FATCA Rules for
Foreign Retirement Account Reporting

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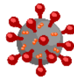
Summary

Beyond the basics of FBARs and Form 8938, taxpayers who live and work abroad may have additional reporting obligations. This class will unveil the complexity of the mandated reporting regime for clients invested in foreign "trusts" and passive foreign investment companies (PFICs) such as foreign money market accounts [yikes!], mutual funds, hedge funds, insurance products and [oh my!] pension and retirement accounts that do not enjoy the same tax benefits of their American counterparts.



Includes updates with regards to COVID-19 relief legislation

The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

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I. What is FATCA?

The Foreign Account Tax Compliance Act (FATCA) was passed as part of the HIRE Act in 2010[1] 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 US 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 other than penalty avoidance to disclose their foreign financial accounts and foreign assets. The penalties are indeed substantial, compelling many – but not yet all – to comply with their reporting obligations.

Bank Secrecy Act (BSA)[2]

FATCA reporting requirements are imposed in addition to those already mandated by the BSA, which requires US persons to disclose the existence of and details about foreign currency transactions and bank accounts held abroad to the US Treasury. The BSA regime requires US persons to submit the following reports (when applicable):

- Financial Institutions Currency Transaction Report (CTR) to disclose currency transactions (**FinCEN 104**);
- Report of International Transportation of Currency or Monetary Instruments (CMIR) required from any person who transports, mails, or receives foreign currency (**FinCEN 105**);
- Report of Foreign Bank and Financial Accounts (FBAR) listing foreign accounts (**FinCEN 114**); and
- Suspicious Activity Report (SAR) detailing transactions deemed to be suspicious (varying FinCEN forms depending on whether the submitter is a bank, casino, money services business or a securities firm).

NOTE: Most but not all of these reports are required only if the reportable transaction or account exceeds $10,000.

Congress enacted the BSA in response to concerns that US 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; however, the IRS may not conduct an audit under the guise of a BSA investigation.[3]

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),[4] the reporting requirements for suspicious activity and cash transactions were enhanced. Information sharing between financial institutions and federal law

[1] Hiring Incentives to Restore Employments ACT (HIRE), §501(a).

[2] The BSA (Public Law No. 91-508), also known as the Currency and Foreign Transactions Reporting Act of 1970, has been amended several times and now includes the Anti-Drug Abuse Act of 1986 which contains the Money Laundering Control Act of 1986 as well as the Money Laundering Suppression Act of 1994.

[3] *US v. Deak Perera & Co.*, 566 F. Supp. 1398 (D.D.C. 1983).

[4] Public Law No.107-56.

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enforcement was encouraged. Civil penalties – including for non-willful violations – were increased under the American Jobs Creation Act of 2004.[5]

NOTE: The BSA is a part of Title 31 (Money and Finance). FATCA, on the other hand, is part of Title 26 (Internal Revenue Code).[6] While in many instances, reporting requirements are duplicative, FATCA ultimately requires the disclosure of a much broader range of offshore assets.

Back to FATCA

Ostensibly enacted to recoup annual tax shortfalls due to offshore tax abuses estimated to be as high as $100 billion annually,[7] FATCA provisions were projected to raise only $870 million each year – a recapture shortfall of $99 billion! Since enactment, the IRS has collected roughly $11 billion; but these collections are the result primarily of penalties for failure to file **FinCEN 114** (FBAR) rather than for non-compliance with the act.[8]

In fact, Byrnes and Munro argue that FATCA was never intended to close the tax gap but rather to "force foreign financial institutions to disclose their US account holders or pay a steep penalty for nondisclosure."[9] Thus, the apparent motivation behind FATCA was the design of an informational system that would rely on *foreign* entities to report what US taxpayers did not. And in this manner the burden of compliance was shifted – at least in part – from individuals to FFIs that must now somehow determine if their accounts are in fact discretely owned by US citizens and residents.

Financial Privacy

It has been argued and judicially contested that FATCA (and the BSA) significantly infringe upon the rights of privacy guaranteed by the 4th Amendment of the US Constitution.

Congress responded to public concerns raised by intrusions seemingly authorized under the BSA by enacting The Right to Financial Privacy Act of 1978 (RFPA),[10] which established that individuals did in fact have a reasonable expectation to financial privacy. In 1999, this right was further cemented in the Financial Modernization Act, better known as the Gramm-Leach-Bliley Act (GLBA).[11] Financial institutions were now required to conspicuously disclose notices of privacy policies and practices. Citing national security concerns after the September 11 attacks, the PATRIOT Act once again curtailed and infringed upon privacy rights. And when FATCA was enacted less than a decade later, it marked "the beginning of the end of financial privacy."[12]

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[5] Public Law No. 108-357.

[6] The IRS has delegated authority to enforce the BSA's criminal provisions, however the Financial Crimes Enforcement Network (FinCEN) retains the final authority to impose Internal Revenue Code Title 31 civil penalties.

[7] Senate Permanent Subcommittee on Investigations, "Tax Havens Banks and U.S. Tax Compliance," Staff Report, July 17, 2008.

[8] Byrnes & Munro, *Background and Current Status of FATCA*, Texas A & M University School of Law Legal Studies Research Paper No. 17-31 (2017).

[9] HIRE Act, 156 Cong Rec § 1745, daily ed Mar 18, 2010 (Statement of Sen. Levin).

[10] Public Law No. 95-630.

[11] Public Law No. 106-102.

[12] Wisiackas, *Foreign Account Tax Compliance Act: What It Could Mean for The Future of Financial Privacy and International Law*, 31 Emory International Law Review, 585 (2017).

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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 US persons (our clients) must fulfill their reporting obligations. Tax pros must guide and assist; or, at a minimum, raise awareness to ensure that unwitting taxpayers can make educated choices.

Legal Opinions

It is 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 pros 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 at the front-line. It should be – and is – their duty to elicit the appropriate information from taxpayers necessary to determine if they are US persons subject to the reporting mandates, have accounts and assets that are reportable, and are not subject to a legal exemption or exception.

Once identified, it is often easy to ensure compliance, gather essential facts and prepare the requisite forms. With training and practice, a diligent practitioner can serve clients who need to do no more than submit current-year FBARs (as per the BSA) or **Form 8938, Statement of Specified Foreign Financial Assets** (as per FATCA). But client situations are frequently neither simple nor straight-forward. Foreign income may have been under-reported. Foreign accounts and assets unreported. These are but a few examples of hot button issues that should be referred to counsel for guidance.

When it gets messy

With more than three dozen FATCA-related forms listed by the IRS,[13] it soon becomes clear that FATCA compliance extends well beyond mere offshore bank and asset reporting. This manual will limit its focus on disclosure issues related to offshore retirement account arrangements. US 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 US where taxpayers will face income tax consequences and mandated disclosures as per the BSA and FATCA.

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II. Retirement Accounts

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

[13] As listed on by The International Tax Blog (available at https://intltax.typepad.com/intltax_blog/international-forms.html, last accessed May 4, 2021).

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A. What's available here?

In the US, we distinguish between qualified and non-qualified plans. The former satisfies the criteria of the Employee Retirement Income Security Act (ERISA),[14] 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, 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.
- Company plans established outside of the US for the benefit of non-resident alien employees.[15]

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.[16] 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.

