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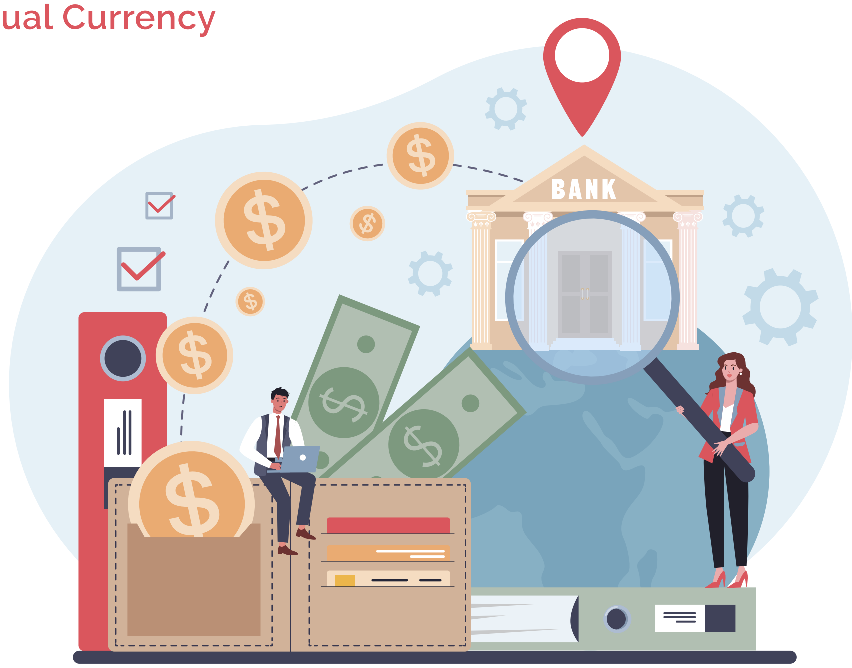


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See page 19 for details.

Foreign Retirement Account Reporting

A shift in focus

By Monica Haven, J.D., LL.M., EA

U.S. citizens living and working abroad face a myriad of onerous reporting requirements for foreign bank accounts (FinCEN 114) and assets (Form 8938). The U.S. Treasury has engaged in much-publicized enforcement activity, which — to the joy of tax practitioners — has compelled taxpayers to become compliant. The tax professional community must now shift its focus to clients invested in passive foreign investment companies (PFICs), such as foreign money market accounts, mutual funds, hedge funds, insurance products, pensions and retirement accounts, which do not enjoy the same tax benefits of their American counterparts. This article will focus on the complexity of the mandated reporting regime for PFICs (Form 8621) and for those investments deemed to be foreign "trusts" (Form 3520).

What is FATCA?

The *Foreign Account Tax Compliance Act* (FATCA) was passed as part of the *Hiring Incentives to Restore Employment (HIRE) Act* in 2010 in a broad attempt to combat offshore tax evasion by imposing a stringent reporting regime on individuals and foreign financial institutions (FFIs).

FFIs and certain other non-financial foreign entities are offered a carrot and stick: In exchange for disclosing information about the foreign assets held by their U.S. account holders, FFIs are exempt from 30% IRS-mandated withholdings on the receipt of deposits and payments made to them. Individuals, on the other hand, are given no incentive to disclose their foreign financial accounts and foreign assets other than penalty avoidance. The penalties are indeed substantial, compelling many — but not yet all — to comply with their reporting obligations.

FATCA reporting requirements are imposed in addition to those already mandated by the *Bank Secrecy Act of 1970* (BSA), which requires U.S. persons to disclose to the U.S. Treasury the existence of and details about foreign currency transactions and bank accounts held abroad. Congress enacted the BSA in response to concerns that U.S. citizens were using foreign bank secrecy laws to conceal illegal activities. The Secretary of the Treasury was given broad discretion to define the entities subject to the law and the amount of detailed disclosure to be made and retained.

Post-9/11, Congressional focus shifted from money laundering to terrorist financing and with the passage of the *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism of 2001* (USA PATRIOT Act), the reporting requirements for suspicious activity and cash transactions were enhanced. Information sharing between financial institutions and federal law enforcement was encouraged. Civil penalties — including for non-willful violations — were increased under the *American Jobs Creation Act of 2004*.

