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New guidance and forms to report foreign accounts and use of trust property

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After passing major tax legislation in 2010 and following up with some regulations and guidance notices, the US tax authorities have now released:

- Form 3520 – the 2010 annual return to report transactions with foreign trusts;
- Form TD F 90-22.1 – an updated report of foreign bank and financial accounts; and
- Notice 2011-34 – further guidance on complying with the foreign account reporting legislation.

Form 3520 for tax year 2010 is due on the date that the US taxpayer's income tax return is due, including extensions, meaning that the completed form must be postmarked as sent to the Internal Revenue Service (IRS) as of that date. Form TD F 90-22.1 must be received by the US Treasury Department on or before June 30 2010.[1]

Background

FBAR

US persons with financial interests in or signature or other authority over foreign bank accounts, securities accounts and other financial accounts are required to report such interests on Form TD F 90-22.1, commonly referred to as a foreign bank account report (FBAR). In October 2008 the Treasury Department issued a revised FBAR with various changes, including a change to the definition of 'US person' to include not only a citizen or resident of the United States, but also a person in and doing business in the United States. On February 24 2011 the Treasury's Financial Crimes Enforcement Network (FinCEN) issued final FBAR regulations. The final rules apply to FBARs due by June 30 2011 with respect to accounts maintained in 2010 and for those filed in subsequent years (for further details please see "US Treasury Department publishes final rule for foreign bank account reports"). On March 26 2011 the IRS issued a new FBAR form and instructions. The revised instructions reflect the changes made by FinCEN's final FBAR regulations.

Form 3520

The recipient of a distribution from a foreign trust is required to file Form 3520 to report the distribution to the IRS, regardless of the amount of the distribution received or its tax consequences to the recipient (there is no such reporting requirement for distributions from a US domestic trust). The Hiring Incentives to Restore Employment Act 2010 (commonly known as the HIRE Act) broadened the tax law to provide that use of property held in a foreign trust after March 18 2010 by a US grantor or US beneficiary (or any US person related to a US grantor or US beneficiary) will be treated as a distribution to the US grantor or beneficiary of the fair market value of the use of the property. This deemed distribution rule will not apply to the extent that the foreign trust is paid the fair market value for the use of the property within a reasonable period of such use (for further details please see "Tax Relief Act, reporting requirements and planning for use of foreign trust property"). On March 6 2011 the IRS posted the 2010 instructions for Form 3520, and on March 11 2011 it posted the 2010 Form 3520.

Foreign Account Tax Compliance Act

The Foreign Account Tax Compliance Act (commonly known in the United States by its acronym, FATCA) provisions of the Hiring Incentives to Restore Employment (HIRE) Act 2010 require non-US financial institutions

to provide the IRS with sufficient information to identify accounts held by US persons with an average month-end balance of $50,000 or more. Failure to do so will result in a 30% withholding tax on US-source payments to those accounts, effective for payments made after December 31 2012, although obligations outstanding as of March 18 2012 will be exempt. Withholding can be avoided if the foreign financial institution enters into a foreign financial institution agreement. On August 27 2010 the IRS released Notice 2010-60, describing how such institutions are to comply with the new law (for further details please see "Tax Relief Act, reporting requirements and planning for use of foreign trust property"). The Treasury and the IRS have now published further guidance in Notice 2011-34, released April 8 2011. This new notice provides guidance in response to certain priority concerns.

New FBAR

As with its predecessor, the new FBAR (Form TD F 90-22.1) contains five parts which have not been substantively altered. These parts provide space to report:

- filer information;
- information on foreign financial accounts owned separately and those owned jointly; and
- information on foreign financial accounts where the filer has signature or other authority but no financial interest in the account, and where the filer is filing a consolidated report.

The instructions to the new FBAR have been substantively revised to reflect the rules of the final FBAR regulations. The instructions define 'US person' to mean a US citizen, US resident, entities created or organised in the United States or under the laws of the United States (including but not limited to corporations, partnerships or limited liability companies), and trusts or estates formed under the laws of the United States. This new definition no longer includes a person in and doing business in the United States.

The instructions now note that the federal tax treatment of an entity does not determine its FBAR filing obligation. Thus, an entity disregarded for US income tax purpose (eg, a single member limited liability company) and a

trust treated as owned by its grantor for income tax purposes (a 'grantor trust') must file an FBAR if otherwise required to do so. Although not specifically stated in the instructions, trustees of trusts formed under US law have an FBAR filing obligation with regard to any foreign financial accounts of the trust, even though such a trust may be classified as foreign for US income tax purposes.

The definitions for 'financial account' and 'foreign financial account' are clarified in the new FBAR instructions. Financial accounts now specifically include insurance and annuity policies with a cash value issued outside the United States (even where the insurance company has elected to be treated as a domestic corporation for US income tax purpose). 'Foreign' means that the account is physically located outside the United States, regardless of whether the financial institution itself is US or foreign.

The new instructions also clarify when a US person has a financial interest in a foreign financial account. In addition to the situation where the US person is the owner of record of the foreign account, a US person has a financial interest in a foreign account for which the owner of record or holder of legal title of the account is a trust when the US person is the grantor of the trust and is treated as the owner of the trust for US income tax purposes under the grantor trust rules. The final FinCEN rule said that a US person who has a greater than 50% present beneficial interest in the assets of a trust or who receives more than 50% of the current income of the trust has a financial interest in any foreign financial account for which the trust is the owner of record. This rule has been stated slightly differently in the new instructions as "a greater than 50% present beneficial interest in the assets or income of the trust", dropping the receipt of income language.