<u>Tax Treatment</u>

While each qualified plan is established under varying code provisions and administered for a different subset of employees, all share the following preferential tax benefits:

- Employers receive an immediate tax deduction for amounts contributed to the plan on behalf of their employees.
- When plans provide for employee contributions, such contributions are made with pre-tax dollars.[17]
- Income and growth earned within the plan fund is tax-deferred until distributions occur.
- And if qualifying distributions are made in the form employer stock, tax on the appreciated value of the stock is deferred until the stock is sold.
- Qualified distributions may be rolled over tax free.

In short, these plans provide immediate tax savings to both employer and employee. These benefits may be compounded further with the ability to earn untaxed income and growth during the accumulation period and, upon distribution, enjoy reduced tax liabilities should plan participants find themselves in lower post-retirement tax brackets. Alas, none of these perks are typically available to American participants in overseas retirement accounts.

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[14] Public Law No. 93-406.

[15] IRC §1003(b).

[16] Defined and governed by IRC §§401, 403, 408 and 414.

[17] While contributed amounts are income tax-deductible, they are nevertheless subject to FICA and FUTA tax.

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B. What's available there?

Foreign plans vary from employer to employer, country to country. Of the roughly $18 trillion of assets held in the top 300 pension funds worldwide, sovereign and public sector funds account for two-thirds of total assets. Most retirement arrangements are in the form of defined benefit plans.[18] The top twenty funds are invested roughly equally in equities and fixed income securities while maintaining just over 20% of their holdings in cash. North American funds tend to favor equities, while Asia-Pacific funds prefer debt instruments.[19]

Tax Treatment

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

- 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 US even if also subject to tax abroad. (The effect of double taxation may be mitigated with the help of the Foreign Tax Credit in whole or in part.)
- And to add insult to injury, all distributions will be taxed in full, with no adjustment for taxes already paid during the growth phase.

NOTE: While not attributable to tax provisions, US taxpayers may be further harmed by currency fluctuations since contributions to the plan may have been made when the dollar was weaker relative to the host country's currency than at the time that distributions are taken, as the following example illustrates:

> Jake, a US citizen, moved to Mexico City in January 2010. He lived and worked in-country for ten years. His Mexican employer regularly contributed 10,000 pesos per month to the company retirement plan on Jake's behalf. If the exchange rate at the time of the initial contribution was roughly 13 pesos to the dollar and the rate in December 2019 when Jake retired and returned to the US was 19 pesos to the dollar, the accumulated value of Jake's account (1.2 million pesos) would be worth only $64,000 – one-third less than the value of the aggregate contributions ($92,000). [For simplicity, this example ignores the benefit of monthly compounding and presumes that the exchange rate remained constant throughout the growth period and only changed precipitously on the date of withdrawal.]

NOTE: The best way to avoid the currency exchange problem is to hold investments in the currency that will be used at retirement.[20]

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[18] A defined-benefit plan is an employer-based program that pays benefits based on factors such as length of employment and salary history rather than investment performance of the underlying portfolio. Employers assume the investment risk of the plan and are generally required to make up any payout shortfalls with cash infusions.

[19] Watson, *The World's Largest Pension Funds – 2019*, Thinking Ahead Institute (available at https://www.thinkingaheadinstitute.org/en/Library/Public/Research-and-Ideas/2019/09/P_I_300_2019_research_paper, last accessed May 4, 2021).

[20] Epstein, *What Taxes Do I Owe on Retirement Accounts Abroad?*, (available at https://www.investopedia.com/articles/personal-finance/060115/how-taxes-retirement-accounts-abroad-work.asp, last accessed May 4, 2021).

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Treaty Provisions

There are currently 68 bilateral tax treaties in effect between the US and individual foreign governments.[21] These agreements are designed to ensure that residents (not US citizens) of foreign countries are taxed at reduced rates or are exempted from US taxation on certain items of US-source income. Conversely, US residents or citizens are taxed at reduced rates or are exempted from foreign taxes on certain items of foreign-source income.

While all treaties are based upon Article 18 of the Model Treaty[22] and offer reciprocity, each treaty is unique. If a particular treaty does not address the tax treatment of a specific source of income – or there is no applicable treaty in effect – US taxpayers will be subject to the same rules that otherwise apply to all US citizens and resident aliens filing **Form 1040** or non-resident aliens (NRAs) filing **Form 1040-NR**.

NOTE: Tax treaties reduce US taxes of foreign persons but, with few exceptions, do not reduce the US taxes of US citizens or residents, who are subject to US income tax on their worldwide income.[23]

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** to their income tax return. Failure to file **Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)** is subject to a $1,000 penalty (for individual filers) or $10,000 (for corporate filers) for each undisclosed position claimed.

NOTE: If – due to a treaty-based position – the taxpayer does not meet the filing threshold and is not normally required to file a return, he must nevertheless file the return, if only to disclose the treaty provision.

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.[24]

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

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[21] *United States Income Tax Treaties – A to Z* as listed by the IRS (available at https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z, last accessed May 4, 2021).

[22] The Model Treaty serves as the **starting point for negotiations** between countries. The Model is not legally binding, but its language is often incorporated verbatim into a negotiated treaty. [The Model is available at https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=6&ved=2ahUKEwjVtNOVnojiAhWSGXwKHRffAsUQFjAFegQIABAC&url=https%3A%2F%2Fwww.treasury.gov%2Fresource-center%2Ftax-policy%2Ftreaties%2FDocuments%2FTreaty-US%2520Model-2016.pdf&usg=AOvVaw07X8-LG3B9dKzeiwBHKqz3, last accessed May 4, 2021].

[23] IRS *Publication 901, US Tax Treaties*, Cat. 46849F (Rev. September 2016)

[24] *Workplace Retirement Accounts*, US Govt. Accountability Office Report to the Ranking Member, Senate Committee on Finance (January 2018).

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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.

International Retirement Plans

Retirement income from foreign sources can come from any of these types of accounts:

- A pension plan or annuity paid from a foreign employer, foreign trust, or other entity.
- A trust established by a foreign employer.
- A payment from a foreign insurance company.
- A payment from a foreign government or one of its agencies, including a foreign social security pension.

A study of plan features available around the world confirms that the mandatory retirement age varies from a low of 62 (Singapore) to 67 (US currently and Canada by 2029), with an odd outlier in Malaysia where early retirement at age 40 (!) is available to government employees after ten years of service.

Based on a slightly dated survey performed by the HSBC Bank in 2013, respondents stated that only 60% of UK residents believed that their retirement savings would be adequate, whereas 88% of Singaporeans were confident in the ability to save sufficiently. More recently, a study by Northwestern Mutual found that 21% of Americans have not saved even a single dollar for retirement and GoBankingRates.com found that 42% have saved less than $10,000 for retirement. Based on a CIBC poll, 30% of Canadians queried admitted that they have no retirement savings.[25]

Foreign Social Security (SS) Benefits

Many countries offer plans that are to some extent comparable to the American Social Security system, with a twist: In Singapore, workers and their employers contribute to the Central Provident Fund which provides for an Ordinary Account that can be used for investment, education expenses or a home purchase; a Special Account earmarked for retirement; and a Medisave account for hospital and insurance costs. In the United Kingdom (UK), workers can choose to defer receipt of State Pension funds, thereby becoming eligible for additional funds much like increased benefits offered to US retirees who choose to postpone SSA benefits until "full" retirement age.

