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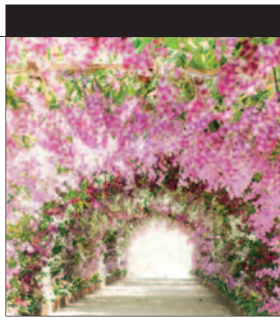

Tax Compliance for Integrated Estate Planning Trusts

Planning considerations to ensure all applicable tax reporting and compliance aspects of integrated estate planning trusts are met.

ERIC R. KAPLAN

As the popularity of individuals creating (settling) either domestic or foreign integrated (meaning having components that enhance both estate planning goals and preservation of assets from litigation risks) estate planning trusts (IEPTs) increases, estate planning practitioners, asset preservation practitioners, and certified public accountants alike must be well-versed in all applicable tax reporting and compliance aspects. As it may seem that there are always new or obscure laws or tax forms that magically appear when one least expects it, practitioners, accountants, and clients must keep abreast of changes in the Internal Revenue Code as well as all changes and updates to the applicable tax filing requirements. The last thing a client wants to do is invest in an expertly drafted and funded IEPT and then end up receiving a "Notice of Tax Due" form or a Federal Tax Lien or Levy action by the Internal Revenue Service because certain filings were either (a) filed late; (b) filed improperly or incompletely; or (c) not filed at all. Should a client receive such a notice from the Internal Revenue Service, chances are greater than 99.9% that the client's attorney and accountant will be the next to know, and likely within the next few minutes (with the possible exception if it is a weekend, personal day, or federal holiday).

IEPTs are defined as trusts that combine traditional death-time estate planning with lifetime asset protection goals. IEPTs can be either domestic trusts or foreign trusts. The reader should note that a trust can be designed and drafted to be a foreign trust for all non-tax purposes, but at the same time can be designed and drafted to be a domestic trust for federal tax purposes (as more thoroughly discussed below). Moreover, what may be designed and drafted to be a domestic trust for tax purposes may nevertheless become a foreign trust for federal tax purposes upon the occurrence of certain circumstances, such as if a nonresident alien becomes a trustee or protector.

Additional circumstances whereby a "domestic" trust for tax purposes may automatically become classified as a "foreign" trust for tax purposes is when an IEPT's domestic trustee, or third-party domestic protector, dies or resigns. In this scenario, the IEPT may remain classified as a domestic trust for United States federal tax purposes only if a new trustee or protector, who is a United States person, is appointed within 12 months of the trustee's or protector's death or resignation. If a new trustee or protector is not appointed within the 12-month period, then generally the IEPT will be retroactively classified as a "foreign" trust for United States federal income tax purposes, resulting in: (i) additional tax filing requirements (for what would be late foreign trusts as described in greater detail later in this article); and (ii) exposure to (potentially substantial) fines and penalties for non-compliance.

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The 12-month period referenced in the immediately preceding paragraph is permitted only in the event of an "inadvertent" change, which includes death or resignation. Conversely, in the event a domestic trustee or a domestic protector is removed (which would not be classified as an "inadvertent" change), then such 12-month grace period does not apply. In that case, the IEPT will automatically be classified as a foreign trust for United States federal income tax purposes *as of the date of the removal*. Therefore, if the desire is to keep the IEPT "domestic" for United States federal income tax purposes, it is recommended that a successor domestic trustee or domestic protector be effectively appointed prior to or while the then-serving domestic trustee or protector was removed.

The primary purpose of this article is to provide the reader with a summary of most (if not all) of the tax filing and compliance requirements for a client's IEPT. Prior to delving into the applicable tax filing requirements, a discussion must be had regarding the differences between a "domestic" trust and a "foreign" trust for United States federal tax purposes.

"Domestic" vs. "Foreign" Trusts for United States Federal Tax Purposes

An IEPT may be designed so that it is subject to the protective laws of one of the states that has passed asset protection trust legislation[1] or is instead subject to the protective laws of a foreign jurisdiction. Interestingly, this will not necessarily identify whether the trust is a "domestic trust" or a "foreign trust" for United States federal income tax purposes.

How can one determine if a trust is "foreign?" The fact that a trust is an "offshore" trust to obtain greater protection for the trust's assets under a foreign jurisdiction's laws does not necessarily make the trust "foreign" for tax filing purposes. Furthermore, the simple fact that the trust has been assigned a federal tax identification number is also not indicative of whether the trust is domestic or foreign. Also, whether a trust is a "grantor trust" is not determinative of whether such trust is foreign or domestic.

A domestic "offshore" trust would have the more common Form 1041, U.S. Income Tax Return for Estates and Trusts, tax filing requirements. A foreign offshore trust, on the other hand, has more involved tax filing requirements. The question then arises, how does one differentiate between a domestic and foreign offshore trust?

The Small Business Job Protection Act defines a "foreign trust" by using a two-factor bright-line test. Under this test, all trusts are foreign unless they are domestic, per Section 7701(a)(31). For a trust to be classified as a "domestic trust" for tax purposes, both a "court" test and a "control" test must be satisfied. These tests are described in Section 7701(a)(30)(E)(i) and (ii). Specifically, the tests are as follows:

Court Test. Under the court test of Section 7701(a)(30)(E)(i), a court within the United States must be able to exercise primary supervision over the trust's administration. As permitted under Treas. Reg. 301.7701-7(c)(4)(i)(D), primary supervision may be exercised concurrently by both a U.S. court and a foreign court. Therefore, the trust can be drafted so that the applicable law is that of a foreign jurisdiction, with a U.S. court also having jurisdiction but only for the purpose of "primary supervision over administration" of the trust.

