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Virtual Program

Dissecting the Proposed Foreign Trust Regulations

Today's Panel

Moderator

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Agenda

Background

Proposed regulations

- IRC § 643(i)
- IRC § 679
- Reporting and other rules under IRC §§ 6039F, 6048
- Treaty-based reporting exception
- Other exceptions
- What was not addressed in the proposed regulations?
- Penalties and defenses

Background

In the late 1990s, Congress enacted and amended existing provisions of the Internal Revenue Code to combat abusive offshore tax schemes involving foreign trusts

Small Business Job Protection Act of 1996

- added IRC §§ 643(i), 6039F
- amended IRC §§ 679, 6048, 6677

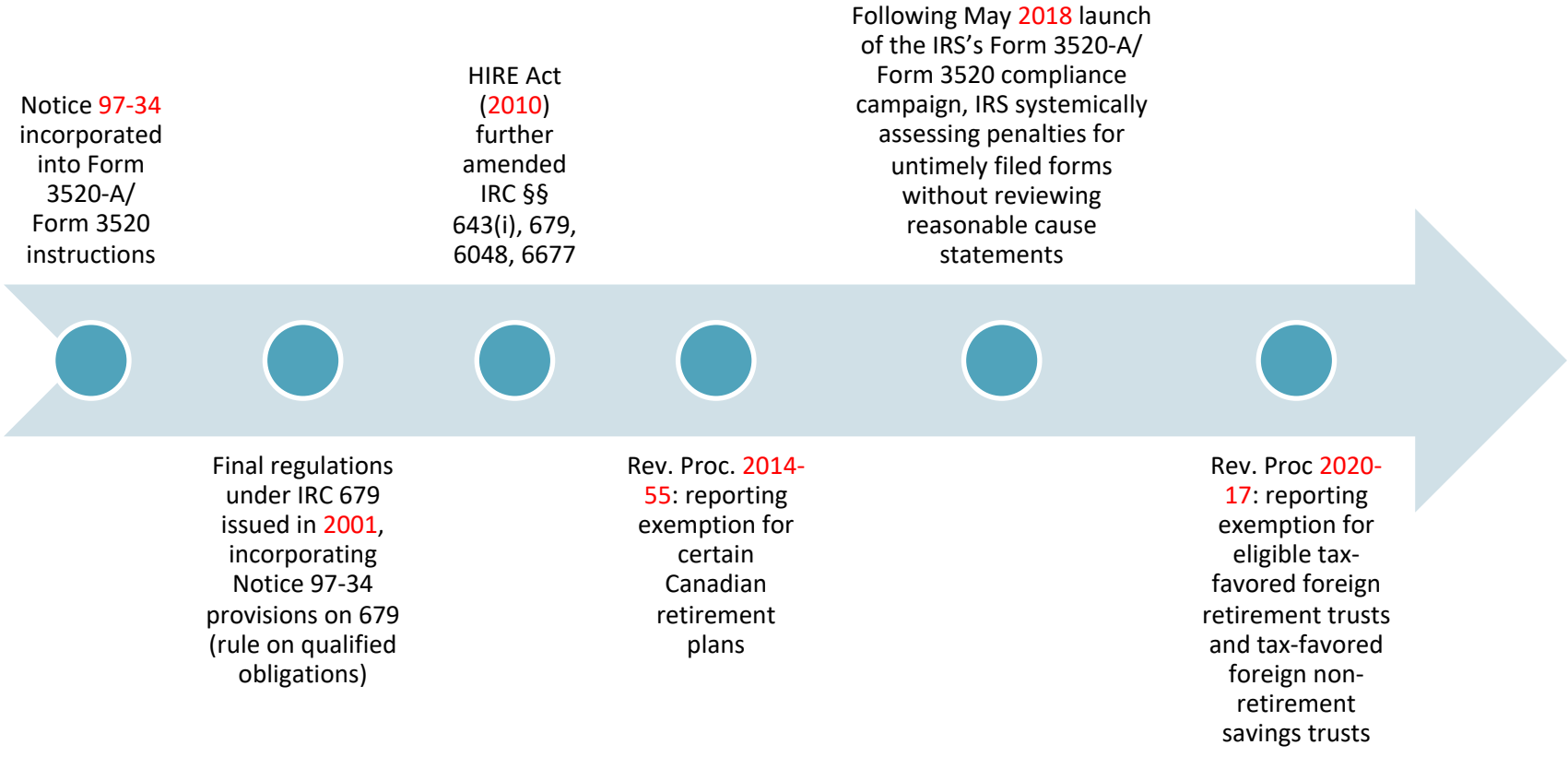
Taxpayer Relief Act of 1997

- Further amendments to IRC §§ 6048

IRS issued Notice 97-34 to implement information reporting requirements triggered by the new or amended provisions under IRC §§ 643(i), 679, 6039F, 6048, 6677

