the beneficiary's rights to receive mandatory distributions. If the beneficiary cannot obtain information to calculate (b), they can use only the value under (a).

(e) 5. In determining the value of a beneficial interest in an estate, the taxpayer can limit the computation to that described in 4.(a) above, if it cannot obtain the information needed to value the beneficial interest.

(2) COMMENTS.

(a) Tax preparers are now obligated to inquire about the foreign assets of their clients so that proper reporting can be made. This will require preparers to be familiar with the foregoing rules, including what constitutes an SFFA and the application of the rules to interests in trusts and estates. Note that the Form 8938 instructions and accompanying regulations provide additional detail and exceptions beyond the general overview provided above.

(b) Importantly, reporting of foreign accounts on an FBAR does NOT relieve taxpayers of reporting SFFAs on the Form 8938.

(c) As noted above, a mere beneficial interest in a foreign trust or a foreign estate is an SFFA that is subject to reporting if the filing thresholds are met. There is no guidance that limits this to current beneficiaries or vested remainder beneficiaries. Thus, contingent beneficiaries at this point should report to avoid a risk of penalty, although an argument can be made that such persons do not have the requisite "interest."

(d) The valuation aspects are interesting. As to interests in a foreign trust, a beneficiary is not generally required to obtain valuation of the trust assets, since he or she needs only to report the value of distributed property. However, if the beneficiary has a mandatory distribution right, an actuarial computation is required. To compute this, the value of the underlying trust assets in that situation will be needed. For foreign estates, some effort will need to be undertaken to obtain the value of the beneficiary's interest. Helpfully for beneficiaries of foreign trusts and foreign estates, if readily accessible value information is not available, valuation can be limited to the value of distributed property that is received.

(e) The question arises whether values reported on the Form 8938 can be used by the IRS to challenge asset values for other purposes, such as estate or gift tax transfer values for transfers occurring in the tax year or in the future. There is nothing that prohibits the IRS from using the reported values, although the probative value of such reporting is arguably limited since the form only requires "reasonable estimates" of value. Nonetheless, to avoid issues if there are somewhat contemporaneous transfers subject to estate or transfer taxes, some coordination of reporting is advisable to avoid creating inconsistent reporting problems to the extent workable within the confines of the Form 8938 reporting rules.

H. CFC And PFIC Reporting, If Applicable.