While this concurrent jurisdiction is embraced by the Treasury Regulations, most *automatic* migration provisions within the trust (i.e., an automatic flee clause) stating that the trust would migrate from the United States if the United States court attempts to assert jurisdiction would prevent a U.S. court from exercising primary supervision over the trust's administration.[2] In other words, the trust would be a foreign trust even prior to the migration occurring. For this reason and because a foreign-based trustee may decide not to alter a trust's applicable law during a given legal crisis, many times the trust is drafted with only a *discretionary* migration clause. Under a discretionary migration clause, the foreign trustee may opt to change the trust's applicable law upon specified enumerated events, such as a threat to trust assets that may be located in the country of the settlor's domicile.

In many trusts during a non-crisis period, the United States-based trustee has the power to act without the consent or joinder of the foreign trustee. Further, in many trusts, a United States person is the "protector," who can veto a trustee's investment and/or distribution decisions. These two factors working in combination result in all substantial decisions being made by one or more United States persons.

[1] As of June 2023, the twenty-one states that currently recognize self-settled trusts include Alabama, Alaska, Arkansas, Connecticut, Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.

[2] See Treas. Reg. 301.7701-7(c)(4)(ii).

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Control Test. Under the control test of Section 7701(a)(30)(E)(ii), one or more U.S. persons must have the authority to control *all* substantial decisions of the trust. Substantial decisions of the trust include, but are not limited to, the following:[3]

- Whether and when to distribute income or corpus;
- The amount of any distributions;
- The selection of a beneficiary;
- Whether a receipt is allocable to income or principal;
- Whether to terminate the trust;
- Whether to compromise, arbitrate, or abandon claims of the trust;
- Whether to sue on behalf of the trust or to defend suits against the trust; and
- Whether to remove, add, or replace a trustee.

Substantial decisions do not include decisions that are "ministerial." Ministerial decisions include decisions regarding details such as bookkeeping, the collection of rents, and the execution of the investment decisions that are made by fiduciaries.[4]

Under the control test, U.S. persons are not considered to control all substantial decisions of the trust if there is an automatic migration provision that provides that "an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust to no longer be controlled by United States persons."[5] A migration provision that is discretionary (i.e., exercised only by resolution of the trustees) should not be classified as an automatic migration provision that would violate the control test because U.S. persons continue to control all substantial decisions of the trust, even if a governmental agency or creditor attempted to collect information or assert a claim.

In many trusts during a non-crisis period, the United States-based trustee has the power to act without the consent or joinder of the foreign trustee. Further, in many trusts, a United States person is the "protector," who can veto a trustee's investment and/or distribution decisions. These two factors working in combination result in all substantial decisions being made by one or more United States persons.

Tax Compliance For "Domestic" Trusts

Whether an IEPT uses the laws of a domestic jurisdiction, such as Nevada,[6] or of a foreign jurisdiction,[7] the trust may be characterized as either a "domestic" or "foreign" trust for United States federal tax purposes—depending on which courts have jurisdiction over the trust's administration and whether the persons making the substantial decisions are U.S. persons. If the trust falls within the definition of a domestic trust for U.S. federal tax purposes, various filing requirements may be relevant. In reviewing the filing requirements mentioned below, one must bear in mind that: (1) a trust's status as a domestic trust rather than as a foreign trust for federal tax purposes is always subject to change, based either upon revisions in the law, or in the trust's provisions or trustee arrangement; and (2) other filing requirements or reporting obligations may exist, depending on state and local rules.

Below is a summary of the various forms that may need to be filed and their respective annual due dates. An integrated estate planning structure can include the IEPT owning an interest in a domestic limited partnership or limited liability company, so the applicable tax return for such an entity is also included on this list.

- IRS Form 1041, U.S. Income Tax Return for Estates and Trusts—April 15th unless extended to September 30th using IRS Form 7004;
- IRS Form 1065, U.S. Return of Partnership Income—March 15th unless extended to September 15th;
- IRS Form 1040, U.S. Individual Income Tax Return—April 15th unless extended to October 15th using IRS Form 4868;
- IRS Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return—Generally, April 15th following the close of each year a transfer is made to the trust or any underlying entities. Any extension of time granted for filing an individual federal income tax return (IRS Form 1040) will also automatically extend the time to file one's federal gift tax return. Also, a Form 709 can be extended separately (for example, if the Form 1040 is not extended) by filing Form 8892, Application for Automatic Extension of Time To File Form 709 and/or Payment of Gift/ Generation-Skipping Transfer Tax, to request an automatic 6-month extension of time to file a federal gift tax return.

Income Tax. A variety of income tax forms can be relevant in the context of domestic trusts.

IRS Form 1041, U. S. Income Tax Return for Estates and Trusts. A partially completed federal income tax Form 1041 will need to be filed with respect to the trust by (generally speaking) each April 15th. A trust that is designed for a client who names himself or herself as a beneficiary of the trust is typically classified as a *grantor trust* for tax purposes under one or more of Sections 673, 674, 676, and 677. When a trust is classified as a grantor trust for tax purposes, the persons creating the trust (i.e., the grantors or settlors) may be taxed on all the grantor trust's items of income, deduction, and credit, as though those persons were the owners of the trust's assets (for income tax purposes only).

In such cases, Form 1041 will reflect the trust's status as a "grantor trust" for federal income tax purposes and will have attached to it a simple list of

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items of income, deduction, and credit that will be reported on the settlor's individual return (IRS Form 1040). A similar form will likely be required to be filed in the settlor's state of domicile, depending on state law.

Some states will tax a trust that is a "grantor trust" as a taxable entity, as opposed to allowing the trust income to flow through and be taxable directly on the settlor's personal state income tax return.[8] As a result, the IEPT itself may have a tax to pay. Unexpected consequences could therefore result, such as a sale to the IEPT triggering taxable gains in that state, or if the settlor personally pays the IEPT's state income taxes, this may be a taxable gift for federal gift tax purposes, requiring the filing of a Form 709 (discussed below).

