

Your Taxes: IRS grants 3-week extension for its tax-amnesty program

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This article is an urgent update for US taxpayers... and it comes just ahead of Yom Kippur

This past May, in an article titled "Your Taxes: US and Israeli tax amnesties," we wrote about a US Internal Revenue Service voluntary disclosure program for undeclared foreign accounts (outside the US). The program, known as the IRS Offshore Income Reporting Initiative (the "Initiative"), was announced on March 23 and was scheduled to terminate Wednesday (September 23).

However, on Monday, the IRS announced "a one-time extension of the deadline for special voluntary disclosures," giving taxpayers until October 15.

United States taxpayers everywhere - including citizens temporarily residing in Israel, citizens who have made aliya, or dual US/Israeli citizens - are still responsible for filing US tax returns and reporting their worldwide income, including income associated with foreign accounts.

This is unlike the exemption from reporting to the Israel Tax Authority non-Israeli source income and gains for 10 years for new residents and "senior returning residents" who live abroad five to 10 years.

In addition to US tax returns, there are numerous informational returns that US persons may be required to file, including TDF 90-22.1 Report of Foreign Bank and Financial Accounts (known as the "FBAR"). There are significant penalties associated with a taxpayer's failure to file these informational returns, and in the case of the FBAR, the penalties are confiscatory.

(For more details about the FBAR, please see "Your Taxes: FBAR for US Taxpayers," published on February 28, 2007, in *The Jerusalem Post*. *The FBAR and the Initiative were most recently written about in the Post last Wednesday.*)

US taxpayers can use the Initiative to resolve noncompliance, and if they qualify, they will not be subject to criminal penalties or the civil-fraud penalty. The need to file

informational returns including the FBAR can also be resolved through the Initiative. This article will discuss some of these often overlooked informational returns.

FBAR

Do you have a foreign bank account you own either individually or jointly? Do you have a foreign investment account you own either individually or jointly? Do you have a debit or credit card that is tied to a foreign account even if not yours? Do you own a foreign mutual fund? Are you trustee of a trust with foreign investments? Do you hold a power of attorney for someone who owns foreign investments? If you can answer yes to any of these questions, you likely have an FBAR filing requirement.

All US persons must file an FBAR to report the existence of a financial interest, signature authority or other authority over foreign financial accounts if in the aggregate at any time during the preceding calendar year the balance of all such accounts equals or exceeds \$10,000. The FBAR is not a tax filing; it is an informational return that must be received by the IRS on June 30, and simply mailing it on June 30 is insufficient.

Form 3520

Have you ever set up a foreign trust? Have you ever contributed funds or property to a foreign trust set up by someone else? Have you ever received gifts from foreign persons? Have you ever received an inheritance from a foreign person? Have you ever received funds from a foreign corporation or partnership in which you do not have an ownership interest? Have you ever loaned funds to a foreign trust? Have you ever received a distribution from a foreign trust? Do you have a debit or credit card that is tied to a foreign (non-US) trust? If you answer yes to any of these questions you may have a Form 3520 filing requirement.

US persons must file Form 3520 to report their (i) creation of a foreign trust; (ii) transfer of money or property to a foreign trust including by reason of death; (iii) receipt of distributions from a foreign trust as well as (iv) receipt of certain gifts from foreign persons.

For purposes of the filing, "distributions" include direct distributions (i.e. a distribution directly to the US beneficiary), as well as indirect distributions (i.e. a US person writes a check that will be satisfied from a foreign trust, or uses a credit card that takes funds out of a foreign trust). If a US person is subject to these reporting rules, the form is due on the date that such person's income tax return is due, including extensions. The form must be filed in duplicate: one copy attached to the US person's income tax return and the second sent separately to the IRS Service Center in Philadelphia.

The penalty for failure to file Form 3520 to report the transfer of funds to a foreign trust is currently "35 percent of the gross value of any property transferred to a foreign trust" and "35% of the gross value of distributions received from a foreign trust" for the failure to report the receipt of a distribution from a foreign trust. If Form 3520 is incomplete, in addition to penalties, the entire trust distribution will be deemed an accumulation distribution and taxed as ordinary income.

It should be noted that if Form 3520 is delinquent more than 90 days after receiving notification from the IRS of such delinquency, an additional penalty of \$10,000 is permitted for every 30 days (or fraction thereof).

