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Legal Update

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United States: Reporting burdens increase for foreign trusts and gifts from non-US persons under proposed rules

Tax News and Developments August 2024

In brief

Treasury and the IRS recently issued proposed regulations regarding reporting of transactions with foreign trusts and the receipt of foreign gifts ("**Proposed Regulations**"). The Proposed Regulations affect US persons who are grantors or beneficiaries of foreign trusts and US persons who receive gifts or bequests from foreign persons. These rules are the most significant development regarding reporting for US persons with interests in foreign trusts since 1997, and they raise many questions for foreign trusts with US-connected persons. Many of those uncertainties are highlighted in recommendations and comments to Treasury by more than 1,000 practitioners and interested stakeholders, including the American College of Trust and Estate Counsel (ACTEC), the Tax Section of the American Bar Association (ABA) and the New York State Bar Association.

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Section 643(i) loans from foreign nongrantor trusts to US grantors and US beneficiaries

A loan of cash or marketable securities from a foreign non-grantor trust directly or indirectly to a US grantor or beneficiary of the trust or to any US person related to a US grantor or beneficiary of the trust is generally treated as a distribution under section 643(i). Direct or indirect use of trust property by a US grantor or beneficiary (or a related US person) is also treated as a distribution to the US grantor or beneficiary.

The Proposed Regulations take a broad approach as to when loans to related persons will trigger a deemed distribution to a US grantor or US beneficiary. In many circumstances, this broad approach leads to unusual consequences.

Deemed distribution treatment for "indirect loans"

The Proposed Regulations include rules for indirect loans made through intermediaries, agents, and nominees. They provide three examples of indirect loans that would trigger a distribution:

- A loan by any person other than the trust to a US grantor or US beneficiary of a foreign trust (or any US person related to a US grantor or US beneficiary) if the foreign trust guarantees the loan;
- A loan made by any person related to the foreign trust to a US grantor or US beneficiary (or a US person related to a US grantor or beneficiary) of the trust if the foreign person is related to a US grantor or US beneficiary; and
- A loan made by a foreign trust to a foreign person, other than to a nonresident alien individual grantor or beneficiary of the trust, if the foreign person is related to a US grantor or US beneficiary of the foreign trust.

For purposes of these rules, a person is considered related to another person if the relationship is one specified in section 267 or 707(b) of the Code relating to disallowance of losses except that family attribution is also extended to spouses.

The Proposed Regulations deem a US beneficiary to receive a distribution when the foreign trust makes a loan to a foreign person if the foreign person is related to the US beneficiary. In the context of a family trust – particularly a multi-generational family trust with several jurisdictional touchpoints – a loan to a foreign family member or an entity controlled by such family does not confer any benefit or advantage on the US beneficiary.

Compliance with the resulting reporting and taxation would be very fact-specific, and commentators have urged the IRS to provide detailed guidance with specific examples and scenarios. There should be exclusions in certain circumstances where the ambiguity of application would be too great while the risks of tax non-compliance remote, specifically with indirect loans treated as distributions by attribution.

Pre-immigration two-year rule

The Proposed Regulations provide a new rule if a foreign person who is a grantor or beneficiary of a foreign trust receives a loan from the foreign trust and becomes a US person **within two years**. Then the grantor or beneficiary would be deemed to receive and be subject to US taxes on a trust distribution equal to the amount of the loan that remains outstanding if the loan was *not* a qualified obligation when the loan was made.

Foreign persons will need to address loans from trusts prior to relocating to the United States. This would create an additional trap for pre-immigration taxpayers who have settled or benefit from foreign trusts at a time when the US tax system was not relevant for them. The US tax treatment of refinancing or restatement of the terms of such existing loans prior to immigration would have to be clarified in this context and further example should be provided in IRS guidance.

Exception for qualified obligations

The Proposed Regulations provide certain exceptions, in particular for “qualified obligations” on the basis of Notice 97-34. The exception for qualified obligations would apply to an obligation that meets the following requirements:

- Is in writing;
- Has a term of five years or less;
- Payments must be made in cash in US dollars;
- Be issued at par and provided for a stated fixed or qualified floating interest rate:
- The yield-to-maturity must not be less than 100% and not greater than 130% of the applicable federal rate on the issue date; and
- All stated interest must be qualified stated interest.