IRS Form 1040, U. S. Individual Income Tax Return. The trust's settlor will file his or her Form 1040 as usual, noting the items of income, gain, loss, etc. reflected on the list attached to the Form 1041 and on the K-1s to be received from the underlying partnerships or limited liability companies.

Gift Tax. IRS Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return. Form 709 is used to report an individual's taxable gifts. However, many IEPTs are designed so that any transfers to such trusts will be considered "incomplete" and therefore non-taxable gifts.

Under Treas. Reg. 25.2511-2(c), a gift is generally incomplete if the donor retains the power to change the interests of beneficiaries. Therefore, the settlors of many IEPTs are given the power to alter the beneficiaries' interests in the trust through both an *inter vivos* (i.e., lifetime) (or perhaps a retained power to add certain beneficiaries) and a testamentary power of appointment. A settlor's retention of these powers of appointment ensures that any transfer to the trust will be an incomplete gift for gift tax purposes, and therefore have no gift tax implications.

Nevertheless, under Treas. Reg. 25.2511-2(j) as in effect prior to December 3, 1999, even though gifts to such a trust were incomplete for gift tax purposes, an informational gift tax return still had to be filed. While such is no longer required under the current version of Treas. Reg. 25.2511-2(j), this requirement still appears to apply when Treas. Reg. 25.6019-1(a) is read in conjunction with Treas. Reg. 25.6019-3. Therefore, while the matter is not entirely clear, it may be wise nevertheless to file IRS Form 709. And, in any event, doing so can provide additional evidence that the settlor no longer "owns" the transferred property.

Accordingly, it may be prudent to file a gift tax return for any gratuitous transfers to the trust or to one of its underlying entities (whether domestic or foreign). It should be filed by April 15th following the close of each year in which a transfer to the trust or to any of its underlying entities is made. Because the return is simply reporting an incomplete gift, it will typically be informational in nature only, with no tax due.

Practitioners and accountants should not assume, however, that every IEPT is designed so that transfers to it will be considered incomplete gifts. Some IEPTs are designed so that transfers to them will intentionally be "completed" gifts for gift tax purposes, the primary motivation of which is to remove the assets from the settlor's taxable estate. Also, practitioners and accountants should not assume that a gift to a trust is incomplete just because the trust is a "grantor trust" or because the settlor is a beneficiary.

Gift tax implications may result when distributions are made from the "incomplete gift" designed structure to or for the benefit of a beneficiary, depending on the identity of the distributee. A transfer back to the settlor will not create a gift taxable event, and a transfer to the settlor's spouse should qualify for the Section 2523 gift tax unlimited marital deduction for transfers between spouses. With respect to other transfers, however, a gift tax return should be filed with respect to any such gift that is not exempt from gift tax, such as under the Section 2503(b) annual gift tax exclusion ($17,000 per beneficiary during 2023). Additionally, gift or transfer tax implications may result when the gift is not within the applicable lifetime gift tax exemption amount (during 2023, $12,920,000) (absent a retroactive new law).

While there is a conflict among professionals whether IRS Form 1040-NR is required to be filed, the preferable view is it be filed by the trustee if any of the IEPT income is taxable in the United States.

Tax Compliance For "Foreign" Trusts

If a foreign trust exists, as defined for U.S. federal tax purposes, tax filings become more important because of the *significant penalties* resulting from a late or incomplete filing or a failure to

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[3] See a comprehensive list of "substantial decisions" in Treas. Reg. 301.7701-7(d)(1)(ii).

[4] *Id.*

[5] See Treas. Reg. 301.7701-7(d)(3).

[6] See footnote 1, *supra*. for a current comprehensive list of domestic jurisdictions that have enacted self-settled asset protection trust legislation.

[7] For example, the Cook Islands, Nevis, or Belize.

[8] For example, special rules may apply in Alabama and Pennsylvania.

file. If a trust is foreign, as defined under Section 7701(a)(31)(B), the following forms may need to be filed on their respective annual due dates:

- IRS Form 3520-A, Annual Information Return of a Foreign Trust with a U.S. Owner—March 15th for most trusts (technically the 15th day of the third month after the trust's tax year end) unless a six-month extension is filed using IRS Form 7004;
- IRS Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts—Generally April 15 (or October 15th if an individual taxpayer's IRS Form 1040 was extended using IRS Form 4868);
- IRS Form 1040-NR, U.S. Nonresident Alien Income Tax Return—June 15th (or April 15th in some cases, such as when the trust has a U.S. office);
- Appointment of U.S. Agent—before filing IRS Form 3520-A (e.g., March 15th).

In addition, if there is a foreign financial account involved (discussed in more detail below), the following form is relevant:

- FinCEN Form 114, Report of Foreign Bank and Financial Accounts—Generally, April 15th with respect to accounts existing in the prior calendar year. However, an individual tax filer receives an automatic six-month extension if FinCEN Form 114 is generally received by October 15th. This form must be filed electronically.

The foreign trust tax compliance portion of this article is divided into the following five categories to explain the related tax filing requirements:

1. When a U.S. Person is Deemed the "Owner" of a Foreign Trust's Assets;
2. When a U.S. Person Makes a Transfer to a Foreign Trust;
3. When a U.S. Person Receives a Distribution from a Foreign Trust;
4. Withholding Requirements as Applied to a Foreign Trust; and
5. Possible Income Tax Issue Should a Settlor Pass Away.

