Foreign Trusts From a United States Perspective: Taxpayer Nightmares and How to Keep Them from Happening

For understandable reasons, the United States has adopted a series of laws designed to prevent U.S. taxpayers from taking advantage of foreign trusts as tax shelters from U.S. income taxation. The obvious application of these laws is to a U.S. citizen attempting to transfer cash or income-producing assets to an offshore trust. When dealing with foreign trusts, however, these laws can apply in circumstances where unsuspecting non-U.S.-citizen taxpayers can be financially devastated by the consequences.

JANE MOVES TO THE UNITED STATES

Jane moved to the United States in 2017 to work as a high-level executive for a U.S.-based company. Jane is a participant in a foreign pension plan and has made regular contributions to the retirement plan for the four years prior to her move to the United States. Three years before her move to the United States, Jane had established a trust in a tax haven jurisdiction that would impose no local income tax on the trust. The trust is a discretionary trust for the benefit of herself and her family, including her husband, John, and their three children. Jane had been advised by European tax professionals to establish the trust to reduce her tax burden in her home country.

The trust is irrevocable and holds $10 million (all dollar amounts in this article are U.S. dollars unless otherwise noted) worth of stocks and bonds. The trust has interest and dividend income of approximately $500,000 per year. The retirement plan holds $500,000 worth of securities, and has interest and dividend income of $50,000 per year.

Because the trust is irrevocable, and both the trust and retirement plan were formed outside the U.S. long before she moved to the U.S., Jane assumed that the U.S. would have no taxing authority over either the trust or the retirement plan. When asked by her U.S. accountant if she had any foreign bank accounts or foreign trusts, she failed to inform the accountant of the offshore trust and pension plan.

As a result of this inaccurate information, the accountant failed to check the appropriate box on Schedule B of Jane's Form 1040 (U.S. individual income tax form), indicating that she had a foreign trust. Later, to purchase a vacation home in 2018, Jane received a distribution from the foreign trust of $1 million. The $1 million was initially deposited in her U.S. bank account and then transferred to an escrow agent for closing on the purchase of the home.

Jane received notice from the Internal Revenue Service (IRS) indicating an intent to audit her 2018 tax return. As a part of the audit, the IRS agent requested and received copies of Jane's bank statement for 2018. The IRS also inquired about any retirement plans in which Jane was a participant. Jane was dismayed when the agent requested substantial information concerning her foreign trust and retirement plan. After the agent received the requested information, Jane was notified by the IRS of the following:

1. Jane should have filed a Form 3520 by the due date of her 2017 income tax return to report a deemed transfer of $10 million to the foreign trust on the date of her arrival in the United States for U.S. income tax purposes. IRC §§6048(a) and 679(a)(4) and IRS Notice 97-34, 1997-1 C.B. 422. Further, upon examination of the retirement plan documents and Jane's contributions made thereto, it was determined that Jane was the owner of a nonqualified deferred compensation trust for U.S. income tax purposes. IRC §402(b) and Treas. Reg. §1.402(b)-1(b)(6). As a result, Jane also should have reported the deemed transfer of $500,000 to the retirement plan on the date of her arrival in the United States. IRC §§6048(a) and 679(a)(4) and IRS Notice 97-34, 1997-1 C.B. 422. A transfer to the foreign trusts is deemed to occur because Jane funded the foreign trusts within the five years preceding her arrival in the U.S. *Id*. The penalty for the failure to file the Form 3520 is $3,675,000 million (35 percent of the value of the deemed transfers). IRC §6677(a).
2. Jane's trust and retirement plan should have filed Form 3520-A by March 15 each year after she became a U.S. resident. IRC §6048(b) and IRS Notice 97-34. At that time, both the foreign trust and retirement plan acquired a U.S. transferor (within five years of being created) and U.S. beneficiaries, causing them to become "grantor trusts." IRC §679. This form must be filed by any foreign trust considered a "grantor trust" with respect to a U.S. citizen or U.S. resident for U.S. income tax purposes. The filing of Form 3520-A is an ongoing requirement as long as Jane remains a U.S. person. The penalty for failure to file Form 3520-A is 5-percent of the end of the year value of the trust. IRC §6677(b). Assuming that the trust and retirement plan had a combined value of $10,500,000 at the end of both 2017 and 2018, the total penalty would be $1,050,000.
3. Because Jane's trust and retirement plan are considered "grantor trusts," she is deemed the owner of the property. IRC §§671 and 679. In other words, the trust and retirement plan are more or less transparent for U.S. income tax purposes. Therefore, Jane should have been reporting the interest, dividends, and capital gains of her foreign trust and retirement plan on her U.S. income tax return each year. Since Jane is in the maximum tax bracket (39.6 percent for 2017, 37 percent for 2018), she would owe approximately $421,300 in additional income taxes for 2017 and 2018, along with net investment income taxes of $41,800. Interest expense would also be paid to the IRS for any past due taxes.
4. The IRS also imposed a 20-percent negligence penalty of $92,620, ($463,100 tax times 20 percent penalty) with respect to the underreported income earned by the foreign trust and retirement plan. IRC §6662(b)(1).
5. Jane should also have filed Form 3520 in the year she received the $1 million distribution from the trust. Because she failed to file Form 3520 reporting the receipt of the $1 million, a penalty equal to 35 percent of the unreported $1 million distribution or $350,000 would be imposed. IRC §§6048(a) and 6677(a).