Australia's Age Pension benefits are designed to supplement a quasi-public 401(k)-like program known as the Superannuation account to which citizens are required to contribute 9.5% of the salaries every year. Malaysia, too, requires employers and employees to make mandatory contributions to the Employee Provident Fund.

Foreign SS benefits are generally taxed in the US as if they were foreign pensions or annuities and are often also taxed by the country making the payments. However, Totalization Agreements between the US and other nations can be used to mitigate the effects of double taxation. Under such agreements, SS benefits are typically taxed only by the country of residence rather than by the country in which the benefits accrued. For example, SS benefits paid to US residents by Germany and Canada are treated as if paid by the US and are, therefore, taxable only in the US subject to the same income-based inclusion rates of 50% and 85% as benefits paid by the Social

[25] Moran, *Retirement Plans from Around the World*, October 28, 2020 (available at https://www.investopedia.com/financial-edge/0412/retirement-plans-from-around-the-world.aspx, last accessed May 94, 2021).

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Security Administration (SSA). **NOTE:** Only 30 countries currently have Totalization Agreements with the US.[26]

C. US Reporting for Foreign Retirement Accounts

1. Employee and employer contributions to foreign retirement arrangements must be added to reportable wage income unless exempt by treaty.[27] **REMINDER:** Income paid in the host country's currency must be converted to US dollars at the applicable exchange rate on each date received.[28]

2. If eligible, the taxpayer may attach **Form 2555, Foreign Earned Income** to his tax return to claim the Foreign Earned Income Exclusion (FEIE), the Foreign Housing Exclusion and/or the Foreign Housing Deduction.[29] **NOTE:** Foreign retirement plan contributions required to be included as taxable income are *not* eligible for the FEIE and may not be used when computing the maximum allowable exclusion.

3. If foreign income tax was assessed on any earned income that was not excludible using the FEIE or based on an applicable treaty provision, the taxpayer may file **Form 1116, Foreign Tax Credit**.[30]

4. Foreign Social Security benefits must be included in gross income on **Form 1040**, Schedule 1, Line 8 unless a Totalization Agreement is in effect. Foreign benefits eligible to be taxed to the country of residence (rather than the source country) may, if specified in the Agreement, be taxed in the same manner as SS benefits in the US. In this case, the foreign amount would be added to the amount that was reported on the taxpayer's **Form 1099-SSA**. The combined amount is then reported on **Form 1040**, Line 5a; the taxable amount after applying the 50% or 85% limitation is reported on Line 5b.

5. Interest and dividend income attributable to any foreign accounts must be reported on **Form 1040**, Schedule B (and Schedule D if capital gains, losses or distributions]. The taxpayer must answer Questions 7 and 8 in Part III of Schedule B, confirming his knowledge of FBAR and **Form 3520** filing requirements.

6. If reporting thresholds are met, the taxpayer must attach **Form 8938** to his income tax return and use Part II of the form to cross reference foreign investment income reported elsewhere on the return.

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[26] The list of countries is available at https://www.irs.gov/individuals/international-taxpayers/totalization-agreements (last accessed May 4, 2021).

[27] The taxpayer must attach **Form 8833** if claiming benefit under any treaty-based position.

[28] The Bureau of the Fiscal Service provides current and historical exchange rates to convert foreign currency into US dollars [available at https://www.fiscal.treasury.gov/fsreports/rpt/treasRptRateExch/treasRptRateExch_home.htm, last accessed May 4, 2021]. In the alternative, any other verifiable exchange rate may be used if its source is disclosed.

[29] To qualify for foreign earned income exclusions and deductions, the taxpayer must (1) have foreign earned income; AND (2) be a US citizen or resident alien who either (a) resides in a foreign country for at least one full tax year from January 1st through December 31st (Bona Fide Residence Test) OR (b) be physically present in the foreign country for at least 330 days during any consecutive 12-month period (Physical Presence Test); AND (3) have a tax home in a foreign country (with no abode in the US) [IRC §911].

[30] Four tests must be satisfied for a foreign tax to qualify for the credit: (1) The tax must be imposed on the taxpayer, (2) the taxpayer must have paid (accrued) the tax, (3) the tax must be the legal and actual foreign tax liability, and (4) the tax must be an income tax or imposed in lieu of an income tax [IRC §901].

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7. Separately, the taxpayer must submit **FinCEN 114** to report foreign accounts if the filing threshold is met.

8. Additional forms may be required to disclose foreign pensions and annuities invested in mutual funds (**Form 8621**), as well as retirement plan distributions (**Form 3520**) [discussed later].

III. Foreign Account and Asset Reporting Requirements

While this text will focus primarily on the less familiar FATCA reporting requirements as they specifically apply to foreign retirement accounts and pensions, it would neverthelss be incomplete if at least a cursory review of the more standard filing requirements were omitted. And because all but the smallest foreign retirement arrangements will likely rise to applicable filing thresholds, a brief discussion of FBAR and **Form 8938** rules is warranted.

A. Foreign Accounts

A US person must electronically file **FinCEN 114** (FBAR) if, at any time during the calendar year, he had a financial interest in or signatory authority over one or more foreign financial accounts with an aggregate value in excess of $10,000.

A US person is defined as a US citizen, resident alien or any entity created (organized) under US law and includes the following:

- An individual who becomes a US resident alien if he has been granted a US Permanent Resident Card (Green Card Test) by the US Citizenship and Immigration Services (USCIS). Alternatively, an individual who became a resident alien if he was physically present for at least 31 days during the tax year AND 183 days during the most recent 3-year period (Substantial Presence Test).[31] **NOTE:** While an individual may forfeit his residency status for immigration purposes, his *tax residency* is, for all intents and purposes, permanent. He will forever be treated and subject to US tax laws in the same manner as all US citizens unless his residency status is administratively or judicially removed, or he has taken proactive legal steps to abandon his status.
- Entities including but not limited to corporations, partnerships, limited liability companies, trusts and estates. **NOTE:** An entity disregarded for income tax purposes is nevertheless subject to the foreign account reporting mandate.

Financial accounts may include monetary and non-monetary assets (e.g., banks, brokerage accounts, insurance cash values, annuities, and mutual funds, amongst others). Foreign retirement accounts and pensions are not specifically enumerated by the IRS[32] but depending on how and where the assets in the retirement account are held, FBAR reporting is most likely required. **NOTE:** *Qualified* retirement plans – generally US-based – are exempt.

Each account must be valued separately at its highest value as reported to the account holder on periodic statements, regardless of when that maximum value was achieved during the calendar

[31] Tax residency is determined by either the Green Card or Substantial Presence test [Treas. Reg. §§ 301.7701(b)-1].

[32] Comparison of Form 8938 and FBAR Requirements, (available at https://www.irs.gov/businesses/comparison-of-form-8938-and-fbar-requirements, last accessed May 4, 2021).

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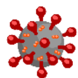
year. The value must then be converted to US currency using the applicable exchange rate on December 31. After each separate account has been valued and converted, all account values are aggregated to determine whether the foreign account reporting threshold ($10,000) has been met for the reporting period.

The annual reporting cycle is on a calendar year basis (January to December). The deadline for filing **FinCEN 114** is April 15th, with an *automatic* extension to October 15th. For taxpayers residing abroad, the initial deadline is deferred until June 15th, with an *automatic* 4-month extension.[33] In both 2020 and 2021, may tax filing deadlines were extended to ease the burden of tax reporting during the COVID-19 pandemic. However, the FBAR deadline was not extended in either year.