The above requirements highlight again how unlikely it would be that loans granted by foreign trusts before a settlor or beneficiary moves to the United States to qualify when the US tax rules would not be relevant for them absent planning specifically designed to have the obligation qualify as a qualified obligation. For example, the loans **generally may not** be stated in US dollars or set at an interest rate with reference to the US applicable federal rate set by the IRS absent specific planning.

Additionally, the Proposed Regulations further require that the US grantor or beneficiary must extend the period of assessment for income tax attributable to the loan and any consequent income tax charges **until three years from maturity**. The US grantor or beneficiary must also report the obligation and any payments made on Form 3520.

Consequences of deemed distribution

The amount treated as a deemed distribution for these purposes is generally:

- The issue price of a loan of cash,
- In the case of a loan of marketable securities, the fair market value of the securities, and
- In the case of the use of trust property without fair market value compensation, the fair market value of the use less any payments made within a reasonable time period.

A distribution of marketable securities would require under these rules that the trust recognize gain or loss as if the securities were sold at fair market value. This means that the deemed distribution would carry out an additional amount of the trust’s distributable net income that may be subject to US taxation and reporting.

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Section 679 implications of loans from foreign trusts and use of trust property

A US person who transfers property to a foreign trust which has a US beneficiary is treated as the owner of the trust under the grantor trust rules. The Proposed Regulations would clarify when a trust is deemed to have a US beneficiary by aligning section 679 with the new rules under section 643(i) discussed above.

As noted above, the Proposed Regulations provide that an indirect loan from a foreign trust to a US person includes a loan made by any person (US or foreign) if the foreign trust provides a guarantee for the loan. Loan guarantees by foreign trusts to US persons are treated as distributions subject to US tax, similar to direct loans or use of trust property. The general rule would not apply to loans if one of the following conditions applies:

- The loan of cash received by a US person is in exchange for a qualified obligation;
- The US person who uses trust property (other than a loan of cash or marketable securities) pays the foreign 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, or
- The US person who receives a loan of cash or marketable securities or who uses trust property is an exempt organization under section 501(c)(3).

Section 679(d) generally provides the presumption that if a US person directly or indirectly transfers property to a foreign trust, the IRS may treat the trust as having a US person, unless the US person reports the transfer on Form 3520 and attaches an explanatory statement demonstrating that US persons cannot benefit directly or indirectly, including at termination.

The Proposed Regulations would further allow the IRS to request additional information related to the foreign trust and its potential beneficiaries. Pre-immigration taxpayers will need to navigate the expanded section 679 with respect to any trusts settled within five years of their residency starting date.

Changes to foreign gift reporting

US persons are required to report gifts or bequests from a foreign person on Form 3520 if the gift or bequest exceeds USD 100,000. The Proposed Regulations would index the USD 100,000 reporting threshold for inflation.

Form 3520 does not currently require reporting the identifying information of the foreign donor-transferor. The Proposed Regulations would require reporting of such information (for example, name and address).

Furthermore, the Proposed Regulations clarify that a dual-resident taxpayer would not be treated as a US person for this reporting for any period that the taxpayer is treated as a foreign person.

Reporting transfers to and distributions from foreign trusts

US persons are required to report any distribution from a foreign trust on Form 3520. A US person who receives a distribution from a foreign trust that is treated as a gift for income tax purposes (such as a distribution from a grantor trust) is still required to report the distribution as a foreign trust distribution rather than a foreign gift.

Domestication of a Foreign Trust to a US trust

The Proposed Regulations include an example where a foreign non-grantor trust decants to a domestic (i.e., US) non-grantor trust. The example concludes that the decanting is a distribution of trust corpus and income from the foreign non-grantor trust to the domestic non-grantor trust that would be reportable on Form 3520 Part III for the year of the decanting. The IRS included this example to illustrate section 6048 reporting; however, the language of the example could suggest that the IRS would treat the decanting as a distribution for trust income tax purposes and not solely for reporting. Hopefully, in the final regulations, the IRS would clarify that such a decanting (i.e., transfer) would be a distribution only for reporting purposes and not for substantive tax purposes.