When a U.S Person is Deemed the "Owner" of a Foreign Trust's Assets. A foreign trust that is designed as a "self-settled" trust (i.e., a trust that names the settlor as a beneficiary of the trust) is typically classified as a grantor trust (see earlier discussion). A foreign trust will also be a grantor trust if it is created by a settlor who is a U.S. person (e.g., a U.S. citizen, a U.S. resident, or an entity created in the U.S.), provided that any U.S. person does or can receive financial benefits from the trust. As such, the settlor is deemed the owner of the foreign trust assets for income tax purposes. In that case, the following forms should be prepared, completed, and filed:

IRS Form 3520-A, Annual Information Return of Foreign Trust with a U.S. Owner. If a U.S. person is the grantor of a foreign grantor trust, and as such is treated as the owner of the trust assets under the grantor trust rules set forth in Section 679, they should ensure that the trustees of the foreign grantor trust file IRS Form 3520-A, Annual Information Return of Foreign Trust with a U.S. Owner, which is due on the 15th day of the third month after the end of the trust's tax year (i.e., March 15th for most foreign trusts). Penalties will be imposed if Form 3520-A is filed with incomplete information or is filed late. The penalties for a late-filed or incomplete Form 3520-A are the greater of $10,000 or 5% of the value of the trust's assets as deemed owned by the U.S. person. Even if a filer makes a protective filing,[9] this filing should be timely to avoid having to contest an automatic penalty issued by the IRS.

Included in Form 3520-A are both a Foreign Grantor Trust Owner Statement and a Foreign Grantor Trust Beneficiary Statement, both of which are discussed below. A Foreign Grantor Trust Owner Statement must be provided to the U.S. grantor so that they can report the income and expense items on the U.S. grantor's Form 1040. This statement is to be attached to Form 3520 (discussed below) to be filed by the grantor. If a U.S. beneficiary received a distribution from the foreign trust during the calendar year, a Foreign Grantor Trust Beneficiary Statement must be attached to that U.S. beneficiary's Form 3520. The Form 3520 is not, however, to be attached to the U.S. beneficiary's Form 1040 (see below).

With respect to those states mentioned above that tax a grantor trust as a taxable entity (as opposed to allowing the trust income to flow through and be taxable directly on the settlor's personal state income tax return),[10] the trust itself may have a tax liability. Therefore, it is imperative that taxpayers in such states first consult with their tax advisers to determine if such a trust-level tax applies.

IRS Form 1040-NR, U.S. Nonresident Alien Income Tax Return. The trustee of the foreign trust may also need to file IRS Form 1040-NR. While there is a conflict among professionals whether this form is required to be filed, the preferable view is that IRS Form 1040-NR be filed by the trustee if any of the IEPT income is taxable in the United States.[11] Because the IEPT is a grantor trust for tax purposes, "Grantor Trust" should be clearly printed at the top of each page. Except for the name and address on the first page, the remaining pages of the return should be left blank. A supplementary schedule should be attached to the return and

[9] Meaning a filing that is not required for the trust but filed anyway.

[10] See footnote 8, *supra*.

[11] The instructions to Form 1041 indicate that a foreign trust should file Form 1040-NR. The instructions to Form 1040-NR indicate the person filing the form should change the form to reflect the provisions of Subchapter J, Chapter 1, of the Internal Revenue Code.

[12] See page 8 to the instructions to IRS Form 3520-A.

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titled "Beneficiary Statement." This Beneficiary Statement should detail the grantor's name, taxpayer identification number, and items of income and expense. Form 1040-NR is due on June 15th (or April 15th if the trust has a U.S. office) of the year following the calendar year when the foreign grantor trust received the taxable income.

The penalty for a late-filed Form 1040-NR is usually 5% of the amount due for each month or part of a month that the return is late unless the taxpayer has a reasonable explanation. However, in the typical situation where a foreign trust is a grantor trust, no tax is due on the Form 1040-NR itself.

IRS Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. A U.S. grantor of a foreign grantor trust is required to annually file Form 3520. The grantor needs to file this form each year even if the grantor neither made a transfer to, nor received a distribution from, the foreign trust. The Form 3520 is filed separately at a different location than where the Form 1040 is filed, and it is not attached to the U.S. grantor's Form 1040 for such year.

If there are two settlors of the trust, and those settlors file a joint income tax return, they can also file a joint Form 3520. Unless properly extended, Form 3520 is due each year by April 15th for reporting information with respect to a foreign trust for the immediately preceding calendar year. The due date for Form 3520 can be extended only by extending the due date of the taxpayer's individual income tax return (Form 1040). The due date for a Form 3520 that is being filed with respect to a U.S. decedent is the due date of the decedent's estate tax return (Form 706), including extensions. For the purpose of reporting contributions to the IEPT, the penalty for failing to timely file a complete tax return each year is the greater of: (i) $10,000; or (ii) 35% of the value of the assets transferred to the foreign trust. If Form 3520 is timely filed, the foregoing penalties still apply to any unreported or underreported contributions and distributions. Under certain circumstances, additional penalties may apply.

Appointment of a U. S. Agent for Tax Purposes. If a domestic "agent" is designated for the trust, such designation must be made in writing for the foreign trust before the due date of IRS Form 3520-A (e.g., March 15th). The U.S. Agent must be available to accept service of process, give testimony concerning the foreign trust, and allow for the examination of trust records for the purpose of determining the amount of tax due and owing. There are no penalties, *per se*, for not appointing a U.S. Agent because the appointment of a U.S. Agent is not mandatory. In the event of an audit, however, if a U.S. Agent has not been timely appointed in writing, the Internal Revenue Service may determine the amount of income required to be included by the U.S. owner.

A U.S. grantor of a foreign grantor trust is required to annually file Form 3520. The grantor needs to file this form each year even if the grantor neither made a transfer to, nor received a distribution from, the foreign trust.

Also, if the trust does not appoint a U.S. Agent, the following documents must be attached to IRS Form 3520-A:

- A summary of the terms of the trust that includes a summary of any oral agreements or understandings the U.S. owner has with the trustee, whether or not legally enforceable; and
- A copy of all trust documents (and any revisions), including the trust instrument, any memoranda of wishes prepared by the trustees summarizing the settlor's wishes, any letter of wishes prepared by the settlor summarizing his or her wishes, and any similar documents.[12]

When a U.S. Person Makes a Transfer to a Foreign Trust. Filing requirements in this case differ, depending upon whether the transfer made by a U.S. person to a foreign trust is made gratuitously or in exchange for an obligation.