FATCA was enacted to recoup annual tax shortfalls due to offshore tax abuses with the help of an informational system designed to rely on foreign entities to report what U.S. taxpayers did not. The burden of compliance was thereby shifted — at least in part — from individuals to FFIs that must determine if their accounts are in fact discretely owned by U.S. citizens and residents.

It has been argued and judicially contested that FATCA and the BSA significantly infringe upon the rights of privacy guaranteed by the Fourth Amendment of the U.S. Constitution. Yet, while scholars debate and legal battles are waged, FATCA for the moment remains inviolate. The burdensome rules remain in place. Penalties for failure to comply are oppressive. Affected U.S. persons (our clients) must fulfill their reporting obligations. Tax professionals must guide and assist or, at a minimum, raise awareness to ensure that unwitting taxpayers can make educated choices.

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Practitioner awareness. It's critical to note that while requisite reporting requirements are mechanical in nature — often requiring little more than form completion — legal compliance is of great complexity and dependent upon proper interpretation of the law. Tax professionals who are otherwise not licensed to provide legal counsel should refrain from stepping beyond their areas of expertise and instead defer to attorneys specializing in the areas of international tax law, voluntary disclosures and (if necessary) criminal defense.

On the other hand, tax practitioners must be issue-spotters. Based on close contact with and knowledge of their clients, these professionals are on the front line. It should be, and is, their duty to elicit the appropriate information from taxpayers necessary to determine if they are U.S. persons subject to the reporting mandates, have accounts and assets that are reportable and are not subject to a legal exemption or exception.

With more than three dozen FATCA-related forms listed by the IRS, clearly FATCA compliance extends well beyond mere offshore bank and asset reporting. This article will limit its focus on disclosure issues related to offshore retirement account arrangements. U.S. citizens living and working abroad will encounter an array of individual and employer-provided retirement plans, pensions and annuities. Each of these are subject to a multitude of tax rules within the host country as well as in the United States where taxpayers will face income tax consequences and mandated disclosures as per the BSA and FATCA.

Retirement accounts

To understand the tax and disclosure regimes that apply to retirement accounts abroad, it's best to start first with a review of employer-provided savings options available in the United States on terra firma and then compare and contrast them with those offered to U.S. citizens abroad.

U.S. plans: In the United States, we distinguish between qualified and non-qualified plans. The former satisfies the criteria of the *Employee Retirement Income Security Act* (ERISA), enacted in 1974 primarily to protect worker accounts by ensuring that plan administrators and fiduciaries do not misuse plan assets. ERISA introduced minimum standards for participation, funding and benefit accrual, and placed restrictions on the discretionary authority and managerial control of those responsible for investment and safekeeping of employee funds.

While ERISA governs many employer plans, certain arrangements are exempt, including retirement plans established by government entities and churches and company plans established outside of the United States for the benefit of non-resident alien employees.[1]

Qualified (ERISA-compliant) plans include defined contribution, money purchase pension, profit-sharing, stock bonus, SEP, SIMPLE and Keogh plans as well as non-profit employee and teacher annuities.[2] Non-qualified plans include deferred-compensation, split-dollar life insurance and executive bonus plans. Because these plans do not have to satisfy the stringent criteria of ERISA-mandated rules, non-qualified plans can be specifically tailored to employer and employee needs. But this flexibility comes at a price. In general, non-qualified plans must be funded with after-tax dollars. Qualified plans, on the other hand, provide for deductible contributions and tax-deferred growth.

Although established under varying code provisions and administered for a different subset of employees, all qualified plans share preferential tax benefits, including:

- Immediate tax deductions for employer and employee contributions
- Tax-deferred income and growth
- Tax deferred recognition of appreciation if qualifying distributions are made from employer stock
- Tax-free rollovers

In short, these plans can provide immediate tax savings to both employer and employee. Alas, none of these perks are typically available to American participants in overseas retirement accounts.