Therefore, the total amount due to the IRS was $5,630,720.

Jane was so disenchanted with the experience that she immediately resigned her position and returned to her home country on December 31, 2019. Jane was shocked once again when her U.S. accountant prepared her final U.S. income tax return. Included on this final return was the unrealized gain in her foreign trust and retirement plan portfolios. This is because the trust and retirement plan reverted to non-grantor trust status upon her departure causing another deemed transfer. IRC §§672(f) and 684, Treas. Reg. §1.684-2(e). Most of this gain had accrued prior to her arrival in U.S. The total gain on the two portfolios was $5,250,000. Since the U.S. imposes a maximum capital gains rate of 20-percent, the total tax due on the appreciated portion of her foreign trust portfolio was $1,050,000, plus net investment income tax of $199,500.

Jane made three mistakes regarding the trust and retirement plan:

- Jane assumed the U.S. would treat her foreign trust and retirement plan the same way her home country did;
- She failed to notify her U.S. accountant of the existence of the foreign trust and retirement plan; and
- She failed to consult with her accountant prior to her abandonment of her U.S. residency for U.S. income tax purposes.

With proper planning, Jane could have limited her liability to $687,500—the taxes on the trust and retirement plan's income for the 3-year period that she was a U.S. resident. As seen by the size of the penalties imposed on taxpayers who fail to file the information Forms 3520 and 3520-A, the U.S. government is very serious about compliance with foreign trust reporting activities. Such penalties can be avoided if the IRS is convinced that failure to file was for reasonable cause. IRC §6677(d).

In this case, because Jane failed to inform her accountant about the trust and retirement plan's existence, the IRS may not waive the penalty. Furthermore, the IRS may consider civil and criminal actions for tax fraud as well.

SUMMARY

As one might expect, the U.S. government is taking a serious look at the finances of foreigners and foreign entities, like foreign trusts. The IRS has a number of tools in their arsenal to ensure compliance with foreign trust tax and reporting rules by U.S. taxpayers. Both U.S. citizens and non-U.S. citizens resident in the U.S. —who have established foreign trusts or retirement plans, or who are beneficiaries of a foreign trust or retirement plan—must comply with these rules. As discussed, the tools at the IRS' disposal include penalties for failure to file Form 3520 and Form 3520-A, the grantor trust rules, negligence penalties, and the accumulation distribution tax and associated interest charges. Given the financial impact and the complex nature of these foreign trust rules, any person dealing directly or indirectly with a foreign trust or retirement plan should consult with a professional experienced in the U.S. income taxation of foreign trusts.

A foreign trust is not a "bad" thing in and of itself, and may have practical and useful purposes, including enabling the purchase of international investments, creditor protection planning, reduction of taxes in other countries, and efficient management of trust assets for the benefit of non-U.S. beneficiaries. Therefore, the U.S. tax system does not prohibit the use of foreign trusts, but rather has imposed a complex system of reporting, tax transparency, accumulation taxes, and deemed sale rules to discourage U.S. taxpayers from using offshore trusts as tax shelters. Any person either directly or indirectly involved with a foreign trust as a creator of the trust, as a trustee of the trust, or as a beneficiary of the trust, should consult with a qualified professional to make sure they have complied with the foreign trust tax rules.

Failure to comply with these rules could be harmful to an investor's financial health.

The information contained herein is general in nature and based on authorities that are subject to change. Applicability to specific situations should be determined through consultation with your tax adviser.

ABOUT THE AUTHOR

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