The Internal Revenue Code also requires US persons to disclose the receipt of large gifts or bequests from foreign persons. The disclosure requirement is tied to the identity of the donor, and there are different thresholds based upon the donor. For example, there are higher thresholds for gifts received from nonresident alien individuals and foreign estates than there are for gifts from foreign partnerships and foreign corporations. Consequently, a US person is required to report the receipt of gifts from a nonresident alien or foreign estate only if the total amount of gifts from that nonresident alien or foreign estate is more than \$100,000 during the tax year. Once the \$100,000 threshold has been met, the US person must separately identify each gift that is more than \$5,000, but doesn't have to identify the donor.

The penalty for failure to file Form 3520 reporting the receipt of a large foreign gift is less than that for filing Form 3520 reporting the receipt distributions from the foreign trust. The penalty for failing to timely report the receipt of a foreign gift is 5% per month. The penalty increases each month that Form 3520 is delinquent and continues up to a total of 25%. The penalty is due upon notice and demand.

Form 3520-A

Did you create a foreign trust at any time? If you have recently become a US taxpayer, did you create a foreign trust within five years of becoming a US taxpayer? Be sure not to answer too quickly.

It is important to note that the Internal Revenue Code and Treasury regulations can re-characterize a transaction. For example, if a taxpayer transfers assets to his or her parents who are not US taxpayers, who then settle a foreign trust, the trust will likely be deemed created by the US taxpayer. Treas. Reg. Section 1.679-3(c) provides that "a transfer to a foreign trust by a person to whom a US person transfers property is treated as an indirect transfer by a US person to the foreign trust if such transfer is made pursuant to a plan one of the principal purposes of which is the avoidance of United States tax."

The principal purpose of a transfer will be deemed to be tax avoidance if: (i) the US person is related to a beneficiary of the foreign trust; and (ii) the US person cannot demonstrate to the satisfaction of the IRS that there was no other basis for creating the trust to benefit such person.

Additionally, even if a foreign trust appears to have no US beneficiaries, the Internal Revenue Code can override the determination and treat the trust as having a US beneficiary regardless of what is provided in the trust document itself. For example, according to Section 679(c)(1) a trust will be deemed to have a US beneficiary unless: (i) under the terms of the trust no part of the income or corpus could be paid or accumulated for the benefit of a US person; and (ii) if the trust terminated during the tax year, no part of the income or corpus could be paid to a US person.

Furthermore, Treas. Reg. Section 1.679-2(a)(4)(ii)(A) provides that if the trust documentation can be amended to benefit a US person, then it will be classified as if there were such a US beneficiary. Similarly, Treas. Reg. Section 1.679-2(b)(1) provides that if a beneficiary of the trust is a controlled foreign corporation or a foreign partnership in which the taxpayer is a partner, the trust will similarly be classified as having a US beneficiary.

The consequence of having settled a foreign trust, which is classified as having a US beneficiary, is that the taxpayer will be deemed to own the trust under the grantor trust rules. Consequently, the taxpayer will be liable for paying the income tax on the trust's income. Additionally, the taxpayer will be required to file Form 3520-A. The form must be filed by March 15, but a six-month extension may be received by filing Form 7004. The penalty for failure to file Form 3520-A is 5% of the December 31 value of the portion of the trust's assets treated as owned by the taxpayer.

Form 5471

Do you own a foreign corporation? Are you a director or officer of a foreign corporation? If the answer to either of these questions is yes, you may have an obligation to file Form 5471.

Certain US citizens and residents who are officers, directors, or shareholders of foreign corporations must file Form 5471. While there are several categories of persons who must file the form, if a US officer or director acquires stock to meet the 10% ownership requirement, or if a US person had control of a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the foreign corporation, such person would also have a filing obligation.

A person is in control of a foreign corporation if: (i) the person owns stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote; or (ii) the person owns more than 50% of the total value of shares of all classes of stock of a corporation. The form is due at the same time as the US person's income tax return. There is a \$10,000 penalty for each annual accounting period for which the failure to file Form 5471 exists.

What about Israel?

The Israeli and US tax systems are separate. That there is a tax treaty between the US and Israel does not exempt US taxpayers from their US tax and reporting obligations. But there is a system of foreign tax credits that helps avoid double taxation. There is an information-exchange clause in the treaty that enables the IRS and ITA to communicate.

On a separate note, there is currently an Israeli tax-reporting extension for trusts until October 30, regarding the years 2006-2008. In addition, there is an amnesty offer for certain pre-2006 trusts allowing them to pay tax at a rate of 4%-10% of their value at the end of 2005 in settlement of the pre-2006 Israeli tax liability, if any.

As always, consult experienced tax advisers in each country at an early stage in specific cases.

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