Foreign plans: Barring overriding tax treaty provisions, most foreign pension plans and retirement accounts are deemed to be non-qualified for U.S. tax purposes regardless of their classification under the laws of the host country. As a result:

- Employee contributions cannot be used to reduce the employee's taxable income
- Employer contributions on behalf of the employee are includible as taxable income to the employee
- Income and growth during the accumulation phase are taxable to the employee annually
- Eventual distributions are taxed by the United States even if also subject to tax abroad
- All distributions will be taxed in full, with no adjustment for taxes already paid during the growth phase

There are currently 68 bilateral tax treaties in effect between the United States and individual foreign governments. These agreements are designed to ensure that residents (not necessarily citizens) of foreign countries are taxed at reduced rates or are exempted from U.S. taxation on certain items of U.S.-source income. Conversely, U.S. residents or citizens are taxed at reduced rates or are exempted from foreign taxes on certain items of foreign-source income.

Treaty provisions, when available, supersede provisions of the Internal Revenue Code. Taxpayers wishing to avail themselves of a favorable treaty provision must disclose that provision by attaching Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*, to their income tax return. Failure to file Form 8833 is subject to a $1,000 penalty (for individual filers) or $10,000 (for corporate filers) for each undisclosed position claimed.

The IRS recommends that taxpayers begin their analysis of an applicable treaty with Article 4 (in most treaties), which requires that tax residency must be established based on the domestic law of the host country. Residency will then determine how remaining treaty articles on pensions and annuities will be applied. If a taxpayer is deemed to be a dual resident under local law, tie-breaker rules must be used to identify the country to which the taxpayer has closer personal and economic connections. Taxpayers should also examine all treaty protocols to verify whether residency rules have been amended.

Few treaties allow foreign retirement accounts to be treated in a manner similar to their American qualified counterparts. As a result, contributions and distributions remain includible in gross income, albeit possibly taxed at reduced rates if addressed by the terms of a specific treaty or eligible for the foreign tax credit if subject to income taxation here and abroad.

Passive foreign investment companies (PFICs)

A PFIC is an entity that holds mainly passive assets or receives mainly passive income from interest, dividends, capital gains, rents, etc.[3] PFICs typically include foreign mutual funds, money market accounts, pension funds, partnerships and other pooled investment vehicles, such as a real estate investment trust (REIT).

The PFIC tax regime was created under the *Tax Reform Act of 1986* with the intent of leveling the playing field between foreign and U.S.-based mutual funds, which are required to pass through all income to investors annually. In earlier years, foreign mutual funds and their investors were able to avoid U.S. taxation. The funds derived only foreign-source income that was not taxable to the corporation and, because the funds were owned by a large number of investors who each held only a small percentage of total assets, individual shareholders were not bound by the tax reporting requirements of a controlled foreign corporation.[4]

With the enactment of the PFIC rules, shareholders of certain foreign investment companies must report undistributed earnings regardless of their ownership percentage. Any tax benefits previously enjoyed succumbed to the requirements that shareholders are directly and individually taxed and that foreign fund companies are subject to an interest charge on undistributed income and gains (much in the same manner as their U.S. counterparts).

Shareholders have three options to report their allocable share of undistributed income: (1) claim a qualifying electing fund (QEF) election; (2) claim a mark-to-market (MTM) election; or (3) employ the default PFIC treatment.[5] **Note:** Regardless of the method selected, the benefit of tax deferral, once the hallmark of investing in foreign mutual funds, has been eliminated.

PFIC defined: If at least 75% of a foreign corporation's gross income is attributable to passive income (income test) or at least 50% of the corporation's total assets are passive assets (asset test), the entity will be classified as a PFIC. Passive assets for purposes of this definition are those assets that generate interest income, dividends, capital gains, royalties (unless derived from an active trade or business) or rents (unless derived from actively managed property).[6] In this context, most investment income is deemed to be passive. Passive income, however, does not include income derived from the active conduct of a U.S. bank, qualifying insurance company or export trade company, nor does it include income generated from related party transactions. A PFIC is most often thought to be a foreign mutual fund, but foreign pensions, annuities and retirement accounts may be PFICs as well.