Gratuitous Transfer to a Foreign Trust. Any gratuitous transfer (i.e., gift) of property to a foreign trust by a U.S. person is required to be reported on Form 3520. A gift would occur if a grantor transfers property (including cash) to the foreign trust or if the grantor pays any bills or expenses on behalf of the foreign trust. Likewise, a sale to the trust for less than full consideration is treated partly as a gift.

A loan by a U.S. person to the trust can be treated as a contribution, unless the loan is a "qualified obligation" (i.e., certain five-year or lesser-period loans). Also, the conversion of a "domestic trust" to a "foreign trust" for tax purposes is deemed to be a gratuitous transfer of all the assets of the domestic trust to the foreign trust. Therefore, at the time of the conversion to a foreign trust for tax purposes, there is a deemed gift from the grantor to the foreign trust, and the entire fair market value of the assets on such date would need to be reported as a gratuitous transfer of property on Form 3520.

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Sale of Property to a Foreign Trust in Exchange for an Obligation. The sale of property to a foreign trust in exchange for an obligation is also required to be reported on Form 3520. Even if a U.S. taxpayer receives fair market value in the form of a promissory note or a private annuity in return for property transferred to the foreign trust, such a transfer must be reported. It should be noted that it does not matter whether a promissory note received meets the definition of a "qualified obligation," the transfer of property in exchange for such "qualified obligation" must still be reported.

At the present time, a fair market value sale of property by the foreign trust for cash is not reported on Form 3520. However, the person completing Form 3520 should carefully read the form as well as the instructions in case such a filing requirement is subsequently added by the Internal Revenue Service.

When a U.S. Person Receives a Distribution from a Foreign Trust.

If a U.S. person (e.g., a trust beneficiary) receives a distribution from a foreign trust, the U.S. person must meet the reporting requirements for distributions as detailed in the instructions for Forms 3520 and 1040. Also, for this purpose, any loan (either direct or indirect) to a U.S. person is deemed to be a distribution, even if such loan meets the definition of a "qualified obligation." Any loan of marketable securities to a U.S. person is also treated as a distribution.

Uncompensated Use of Trust Property. If a U.S. person uses trust assets without paying full consideration for such use, the value of the uncompensated (or undercompensated) use of trust property (whether real property or personal property) by the U.S. person will be treated as a trust distribution. For example, if real property owned by the foreign trust has a fair market rental value of $5,000 per month, but the U.S. person only pays $3,000 per month for the use of the property, then there will be a deemed distribution of $24,000 per year to the U.S. person, who must report said amount as a distribution on the Form 3520 or be subject to a penalty in the amount of the greater of (i) $10,000, or (ii) a 35% assessment on the amount of the deemed distribution.

It does not matter whether a sale of property to a foreign trust in exchange for a promissory note received meets the definition of a "qualified obligation," the transfer of property in exchange for such "qualified obligation" must still be reported.

Also, any property (including cash) that is transferred to a U.S. person by an intermediary who has received property from a foreign trust is treated as property transferred directly by the foreign trust to the U.S. person if the intermediary received the property from a foreign trust pursuant to a plan of which a principal purpose was U.S. tax avoidance.

Trust Beneficiary Statement. A U.S. beneficiary who receives a distribution from a foreign trust may also be required to attach either a Foreign Grantor Trust Beneficiary Statement or a Foreign Nongrantor Trust Beneficiary Statement, as applicable, to his or her related Form 3520 for the year the distribution is received. Failure to attach such a statement to this tax return may result in the Internal Revenue Service treating the distribution as an accumulation distribution.[13]

Withholding Requirements as Applied to a Foreign Trust.

A U.S. person that makes any payments to a foreign person (including a trust that is classified as a foreign trust for tax purposes) may be required to withhold an "estimated amount" of tax depending on the classification of the type of U.S. source income. As applied to the foreign trust, various withholding taxes may apply in the following two situations:

1. An unrelated U.S. person may have an obligation to withhold a certain amount of tax from a payment made to a foreign trust. For example, a U.S. brokerage firm may be required to withhold up to 30% on the payments on dividends from a U.S. company to a foreign trust and file Forms 1042 and 1042-S by March 15th;[14] or
2. If the foreign trust owns an interest in a domestic entity, such as a domestic partnership, there may be withholding obligations at the entity level. Depending on the type of assets owned by this domestic entity and on the documentation provided by the foreign trust to the domestic entity, it may have a withholding obligation on either a payment made to the foreign trust or on the pro rata share of the income allocable to such foreign trust.

U.S. source income received by a foreign person is classified as either investment income (discussed below) or income from a trade or business. Income from real estate may be classified as *either* investment income (see immediately below) or trade or business income (see further below) depending on whether a Section 871(d) or Section 882(d) net election is made. Due to the

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possible loss of tax deductions associated with investments in U.S. real estate, a tax professional should be contacted prior to either directly or indirectly investing in any U.S. real estate through an entity.

Section 1441—Withholding of Tax on Nonresident Aliens (Investment Income) and Section 1442—Withholding of Tax on Foreign Corporations (Investment Income). Unless a lower rate is provided by a tax treaty or an exception applies, when a "U.S. payor" makes a payment of income that is classified as fixed, determinable, annual, or periodic (FDAP income) to a foreign person, the "U.S. payor" may be required to withhold 30% of the amount of the payment. FDAP income generally includes interest, dividends, rents, and annuities. Some exceptions may apply. For example, generally U.S. source interest income and U.S. source capital gain are exempt from withholding; however, U.S. dividend income is generally subject to a 30% withholding requirement unless the foreign trust is able to (and does) meet certain requirements to avoid such withholding.