Comprehensive regulations not subsequently issued

Background


Notice 97-34 incorporated into Form 3520-A/ Form 3520 instructions
Final regulations under IRC 679 issued in 2001, incorporating Notice 97-34 provisions on 679 (rule on qualified obligations)
HIRE Act (2010) further amended IRC §§ 643(i), 679, 6048, 6677
Rev. Proc. 2014-55: reporting exemption for certain Canadian retirement plans
Following May 2018 launch of the IRS's Form 3520-A/ Form 3520 compliance campaign, IRS systemically assessing penalties for untimely filed forms without reviewing reasonable cause statements
Rev. Proc 2020-17: reporting exemption for eligible tax-favored foreign retirement trusts and tax-favored foreign non-retirement savings trusts

IRC § 643(i) and Proposed Regulations

Overview

- Enactment in 1996
- Notice 97-34 Guidance
- 2010 HIRE Act Amendments
- 2024 Proposed Regulations

- <u>Summary of Proposed Regulations</u>
  - Prop. Reg. § 1.643(i)-1: Loans from and use of trust property of foreign nongrantor trusts
  - Prop. Reg. § 1.643(i)-2: Exceptions
  - Prop. Reg. § 1.643(i)-3: Consequences of section 643(i) distribution
  - Prop. Reg. § 1.643(i)-4: Examples
  - Prop. Reg. § 1.643(i)-5: Applicability Date

IRC § 643(i) – Background

- First enacted in 1996
- Loan of cash or marketable securities from foreign trust to any U.S. beneficiary, or related U.S. persons, treated as distribution from trust to beneficiary
- Treasury is authorized to issue regulations with exceptions:

> *"The legislative history explains that these regulations are expected to provide an exception under section 643(i) for loans with arm's-length terms, and in applying this exception, the regulations should consider whether there is a reasonable expectation that the grantor, beneficiary, or related person would repay the loan. H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess., at 334 (1996)."*

Notice 97-34 Guidance

- Loan that is a “qualified obligation” not treated as distribution

- Key requirements:
  1. Obligation must be in writing
  2. Term must not exceed five years
  3. Must be denominated in U.S. dollars
  4. Yield to maturity between 100% and 130% of AFR
  5. U.S. transferor must extend assessment period
  6. Reporting on Form 3520 annually

- These requirements are much narrower than what might have been expected based on the language of the legislative history

IRC § 643(i) 2010 HIRE Act Amendments

- Expanded Section 643(i) to include uncompensated use of trust property other than cash or marketable securities

- Any uncompensated use of trust property by U.S. grantors, beneficiaries, or related U.S. persons is treated as a distribution, based on the fair market value of the property's use
  - Uncertainty regarding tax treatment in situations where property is only used for part of year when property is available exclusively for the beneficiary vs. when it is part of a rental pool
  - *G.D. Parker Inc. v. Commissioner*, T.C. Memo. 2012: Involved withholding tax issues concerning the use of property owned by a U.S. corporation. Case discussed (to a limited extent) determination of use value regarding income inclusion for personal use of properties by individuals linked to corporation. Despite limited access for third parties, only one month's income from the Spanish property was included, based on the actual use by the owner's family.

IRC § 643(i) Proposed Regulations

- The proposed regulations generally incorporate section 643(i) guidance from Notice 97-34 with modifications to provide procedural rules and provide guidance implementing the HIRE Act amendments to section 643(i)

- The Preamble recites the legislative history, but does not explain or seek to justify the very narrow reading. It notes that Notice 97-34 provided similar qualified obligation rules for transfers to foreign trusts.
  - However, the policy considerations here are not the same

Prop. Reg. § 1.643(i)-1: Loan from foreign nongrantor trust

- Indirect loans of cash or marketable securities made through intermediary, agent, or nominee treated as made by foreign trust