Tax practitioners disagree on the impact of the new language – "present beneficial interest" – on the reporting obligation of a US beneficiary which is one of several purely discretionary beneficiaries. FinCEN stated in its final rules that it does not intend for a beneficiary of a discretionary trust to have a financial interest in a foreign account simply because of his or her status as a discretionary beneficiary. Thus, it appears that a facts and circumstances test will still be relevant in determining whether a US beneficiary has an FBAR filing obligation (for further details please see "Reporting of offshore investments - proposed regulations and the HIRE Act").

The new instructions simplify the definition of 'signature authority' and detail exceptions to the FBAR filing requirement for certain individuals who have signature authority over, but no financial interest in, a foreign financial account. The revised FBAR includes additional exceptions to the filing requirements for:

- the spouse of an individual who files the FBAR (when certain other conditions are met);
- governmental entities, including colleges and universities;
- international financial institutions where the US government is a member;
- individual retirement account owners and beneficiaries;
- participants in and beneficiaries of tax-qualified retirement plans;
- consolidated FBAR filers; and
- correspondent or nostro accounts used for bank-to-bank settlements.

The new instructions specifically state that a trust beneficiary with a financial interest is not required to report the trust's foreign financial accounts on an FBAR if the trust, trustee of the trust or agent of the trust is a US person and files an FBAR disclosing the trust's foreign financial accounts.

The revised instructions detail the penalties for failure to file an FBAR. Generally, the civil penalty does not exceed $10,000 and, if there is reasonable cause for the failure to file and the balance in the account is properly reported, no penalty will be imposed. But a person who wilfully fails to report may be subject to a civil monetary penalty equal to the greater of $100,000 or 50% of the balance in the account at the time of the violation, as well as criminal penalties.

Form 3520

Form 3520 for tax year 2010 addresses the Hiring Incentives to Restore Employment Act 2010 change that the beneficiary's use of trust property held in a foreign trust is a deemed distribution to that beneficiary. The instructions specify that a US beneficiary or a US person related to the US beneficiary who directly or indirectly received the use of any property of a

foreign trust must report the fair market value of such use as a distribution unless the trust is compensated at fair market value for such use within a reasonable period of time. The rule is applicable for the use of trust property after March 18 2010.

The fair market value of the uncompensated use is reported in Part III of Form 3520. The filer is instructed to report the fair market value of the use and the date of first uncompensated use in the table at Line 25. Uncompensated use of trust property is considered to be a loan and Line 25 retains its previous loan verbiage, but adds a note about use of trust property. The revised Form 3520 and instructions do not include an annual status report for compensated use of trust property, as it does for a qualified loan obligation, so if the trust is compensated for the use then there is no Form 3520 filing requirement. No guidance has yet been issued on determining fair market value of the use or what constitutes a reasonable period of time.

Notice 2011-34

A 'foreign financial institution' subject to the Foreign Account Tax Compliance Act is any non-US entity that:

- accepts deposits in the ordinary course of a banking or similar business;
- holds financial assets for the account of others as a substantial portion of its business; or
- is engaged in the business of investing or trading in securities, partnership interests or commodities or interests in the same.

Notice 2010-60 stated that a trust company will be considered a foreign financial institution, and that a trust settled and funded by an individual for the sole benefit of his or her children could also be considered a foreign financial institution. Notice 2011-34 does not expand on the previous comments regarding trusts; instead, it provides guidance on:

- the procedures to be followed by participating foreign financial institutions in identifying US accounts among their pre-existing individual accounts (includes accounts with private banking departments which provide trust and fiduciary services);

- the definition of the term 'passthru payment' and guidance with respect to the obligation of participating foreign financial institutions to withhold on passthru payments;
- the categories of foreign financial institution that will be deemed compliant under the Foreign Account Tax Compliance Act rules;
- the obligation of participating foreign financial institutions to report with respect to US accounts;
- the treatment of qualified intermediaries (the Treasury and IRS intend to issue separate guidance with respect to foreign financial institutions acting as foreign withholding trusts or foreign withholding partnerships and to coordinate the reporting and withholding requirements for qualified intermediaries, foreign withholding partnerships and foreign withholding trusts);
- the application of the Foreign Account Tax Compliance Act rules to expanded affiliated groups of foreign financial institutions; and
- the effective date of foreign financial institution agreements.

According to Notice 2011-34, the Treasury and the IRS still intend to issue regulations along with draft foreign financial institution agreements and draft information reporting and certification forms.

Comment

US tax compliance continues to be complicated and burdensome. Forms and instructions have been reissued and simplified, but more taxpayers will find themselves with a reporting requirement. Guidance issued on the expanded information reporting requirements imposed on foreign financial institutions with respect to certain US accounts already exceeds 100 pages. Advisers to international families and foreign financial institutions must continue to be up to date on US filing requirements in order to save their clients from substantial monetary penalties and possible criminal investigation. As recently as May 19 2011, a Boston venture capitalist and bank director was charged with failing to report his foreign bank account and income following an investigation by the IRS Criminal Investigation Division.

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Endnotes

(1) Both forms and the full text of Notice 2011-34 can be found at www.irs.gov.