If the trustee of the foreign grantor trust that has a U.S. settlor desires to avoid certain withholdings with respect to any foreign financial account that holds any securities (either U.S. securities or foreign securities), an IRS Form W-8IMY, Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding and Reporting needs to be prepared, and signed by the trustee on behalf of the foreign trust, and an IRS Form W-9, Request for Taxpayer Identification Number and Certification needs to be prepared and signed by the U.S. settlor. In the event the aforementioned forms are not completed, the foreign financial institution will typically be required to withhold estimated income tax at the rate of 30% of interest or dividend income and 30% of the *proceeds of sale of any security* (as opposed to the amount of gain). These forms should comply with the foreign financial institution's requirements. IRS Forms W-8 IMY and W-9 also most likely will need to be provided by the foreign trust to any domestic payors of income or distributions to the foreign trust (e.g., a domestic limited partnership in which the foreign trust is a partner). Similar rules apply to a foreign LLC or partnership owned by the foreign trust.

Section 1445 – Withholding of Tax on Dispositions of U.S. Real Property Interests. Because, as noted above, the foreign trust is considered a foreign person, Section 1445 may require withholdings attributable to any sale of U.S. real property interests (USRPIs) owned by the foreign trust. There are two types of USRPIs – direct investments and indirect investments:

1. A direct investment in U.S. real property. For example, if the IEPT were to own an apartment building located within the United States.

2. An indirect investment where a foreign person owns a U.S. corporation, and the U.S. corporation owns the U.S. real property. Such a domestic corporation is referred to as a U.S. real property holding company (USRPHC) if the fair market value of the real estate equals or exceeds 50% or more of the value of the domestic corporation's (i) worldwide real property interests; and (ii) its trade or business assets. For example, if the foreign trust were to own a domestic corporation and the domestic corporation owns only a Colorado apartment building, the domestic corporation would be classified as a USRPHC. Further, the USRPHC will be classified as a USRPI held by the foreign trust.

Generally, if a foreign person owns a USRPI and such foreign person sells the USRPI, the purchaser of the USRPI is required to withhold 15% of the sales price of the USRPI. The rules regarding USRPIs, as well as the rules regarding any investments by a foreign person in U.S. real estate, are complicated. Therefore, if a foreign trustee decides to purchase any interest in U.S. real property (either indirectly through a domestic corporation or directly) on behalf of a foreign trust, such issues and the related reporting requirements should be properly vetted before proceeding.

Possible Income Tax Issue Should the Settlor Pass Away. It is important to note that Section 684 provides for possible gain recognition when a transfer of appreciated assets is made to a foreign trust. For U.S. income tax purposes, the transfer is treated as a sale or exchange of the assets by the transferor. During a settlor's life, this income tax is inapplicable to transfers made to the foreign (grantor) trust, because the foreign trust is a grantor trust for federal income tax purposes, and Section 684(b) provides a specific exception to gain recognition for transfers made to a grantor trust. However, upon the death of a settlor, all or part of the foreign trust is no longer classified as a grantor trust for tax purposes, and recognition of taxable income on "certain items" (income in respect of a decedent or IRD items) could occur.

IRD items are those that have been earned by the decedent prior to the time of death, but the decedent has not paid income tax on such item. For example, IRD includes (with some exceptions) accrued interest on bonds, income items earned through a partnership or limited liability company in some cases, and payments under installment sale contracts, annuities, and retirement plans, as well as other certain items.

In many cases, the recognition of this gain on IRD items may be beneficial from an estate tax point of view, in that the income tax attributable to such recognition will be reported as a

[13] See I.R.C. Section 6048(c)(2)(A).

[14] See Treas. Reg. 1.1461-1(b)(1) and (c)(4)(ii)(A).

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liability of the deceased settlor's estate, thereby reducing the amount of estate tax due. On the other hand, in some cases, it may be better to avoid the recognition of gain on IRD items at the time of the settlor's death. Therefore, should the foreign trust own any bonds, annuities, or installment notes, or if the foreign trust is a beneficiary of a retirement plan, a discussion should be had regarding the various planning opportunities that may be available.

In any event, the Form W-8 IMY and Form W-9 described above (i.e., post death) are no longer available as a method of avoiding withholding. Therefore, taxes may be paid earlier in the way of withholding taxes instead of on the settlor's tax return on the following due date for the settlor's individual tax return (IRS Form 1040).

Also, any income earned by the foreign trust after the settlor's death that is accumulated and not currently distributed to a U.S. beneficiary in the same year it is earned could be taxed at a higher ordinary income tax rate instead of a more favorable capital gain or qualified dividend tax rate.

Additional Miscellaneous Reporting Considerations

Irrespective of whether the IEPT is classified as foreign or domestic for tax purposes, the following forms are required to be filed under certain circumstances:

FinCEN Form 114 Report of Foreign Bank and Foreign Financial Accounts. A FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR) must be completed and electronically filed with the Treasury Department by April 15th (unless effectively extended to October 15th) of each year by each U.S. person who has a "financial interest" in or signature authority or other authority over bank securities, or other financial accounts in a foreign country, the value of which exceeds $10,000 at any time during the previous calendar year. This filing requirement could pertain to a trust, and/or to any individual who has such an interest in or authority over a foreign account. Thus, there may be multiple filers for a single account. Failure to file the FBAR may result in the imposition of civil and criminal penalties.

The filing instructions for the FBAR provide that a "financial interest" includes an interest held by a U.S. person in a trust in which the U.S. person has a present beneficial interest, either directly or indirectly, in more than 50% of the assets or from which the U.S. person receives more than 50% of the current income.