Elective treatment: Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, is used to notify the IRS of the taxpayer's elections, whether to suffer the default treatment that postpones income recognition until it is taxed as ordinary income upon distribution or to claim one of two available elections that accelerate income recognition in exchange for capital gain treatment upon disposition. If early recognition is elected, the remainder of the form is used to compute the tax currently due. Let's take a closer look at the three options available to shareholders for reporting their allocable share of undistributed income:

1. **The QEF option:** If elected, shareholders of foreign mutual funds will be treated much in the same manner as shareholders of domestic funds. Electing individuals must include their pro rata share of the fund's investment income as ordinary income and the pro rata share of the fund's transactional income as capital gains on their personal returns. While familiar to U.S.-based investors, this method requires that the electing shareholder receives a PFIC Annual Information Statement each year signed by an authorized representative of the PFIC.[7] Alas, most foreign mutual funds are unable or unwilling to comply with U.S.-mandated disclosure information; therefore, few U.S. taxpayers can avail themselves of QEF treatment.

   The election must be made on a timely filed return but cannot be applied retroactively. If the election had not been made in earlier years but the taxpayer wishes to elect QEF treatment for current and future years, they must make a purging election, which will have the effect of a deemed sale and repurchase of fund shares.

   To purge the so-called §1291 taint, the taxpayer must recognize a tax consequence in the year of the purge resulting from the gain on sale of the PFIC based on a deemed sales transaction at the fund's year-end value. Any gain recognized will be treated as an excess distribution, which must be annualized over the lesser of the taxpayer's holding period or three years and taxed at the highest ordinary rate in effect each year.[8] **Note:** The purge election is often best made when there has been little or no appreciation in the PFIC account during the investor's tenure to date.
2. **The MTM election:** This option is available only if the taxpayer is invested in a PFIC that is a marketable security traded on a U.S. stock exchange.[9] At the close of each year, gains will be computed as if there had been a disposition of the PFIC stock. The resulting gain (loss) is taxed as ordinary income (loss); the investor's basis is increased by the amount of income inclusion or decreased by the recognized loss. **Note:** Losses is excess of accumulated MTM gains may not be deducted against ordinary income.

   The election must be made on a timely filed return (including extensions) in the first year of fund ownership. As before, the election cannot be made retroactively; therefore, a purging election will be required to set things right for current and future years.
3. **Default treatment:** If neither election is made, the taxpayer may defer income recognition of the undistributed income until the PFIC makes an excess distribution, defined as either (a) sale of the PFIC stock or (b) an actual distribution that exceeds 125% of the average distribution of the prior three years. Through a complex calculation, the tax due on the excess distribution is the sum of deferred yearly amounts computed at the highest ordinary income tax rate in effect for each year to which income is allocated plus interest! **Note:** The taxpayer may not recognize a loss on disposition.

   Example: John, a U.S. citizen, invests $15,000 in a foreign mutual fund that qualifies as a PFIC in 2017. Three years later, the investor sells all shares for $18,000. Since the taxpayer did not elect either QEF or MTM treatment, he must report his gain using the default rule. As a result, the taxpayer must compute his taxable gain as if one-third of the gain had been allocated to current and each of the prior two tax years at the highest marginal rate plus accrued interest.

Reporting requirements: Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, must be filed if: (1) the taxpayer received PFIC distributions or

recognized a gain (loss) on sale of the PFIC stock; (2) the taxpayer is making a QEF or MTM election or reporting information with respect to such elections; or (3) the aggregate value of the shareholder's PFIC stock is greater than $25,000 and the taxpayer is required to file an annual report.[10]

Taxpayers who hold one or more PFIC must file a separate Form 8621 for each PFIC owned. The form(s) must be attached to the taxpayer's timely filed income tax return. If the taxpayer is not required to file a tax return, Form 8621 (on its own) must be submitted to the IRS by mail.