- Introduction of new anti-abuse rule for loans to NRAs
  - If foreign trust makes a loan to NRA grantor or beneficiary who becomes U.S. resident or citizen within two years, the loan amount outstanding on that date is considered distributed when the individual becomes a U.S. resident or citizen, absent an exception specified in Prop. Reg. § 1.643(i)-2

Observations:

- No apparent authority for the anti-abuse rule. Perhaps it might be justified if the loan were a demand loan. Otherwise, no reason why distribution should be deemed to have occurred on change of residence as opposed to when the loan was made (in which case section 643(i) would plainly not apply).
- Why treat actual pre-immigration distribution more favorably?
- Foreign loan typically not designed to meet qualified obligation criteria

Prop. Reg. § 1.643(i)-1: Use of Trust Property

- Any direct or indirect use of foreign nongrantor trust property by U.S. grantor or beneficiary generally treated as section 643(i) distribution
  - *Indirect* use includes use by any U.S. person related to grantor or beneficiary or by agent or nominee of U.S. grantor or beneficiary, or agent or nominee of U.S. persons related to grantor or beneficiary
  - *Indirect* use also includes use by a foreign person related to the U.S. grantor or beneficiary (other than a nonresident alien individual beneficiary of the trust), unless the U.S. grantor or beneficiary:
    (i) meets the reporting requirements of Prop. Reg. § 1.6048-4 regarding the use; and
    (ii) an explanatory statement is attached to their federal income tax return demonstrating that the use of trust property would have been allowed irrespective of their status as a grantor or beneficiary of the foreign trust

Prop. Reg. § 1.643(i)-2: Exceptions

- "Qualified obligations"
  - Definition of "qualified obligation" mostly consistent with Notice 97-34, but clarifies that obligation must be issued at par with fixed interest rate or qualified floating rate (as defined in Reg. § 1.1275-5(b)) and all stated interest must be qualified stated interest (as defined in Reg. § 1.1273-1(c))
    - ***Observation***: In general, these requirements have always been much narrower than the language of the legislative history
    - What is purpose of requirement that loan must be denominated in dollars?
- Fair market value (FMV) compensation for trust property use
  - FMV determined based on facts and circumstances of each case, including the type of property used and the period of use.
    - ***Observation***: How to determine use value still not addressed, and no guidance has been provided
  - Payment must be made within a reasonable period. What is reasonable based on facts and circumstances? Safe harbor if payment made, or periodic payments commence, within 60 days of start of use of trust property.

Prop. Reg. § 1.643(i)-2: Exceptions

- De minimis use of trust property
  - Aggregate use of 14 days or less by a U.S. grantor/beneficiary or certain U.S. relatives will not be treated as a section 643(i) distribution
    - ***Observation***: Not a significant exception because the proposed regulations would aggregate the use of the property by U.S. persons (e.g., a family of U.S. persons), quickly exceeding the limit

- Certain loans by certain CFCs and PFICs
  - Loans of cash from a foreign corporation to a U.S. beneficiary of a foreign nongrantor trust will not be treated as a section 643(i) distribution if the loan amount does not exceed the undistributed earnings and profits previously included in the beneficiary's gross income under sections 951, 951A, or 1293
    - Prevents double taxation on amounts already included in the U.S. beneficiary's gross income as Subpart F income or GILTI with respect to a CFC or under QEF election with respect to a PFIC

Prop. Reg. § 1.643(i)-4: Examples

- 12 examples illustrate rules regarding loans of cash, marketable securities, and use of trust property; applicable exceptions; and tax consequences of a § 643(i) distribution
- The examples include sample transactions involving:
  1. Loan to contingent remainder beneficiary
  2. Loan from foreign nongrantor trust to a foreign grantor trust
  3. Loan by a person related to a foreign nongrantor trust
  4. Guaranteed loan by an unrelated person
  5. Loan to a foreign person related to a U.S. beneficiary
  6. Loan to wholly owned corporation of U.S. beneficiary
  7. Subsequent transactions
  8. Uncompensated use of trust property
  9. Partially compensated use of trust property
  10. Uncompensated use of trust property and accumulated income
  11. Partial grantor trust property use
  12. Use of trust property by exempt entity