The filing instructions further provide that a U.S. person has a financial interest in any foreign account that is owned directly or indirectly by a grantor trust that the U.S. person created (such as the IEPT). As such, the settlor of a trust may be required to file the FBAR even if the settlor is not a beneficiary of the trust. Furthermore, any trust created, organized or formed in the United States must file this form to report any foreign accounts that collectively exceed $10,000.

Hiring Incentives to Restore Employment Act (HIRE Act). The HIRE Act, as part of the Foreign Account Tax Compliance Act (FATCA), implemented a new Section 6038D which requires any individual (and certain entities) who during any taxable year holds any interest in a specified foreign financial asset to attach to such person's tax return certain information with respect to each asset. IRS Form 8938, entitled "Statement of Specified Foreign Assets," is required to be filed by certain individuals and certain entities to report owned foreign financial assets if the total value of those assets exceeds an applicable amount (e.g., $100,000 for married taxpayers filing jointly; $50,000 for a single taxpayer) on the last day of the year, or (for individuals) more than $150,000 at any time during the year for married taxpayers filing jointly or $75,000 for a single taxpayer.

Specified foreign financial assets generally include assets such as any financial account maintained by a foreign financial institution, and to the extent held for investment and not held in a financial account, any stock or securities issued by someone that is not a U.S. person, any interest in a foreign entity, any financial interest or contract with an issuer or counterparty that is not a U.S. person, and certain commodities held offshore.

Additionally, under the HIRE Act, a shareholder in a passive foreign investment company (PFIC) or foreign mutual fund is required to report information under Section 1298(f) and is required to attach Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund" to the PFIC shareholder's annual income tax or informational return. In addition, effective as of December 28, 2016, a PFIC shareholder must now file a separate Form 8621 for each PFIC in a chain of ownership and can no longer complete Form 8621 for the first PFIC in a chain of ownership and then, in an attachment, provide the information required on Form 8621 for each of the other PFICs in the chain. Unless certain tax deferral strategies are being implemented, a timely QEF election is critical to avoid certain loss of preferential tax rate treatment on income, and the ability to borrow from the PFIC without severe tax consequences.

Agriculture/Farm Service Agency Form FSA-153. If an asset that represents an interest in a ranch, farm, or other agricultural property is transferred to or from the IEPT, the Department of Agriculture requires that Farm Service Agency Form FSA-153 be filed within ninety (90) days after the date such transfer occurs.

Furthermore, a change in trustees also requires an additional filing of the FSA-153 within ninety (90) days after

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the deed reflecting such change is executed. "Agricultural property" means any land in the United States which is either (i) used for forestry production or (ii) currently used for, or, if currently idle, used within the past 5 years, for farming, ranching, or timber production, except land not exceeding 10 acres in the aggregate if the annual gross receipts from the sale of the farm, ranch, or timber products produced thereon do not exceed one thousand dollars ($1,000). Examples of agricultural land include (a) land used for animal trapping; (b) land used for game or wildlife management; (c) land used for hunting carried on as a business enterprise; (d) land exceeding 10 acres in which 10% is stocked by trees of any size for which it would be economically feasible to market such trees, including land that formerly had such tree cover and that will be naturally or artificially regenerated; and (e) land on which any crop is grown, even if someone other than the landowner uses such crop for commercial purposes regardless of whether the landowner receives any monetary or non-monetary compensation from the crop.

The Code of Federal Regulations requires that a "foreign person," or an entity in which a foreign person owns a substantial interest (which would include an underlying family limited partnership or a family limited liability company) that acquires, disposes of, or holds an interest in United States agricultural land shall disclose any such transaction and holdings to the Secretary of Agriculture within ninety (90) days after such transaction occurs.[15] The definition of a "foreign person" includes the IEPT, *even if* the IEPT is a "domestic trust" for U.S. tax purposes. The definition of a "foreign person" also includes the partnership or limited liability company in which the IEPT is a partner or member. The regulations require that these reports be filed with the Farm Service Agency office in the county where the subject land is located within the ninety (90) days mentioned above.

The penalty for not filing Form FSA-153 within ninety (90) days of the transfer of the agricultural property to or from the IEPT is equal to the product of (i) one-tenth of one percent (0.10%) of the fair market value of the IEPT's interest in the particular agricultural property that prompted the filing requirement; and (ii) the number of weeks that Form FSA-153 remains unfiled. For example, on a $1,000,000 property, the Department of Agriculture could assess a penalty of $1,000 per week, totaling to $52,000 one year after the property is transferred to the structure (or $104,000 two years after such transfer, and so on) up to a maximum of 25% of the fair market value of the agricultural property. This penalty may be reduced based on various factors; however, the potential magnitude of this penalty deserves special attention to meet these filing requirements.

Real Estate Transfers. Transfers of real estate may result in a state or local real estate transfer filing obligation and/or a related transfer tax being due and payable.

Foreign Corporations, Foreign Partnerships, and Foreign Limited Liability Company Obligations. In addition to filing an income tax return, there are additional filing requirements for certain foreign corporations, foreign partnerships, and foreign limited liability companies. For example, certain transfers of property to a foreign corporation generally must be reported on IRS Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation. In regard to certain transfers made to a foreign corporation or to a foreign limited liability company that is classified as a foreign corporation for tax purposes, if the amount of cash or fair market value of the property exceeds $100,000 or if the transfer results in the transferor directly or indirectly owning at least 10% of the foreign corporation, such transfer must be reported on Form 926. The penalty for not filing is 10% of the fair market value of the property at the date of the transfer. The limit to this penalty is $100,000 unless the failure to comply was due to intentional disregard.

Any loan (either direct or indirect) to a U.S. person by a foreign trust is deemed to be a distribution, even if such loan meets the definition of a "qualified obligation." Any loan of marketable securities to a U.S. person is also treated as a distribution.