Unintentional failure to file may result in a maximum fine of $13,481[34] per year regardless of the number of unreported accounts.[35] For willful violations, the penalty can be raised to the greater of $134,806 or 50% of the account value, along with potential criminal sanctions (maximum $250,000) and/or up to five years jail time.[36]

B. Foreign Assets



In addition to the FBAR, certain taxpayers may also be required to file **Form 8938** along with their US income tax return, subject to the usual filing deadline (or extension).[37] Due to the COVID-19 pandemic, TY'19 filing deadlines for all income tax returns – including requisite attachments (e.g., **Form 8938**) – due between April 1st and July 15th were postponed until July 15th, 2020 and for TY'20, the filing deadline for individual returns was deferred until May 17, 2021.[38]

Individuals, as well as "specified entities" – including any domestic corporation, partnership or trust "formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets" – is subject to the reporting mandate.[39] If applicable, filers may be required to submit both the FBAR and **Form 8938** with seemingly duplicative information, but they will not have to file **Form 8938** if the same foreign financial assets have also been reported on other FATCA forms.[40]

Instructions for **Form 8938** list reportable assets; specifically mentioning foreign pension and deferred compensation plans. Once again, *qualified* US retirement plans are exempt from reporting while comparable foreign plans are not.

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[33] The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015.

[34] As per the Federal Civil Penalties Inflation Adjustment Act of 2015, penalty amounts are adjusted annually for inflation.

[35] IRS Internal Memorandum SBSE-04-0515-0025 (May 13, 2015).

[36] If other laws have been violated, the criminal penalty may be increased to $500,000 and/or 10 years in jail.

[37] IRC §6038D.

[38] IRS Notices 2020-23 and 2021-21.

[39] Treas. Reg. Sec. 1.6038D-2.

[40] **Form 926** Filing Requirement for US Transferors of Property to a Foreign Corporation**, Form 3520** Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, **Form 5471** Information Return of US Persons With Respect to Certain Foreign Corporations, **Form 5472** Information Return of a 25% Foreign-Owned US Corporation or a Foreign Corporation Engaged in a US Trade or Business**, *Form 8621*** Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund, ***Form 8865*** Return of US Persons With Respect to Certain Foreign Partnerships.

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Filing thresholds for taxpayers who reside within and outside of the US differ: An taxpayer residing in the US must file **Form 8938** if he has an interest in one or more specified foreign financial assets with an aggregate value of either $50,000 on December 31st or $75,000 at any time during the year. If residing abroad,[41] **Form 8938** must be filed if the taxpayer has an interest in one or more specified foreign financial assets with an aggregate value of either $200,000 on December 31st or $300,000 at any time during the year. If married and filing jointly, the respective thresholds are doubled.[42]

Failure to disclose foreign assets may result in a maximum fine of $10,000 plus an additional $10,000 penalty for each 30-day period after the IRS issues its 90-day failure to disclose notification. The maximum penalty equals $50,000.[43] Additionally, the statute of limitations for an income tax return (**Form 1040**) remains open until three years after an associated **Form 8938** with *all* reportable assets has been filed – if even just one asset is omitted, the entire return remains at risk!

IV. Passive Foreign Investment Companies (PFICs)

And now we get to the meat of the matter…

A PFIC is an entity that holds mainly passive assets or receives mainly passive income from interest, dividends, capital gains, rents, etc.[44] PFICS typically include foreign mutual funds, money market accounts, pension funds, partnerships and other pooled investment vehicles, such as REITs.

The PFIC tax regime was created under the Tax Reform Act of 1986 with the intent of leveling the playing field between foreign and US-based mutual funds (which are required to pass-through all income to investors annually).[45] In earlier years, foreign mutual funds and their investors were able to avoid US 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.[46]

With the enactment of PFIC rules, shareholders of certain foreign investment companies must now report undistributed earnings regardless of their percent ownership. 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 US counterparts).

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[41] "Foreign" taxpayers must satisfy the Bona Fide Residence (BFR) or Physical Presence (PPT) tests (IRC §911). BFR requires that the taxpayer be a resident of one or more foreign countries for an uninterrupted period that includes an entire tax year. PPT requires that the taxpayer be present for at least 330 full days during any 12-month period that ends during the current tax year.

[42] Reg. §1.6038D-2T(a)(1), Reg. §1.6038D-2T(a)(2).

[43] IRC §6038D(d).

[44] IRC §1297.

[45] The undistributed income of a Regulated Investment Company (RIC) is subject to an annual excise tax of 4% [IRC §4982]. To avoid the tax, the RIC must distribute at least 98% of its ordinary income and 98.2% of its capital gain for to its shareholders annually.

[46] IRC §957.

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Shareholders have the option to report their allocable share of undistributed income on one of three ways by claiming:

- a Qualifying Electing Fund (QEF) election,
- a Mark-to-Market (MTM) election, OR
- the default PFIC treatment as per IRC §1291.

NOTE: Regardless of the method selected, the benefits of tax deferral once the hallmark of investing in foreign mutual funds has been eliminated.

A. What is a PFIC?

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.[47] Passive assets for purposes of this definition are those assets which generate interest income, dividends, capital gains, royalties (unless derived from an active trade or business), or rents (unless derived from actively managed property).[48] 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 US 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.[49] **NOTE:** If a foreign corporation is classified as both a PFIC and controlled foreign corporation (CFC), the US shareholders of the CFC are exempt from the PFIC reporting regime.[50]

B. Taxpayer Elections

The purpose of **Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund** is two-fold:

1. The form 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.

2. Presuming that early recognition is elected, the remainder of the form is used to compute the tax currently due.

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[47] Once classified as a PFIC and unless a purging election is made, the corporation will forever be treated as a PFIC for US tax purposes, even if the foreign company no longer currently qualifies under the Asset or Income Tests. However, PFIC rules do not apply to entities eligible to elect our of corporate classification by filing **Form 8832, Entity Classification Election** [Treas. Reg. §§301.7701-2 & -3].

[48] IRC §1297(a).

[49] Although the IRS issued proposed regulations in 2019 [84 FR 33120], taxpayers may for the moment continue to rely upon IRS Notice 88-22 for definitions and examples of passive investments.

[50] A CFC is a multi-national corporation in which US shareholders who individually own more than 10% of the company's voting stock, collectively own more than 50% of the foreign entity [IRC §957]. CFC shareholders must attach **Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations** to their income tax return.

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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.[51] While familiar to US-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.[52] **NOTE:** Most foreign mutual funds are unable or unwilling to comply with US-mandated disclosure information and so few US 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, he 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.[53] **NOTE:** A purging election is often best made when the has been little or no appreciation in the PFIC account during the investor's tenure to date.

The MTM Election

This option is available only if the taxpayer is invested in a PFIC that is a marketable security traded on a US stock exchange.[54] 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 and so a purging election will be required to set things right for current and future years.

Default Treatment

If neither election is or can be 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

[51] **NOTE:** The taxpayer may make an election to defer payment of tax due on undistributed earnings [IRC §1294]. The election will be terminated upon receipt of distributed earnings, disposition of the PFIC or revocation. **Form 8621,** Part VI must be completed annually to help track the resulting tax and interest balances due.

[52] Treas. Reg. §1.1295-1.

[53] Treas. Reg. §1.1291-10.

