Is Offshore Evil? Current Legislative Developments

By, Marianne Kayan, ABA RPTE Section Fellow
Paley Rothman, Bethesda, Maryland

Suggested Legislation: Expanded Reporting- Foreign Trust Penalty Provisions

The President's FY 2009 Budget suggests several proposals for expanded information reporting. One proposal is legislation to revise the penalties for failing to comply with the foreign trust reporting regime. Foreign trust reporting occurs on Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts* and/or Form 3520-A, *Annual Information Return of Foreign Trust With a US Owner*.[1]

Form 3520-A is generally filed by the trustee of a foreign grantor trust.[2] The form discloses the identity of and information about the grantor and the trust assets. The form contains a balance sheet for the trust, with a detailed statement regarding the income attributable to a US owner and a statement detailing the distributions to any US person. Under current law, the failure to file or accurately complete the Form 3520-A subjects the US owner of the foreign trust to a penalty of 5% of the "gross value" of the foreign trust assets that US law attributes to the US owner.[3] Penalties significantly expand if the IRS provides notice to the grantor of the failure to file, and the form is not filed within 90 days of the notice. At that point a penalty of $10,000 is assessed for each 30 day period until the 3520-A is filed.[4] The total monetary penalty, however, cannot exceed the "gross value" of the trust assets considered owned by the US grantor.

Form 3520 is generally filed by i) the US person who creates or transfers property to a foreign trust, ii) US persons treated as owners of a foreign trust, iii) US persons who receive a distribution from a foreign trust, or iv) US persons who receive large gifts from abroad. The 3520 requires a substantial amount of information regarding contributions and distributions from the trust. Under current law, those who fail to file Form 3520 are subject to a 35% penalty on the "gross reportable amount", which includes the gross value of property transfers to the trust or the gross amount of distributions received from the trust.[5] Once the IRS mails notice of the failure to report, after 90 days, an additional penalty of $10,000 is imposed for each 30 day period during which the failure continues. The penalty, however, may not exceed the gross reportable amount.[6] Although the recipients of large foreign gifts report the gifts on the Form 3520, the failure to file penalty is based on a different code section, IRC Section 6039F, under which a 5% penalty of the amount of the gift is imposed per month, to a maximum of 25%[7]; the suggested legislation does not impact the penalty provisions related to reporting large foreign gifts.

New legislation is apparently necessary because the IRS often obtains information about foreign trusts from third parties or public records. Without assistance from those involved, the IRS has difficulty determining the "gross reportable amount" or the "gross value"; without this information, it is difficult for the IRS to assess the penalty amount properly. Moreover, the IRS may not be able to meet the 7491(c) burden of production to support the penalty.[8]

The proposed legislation amends the initial penalty resulting from the failure to file the Form 3520 to be the greater of 35% of the gross reportable amount (if known) or $10,000.[9] It is likely that the 5% penalty resulting from the failure to file the 3520-A would be the greater of 5% of the gross value (if known) or $10,000. The additional penalty of $10,000 remains unchanged for each 30 day period the failure to report continues. The intent of the legislation is to create an incentive for individuals to cooperate with the IRS to determine the gross reportable amount. It is estimated that if the legislation were effective for information reports filed after 1/1/2009, $3MM in revenue would occur over the next ten years.[10] This increase in revenue is significantly lower than the anticipated increase in revenue from any of the other expanded reporting suggestions.

Expatriation Legislation

In the current session of Congress, a number of bills have been introduced that add additional rules and taxes to the current expatriation tax regime. The expansion of the expatriation regime is a revenue raiser, and because these rules impact few people, the provisions have been popular to add into various bills.

Under the current tax regime, for a ten year period a covered expatriate is subject to US income tax on US source income, gift tax on gifts of US securities and debt obligations of US issuers, and gift and estate tax on transfers of stock of closely held foreign corporations that own US assets.[11] A covered expatriate is a US citizen or permanent resident who has either $2MM of net worth, average income for the proceeding five years of $124,000 (indexed for inflation), or fails to certify his or her tax compliance.[12]

The major provision of the pending expatriation legislation is the “mark- to-market tax” or “exit tax.” Under the exit tax provisions, a covered expatriate is treated as selling all assets the day prior to the expatriation. The first $600,000 of gain realized, however, would not be taxed.