IRC § 679 and Proposed Regulations

IRC § 679-Background

- IRC § 679 enacted by Tax Reform Act of 1976
  - IRC § 679(a)(1): A US person who directly/indirectly transfers property to a foreign trust is treated as the owner of the foreign trust to the extent of the transferred property if, under the trust terms, the income or corpus of the trust may be paid to or accumulated for the benefit of a U.S. person during the taxable year, including if the trust terminated during the taxable year
  - FMV exception: IRC § 679(a)(1) not applicable to US person's transfer to foreign trust in exchange for consideration of at least the FMV of the transferred property

IRC § 679-Background

- Small Business Job Protection Act of 1996 amended IRC § 679 to provide that loans not taken into account for FMV exception, except as provided in regulations
  - Notice 97-34 provided that a loan is taken into account for FMV exception if it is a "qualified obligation"
  - IRS issued final regulations in 2001 under IRC § 679 (T.D. 8955), but IRC § 679 was subsequently amended by HIRE Act in 2010
- The proposed regulations make two additions to Treas. Reg. § 1.679-2, providing guidance on two provisions added to section 679 by the HIRE Act

Prop. Reg. § 1.679-2(a)(5)

- Transactions treated as causing trust income or corpus to be paid or accrued for the benefit of a U.S. person:
  - Any direct or indirect loan of cash/marketable securities from a foreign trust or portion of a foreign trust to any U.S. person
  - The direct or indirect use of any other property of a foreign trust or portion of a foreign trust by a U.S. person
- An *indirect* loan of cash/marketable securities includes:
  - One made by any person to a U.S. person if the foreign trust provides a guarantee for the loan
  - One made from a foreign trust to a U.S. person through an intermediary, such as an agent or nominee of the foreign trust, or from a person related (Prop. Reg. § 1.643(i)-1(d)(9)) to the foreign trust

Prop. Reg. § 1.679-2(a)(5)

- For these purposes, a loan from a foreign trust to, or the use of property of a foreign trust by, a grantor trust or a disregarded entity is treated as a loan to or use by the owner of the grantor trust or of the disregarded entity, respectively

Prop. Reg. § 1.679-2(b)(3)

- A loan of cash/marketable securities or the use of trust property that does not qualify for exceptions in Prop. Reg. § 1.679–2(a)(5)(iii) (e.g., qualified obligation) is treated as paid to or accumulated for the benefit of a U.S. person if:
  - the loan is made to, or the property is used by, a foreign entity described in § 1.679–2(b)(1) [CFC, foreign partnership of which U.S. person is a partner, foreign trust/estate with U.S. beneficiary under Treas. Reg. § 1.679-2(a)(1)], or
  - if the loan is made through, or the property is used by, an intermediary or is made by any other means where a U.S. person may obtain an actual or constructive benefit, as described in Treas. Reg. § 1.679–2(b)(2)

Prop. Reg. § 1.679-2(d)

- Prop. Reg. § 1.679-2(d) implements section 679(d), providing that the IRS may treat a foreign trust as having a U.S. beneficiary, unless the U.S. person--
  - Reported the transfer to the trust pursuant to Prop. Reg. § 1.6048-2; and
  - Attaches an explanatory statement to the U.S. person's federal income tax return, demonstrating that, immediately after the transfer, the trust does not have a U.S. beneficiary pursuant to Treas. Reg. § 1.679-2(a)(1)

- The IRS may request additional information regarding the foreign trust and its potential beneficiaries to determine whether Treas. Reg. § 1.679-2(a)(1) is satisfied
  - U.S. person required to provide the requested information within 60 days (or 90 days if outside the U.S.) following the IRS's written notice
  - Failure to timely provide the requested information results in a presumption by the IRS that the trust has a U.S. beneficiary

Reporting and Other Rules under IRC §§ 6039F, 6048

Prop. Regs. under IRC § 6039F

- Prop. Reg. § 1.6039F-1(b)
  - *Anti-abuse rule*: IRS can re-characterize an amount that taxpayer receives as a gift if taxpayer does not treat it as a gift or income (such as purported loan) if facts and circumstances indicate it is a gift

- Prop. Reg. § 1.6039F-1(g): Beginning on date when IRC § 2801 regulations are final, covered gifts/bequests exceeding the annual gift exclusion amount ($18K for 2024) must be reported on Form 3520/Part IV
  - How would recipient know that donor was expatriate/former citizen or green card holder?
  - Gifts/bequests to U.S. citizen spouses excluded from IRC § 2801 tax, but must still be reported under IRC § 6039F

Prop. Regs. under IRC § 6048

- Prop. Reg. § 1.6048-2(b): clarifies that deemed transfers under IRC §§ 679, 684 are reportable events
  - Outbound migration of U.S. trust under Treas. Reg. § 1.684-4
  - Transfer of property in exchange for loan, whether a qualified obligation or not

- Prop. Reg. § 1.6048-4(b): inbound migration of a foreign trust (when a foreign trust becomes a domestic trust) treated as a distribution
  - For income tax and reporting purposes?