[54] Treas. Reg. §1.1296-1.

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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! Additionally, the taxpayer may not recognize a loss on disposition.

A US 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.

[See Appendix A for a more detailed sample computation.]

Comparing Choices

Tax pros familiar with code provisions as they apply in other (unrelated) circumstances might find these comparisons helpful:

- With the option to recognize some income (ordinary) in the current tax year and postpone tax on the growth of the fund (capital) until disposition, the QEF election appears to mirror §83(b) election available to recipients of restricted stock.[55]
- On the other hand, the MTM election within the PFIC regime that calls for gain recognition (ordinary) based on a deemed sales transaction is similar to the tax treatment of regulated futures, non-equity options and foreign currency contracts (also known as §1256 contracts).[56]
- PFIC filers under the default treatment do not recognize current income and, instead, defer taxation (at ordinary rates) until a distribution or disposition event occurs; much in the same way that investors in a non-deductible Traditional IRA do[57] (albeit with the disadvantage of the extremely complex annualization rules required under the PFIC regime).

While tax treatment as per the QEF or MTM elections seem to offer preferable tax outcomes, it is important to note that they are available to taxpayers *only* if fund information is readily available (QEF) or fund shares are publicly traded (MTM).

[For a graphic overview, refer to PFIC Analysis in Appendix B.]

State Tax Treatment

States do not uniformly conform to federal tax treatment of PFICs. Where some states include PFIC income in the year recognized by the IRS, others prohibit the inclusion of the phantom income created by deemed dispositions or the QEF and MTM elections. Some states are helpfully explicit, clarifying that they do not recognize IRC §§ 1291 – 1298 income [e.g., California],[58] but

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[55] An employee may elect to recognize compensation income (ordinary) on the date of the stock's receipt rather than on the date of its vesting. Any appreciation in the stock's value after the date of transfer is taxed as a capital gain when the stock is ultimately sold.

[56] Frequently, §1256 transactions remain open at year-end; in other words, the contract has not yet expired or been exercised. However, mark-to-market rules require that the investor treat these contracts as if they had been sold at their Fair Market Value (FMV) on the last day of the tax year. **NOTE:** In the case of §1256 contracts, only a portion (40%) of the annually recognized gain is taxed as short-term capital gains at ordinary income rates, with the remainder (60%) taxed at long-term capital gains rates.

[57] IRC §408(d)(1).

[58] California's position is that a foreign corporation is treated as a regular corporation. As a result, income from a foreign corporation will not be recognized (nor taxes imposed) until a distribution is received or an actual disposition has occurred

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most state form instructions and even legislative codes are frustratingly silent. As a result, practitioners may be required to make taxable income or basis adjustments on state returns.[59]

C. Reporting Requirements

Form 8621 must be filed if:

- the US taxpayer received (in)direct PFIC distributions or recognized a gain (loss) on sale of the PFIC stock;
- the US taxpayer is making a QEF or MTM election or reporting information with respect to such elections; OR
- the aggregate value of the shareholder's PFIC stock is greater than $25,000 and the taxpayer is required to file an annual report.[60]

Taxpayers who hold one or more PFICs 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.

Exempt Taxpayers

Filers are subject to the reporting requirements even if they hold shares in the PFIC indirectly through a pass-through entity such as a partnership or are the beneficiaries of a trust. On the other hand, the following individuals are exempt:[61]

- Dual residents of the US and a country with which the US shares a tax treaty if the taxpayer files as an NRA. **NOTE:** These taxpayers must submit **Form 8833** with **Form 1040-NR**.
- Dual status aliens do not have filing requirement for the part of the year that they were non-residents. **NOTE:** These taxpayers must submit **Form 8621** with **Form 1040** for the part of the year that they become resident aliens.
- Bona fide residents of Guam, Northern Mariana Islands and US Virgin Islands. **NOTE:** This exception does not apply unilaterally to residents of all US territories. Those in territories required to submit US income tax returns (e.g., residents of American Samoa and Puerto Rico), must submit **Form 8621.**[62]
- 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), do not have a **Form 8621** filing requirement as long as no PFIC distributions were received. This exception allows qualifying taxpayers to dispose of a "bad" investment before the PFIC regime overwhelms them.
- Individuals who own or are beneficiaries of a foreign trust or pension are exempt filers if an applicable tax treaty specifies that the PFIC earnings are not taxable until distribution.

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[blog entry by Mary Beth Lougen, June 1, 2016 (available at https://www.taxconnections.com/taxblog/no-uniform-treatment-of-pfics-at-the-state-level/, last accessed May 6, 2021)].

[59] The PFIC provisions may create a timing difference between the federal and state recognition of income derived by a PFIC, potentially necessitating a state adjustment to properly reflect the California taxable income [FTB Water's Edge Manual, Chapter 6 (available at https://www.ftb.ca.gov/tax-pros/procedures/index.html, last accessed May 6, 2021)].

[60] IRC §1298(f).

[61] Treas. Reg. §1.1298-1(c).

[62] Federal Register, 81 FR 95459 (2016).

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- 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 do not have a PFIC filing requirement. **NOTE:** While many FATCA filing thresholds are adjusted annually for inflation, this de minimis limitation remains unaltered.

> A US 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 December 31st, respectively. The taxpayer filed timely elections to treat A Corp as a QEF and an MTM election with respect to of B Corp, but made no election with regards to C Corp. The taxpayer 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 his ownership, in the aggregate, is worth less than $25,000. As per the default PFIC rules, the taxpayer has neither excess distributions nor elections to report for C Corp and can, therefore, avail himself of the de minims filing exception.

Non-compliance

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.

As DeBlis and Brody conclude, the tax rules for PFICs "are almost unmatched in their complexity and draconian features."[63] **Form 8621** in its current incarnation is 4 pages long and accompanied by 13 pages of instructions. The IRS estimates that recordkeeping and form preparation time will come to more than 37 hours each year![64]

The colloquial warning, "Do not try this at home" seems particularly apropos. Practitioners unfamiliar with the complexities of the law and the intricacies of **Form 8621** should not wade into these murky waters and should instead refer their clients to those with experience and expertise.

International Tax Specialist Hodgen further proposes that practitioners advise US taxpayers "to get rid of foreign mutual funds and buy individual stocks and bonds. The advice has nothing to do with investment strategy. It has everything to do with preventing brain damage."[65]

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V. Foreign Trusts

At first blush, it may seem that this text is suddenly veering in a new and unrelated direction, jumping from the disclosure of foreign retirement accounts to that of foreign trusts. Practitioners often equate "trusts" to those with which they are most familiar: The living (or family) trust, established by individuals for the primary purpose of probate avoidance. Such trusts – if properly funded with most, if not all of the grantor's assets – are typically managed by the grantor during the grantor's life. Upon incapacitation or

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[63] DeBlis III and Brody, *Understanding the PFIC Rules and the Implications of Owning Foreign Mutual Funds*, EA Journal (Nov/Dec 2016).

[64] IRS instructions for **Form 8621** (Dec. 20).

[65] Blog entry dated August 19, 2011 by Phil Hodgen (available at https://hodgen.com/tag/pfic/, last accessed May 5, 2021).

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death of the grantor, a previously named successor trustee assumes the responsibilities of asset management and eventual distribution to named beneficiaries. If all goes smoothly, judicial oversight can be avoided.