With respect to a foreign corporation, in addition to the Form 926 mentioned above, a U.S. shareholder, officer or director may need to annually file IRS Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. Generally, if a U.S. person owns 10% or more of a foreign corporation, Form 5471 needs to be filed on an annual basis. IRS Form 8992, U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI) may also need to be filed. The penalty for a failure to file Form 5471 is $10,000. If Form 5471 is not filed within 90 days after the IRS has mailed a notice of the failure to the U.S. person, an ad-

[15] 7 C.F.R. 781.

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ditional $10,000 (per foreign corporation) is charged for each 30-day period, or fraction thereof, during which the failure continues after the 90-day period has expired. The additional penalty is limited to a maximum of $50,000 for each failure.

If the corporation (or even simply an investment in certain offshore mutual funds) is owned by a U.S. person, and such corporation or fund is considered to be a passive foreign investment company (a PFIC, as it is commonly called), an annual report to the Internal Revenue Service may be required.

Although beyond the scope of this article, the reader should take note to review the instructions to IRS Form 1120-F, U.S. Income Tax Return of a Foreign Corporation, to determine whether it is required to be filed to report any United States sourced or "effectively connected" income.

If a foreign limited liability company does not make the proper "check the box" election on a timely filed IRS Form 8832, Entity Classification Election, the limited liability company will default to being taxed as a corporation under U.S. tax laws if the members all have limited liability. As a result, the limited liability company may become subject to a "double taxation" regime. Therefore, if one prefers to have the foreign limited liability company treated as a flow-through entity (i.e., as a partnership if there are two or more members, or as a "disregarded" entity if there is only one member) to avoid the double taxation inherent in most corporations, then an IRS Form 8832 needs to be timely filed within 75 days after the end of the first year to which the election will apply. If such Form is not timely filed, relief is provided under Revenue Procedure 2009-41[16] providing an extra three years to file the Form, so long as certain criteria are satisfied.

If the foreign limited liability company has two or more members and has checked the box to be treated as a partnership, or if the entity is a foreign partnership treated as a partnership under U.S. tax laws, then Treas. Reg. 1.6038B-2 applies. Subsection (a)(1)(ii) of this Regulation states that if transfers are made to a foreign partnership or to a foreign limited liability company classified as a foreign partnership for tax purposes, and if the value of the property transferred plus cash during the year exceeds $100,000, the transferor must report the transfer on IRS Form 8865, Information Return of U.S. Persons With Respect to Certain Foreign Partnerships. Also, generally, if a United States person owns 10% or more of a U.S.-controlled foreign limited liability company that is taxed as a partnership, Form 8865 information must be annually filed. The penalty for failure to file is $10,000. Also, if the return was required to report a contribution to the partnership or limited liability company, the penalty is 10% of the value of the contribution (capped at a $100,000 penalty).

A U.S. person that makes any payments to a foreign person (including a trust that is classified as a foreign trust for tax purposes) may be required to withhold an "estimated amount" of tax depending on the classification of the type of U.S. source income.

If the foreign limited liability company is wholly owned by one U.S. member, then IRS Form 8858, Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs) must be annually filed. The penalty for a failure to file is $10,000.

If a foreign trust owns any single member domestic limited liability companies, then there is a filing requirement for IRS Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business that may be due each March 15th (which can be extended for six months by filing a properly completed IRS Form 7004). IRS Form 5472 may need to be accompanied by a *pro forma* IRS Form 1120, U.S. Corporation Income Tax Return. However, it is strongly recommended that a taxpayer first confirm these IRS Form 5472/1120 requirements and due dates with the taxpayer's certified public accountant as exceptions may exist. Further, if a controlled foreign corporation exists as part of an overall planning structure, then IRS Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations will be annually required.

There are other more obscure forms or information-disclosure requirements, including, but certainly not limited to:

- United States Department of Commerce, Bureau of Economic Analysis Form BE-10, Benchmark Survey: U.S. Direct Investment Abroad;
- United States Department of Commerce, Bureau of Economic Analysis Form BE-11, Survey of U.S. Direct Investment Abroad; and
- United States Department of Commerce, Bureau of Economic Analysis Form BE-12, Benchmark Survey: Foreign Direct Investment in the United States.

[16] 2009-39 IRB 439.

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Forms BE-10 and BE-12 are required every five years if any foreign trusts or companies are involved in foreign or U.S. business or certain real estate assets or activities. Form BE-11 is an annual survey conducted to secure current economic data on the operations of U.S. parent companies and their foreign affiliates.

Also, certain reporting to a governmental agency of information about the individuals and corporate entities (and their individual direct or indirect principals) who have significant "control" (e.g., powers to cause distributions of the trust or entity assets) over U.S. companies owned by the trust, will be required by the recently enacted Corporate Transparency Act.

Change of Address or Responsible Party. Also, in the event there is a change in the fiduciary's or responsible party's identity or address relating to a trust or entity, an IRS Form 8822-B, Change of Address or Responsible Party—Business should be filed within sixty (60) days of the change with the IRS so that refunds and correspondence are properly disseminated. This applies to (i) in the case of a trust, the individual settlor of a trust; and (2) in the case of partnership or LLC, the individual who controls access to the entity's assets (e.g., a general partner of a partnership or a manager of an LLC). Incidentally, if anyone changes their own address, an IRS Form 8822, Change of Address should be filed to notify the IRS where correspondence should be sent.

Conclusion

The various tax filings that must be considered when IEPTs are involved in asset preservation planning can be quite voluminous. In addition to the federal filings discussed in this article, there are also tax compliance issues for a practitioner and accountant's consideration on a state-by-state and, in some instances, local governmental basis. Therefore, advisors should carefully consider each of the tax returns mentioned in this article, as well as any relevant state or local filings, in order to determine which apply in each circumstance for each tax year. ■