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April 10 2003

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Receipt of Foreign Gifts and Bequests
Distributions Received from Foreign Trusts
Reportable Events Involving Foreign Trusts
US Owners of Foreign Grantor Trusts
Beneficiary Statements
Foreign Bank Account Reporting

April 15 marks the filing due date not only for US income tax returns, but also for the reporting of foreign gifts, distributions from foreign trusts and income earned in foreign grantor trusts. US citizens, resident aliens and domestic partnerships, corporations, estates and trusts ('US persons') use Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, to provide the Internal Revenue Service (IRS) with the required information. In general, Form 3520 is due on the date that the US person's income tax return is due, including extensions, and is to be sent to the Internal Revenue Service Centre.(1) In addition, US persons must report a financial interest in, signature authority or other authority over financial accounts in foreign countries if the aggregate value exceeds $10,000 by filing Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, on or before June 30 with the US Department of Treasury.(2) Form 3520 and Form TD F 90-22.1 can be obtained from the IRS website at www.irs.gov.

Receipt of Foreign Gifts and Bequests

Reporting requirements are imposed on any US person (other than certain tax-exempt organizations) who receives foreign gifts after August 20 1996. A 'foreign gift' generally means any amount received from a person other

than a US person which the recipient treats as a gift or bequest. Foreign gifts and bequests are reported on Part IV of Form 3520. The US person is to provide the date of the gift or bequest, a description of the property received and its fair market value.

Different reporting thresholds are used to determine whether the receipt of a gift from a foreign person is reportable. The particular threshold used depends on whether the gift is received from a non-resident alien individual or foreign estate, or from a foreign partnership or corporation. To calculate whether gifts received during the taxable year from a particular foreign person exceed the relevant threshold, the taxpayer must aggregate gifts from foreign persons which the taxpayer knows or has reason to know are related (within the meaning of the Internal Revenue Code), irrespective of whether the gift from a related person would independently exceed the reporting threshold.

Gifts from foreign individuals and foreign estates

A US person must report the receipt of gifts from a non-resident alien or foreign estate only if the aggregate gifts from that non-resident alien or foreign estate exceed $100,000 during the taxable year. Once the $100,000 threshold has been met, the donee must separately identify each gift in excess of $5,000, but is not required to identify the donor.

Gifts from foreign corporations or foreign partnerships

A US person is required to report the receipt of gifts from foreign corporations and foreign partnerships if the amount received from all such entities exceeds $11,642 (for tax year 2002, as modified by cost-of-living adjustments) during the taxable year. Once that threshold has been met, the donee must separately identify all purported gifts from a foreign corporation or foreign partnership, including the identity of the donor entity. Gifts from foreign corporations or foreign partnerships are subject to recharacterization by the IRS as dividends or other corporate distribution.

Penalty for failure to file

Subject to a 'reasonable cause' exception, a US person who fails to report such foreign gifts on Form 3520 will be subject to penalties equal to 5% of each gift for each month of non-compliance (not to exceed 25% of the aggregate foreign gifts). The IRS is also authorized to determine the tax

consequences of any unreported gift based on the information available to it, which means that the IRS could treat the amounts received as taxable income.

Exceptions to reporting requirement

There are two primary exceptions to the foreign gift reporting rules. First, qualified tuition and medical payments (ie, those made directly to the school or medical service provider) are not 'foreign gifts' and need not be reported. Second, distributions from a foreign trust to a US beneficiary, the receipt of which is reported by such beneficiary in Part III of Form 3520, do not have to be reported again as gifts in Part IV.

Distributions Received from Foreign Trusts

If a US person directly or indirectly receives any distribution from a foreign trust (including certain loans) after August 20 1996, the US person must file Form 3520 for the relevant taxable year. The recipient must report the distribution from the trust on Form 3520 even if another US person may be treated as an owner of part of the foreign trust under the grantor trust rules.

Required information and penalties for failure to file

Form 3520 asks for basic identifying information (eg, name, address and tax identification number) of the person filing, the foreign trust and its trustee, and the foreign trust's US agent, if any. In addition, Part III of Form 3520 asks for the following information regarding distributions to a US person from a foreign trust:

- the date of distribution and a description of property received by the US beneficiary from the foreign trust during the taxable year;
- information regarding any loan from a related foreign trust; and
- whether the beneficiary received a foreign grantor trust beneficiary statement or foreign non-grantor trust beneficiary statement.

A US person who fails to report on Form 3520 an otherwise reportable distribution from a foreign trust may be subject to a 35% penalty on the gross amount of the distribution.