Prop. Regs. under IRC § 6048

- Proposed regulations generally incorporate Notice 97-34 on the taxation of FNGT distributions to U.S. beneficiaries under the actual and default methods
  - But for purposes of the default method, Prop. Reg. § 1.6048-4(d)(3) provides the interest charge is computed based on the following assumptions (in the absence of a Foreign Non-Grantor Trust Beneficiary Statement)
    - The FNGT has existed for 10 years
    - No taxes described in IRC § 665(d) have been imposed on the trust in any applicable previous year (even if a distribution had been made and tax under IRC § 665(d) had been imposed)

Treaty-Based Reporting Exception

Tax Treaty Background

Under many (but not all) of our treaties, an individual who is resident under U.S. law and the treaty partner's law will be treated as a resident of only one country, based on application of a series of tie-breaker tests

Treas. Reg. § 301.7701(b)-7 provides that such an individual who tie-breaks to the other country (misleadingly referred to as a "treaty dual resident") remains a resident for purposes other than computation of tax and withholding

In particular, Treas. Reg. § 301.7701(b)-7(c) states that "Generally, for purposes of the Internal Revenue Code other than the computation of the individual's United States income tax liability, the individual shall be treated as a United States resident."

The IRS has interpreted this to mean that a treaty dual resident must file information returns as a U.S. resident, although there are specific exceptions

Proposed Regulations' Treaty Rules

The Proposed Regulations deal with certain issues arising where an individual is treated as a resident of another country under the residence article of a tax treaty:

- Prop. Reg. § 1.6039F-1(f)(1): Gift by dual resident alien who tie-breaks to the treaty partner is treated as made by a foreign person and is therefore reportable
  - How and when will the donee know the status of the donor?

- Prop. Reg. § 1.6048-3(e)(5): Dual resident alien who tie-breaks to the treaty partner does not have to report transfer to foreign trust

Gaps in the Proposed Regulations

- Unfortunately, the coverage of issues relating to such persons is not comprehensive

- In particular, the status of a trust as a grantor trust or non-grantor trust is different depending on whether the grantor is a foreign or U.S. person. It may also affect whether the trust is foreign or domestic.
  - If the rule of Reg. § 301.7701-7(b) is applied literally, a treaty dual-resident grantor's substantive tax liability is to be computed on the basis that the grantor is foreign
  - But what about the trustee and the beneficiaries? Under this rule, must they treat the trust as foreign or domestic and as a grantor trust or non-grantor trust on the basis that the grantor is a U.S. person?
    - ➢ Is the result different for reporting purposes?

Other Exceptions

Exception to Reporting Transfers to Foreign Trusts

§ 1.6048-5(a): a Reportable Event does not include any of the following:

1. A transfer of property to a foreign trust that is a transfer for fair market value
   - However, a transfer for FMV is a Reportable Event if the transaction is with a foreign trust that is related to the transferor and the payment is an obligation of the trust without regard to whether it is a Qualified Obligation
2. Any transfer of property to certain compensatory foreign trusts as described in sections 402(b), 404(a)(4) or 404A
3. Any transfer of property to a foreign trust provided the trust has received a determination letter from IRS that the trust qualifies as a section 501(c)(3) organization and is exempt from tax under section 501(a)

Exception to Reporting Transfers to Foreign Trusts

§ 1.6048-5(b): an exception for certain eligible U.S. individuals' transactions with, or ownership of, certain tax-favored foreign retirement trusts, non-retirement savings trusts and de minimus savings trusts.

1. A *tax-favored foreign retirement trust* means a foreign trust that is established under the laws of a foreign jurisdiction to operate exclusively or almost exclusively to provide, or to earn income for the provision of, pension or retirement benefits and ancillary or incidental benefits, and that meets certain additional requirements, such as contribution limitations or value thresholds, conditions for withdrawal, and information reporting. See proposed § 1.6048-5(b)(2).