Living trusts and indeed grantor trusts and potentially a part of the ensuing discussion, but it's time to expand the concept of trusts to include those pesky foreign retirement arrangements. Mistakenly, tax pros may assume that retirement accounts abroad conform to familiar home-based accounts such as employee pension plans, SEPs, SIMPLEs and KEOGHs, overlooking the critical distinction that the US plans are "qualified" while foreign plans generally fail to satisfy requisite US 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."[66] 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 US tax purposes, it is 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 as they cannot satisfy even the most basic criteria that they be "created or organized in the United States."[67] Certain foreign trusts, albeit only a limited few, may qualify for exemption if they can conform to all requirements of participation, non-discrimination, contribution and distribution standards imposed upon their American counter-parts.[68] It is rare and generally unlikely that a foreign retirement plan would be established at its outset to comply with US regulations.

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A. Tax Treatment of Non-exempt Trusts

US tax treatment will depend on who is deemed to be the trust's owner, whether the employee or the employer. Counter-intuitively, trusts wherein employer contributions exceed those of the employees are known as Employees' Trusts; all others are referred to as Foreign Grantor Trusts.

<u>Employees' Trust</u>

An employee who has made only "incidental contributions" to the retirement arrangement may not be considered to be an owner of the trust.[69] As long as aggregate employee contributions do not exceed 50% of total contributions, the plan may potentially qualify for reduced reporting requirements. Additional criteria demand that participants are not a highly compensated employees 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,

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[66] Teas. Reg. §301.7701-4 (a).

[67] IRC §401(a).

[68] IRC §501(c)(22)(C).

[69] Treas. Reg. §1.402(b)-1(b)(6).

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employees participating in these trust arrangements must include all contributions – whether made by the employee or employer – in gross income in the contribution year. 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:** This "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 which have been previously taxed provide the employee with basis and are not taxed again when withdrawn. An employee who takes a lump-sum withdrawal will be subject to tax on all account earnings in excess of basis. An employee who withdraws lesser amounts will be taxed on accumulated income and growth first, and only entitled to the tax-free withdrawal of his basis when all account earnings have been exhausted.[70]

Foreign Grantor Trust

Foreign retirement arrangements that do not qualify as Employees' Trusts are deemed to be Grantor Trusts subject to enhanced reporting requirements and compliance costs, including:

- Income inclusion of all contributed amounts.
- Recognition and inclusion of all amounts earned during the accumulation phase, even if undistributed.
- Reporting requirements that include annual submission of **Forms 3520** and **3520-A**.
- And if the plan invested in a PFIC (e.g. mutual fund), **Form 8621** is required.

CRITICAL: 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** and **FinCEN 114**.

[For a graphic summary, refer to the Trust Decision Tree in Appendix C.]

NOTE: A tax treaty, if applicable, can override the rules outlined herein and dictate alternative tax treatment. As a result, it is important to begin every analysis of any foreign retirement arrangement with a check to see if a treaty exists with the host country and whether that treaty addresses the treatment of retirement accounts.

> "[I]f a resident of a Contracting State participates in a pension fund established in the other Contracting State, the State of residence will not tax the income of the pension fund with respect to that resident until a distribution is made from the pension fund."[71]

For those trusts subject to the elevated reporting requirements, a detailed discussion of the requisite forms now follows.

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[70] IRC §72.

[71] *Protocol Amending the Tax Convention With Spain*, Article X of the Protocol amends Article 20 (Pensions, Annuities, Alimony and Child Support) of the existing Convention by adding a new paragraph 5 (February 8, 2016) [available at https://www.congress.gov/congressional-report/114th-congress/executive-report/2, last accessed May 5, 2021].

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B. Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts

US persons must report the creation of foreign trusts, transfers of property into and distributions from such trusts whenever there is a reportable event. US persons must also report the receipt of large gifts and bequests from foreign sources[72] **NOTE:** Gifts from related parties must be aggregated to determine if the filing threshold has been met.

Specifically, a US person must file **Form 3520** if he:

- is 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 US 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 an NRA or foreign estate in excess of $100,000 or more than $16,815 [in 2021] from a foreign corporation or partnership.[73]

> A foreign grandparent of a US 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 3520. And if the trustee did not file **Form 3520-A**, the granddaughter will be required to file a substitute 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.

<u>Filing Exceptions</u>

Form 3520 is not required to be filed for the following transactions:

- Most fair market value transfers to foreign trusts, except transfers of qualified obligations, transfers of appreciated property for which the transferor does not immediately recognize gain, and transfers involving a transferor who is related to the foreign trust.[74]
- Transfers to foreign trusts recognized as exempt IRC §501(c)(3) organizations, as well as distributions from foreign trusts to US exempt organizations.
- Transfers to certain other exempt trusts.[75]

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[72] IRC §6038.

[73] IRC §6039F and Rev. Proc. 2020-45.

[74] Qualified obligations include certain written loan agreements with specified terms and yield-to-maturity [IRS Notice 97-34, 1997-25 I.R.B. 22].

[75] As per IRC §§402(b), 404(a)(4), and 404A.

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- Transfers to and distributions from a Canadian registered retirement savings plan (RRSP) or Canadian registered retirement income fund (RRIF).[76] **NOTE:** While exempt from **Form 3520** filing, these plans are nevertheless subject to disclosure as per the FATCA and FBAR mandates.
- Distributions from foreign trusts that are taxable and reported as compensation for services rendered.[77]

New rules, effective March 16, 2020,[78] have provided for additional exceptions and thereby eliminated **Form 3520** – as well as **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.[79]

An eligible individual is (1) a US citizen or resident alien, who (2) is compliant with all income tax filing requirements for the most recent three years, and (3) has included in his 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 3520 and 3520-A forms) to become compliant and eligible for *future* relief from 3520 and 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,[80] 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 3520 and 3520-A filing requirements, these tax-favored trusts are nevertheless subject to FBAR and FATCA filing mandates, as well as the US income tax regime.

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[76] Rev. Proc. 2014-55.

[77] IRC § 672(f)(2)(B).

[78] Rev. Proc. 2020-17.

[79] The taxpayer may request a refund within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever is later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid [IRC §6511].

[80] Maximum allowable contributions are limited to $50,000 per year with a lifetime cap of $1,000,000 per participant. Unfortunately, the Revenue Procedure is not clear whether these limits apply only to the employee's portion or also includes the employer's contribution, and whether post-tax voluntary contributions are countable.

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Unfortunately, it is not yet possible to provide a definitive list of qualifying programs that satisfy the definition of tax-favored foreign trusts under the Procedure. The law firm of Golding and Golding has attempted an analysis of Australia's Superannuation program ("the Super")[81] which, in summary, concluded that sufficient criteria are satisfied: The Super is a foreign trust established under local jurisdiction which mandates that the program issues an annual report to participating employees. The program is non-discriminatory and conditions withdrawals and distributions upon reaching a specified retirement age; penalties for early withdrawals are imposed.

However, the Super allows for mandatory employer and voluntary employee pre-tax contributions (the aggregate not to exceed 25,000 AUD), and also allows for additional post-tax employee contributions up to 100,000 AUD. Golding argues that these post-tax contributions do not defeat the intended purpose of a plan designed primarily for pre-tax deferral. As such, the Super should be classified as a tax-favored trust, *not* subject to 3520 and 3520-A reporting.

