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Foreign Affairs: A Primer on International Tax and Estate Planning (Part 3)

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INTRODUCTION

This is the third and final installment in a series of articles providing a primer on international planning for domestic estate planners and tax practitioners. This series is intended to assist domestic advisors in identifying pitfalls that may arise unexpectedly in the course of a representation and in recognizing opportunities that can be leveraged to the benefit of the internationally connected client. Our first installment addressed the international income and transfer tax paradigm generally as it applies to individuals and to trusts established by or for the benefit of U.S. persons.[1] Our second installment addressed U.S. expatriates and the various specialized tax regimes that apply to cross-border transactions, including those applicable to U.S.-controlled foreign corporations, passive foreign investment companies, and foreign investment in U.S. real estate.[2] This final installment will focus on the ever-expanding class of information reporting regimes imposed on taxpayers with ties to the United States.

We live in an era that necessitates an unprecedented level of disclosure of personal and financial information to both governments and private institutions. In this age of financial transparency and global information exchange, internationally connected clients, many of whom have spent decades seeking enhanced privacy protections, must now accept that compliance with tax reporting requirements demands a level of transparency that may feel uncomfortable, offensive, or even dangerous. These requirements are complex and require clients to seek the counsel of knowledgeable advisors who can help them establish structures that accomplish their economic goals while controlling their reporting obligations to the greatest extent possible. After vetting the available international options, clients and advisors alike may be surprised to reach the conclusion that, for some structures, the United States is now the ''offshore'' jurisdiction of choice for tax, reporting, and regulatory reasons.[3]

THE FOREIGN ACCOUNT TAX COMPLIANCE ACT

As noted in prior installments of this series, U.S. persons are taxable on their worldwide income. Tax enforcement and compliance for U.S. persons maintaining accounts at U.S. financial institutions historically has been centralized and straightforward, in large part due to the fact that U.S. institutions are subject to the jurisdiction of U.S. tax authorities and are thus obligated to provide relevant information to both the Internal Revenue Service and the account holders themselves. By contrast, foreign institutions historically have been less concerned with the tax obliga-

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[1] *See* 42 Tax Mgmt. Est., Gifts & Tr. J. 187 (July/Aug. 2017).

[2] *See* 42 Tax Mgmt. Est., Gifts & Tr. J. 247 (Sept./Oct. 2017).

[3] *See* European Parliamentary Research Service, *EU-US trade and investment relations: effects on tax evasion, money laundering and tax transparency*, PE 598.602 (Mar. 2017) (''The United States of America is seen as an emerging leading tax and secrecy haven for rich foreigners''). *See also* Richard LeVine, Aaron Schumacher & Shudan Zhou, *A Comparison: FATCA and the Common Reporting Standard*, 27 J. Int'l Tax'n 43 (Mar. 2016) (arguing that ''the United States is becoming the big black hole in the global transparency network that it pioneered in building'').

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tions of their U.S. account holders and have instead focused on applicable local regimes. This presented a challenge for even the most compliant U.S. taxpayers, who could not simply request that a foreign bank issue the equivalent of IRS Form 1099. This dynamic also resulted in a significant level of non-compliance, both intentional and unintentional, on the part of U.S. taxpayers with foreign financial accounts.

The Foreign Account Tax Compliance Act (FATCA) was enacted in 2010 as a legislative response to these ongoing challenges.[4] These challenges were viewed most publicly through the investigation of non-U.S. financial institutions, including UBS AG, by the U.S. Department of Justice, and the staggering number of taxpayers coming forward in response to the IRS's Offshore Voluntary Disclosure Initiative, which allowed U.S. taxpayers to correct historical tax and reporting irregularities in a relatively predictable manner. The basic effect of FATCA is to strong arm foreign institutions into cooperating with a newly established information reporting regime by imposing a substantial U.S. tax withholding on payments to institutions that fail to undertake due diligence procedures to identify, document, and report information with respect to their direct and indirect U.S. account holders.

Although the intent of FATCA was regulation of ''traditional'' financial institutions, as is often the case, the resulting legislation applied much more broadly and has created a ripple of unintended compliance issues for individuals, trusts, and estate planning structures. The inherent complexity of the FATCA regime has been compounded by the response of foreign institutions, many of which have taken extremely conservative views of their compliance obligations, to the extent that many such institutions now impose requirements beyond those strictly required under FATCA. Although this response presumably reflects the aggressive enforcement posture of the U.S. authorities, it has nonetheless resulted in a certain element of unpredictability in implementing and maintaining even basic cross-border estate planning structures.

Basic Rules and Classifications

FATCA created a new Chapter 4 of the Code, consisting of §1471 through §1474, and hundreds of pages of associated regulations and other pieces of administrative guidance.[5] In broad form, §1471 imposes a 30% withholding tax on any ''withholdable payment'' to a ''foreign financial institution'' (FFI) that fails to meet certain reporting requirements applicable to FFIs, and §1472 imposes a 30% withholding tax on any ''withholdable payment'' to a ''non-financial foreign entity'' (NFFE) that fails to meet certain reporting requirements applicable to NFFEs. FFIs are also required to withhold on certain ''pass-thru payments'' to non-compliant FFIs and to ''recalcitrant account holders.''