Certain individuals are not required to file Form 8621, including: (1) dual residents of the United States and a country with which the United States shares a tax treaty if the taxpayer files as an NRA; (2) dual-status aliens for the part of the year that they were non-residents; (3) bona fide residents of Guam, the Northern Mariana Islands or the U.S. Virgin Islands; (4) taxpayers who have owned a PFIC for no more than 30 days during a period beginning 29 days before the first day of the taxable year (December) and ending 29 days after the close of the taxable year (January) as long as no PFIC distributions were received; and (5) individuals who own or are beneficiaries of a foreign trust or pension if an applicable tax treaty specifies that the PFIC earnings are not taxable until distribution. As per the de minimis exception, single taxpayers whose PFIC shares have a fair market value of $25,000 ($50,000 if married) or less on the last day of the tax year also do not have a PFIC filing requirement.

Example: Sarah, a U.S. citizen, owns shares of A Corp, B Corp and C Corp, all of which were PFICs and valued at $5,000, $10,000 and $4,000 on Dec. 31, respectively. The taxpayer timely elects to treat A Corp as a QEF and B Corp as an MTM but made no election with regards to C Corp. Sarah did not receive an excess distribution or recognize gain treated as an excess distribution from C Corp during the year. The taxpayer must file separate Forms 8621 for A and B Corps (to claim the elections) but is not required to file for C Corp because her ownership, in the aggregate, is worth less than $25,000. As per the default PFIC rules, Sarah has neither excess distributions nor elections to report for C Corp and can, therefore, avail herself of the de minims filing exception.

Failure to file Form 8621 may suspend the statute of limitations with respect to the taxpayer's entire return until the omission is corrected, potentially extending the statute for an unlimited period of time. However, if the failure to file was due to reasonable cause, the statute will be suspended only with respect to the unreported PFICs and not to any unrelated portions of the taxpayer's return.

Foreign trusts

At first blush, it may seem this article is suddenly veering in a new and unrelated direction, jumping from the disclosure of foreign retirement accounts to that of foreign trusts. Mistakenly, tax professionals may assume retirement accounts abroad conform to familiar home-based accounts such as employee pension plans, SEPs, SIMPLEs and KEOGHs, overlooking the critical distinction that U.S. plans are "qualified" while foreign plans generally fail to satisfy requisite U.S. code provisions.

Instead, the IRS views most foreign retirement arrangements as trusts established for the purpose of vesting responsibility in trustees "for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit."[11] By that token, a pension plan managed by plan administrators (trustees) for the benefit and protection of employees (beneficiaries) would seem to fit the definition of a trust arrangement perfectly.

Presuming, then, that a foreign retirement account not otherwise "qualified" as per ERISA guidelines is a trust for U.S. tax purposes, it's important to distinguish between those that are exempt and those that are not. Almost by default, foreign trusts will be deemed to be non-exempt since they cannot satisfy even the most basic criteria that they be "created or organized in the United States."[12] Certain foreign trusts, in rare instances, may qualify for exemption if they can conform to all requirements of participation, non-discrimination, contribution and distribution standards imposed upon their American counterparts.[13]

Tax treatment of non-exempt trusts: U.S. tax treatment will depend on who is deemed to be the trust's owner (i.e., the employee or the employer). Counterintuitively, trusts wherein employer contributions exceed those of the employees are known as employees' trusts; all others are referred to as foreign grantor trusts.

Employees' trust: Employees who have made only "incidental contributions" to the retirement arrangement may not be considered to be the owner of the trust.[14] Thus, as long as employee contributions do not exceed 50%, the plan may potentially qualify for reduced reporting requirements. Additional criteria demand that the participant is not a highly compensated employee and that the plan is non-discriminatory. **Note:** If a trust fails to satisfy these requirements, it may be deemed to be a foreign grantor trust subject to additional reporting requirements and income recognition.

In some ways similar to the tax treatment of qualified plans, an employees' trust enjoys the benefit of tax deferral on income and growth accrued during the accumulation period. However, employees participating in these trust arrangements must include all contributions — whether made by the employee or employer — in gross income. In other words, employees not only lose the ability to contribute pre-tax dollars to these plans but must also add amounts contributed by their employers to reportable wage income. **Note:** The "surplus" income, however, is not deemed to have been "earned" and is therefore not eligible for the exclusion under the FEIE.