Filing Deadline

If you thought **Form 8621** was bad… **Form 3520** is six pages long – accompanied by twelve pages of instructions – and demands that taxpayers provide information regarding such items as unrealized gains, loan terms, distributed amounts, even excess accumulation computations. The IRS estimates that recordkeeping and preparation time could average 49 (!) hours.

The filing deadlines (including extensions) for **Form 3520** coincide with those of **Form 1040** or **Form 1041** (if filing for a decedent).[82] However, the form must be mailed separately.

CRITICAL: When completing **Form 3520**, it is important to check box "1k" on Page 1 to ensure that the IRS can cross-reference any extension request filed for an income tax returns with the 3520 filing.

Penalties

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.

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[81] *Is Australian Superannuation taxable in US?*, (available at https://www.irsstreamlinedprocedures.com/australian-superannuation-u-s-tax-treatment-fbar-reporting/, last accessed May 5, 2021).

[82] Due to the COVID-19 pandemic, the filing deadline for **Form 3520** (TY'19) has been extended to July 15, 2020 and May 17, 2021 (TY'20) [IRS Notices 2020-23 and 2021-21].

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C. Form 3520-A, Annual Information Return of Foreign Trust with a US Owner

This form must be filed annually on behalf of a foreign grantor trust[83] with at least one US owner.[84] Each US person treated as an owner of any portion of a foreign trust is responsible for ensuring that the foreign trust files and furnishes the requisite statements to US owners and beneficiaries.[85] If the foreign trust fails to file **Form 3520-A**, then the US owner must complete "to the best of his ability" and attach a substitute **Form 3520-A** to his **Form 3520** in order to avoid a penalty.[86]

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.

Exemption[87]

Just as the filing requirement for **Form 3520** was recently lifted for tax-favored foreign trusts, so was the filing requirement for **Form 3520-A**.

Filing Deadline

Form 3520-A is due by the 15th day of the 3rd 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 US 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**.

Form 3520-A is five pages, accompanied by seven pages of instructions. The IRS estimates recordkeeping and preparation time will average more than 40 hours.

Penalties

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 US owner, not the foreign trust!

Additional penalties may be assessed on the US 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

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[83] Although various trust arrangements may be deemed to be Grantor Trusts under differing code sections, IRC §679 establishes that a foreign trust – one into which a US person directly or indirectly transfers property – is by definition a Grantor Trust.

[84] IRC §6048.

[85] Effective October 27, 2014, custodians of Canadian registered retirement savings plans (RRSPs) and Canadian registered retirement income funds (RRIFs) are not required to file **Form 3520-A** with respect to a US citizen or resident alien who holds an interest in a RRSP or RRIF [Rev. Proc. 2014-55].

[86] IRS instructions are provided with **Form 3520**, Part II, Line 2.

[87] Rev. Proc. 2020-17.

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penalties may be imposed as well.[88] But the IRS is not done yet! If a US owner of a foreign trust is subject to an accuracy-related penalty on his 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**.[89]

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.

VI. 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 yet more as taxpayers must seek counsel able to identify the best penalty relief or amnesty program that can mitigate the fallout of years-long negligence or even willful misconduct.

The price of missteps aside, the tax regime applicable to foreign retirement accounts is, in itself, costly.

An American investor has the choice to purchase a domestic mutual fund that invests in foreign stocks or buy a near-identical fund incorporated abroad. Upon sale of the domestic fund 13 months later, the well-heeled US taxpayer would realize a capital gain subject to the long-term capital gains rate of 20%. By contrast, the gain on sale of the foreign fund would be taxed at *ordinary* income tax rates (37%) under the PFIC regime.

Where once taxpayers – and practitioners – could ignore onerous reporting requirements, confident that 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. Foreign financial institutions have become the US government's best source, providing the IRS with a "direct and easily accessible window" onto the overseas holdings of US citizens.[90] Gone are the days of secret Swiss bank accounts and offshore entities in the Cayman Islands. The financial chickens have come home to roost; or at least come home to be taxed!

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[88] IRC §§7203, 7206 and 7207.

[89] IRC §6662(j).

[90] Kuenzi, *Why Americans Should Never Own Shares in a Non-US Mutual Fund (PFIC)*, 2020 (available at https://thunfinancial.com/home/american-expat-financial-advice-research-articles/why-americans-should-never-ever-own-shares-in-a-non-us-incorporated-mutual-fund/, last accessed May 5, 2021).

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APPENDIX A
Example: PFIC Excess Distribution Calculation[91]

Facts

- Taxpayer (T) is Resident Alien.
- 5 years prior to emigrating to US, T invested $200K in foreign mutual fund.
- Fund did not pay any interest or dividends during investment period until $20K paid in current year (TY'20).
- T did not sell any shares at any time.

Analysis

- Excess distribution? YES. Since this is T's first distribution – but not first year he has held fund – any distribution would be "excess" since it is greater than 125% of average annual distributions in prior 3 years.
- Additional tax currently due? YES. Foreign fund has grown untaxed in 5 prior years; therefore, IRS wants T to pay for that growth at highest ordinary income tax rate applicable to each earlier year *plus* interest on previously unpaid tax.

Computation

1. Excess Distribution = $20,000

2. Holding Period [assume 1/1/16 through 12/31/20] = 366 + 365 + 365 + 365 + 366 = 1,827 days

3. Daily Excess Distribution = $20,000 ÷ 1827 =$10.95/day

4. Annual Excess Distribution allocable to each year:
   - 2016: $4,008
   - 2017: $3,997
   - 2018: $3,997
   - 2019: $3,997
   - 2020: $4,008

5. Annual Tax Liability (@ highest applicable ordinary rate; assume 24% in TY'20)
   - 2016: $4,008 X 39.6% = $1,587
   - 2017: $3,997 X 39.6% = $1,583
   - 2018: $3,997 X 37% = $1,479
   - 2019: $3,997 X 37% = $1,479

   (2016–2019:) Report in current year on Form 1040, Line 12a as "1291 Tax"
   - 2020: $4,008 X 24% = $962 → Report on Form 1040, Schedule 1 as "Other income"

6. Apply Foreign Tax Credit to each year (if eligible)

7. Annual Interest due [assume IRS Interest Rate was unchanged at 4%; T paid tax due on 4/15/21]
   - 2016: $1,587 (due 4/15/17) X 4% ÷ 365 X 1461 days = $254
   - 2017: $1,583 (due 4/15/18) X 4% ÷ 365 X 1096 days = $190
   - 2018: $1,479 (due 4/15/19) X 4% ÷ 365 X 731 days = $118
   - 2019: $1,479 (due 4/15/20) X 4% ÷ 366 X 366 days = $59
   - 2020: No penalty due

8. Total Tax & Interest = $7,711 or almost 40% of distribution!

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[91] Example adapted from Golding & Golding [available at https://www.goldinglawyers.com/foreign-mutual-fund-pfic-8621-excess-distribution-calculation-example/, last accessed may 6, 2021].