2. A *tax-favored foreign non-retirement savings trust* means a foreign trust that is established under the laws of a foreign jurisdiction to operate exclusively or almost exclusively to provide, or to earn income for the provision of, medical, disability, or educational benefits, and that also meets certain additional requirements, such as contribution limitations, conditions for withdrawal, and information reporting. See proposed § 1.6048-5(b)(3).

3. A *tax-favored foreign de minimis savings trust* means a foreign trust that is established under the laws of a foreign jurisdiction to operate as a savings vehicle, that is not treated as a tax-favored foreign retirement trust or a tax-favored foreign non-retirement savings trust, and that meets certain additional requirements, such as information reporting, and whose value is under a de minimis threshold. See proposed § 1.6048-5(b)(4).

Exception to Reporting Transfers to Foreign Trusts

§ 1.6048-5(c): Distributions from Certain Foreign Compensatory Trusts.

Reporting not required for distributions from foreign compensatory trusts described in § 1.672(f)-3(c)(1) (section 402(b) employee trusts and foreign rabbi trusts)

- The exception applies only if the U.S. individual who receives the distribution reports the distribution as compensation income on a Federal income tax return.

§ 1.6048-5(d): Distributions received by Certain Domestic Charitable Organizations.

Reporting not required for distributions received by a domestic organization described in section 501(c)(3)

- The exception applies only if the domestic organization has received a determination letter from the IRS that has not been revoked recognizing the domestic organization's exemption from Federal income tax under section 501(a) as an organization described in section 501(c)(3).

Exception to Reporting – Loan or Uncompensated Use of Trust Property

§ 1.679-2(a)(5)(iii): paragraph (a)(5)(i) does not apply if—

- The U.S. person who receives the loan of cash or marketable securities, or who uses trust property, is an entity described in section 501(c)(3);
- The loan of cash received by the U.S. person is in exchange for a qualified obligation; or
- The U.S. person who uses trust property, other than a loan of cash or marketable securities, pays the trust the fair market value of the use of such property within a reasonable period from the date of the start of the use of the property.
  - A determination as to the fair market value of the use of such property and as to whether a fair market value payment is made within a reasonable period will be based on all the facts and circumstances, including the type of property used and the period of use. In appropriate cases, such as rental of real property, payments may be made on a periodic basis, if doing so would be consistent with arm's-length dealings between unrelated parties.

Exception to Reporting – Loan from Trust

§ 1.679-4(d):

- Repeats that a Qualified Obligation is not reportable

Exception to Foreign Gift Reporting

§ 1.6039F-1(c)(2)(i)(A): no reporting required if the value of the gifts received from a foreign individual or estate, as aggregated, do not exceed $100,000, as modified by cost of living adjustments.

- Valuation includes *covered gifts* and *covered bequests* from foreign person or persons related to the transferor
- Proposed regulations include existing requirement that aggregate gifts from foreign related persons exceeding the $100K threshold be separately reported to the extent each gift exceeds $5K
  - But new requirement to identify each donor

§ 1.6039F-1(c)(2)(ii): notwithstanding the initial exception, above, if the gift qualifies as a *covered gift* or *covered bequest* and exceeds the then-annual exclusion, it is reportable.

§ 1.6039F-1(c)(2)(iii): no reporting required if the foreign gift comes from a foreign corporation or partnership and the amount does not exceed $10,000, as adjusted by cost of living.

- Proposed Regs aggregate the amounts received from the entity if related to the foreign transferor

What was not addressed in the Proposed Regulations?

What was not addressed in the Prop. Regs.?

Due Dates

- Form 3520-A due date did not change
- Remains March 15 or, if an extension is obtained, September 15 for all taxpayers

- Form 3520 due date is April 15 or June 15 (if living abroad)
- If an extension is obtained, due date is October 15 for all taxpayers → does not match the Form 1040 due date for taxpayers living abroad

Foreign Pensions

- Did not provide broad relief for foreign pensions (company and private) that are fully protected from income tax under a treaty

What was not addressed in the Prop. Regs.?

First Time Penalty Abatement

- No relief provided for failure to file beyond reasonable cause defense

Qualified Obligations

- Interest rate is still tied to AFR as opposed to a minimum safe harbor
- Still requires the loan to be denominated in USD

Civil Law Jurisdictions

- No guidance on how to address classification issues presented by civil law jurisdictions, usufructs, employee benefit plans/pensions, etc.