Distributions, either upon disability, retirement or death, are taxed in the same manner as annuities. Contributions that have been previously taxed provide the employee with basis and are not taxed again when withdrawn. Employees who take a lump-sum withdrawal will be subject to tax on all account earnings in excess of basis. Employees who withdraw lesser amounts will be taxed on accumulated income and growth first, and only entitled to the tax-free withdrawal of their basis when all account earnings have been exhausted.[15]

Foreign grantor trust

While most foreign retirement arrangements qualify as employees' trusts, those that do not will be subject to enhanced reporting requirements and compliance costs, including:

Review Questions (answers on page 17)

1. Taxpayers use which form to claim a treaty-based position on their tax return?
   A. Form 3520
   B. Form 8621
   C. Form 8833
   D. A statement citing the treaty country and applicable article of treaty that supports the taxpayer's position on the tax return

2. A passive foreign investment company (PFIC) is a foreign corporation with:
   A. At least 25% of passive income or at least 25% of total assets are passive
   B. At least 50% of passive income or at least 25% of total assets are passive
   C. At least 75% of passive income or at least 25% of total assets are passive
   D. At least 75% of passive income or at least 50% of total assets are passive

3. Which one of the following is not a reporting option for shareholders reporting their allocable share of undistributed income from a PFIC?
   A. Section 83(b) election
   B. Qualifying election fund (QEF) election
   C. Mark-to-market (MTM) election
   D. Default PFIC ordinary income treatment per §1291

4. Which of the following is true regarding U.S. taxation of U.S. citizens or resident aliens participating in foreign pension plans?
   A. Employee contributions reduce the employee's taxable compensation
   B. Eventual distributions may be taxable in the foreign country as well
   C. Income and growth is taxed annually in the United States, but this gives the taxpayer basis in the foreign pension plan
   D. Employer contributions are not taxable in the United States or in the foreign country

- Income inclusion of all contributed amounts
- Recognition and inclusion of all amounts earned during the accumulation phase, even if undistributed
- Annual submission of Forms 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*, and 3520-A, *Annual Information Return of Foreign Trust with a U.S. Owner*, and Form 8621 if the plan invested in a PFIC

All foreign trusts, whether employees' or grantor, remain subject to the FATCA and FBAR reporting regimes and, when respective thresholds are met, the employee must submit Form 8938, *Statement of Specified Foreign Financial Assets*, and FinCEN 114.

Form 3520: U.S. persons must report the creation of foreign trusts, transfers of property into and distributions from such trusts whenever there is a reportable event. U.S. persons must also report the receipt of large gifts and bequests from foreign sources.[16] **Note:** Gifts from related parties must be aggregated to determine if the filing threshold has been met.

Specifically, U.S. persons must file Form 3520 if they:

- Are the responsible party with respect to a reportable event, including the creation or formation of a foreign trust, the transfer of any money or property to a foreign trust, the death of a U.S. grantor of a foreign trust, the conversion of a domestic trust into a foreign trust or any sales to a foreign trust that are not arms-length transactions
- Received, directly or indirectly, a distribution from a foreign trust
- Received a non-taxable gift or bequest from a non-resident alien or foreign estate in excess of $100,000 or more than $16,649 [in 2020] from a foreign corporation or partnership[17]

Example: A foreign grandfather of a U.S. citizen wants to give his granddaughter $20,000. If grandpa simply writes a check from his personal account, his granddaughter will have no Form 3520 filing requirement because the gift received was less than $100,000. However, if grandpa instead instructs the trustee of his foreign grantor trust to issue the check, the granddaughter will be required to file Form 3520 since there is no minimum filing threshold for foreign trust distributions. Additionally, the granddaughter will be required to attach the beneficiary statement from the trust's Form 3520-A to her Form 3520. If the trustee did not file Form 3520-A, the granddaughter will be required to file a substitute Form 3520-A.

A separate Form 3520 must be filed for transactions with each foreign trust; however, spouses who file joint returns may submit a joint Form 3520 if both are grantors to or beneficiaries from the same foreign trust.