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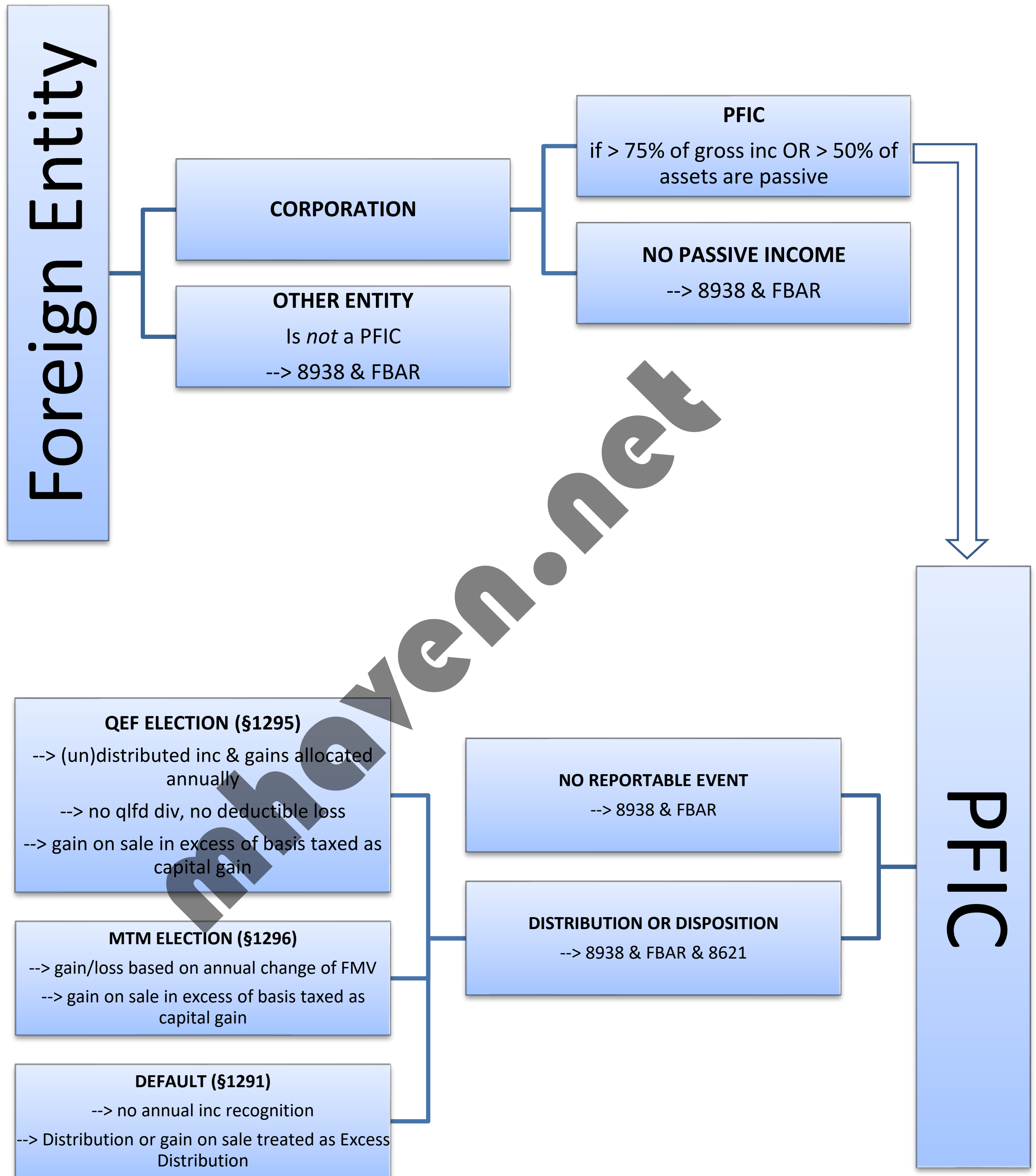
APPENDIX B
PFIC Analysis



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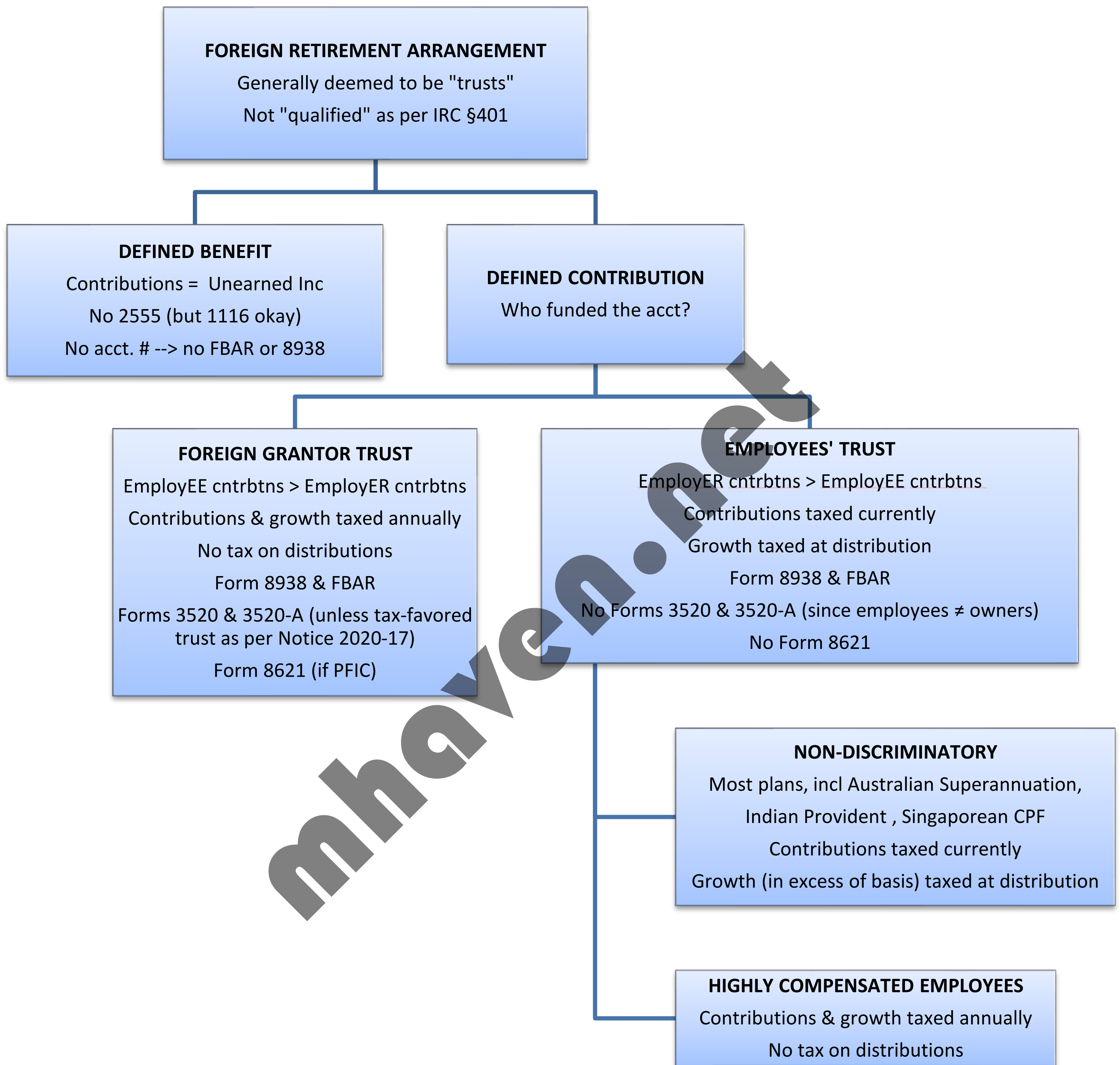
APPENDIX C
"Trust" Decision Tree



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