Foreign Grantor Trust

- No guidance on whether a non-resident by virtue of a treaty who settles a trust causes the trust to become foreign

What was not addressed in the Prop. Regs.?

Default method

- Does not provide guidance on default method available where foreign nongrantor trust becomes a U.S. trust

Exceptions from foreign gift/bequest reporting

- Under proposed regulations, U.S. citizen/resident spouses are still required to report gifts/bequests from NRA spouses if thresholds met

Penalties and Defenses

Form 3520 Foreign Gift Penalties

- Proposed § 1.6039F-1(e)(1) describes the penalties for failure to timely file Form 3520 to report large foreign gifts
- Penalty is *5% of the amount of the foreign gift* for each month (or portion thereof) for which the failure continues, not to exceed 25% in the aggregate
- No penalty is imposed if the failure to comply is due to *reasonable cause and not due to willful neglect*
  - Whether a failure is due to reasonable cause and not willful neglect will be made under the principles set forth in § 1.6664–4 and § 301.6651–1(c) and will be made on a case-by-case basis, taking into account all pertinent facts and circumstances

Treas. Reg. § 301.6651–1(c)(1)

"If the taxpayer exercised *ordinary business care and prudence* and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause."

Treas. Reg. § 1.6664-4(b)(1)

"Generally, the most important factor is the extent of the *taxpayer's effort* to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an *honest misunderstanding* of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge and education of the taxpayer. An *isolated computational or transcriptional error* generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith."

Form 3520 Trust-Related Penalties

- Proposed § 1.6677-1 provides rules for civil penalties that may be assessed if any notice or return required to be filed under proposed §§ 1.6048-2 through 1.6048-4 is not timely filed or contains incomplete or incorrect information

- The proposed regulations provide for three separate civil penalties that correspond to each separate reporting requirement under proposed §§ 1.6048-2, 1.6048-3, and 1.6048-4

- The Treasury Department and the IRS interpret section 6677 as assessing a penalty based on a percentage of a *gross reportable amount*
  - "This interpretation is consistent with the plain text of sections 6048 and 6677 and the purpose of the 1996 Act's modifications to these sections, which is to discourage U.S. persons from using foreign trusts to avoid their U.S. tax obligations."

Gross Reportable Amount

- Proposed § 1.6677-1(c)(1) provides that the term *gross reportable amount* means:
  i. the gross value of the property involved in the reportable event (determined as of the date of the event) in the case of a failure relating to proposed § 1.6048-2,
  ii. the gross value of the portion of the foreign trust's assets (at the close of the trust's taxable year) treated as owned by the U.S. person in the case of a failure relating to proposed § 1.6048-3, and
  iii. the gross amount of the distribution or deemed distribution in the case of a failure relating to proposed § 1.6048-4.

- Proposed § 1.6677-1(c)(2) provides guidance on how to determine the gross value or gross amount of property for purposes of proposed § 1.6677-1(c)(1)

Baseline § 6677 Penalties

- Proposed § 1.6677-1(a)(1) provides that a person who fails to timely file a required notice or return, or fails to provide complete and correct information, is subject to a penalty equal to the greater of *$10,000 or 35% of the applicable gross reportable amount* for each such failure
- If a person reports an amount that is less than the gross reportable amount, the penalty is based on the amount that is unreported

Continuation Penalties

- Proposed § 1.6677-1(a)(2) provides that, if the failure to comply with the applicable reporting requirement continues for more than 90 days after the day on which the IRS mails notice of the failure to the U.S. person required to pay the penalty, the person is required to pay an *additional penalty of $10,000 for each 30-day period* (or fraction thereof) during which the failure continues

Maximum Penalties

- Proposed § 1.6677-1(a)(3)(i) provides that the aggregate amount of Form 3520 baseline and continuation penalties for any single failure *may not exceed the gross reportable amount* with respect to that failure

- In many cases, the IRS will assess penalties before it has received enough information to determine the gross reportable amount. If the aggregate amount of the penalty collected exceeds the applicable gross reportable amount, the IRS will refund the excess amount pursuant to section 6402.
  - **Note**: the limitations period for refund claims under section 6511 applies to the refund of any excess amount (*i.e.*, 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever expires later)