Section 204 of H.R. 3997, *Defenders of Freedom Tax Relief Act of 2007*, passed by the Senate on December 19, 2007 and Section 305 of H.R. 3997 *Heroes Earnings Assistance and Tax Relief Act of 2007*, passed by the House on December 18, 2007 are the bills that have progressed the farthest in the current session of Congress that contain the exit tax; however, it is unlikely that the legislation will move forward because of controversy on nontax matters. Section 204(a) of the Senate version and Section 305(a) of the House version continue the current expatriation regime set out in IRC Section 877 and add the new expatriation regime—the exit tax—at IRC Section 877A. The previous Senate version of the legislation had repealed IRC Section 877, but this repeal is not present in the current version. Having both expatriation regimes in force adds a considerable amount of complexity—not only applying the new exit tax, but continuing to tax the individual on certain assets for ten years.

ACTEC issued comments[13] to pending expatriation legislation on October 10, 2007 and the AICPA issued comments[14] to HR 3997 on January 16, 2008. Several of the issues highlighted by ACTEC's and AICPA's comments are addressed in Section 274 of S. 2642, *American Renewable Energy Act of 2008*, which was introduced before the Senate Committee on Finance on February 14, 2008. Notable changes to the expatriation provisions in S. 2642 include: the exclusion of US real property from the exit tax and not imposing an inheritance or succession tax on transfers to US persons from expatriates. Unfortunately, the existing expatriation regime and the proposed exit tax would both be operational and apply to an expatriate.

Stop Tax Haven Abuse Act (STHAA)

S 681, the STHAA, has been pending at the Senate Committee on Finance since February 17, 2007. Similar legislation in the House, HR 2136, has been pending at various House committees since May and June 2007. It is unlikely in the current session of Congress that this bill will move forward; however, the legislation highlights that Congress is considering how to remedy the tax gap caused by offshore tax evasion.

The STHAA identifies offshore secrecy jurisdictions and then creates a rebuttable presumption in civil or administrative tax collection proceedings that a US person who formed, transferred assets to, was a beneficiary of, or received assets or use of assets from an entity, is deemed to control the offshore entity. Additionally, any value that the US person received would be deemed to be income, and this income would be considered previously unreported.[15]

The legislation also contains provisions that attempt to prevent the misuse of foreign trusts. A grantor of a trust is considered to have the power of any trust protector or similar advisor who could influence or veto the trustee. Further, a US person who receives cash or property from a foreign trust would be deemed to be a beneficiary of the trust.[16]

Liechtenstein Accounts—Banking Secrecy Breached

Liechtenstein is considered by some to be a tax haven because of its bank secrecy laws. A former employee of Liechtenstein's largest bank, LGT, apparently sold bank account records to the German government. The IRS was provided this information.[17] The IRS has stated that they will take action related to more than 100 US taxpayers to ensure proper tax reporting.[18]

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[1] *See* General Explanation of the Administration's Fiscal Year 2009 Revenue Proposals, (2008 Blue Book) Dept. of Treasury, Feb. 2008, p. 72.
[2] IRC Section 6048(b)
[3] IRC Section 6677(b)(2)

[4] IRC Section 6677(a)
[5] IRC Section 6677(c)
[6] IRC Section 6677(a)
[7] IRC Section 6039F
[8] General Explanation of the Administration's Fiscal Year 2009 Revenue Proposals, (2008 Blue Book) Dept. of Treasury, Feb. 2008, p. 72.
[9] *Id*.
[10] *Id*.
[11] IRC Section 877
[12] IRC Section 877(a)(2)
[13] ACTEC, Comment on Expatriation Proposals, October 2007 (See http://www.actec.org/public/Governmental_Relations/HarrisonComments10_10_07.asp)
[14] AICPA Comments on Legislation Revising Tax Rules on Expatriation, BNA Daily Tax Report, February 4, 2008
[15] *See* Title I of S.681 (the STHAA)
[16] *See* Section 106 of S.681 (the STHAA)
[17] IRS to Take Enforcement Action Against US Taxpayers with Liechtenstein Accounts, BNA Daily Tax Report, Feb. 27, 2008.
[18] Commissioner of IRS-Use of Accounts in Tax Haven Nations, IR News Release 2008-26, Feb. 26, 2008.