Creation of a foreign trust by attorneys

Section 6048(a) requires a responsible party to report certain reportable events on Form 3520. Treasury's interpretation of section 6048 in the Proposed Regulations indicates that section 6048 reporting and penalties would extend to attorneys as trust grantors if

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they assist taxpayers in the creation of foreign trusts. This obligation may result in reporting of information currently protected by the attorney-client confidentiality rules.

In addition, it is yet unclear what activities would be sufficient to be treated as creating a trust for the attorney to become a foreign trust grantor and subject to the reporting obligation. Furthermore, in such a situation the attorney will be jointly or subsidiarily liable and subject to the extremely high penalties for failure to report (properly) the creation of the trust. ACTEC and other commentators are urging Treasury to exempt attorneys from this requirement, in particular when they have advised their taxpayers about the taxpayer's own reporting obligations.

Foreign retirement trusts

The Proposed Regulations expand the exception for reporting information regarding certain "tax-favored foreign retirement trusts". Such trusts are 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. In addition, they must also meet one of two requirements:

- **Value Limitation:** aggregate value of the trust(s) is limited to no more than $600,000 at any point during the taxable year, **or**
- **Contribution Limitation:**
  - Percentage of participant's earned income from performance of personal services
  - Annual limit of USD 75,000 or less, **or**
  - Lifetime limit of USD 1,000,000 or less

These limitations are adjusted annually for inflation. There are further conditions to qualify. Withdrawals, distributions, or payments from the trust must be conditioned upon:

- Reaching a specified retirement age; disability; or death,
- For in-service loans, **or**
- For reasons such as hardship, educational purposes, or purchase of a primary residence.

Furthermore, annual information reporting must be provided or available to the tax authorities in the trust's jurisdiction.

If the trust meets the limitations and conditions, the reporting exception applies only to "eligible individuals" defined in the Proposed Regulations as those who have reported as income any contributions to, earnings of, or distributions from such a trust on the applicable US federal income tax return (or an amended return).

Commentators have expressed concerns that taxpayers and their advisers may find it difficult to determine whether their foreign retirement accounts qualify for the tax-favored status and how to properly report them for US tax purposes. In particular, in civil law jurisdictions, the classification of foreign pension-holding vehicles as trusts, companies, or securities/savings accounts would present special compliance challenges and costs. Accordingly, commentators urge the IRS to create a list of foreign pensions that should not be considered foreign trusts for these purposes. For example, the ABA commentators mention specifically UK Self-Invested Personal Pension and Australian Superannuation Plans for further clarification and exemptions from reporting and taxation. Other suggestions are to add per pension / individual exceptions (rather than on an account-wide basis); higher contribution and value limits; trusts established in countries with tax treaties to be exempted from certain reporting. It remains to be seen if the IRS would accept any of these suggestions.

Foreign compensatory trusts

The Proposed Regulations exempt from the reporting requirements also distributions from foreign compensatory trusts, which are already defined in existing US Treasury regulations. The US persons who use this exception must include in their taxable income any required amounts accumulated on their behalf or distributed by the trust to them, excluding any amounts exempt from US income tax under a US income tax treaty.

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Expanded penalties for failure to report

With the expansion of the reporting obligations as mentioned above, the Proposed Regulations also will expand the activities that will be subject to penalties for failure to report information on Form 3520-A or Form 3520 with respect to foreign trusts and gifts or bequests from foreign persons.

Consequently, various commentators have urged the US Treasury to add detailed guidance on the reporting requirements for the creation, transfers, and distributions from foreign trusts to include specific examples and scenarios to help taxpayers and their advisers to understand their compliance obligations.

Furthermore, practitioners have expressed concerns about the automatically imposed high penalties and highlighted that the Proposed Regulations should be revised and finalized to state explicitly that:

- **Automatic One-Time Penalty Abatement:** Such penalty abatement should be added for first-time failures to report to be granted when the taxpayer is otherwise compliant, or the failure was inadvertent or due to erroneous professional advice or good-faith errors.
- **Reasonable Cause Exception:** No penalty should be imposed if a compliance failure is attributable to reasonable cause based on a case-by-case determination and interpreted with flexibility to reflect specific facts and circumstances; additionally, there should not be automatic denials of abatements based on previous compliance issues or reliance on another person to file the reporting.
- **Pre-Assessment Right to Appeal:** Examiners should issue a notice letter warning the taxpayer of potential penalties and allow them an opportunity to appeal before the penalties are assessed. Additionally, taxpayers should have the right to appeal penalty assessments based on reasonable cause before they are imposed, and additional penalties should be deferred until the appeal process is resolved.