Form 3520-A Penalties

- Proposed § 1.6677-1(b) provides a baseline penalty of the greater of *$10,000 or 5%* (rather than 35 percent) of the gross reportable amount
- Continuation penalties may also apply, as for late-filed Forms 3520
- The *U.S. owner*, rather than the foreign trust, must pay the penalty

Reasonable Cause

- As for foreign gift reporting, proposed § 1.6677-1(d) provides that the penalty does not apply if the failure to file is *due to reasonable cause and not due to willful neglect*
  - References Treas. Reg. § 1.6664-4 and § 301.6651-1(c)
  - Determinations to be made on a case-by-case basis, taking into account all pertinent facts and circumstances

- Factors that will not satisfy the reasonable cause exception:
  - The fact that a foreign jurisdiction would impose a penalty for disclosing the required information
  - Refusal on the part of a foreign trustee to provide information for any reason, including difficulty in producing the required information or the existence of provisions in the trust instrument that prevent the disclosure of required information

IRS Enforcement Policy

"Recent feedback from stakeholders has highlighted potential opportunities for improvement with respect to the IRS's penalty processes related to Forms 3520 and 3520-A. As such, the IRS has assembled a working group to further evaluate its penalty processes associated with Forms 3520 and 3520-A to identify opportunities for improvement, reduce burden and incentivize voluntary compliance. We plan to have further details on the group's recommendations soon."

- IRS *E-News for Tax Professionals*, May 10, 2024

QUESTIONS

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Michael Karlin is a co-founder of the law firm of Karlin & Peebles, LLP and has over 45 years of experience advising clients on tax, estate planning and business matters involving a cross-border element. Michael advises individuals and families from abroad who invest in or move to the United States as well as U.S. individuals and families who invest and move abroad, including with regard to the ever-increasing regulatory and reporting obligations associated with such activities. Pre-immigration and expatriation planning are an important part of his practice. He also advises individuals and closely held businesses on the tax and business aspects of operating outside their home jurisdiction.

Michael has been an active member of various professional organizations, including the American Bar Association, the Society of Trust and Estate Practitioners, the USC Institute on Federal Taxation, the State Bar of California and the Los Angeles County Bar Association. He was elected in 2020 as a fellow of the American College of Tax Counsel. He has spoken on many occasions to those and other groups and he also is a prolific contributor of articles to professional publications, which have included the Tax Notes, the Tax Lawyer, the Journal of International Taxation, Tax Management International Journal and Major Tax Planning. Over the years, he has submitted or participated in the submission of many comments on tax legislation, regulations and tax reform and in 2020 started and led a national group that obtained relief from the IRS on the application of U.S. tax residence rules for non-citizens stranded in the United States because of the COVID-19 pandemic.

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Rosy L. Lor is a Managing Director in the BDO USA Private Client Services National Tax Office and co-leads the firm's PCS International Tax Committee. She specializes in cross-border tax matters affecting high net worth individuals. Her areas of expertise include pre-immigration and expatriation tax planning, cross-border estate and gift tax matters, foreign trusts, tax treaties and other international agreements, and tax controversy. She has practiced at a Big 4 accounting firm and spent over 13 years with the IRS Office of Chief Counsel, where she last served as a Senior Technical Reviewer in the Office of Associate Chief Counsel (International).

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Melissa L. Wiley has over 20 years of experience in tax controversy and litigation on a wide range of civil tax matters at the federal and state level. She represents clients at all levels of administrative controversy with the IRS, including audits and cases before the IRS Office of Appeals, and has significant experience handling penalty and international information reporting matters. Her experience includes litigation in the U.S. Tax Court, Court of Federal Claims, and various federal district courts, as well as representing clients facing government and third-party subpoenas and investigations. She also counsels on voluntary disclosures of prior tax noncompliance.

A respected authority on tax controversy topics, Melissa frequently presents on IRS filing requirements, penalties, and enforcement, as well as on ethics and the Corporate Transparency Act. She is active in numerous professional organizations such as the AICPA, where she is the vice-chair of the IRS Advocacy and Relations Committee and a member of the National Tax Committee, and the ABA Tax Section, where she previously served as Vice Chair for Committee Operations and is currently a member of the Nominating and Appointments to the Tax Court Committees. She is also the chair of the DC Bar Tax Audits & Litigation Committee and the Regent for the Federal Circuit for the American College of Tax Counsel.