Rev. Proc. 2020-17 – Relief for eligible taxpayers: New rules, effective March 16, 2020,[18] have provided for additional exceptions and thereby eliminated Form 3520 and Form 3520-A filing requirements for most (but not all) foreign retirement accounts. Eligible individuals are exempt from filing with respect to applicable tax-favored foreign trusts and may even request abatements for penalties assessed under rules previously in effect by filing Form 843, *Claim for Refund and Request for Abatement*, subject to the usual statute for refund claims.

An eligible individual is a U.S. citizen or resident alien who is compliant with all income tax filing requirements for the most recent three years and has included in their income any contributions to, earnings of or distributions from an applicable foreign trust.

Note: Taxpayers who have been otherwise compliant but failed to submit Forms 3520 and 3520-A in prior years are not required to submit the unfiled forms. However, taxpayers who were not compliant with all prior-year income tax filings must submit all delinquent or amended Forms 1040, as well as any omitted Form 3520 and Form 3520-A, to become compliant and eligible for future relief from Form 3520 and Form 3520-A filing requirements.

Applicable tax-favored foreign trusts include those established to provide for:

- **Pension and retirement benefits:** These trusts must be non-discriminatory, limit contributions to a percentage of each plan participant's earned income, restrict withdrawals and distributions, and provide annual information reporting to foreign regulators.
- **Medical, disability and educational benefits:** These trusts must limit contributions to no more than $10,000 annually ($200,000 lifetime), restrict withdrawals and distributions, be tax-favored under local laws and provide annual information reporting to foreign regulators.

Critical: While exempt from Form 3520 and Form 3520-A filing requirements, these tax-favored trusts are nevertheless subject to FBAR and FATCA filing mandates, as well as the U.S. income tax regime.

Reporting requirements: The filing deadlines (including extensions) for Form 3520 coincide with those of Form 1040, *U.S. Individual Income Tax Return*, or Form 1041, *U.S. Income Tax Return for Estates and Trusts*, (if filing for a decedent), although the form must be mailed separately.

Note: Due to the COVID-19 pandemic, the filing deadline for Form 3520 (TY'19) was extended to July 15, 2020.

The penalty for failure to file Form 3520 is the greater of $10,000 or 35% of the unreported gross amount of property transferred or distributions received. The penalty for failure to report a gift is 5% of the value of the gift per month, up to a maximum penalty of 25%. The far bigger and more detrimental issue is that the statute of limitations does not begin to toll until Form 3520 is filed. In other words, the penalty statute remains open indefinitely until the form is filed.

Form 3520-A: This form must be filed annually on behalf of a foreign grantor trust with at least one U.S. owner.[19] Each U.S. person treated as an owner of any portion of a foreign trust is responsible for ensuring

Review Answers

1. A. Incorrect. Form 3520 is used to report certain foreign trust distributions (amongst other items).
B. Incorrect. Form 8621 is used to report income from passive foreign investment companies.
C. **Correct.** Taxpayers file Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b),* to claim treaty provisions.
D. Incorrect. The taxpayer must attach Form 8833 to claim treaty provisions.

2. A. Incorrect. To be classified as a PFIC, at least 75% of the income is classified as passive and 50% of the assets are passive.
B. Incorrect. To be classified as a PFIC, at least 75% of the income is classified as passive and 50% of the assets are passive.
C. Incorrect. To be classified as a PFIC, at least 75% of the income is classified as passive and 50% of the assets are passive.
D. **Correct.** To be classified as a PFIC, at least 75% of the income is classified as passive and 50% of the assets are passive. This is also known as the income and asset test.

3. A. **Correct.** The §83(b) election has nothing to do with PFIC reporting.
B. Incorrect. Taxpayers can make a QEF election or opt for either the MTM election or follow the default treatment.
C. Incorrect. Taxpayers can make the MTM election or opt for either the QEF election or follow the default treatment.
D. Incorrect. If taxpayers do not make either the QEF or MTM election, they will report under the default provisions.