Tax treatment

A distribution to a US person from a foreign trust will be treated as a taxable accumulation distribution if records are not sufficient to show otherwise. However, in the case of a grantor trust, where the US beneficiary receives a foreign grantor trust beneficiary statement and files the statement with his or her Form 3520, the beneficiary may treat all distributions received from the trust in that year as gifts that are not subject to federal income tax. In the case of a non-grantor trust, where the US beneficiary receives a foreign non-grantor trust beneficiary statement and files the statement with his or her Form 3520, the beneficiary can make an actual calculation of the amount of current income, accumulated income and principal distributed to the beneficiary from the trust in that year.

Reportable Events Involving Foreign Trusts

Foreign gifts and distributions from foreign trusts are not the only items to be reported on Form 3520. The following 'reportable events' occurring after August 20 1996 and involving foreign trusts must also be reported:

- the creation of a foreign trust by a US person;
- an *inter vivos* (or lifetime) transfer of money or property (directly or indirectly) to a foreign trust by a US person;
- a transfer of money or property (directly or indirectly) to a foreign trust by a US person by reason of death; and
- the death of a US citizen or resident who was treated as the owner of a foreign trust under the grantor trust rules or whose gross estate included a portion of a foreign trust.

The settlor must file in the case of the creation of an *inter vivos* trust, the transferor must file in the case of a transfer to a foreign trust (other than by reason of death), and the executor files on behalf of an estate.

Gratuitous transfers and qualified obligations

The reporting requirement applies only to gratuitous transfers to foreign trusts - that is, transfers other than transfers for fair market value. A

gratuitous transfer also includes any direct or indirect transfer that is principally structured to avoid the reporting requirements and the US grantor trust rules. A non-gratuitous transfer to a foreign trust generally must be reported on Form 3520 only if the transferor did not recognize all gain realized on the transfer, or if the transferor is related to the trust.

Loans from a foreign trust, or from a person related to the trust, are treated as trust distributions unless the loan is a 'qualified obligation'. Similarly, a loan from a trust or a person related to the trust must be a qualified obligation before it will be taken into account in determining whether the US person made a non-gratuitous transfer to the foreign trust. A person will be treated as related to a trust if he or she is a settlor or beneficiary of the trust or is related, under Internal Revenue Code attribution rules, to any settlor or beneficiary of the trust.

A loan is treated as a qualified obligation only if, among other requirements, it is a written obligation denominated in US dollars with a term that does not exceed five years. The US person must report the qualified obligation's status (including principal and interest payments) in Schedule C of Part I of Form 3520 in each year that the obligation is outstanding. If a qualified obligation subsequently fails to meet the applicable requirements, the US person will be treated as having made a gratuitous transfer to the trust on the date of such failure. The reporting rules for qualified obligations generally apply to obligations issued, or substantially modified, after February 6 1995.

Required information and penalty for failure to file

Form 3520 asks for information on the US person filing the return, including name, address and tax identification number, as well as information on the US decedent, if relevant. Details regarding the foreign trust are also to be provided, including:

- the name of the trust;
- employer identification number (if any);
- address;

- name and address of the trust creator, if different from the person filing the return;

- country where the trust was created; and

- country whose laws govern the trust.

In addition, the US person filing Form 3520 must not only provide the date of transfer and description of property transferred to the foreign trust, but must also indicate whether:

- any other person will be treated as the owner of the foreign trust for US tax purposes;

- the transfer was a completed gift or bequest; and

- any part of income or corpus may benefit any US beneficiary.

Subject to a 'reasonable cause' exception, a US person who fails properly to report a reportable event will be subject to a 35% penalty on the gross value of the property transferred.

US Owners of Foreign Grantor Trusts

Separate from the filing requirement for the above reportable events, a US person who is treated as the owner of any part of a foreign trust under the grantor trust rules is required to report such trust to the IRS annually in Part II of Form 3520. Such a US person is also responsible for ensuring that the foreign trust files a return setting forth a full and complete accounting of the trust's activities and operations for the relevant taxable year, the name of the trust's US agent and any other information as prescribed by regulations. The US person must also ensure that the foreign trust furnishes the proper information, as prescribed by regulations, to each US person who is treated as an owner of part of the trust or who receives, directly or indirectly, any distribution from the trust.