Commentators have highlighted that the high relative amount of the penalties and manner applied by the IRS increase further the burdens for taxpayers, their advisers and service providers.

Gifts or bequests from foreign persons

Failure to report gifts or bequests from foreign persons above the reportable threshold would subject the taxpayer to a penalty of 5% of the reportable amount for each month for which the failure to report persists, up to 25%. In addition, the IRS may also reassess the income tax consequences of the receipt of gift based on all facts and circumstances. Commentators have highlighted that the generally automatically imposed penalty is excessively high compared to the failure.

Creation, transfers and distributions from trusts

The Proposed Regulations elaborate on the penalties for failure to report on Form 3520-A and/or Form 3520 information with respect to foreign trusts, specifically in respect of the following three main currently existing reporting obligations:

- The grantor and/or transferor of property to a foreign trust as well as the executor of a decedent's estate are obligated to report in Part I of Form 3520 certain reportable events:
  - Creation of the foreign trust by a US person,
  - Direct, indirect, or constructive transfer of money or property to a foreign trust by a US person, including a transfer by reason of death, and
  - The death of a US person who was treated as the grantor of a foreign trust and any portion of such foreign trust was included in the decedent's gross estate.
- Any US person who receives directly, indirectly, or constructively any distribution from a foreign trust is obliged to report such distribution in Part III of Form 3520.
- Any US person who is wholly or partly treated as the owner of a foreign trust is responsible for ensuring that Form 3520-A along with its respective owner and beneficiary statements are duly furnished and filed.

Under the Proposed Regulations the failure to comply with the reporting on Form 3520 would subject the taxpayer to a penalty equal to the greater of USD 10,000 or 35% of the gross reportable amount. Additionally, failure to comply with the reporting on Form 3520-A would subject the taxpayer to a penalty equal to the greater of USD 10,000 or 5% of the gross reportable amount. Taxpayers subject to these penalties would be penalized by an additional USD 10,000 for every 30-day period the failure to report

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continues after the first 90 days following payment notice from the IRS. In any case, the aggregate amount of the initial penalties could not exceed the gross reportable amount with respect to the particular reporting failure.

What comes next?

Further comments and questions on the Proposed Regulations requesting clarifications will be exchanged with the IRS by practitioners and interested parties during the public hearing scheduled for 21 August 2024.

Following the hearing, once issued as final, the Proposed Regulations are expected to expand significantly the reporting obligations for US grantors and US beneficiaries of foreign trusts and increase the burdens of compliance. The trustees and the beneficiaries of foreign trusts, especially those with new or existing loans, will need to track the wide-ranging tax and distribution implications of the rules once they become effective.

Many of the commentators to the US Treasury recognize that the new rules under the Proposed Regulations would introduce additional complex and confusing reporting requirements for foreign trusts and gifts from foreign persons. The resulting confusion for taxpayer and their advisers could lead to good-faith misunderstanding, errors and lack of (full) compliance inadvertently. Automatic penalties without proper opportunity for explanation of the tax positions under specific facts and circumstances and advice of tax counsel would further burden with additional costs, time, and effort the taxpayers and service providers in the wealth management industry. The IRS would have to embark on a campaign to inform IRS agents, taxpayers, and tax professionals about the expected additional requirements to facilitate compliance with guidance, FAQs, and clear IRS form instructions.

Any remaining uncertainties and expansion of reporting under the final rules will likely cause taxpayers and their advisers to consider their willingness and approach to challenging the Proposed Regulations once they are finalized. The likelihood of such challenges has increased following the US Supreme Court's decision in *Loper Bright Enterprises v. Raimondo*, No. 22-541 (June 28, 2024), which overturned the Chevron framework that had been used by the courts to defer to the government agency's interpretations in regulations.

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