4. A. Incorrect. Employee contributions to a foreign pension plan do not reduce earnings for U.S. tax purposes.
B. **Correct.** Distributions are taxed by the United States even if they are also subject to tax abroad, which may be mitigated with the help of the foreign tax credit.
C. Incorrect. The taxpayer pays tax on the income and growth annually, but the taxpayer does not receive basis in the plan. Distributions are fully taxable when made.
D. Incorrect. The employer contributions made on behalf of the employee are included on the taxpayer's income tax return when made.

that the foreign trust files and furnishes the requisite statements to U.S. owners and beneficiaries. If the foreign trust fails to file Form 3520-A, then the U.S. owner must complete "to the best of their ability" and attach a substitute Form 3520-A to the Form 3520 in order to avoid a penalty.

Reminder: Plan participants in an employees' trust are not considered to be the owners of the trust and, therefore, do not have a Form 3520-A filing requirement. The filing obligation rests with the employer.

Reporting requirements: Form 3520-A is due by the fifteenth day of the third month after the end of the trust's tax year. Filers must also provide copies of the Foreign Grantor Trust Owner Statement (pages 3 and 4 of Form 3520-A) and the Foreign Grantor Trust Beneficiary Statement (page 5) to all U.S. owners and beneficiaries to allow these individuals to incorporate information about taxable distributions into their personal income tax returns in a timely manner. Taxpayers may request an automatic six-month extension using Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns*.

Failure to timely file or provide all requisite information exposes the taxpayer to a penalty equal to the greater of $10,000 or 5% of the taxpayer's allocable share of the gross value of the trust's assets at the close of the tax year. Yes, the penalty is assessed on the U.S. owner, not the foreign trust!

Additional penalties may be assessed on the U.S. owner for failure to file Part II of Form 3520 to provide foreign grantor trust ownership information. Still more penalties are imposed if non-compliance extends past 90 days after the IRS has issued a notice of non-compliance. Criminal penalties may be imposed as well.[20] But the IRS is not done yet! If a U.S. owner of a foreign trust is subject to an accuracy-related penalty on their income tax return, then such penalty may be increased from 20% to 40% for any underpayment attributable to a foreign transaction that should have been disclosed on Form 3520-A.[21] **Note:** No penalties will be imposed if the taxpayer can demonstrate that failure to comply with the reporting requirements was due to reasonable cause and not willful neglect.

The high cost of investing abroad

By now, it should be clear that the cost of compliance comes at a steep price. To begin, taxpayers may have to engage legal counsel to ascertain which reporting obligations are applicable to them and then find experienced individuals able to prepare a myriad of specialized forms. Past non-compliance will cost even more because taxpayers must seek counsel able to identify the best penalty relief or amnesty program to mitigate the fallout of years-long negligence or even willful misconduct. Where once taxpayers — and practitioners — could ignore onerous reporting requirements, confident the IRS did not and could not realistically enforce its own rules, they must now accept that the tax authority has the tools and the desire to uncover global assets and unreported foreign income. ■

Endnotes

1. IRC §1003(b)
2. Defined and governed by IRC §§401, 403, 408 and 414
3. IRC §1297
4. IRC §957
5. IRC §1291
6. IRC §1297(a)
7. Treas. Reg. §1.1295-1
8. Treas. Reg. §1.1291-10
9. Treas. Reg. §1.1296-1
10. IRC §1298(f)
11. Teas. Reg. §301.7701-4 (a)
12. IRC §401(a)
13. IRC §501(c)(22)(C)
14. Treas. Reg. §1.402(b)-1(b)(6)
15. IRC §72
16. IRC §6038
17. IRC §6039F and Rev. Proc. 2019-44
18. Rev. Proc. 2020-17
19. IRC §6048
20. IRC §§7203, 7206 and 7207
21. IRC §6662(j)

About the author

Monica Haven, EA, J.D., LL.M., is an alum and guest faculty member of the National Tax Practice Institute, a recognized speaker on the professional circuit, and a welcomed lecturer on college campuses and at community organizations. Monica eagerly embraces every opportunity to share her experience and expertise even as she maintains her California-based tax practice, which serves clients throughout the nation and abroad. For additional information, published articles and loads of useful tax information, please head to Monica's website at www.mhaven.net.