Form 3520-A

Form 3520-A, Annual Information Return of Foreign Trust with US Owner, is to be used by a foreign grantor trust with a US owner to satisfy the trust's

annual information reporting requirement. The US owner of the foreign trust must ensure that the trustee who is authorized to sign Form 3520-A for the trust:

- properly completes, executes and files Form 3520-A;
- attaches a foreign grantor trust information statement to the form; and
- sends a foreign grantor trust owner statement to each US owner of a portion of the trust and a foreign grantor trust beneficiary statement to each US beneficiary who received a distribution.

A balance sheet and income statement (applying US tax accounting principles) for the trust are to be filed with the Form 3520-A, along with copies of the owner statement and any beneficiary statements.

In general, Form 3520-A must be filed with the Philadelphia Service Centre and the required statements must be sent by the 15th day of the third month after the end of the trust's taxable year, subject to extensions.

In the case of a foreign grantor trust where the owner is not a US person, the trustee is not required to file Form 3520-A. However, the trustee will usually want to supply its US beneficiaries with a foreign grantor trust beneficiary statement, a form of which can be found on page 4 of Form 3520-A. The trustee need not file the beneficiary statement with the IRS; the beneficiary will attach it to his or her Form 3520.

Penalties for failure to file

For taxable years of US owners beginning after December 31 1995, if the foreign grantor trust does not timely furnish the required information, the US owner may be subject to a penalty equal to 5% of the gross value of the portion of the trust's assets treated as owned by that person.

Beneficiary Statements

Form 3520-A includes a form of beneficiary statement for use by a foreign grantor trust. In the case of a foreign non-grantor trust, however, the IRS has issued no form of beneficiary statement. Instead, the trustee should

prepare a foreign non-grantor trust beneficiary statement which includes all of the required information and send it to the US beneficiary.

In addition to basic identifying information (eg, name, address and tax identification number) about the foreign trust and its trustee, the beneficiary statement must contain the following items:

- the first and last day of the tax year of the foreign trust to which the statement applies;

- a description of property (including cash) distributed or deemed distributed to the US person during the tax year, and the fair market value of the property distributed;

- a statement as to whether the foreign trust has appointed a US agent. If the trust has a US agent,its name, address and taxpayer identification number must be included; and

- a statement that the trust will permit either the IRS or the US beneficiary to inspect and copy the trust's permanent books of account, records and such other documents that are necessary to establish (i) that the trust should be treated for US tax purposes as owned by another person, or (ii) in the case of a non-grantor trust, the appropriate treatment of any distribution or deemed distribution for US tax purposes. Such a statement is not necessary if the trust has appointed a US agent.

In addition, a foreign grantor trust beneficiary statement must also include an explanation of the facts necessary to establish that the foreign trust should be treated for US tax purposes as owned by another person. (The explanation should identify the code section that treats the trust as owned by another person.) It should further contain a statement identifying whether the owner of the trust is an individual, corporation or partnership.

A foreign non-grantor trust beneficiary statement must also include an explanation of the appropriate US tax treatment of any distribution or deemed distribution for US tax purposes, or sufficient information to enable the US beneficiary to establish the appropriate treatment of any distribution

or deemed distribution for US tax purposes. It should further contain a statement identifying whether any grantor of the trust is a foreign partnership or a foreign corporation.

Foreign Bank Account Reporting

Since the promulgation of regulations under the Bank Secrecy Act 1970, US taxpayers have had an obligation to report certain financial accounts by filing Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (commonly known as 'FBAR'). Each US person who has a financial interest in, or signature authority, or other authority over, any financial accounts - including bank, securities or other types of financial accounts - in a foreign country is required to make such a report if the aggregate value of these financial accounts exceeds $10,000 at any time during the calendar year. The FBAR form asks for:

- the type of account;
- its maximum value;
- the account number;
- the name of the financial institution;
- the country in which the account is held; and
- the last name or organization name of the account holder.

Failure to comply with these disclosure requirements constitutes a criminal misdemeanour and may also trigger civil penalties in the event of an audit. The penalty for failing to file Form TD F 90-22.1 is the total amount in the account up to $100,000, or $25,000, whichever is greater. No report is required if the aggregate value of the foreign accounts did not exceed $10,000.

For further information on this topic please contact Jennie Cherry at Kozusko Harris Vetter Wareh LLP by telephone (+1 212 980 0010) or by fax (+1 212 202 4484) or by email (jcherry@kozlaw.com).

Endnotes

(1) Internal Revenue Service Centre, Philadelphia, PA 19255, United States.

(2) US Department of Treasury, PO Box 32621, Detroit, MI 48232-0621, United States.