Where an FFI or NFFE is required to withhold, it is personally liable for payment of the tax, essentially forcing the FFI or NFFE to either act as the tax collector or pay the tax from its own funds. The withholding obligation under FATCA is unlike other U.S. tax withholding regimes, which are intended to serve as a rough proxy for an individual's ultimate U.S. tax liability. FATCA withholding, on the other hand, is punitive in nature and is intended as a means by which to induce compliance.

Administration of the FATCA requirements is accomplished through the issuance of Global Intermediary Identification Numbers (GIINs) and IRS Form W-8BEN-E. Withholding is not required for payments to entities possessing a GIIN. The withholding requirements are intended to implement the provisions of various bilateral intergovernmental agreements (IGAs). These are largely based off of two model IGAs (a ''Model 1 IGA'' and a ''Model 2 IGA'') developed by the Treasury Department. The provisions of the IGAs generally simplify and supersede the FATCA withholding regulations and are described further below.

It perhaps goes without saying that the definitions and categories established under the FATCA regulations are critical in establishing the nature and extent of applicable reporting obligations. What follows is a high-level overview of some of the more important defined terms present in the FATCA regulations.

Foreign Financial Institution. FATCA classifies every non-U.S. entity as either an FFI or an NFFE. An FFI is any ''financial institution'' that is a foreign entity.[6] A financial institution is defined as any entity that falls into one of three categories: (i) a ''depository institution,''[7] meaning an entity that accepts deposits in the ordinary course of a banking or similar business, (ii) a ''custodial institution,''[8] meaning an entity that holds financial assets of others as a substantial portion of its business, or (iii) an ''investment

[4] Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, §501–§541.

[5] All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

[6] §1471(d)(4).

[7] §1471(d)(5)(A); Reg. §1.1471-5(e)(1)(i).

[8] §1471(d)(5)(B); Reg. §1.1471-5(e)(1)(ii). Generally, an entity meets this definition if the entity's gross income attributable to holding financial assets and related financial services equals or exceeds 20% of the entity's gross income during the prior three years. Reg. §1.1471-5(e)(3).

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entity,''[9] meaning an entity that is engaged primarily in the business of investing, reinvesting, or trading in passive investment assets.

The term ''investment entity'' can be further broken down into three subcategories: (i) a ''manager investment entity,'' meaning an entity whose business revolves around providing trading, investing and similar services with respect to the financial assets of third parties, (ii) a ''managed investment entity,'' meaning an entity whose gross income is primarily attributable to investment activities and which is managed by a depository institution, a custodial institution or a manager investment entity, or (iii) a ''fund investment entity,'' which is an entity that functions or holds itself out as a collective investment vehicle, investment fund, or similar entity primarily engaged in the trading of financial assets.[10] Any entity meeting one or more of these definitions will be classified as an FFI for FATCA purposes. An FFI can also include certain holding companies, insurance companies, and treasury centers.[11]

Non-Financial Foreign Entity. The only other category of entity in the FATCA lexicon, the NFFE, is defined under the FATCA regulations simply as a foreign entity that is not a financial institution or is otherwise categorized as an NFFE under an applicable Model 1 IGA or Model 2 IGA (the application of IGAs is discussed below).[12] NFFEs are further categorized as either ''active NFFEs'' or ''passive NFFEs.'' Active NFFEs are generally those deriving less than 50% of their gross income from passive sources and having less than 50% passive assets.[13] Passive NFFEs are those that do not qualify as active NFFEs.

Withholdable Payment. The FATCA withholding obligation applies to ''withholdable payments.'' A withholdable payment generally includes any U.S.-source payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensation, or other fixed or determinable annual or periodical gains, profits, or income.[14] The phrase also includes gross proceeds from the sale or other disposition of any property of a type that can produce U.S.-source interest or dividends, but, importantly, does not include most income taxable in the United States as income effectively connected with the conduct of a U.S. trade or business.[15]

Withholding Agent. Individuals or entities subject to the FATCA withholding obligation are known as ''withholding agents.'' A withholding agent is defined as any person with custody or control of any withholdable payment or pass-through payment. A pass-through payment is any withholdable payment or any other payment attributable to a withholdable payment.[16] If multiple persons qualify as withholding agents with respect to a payment, tax need not be withheld twice.[17]

Application to Common Foreign Estate Planning Structures

The general rules described above are relatively straightforward on their face. Applying them to common international estate planning structures, though, can present both conceptual and technical difficulties. Although the concepts behind FATCA and its 30% percent withholding regime are easy to understand in the abstract, complexities arise in their application due to the expansive nature of the regime and, indeed, the inconsistencies in interpretation. Moreover, practitioners may find that the interpretation of FATCA requirements varies from financial institution to financial institution. In the case of the application of FATCA to foreign trusts, this dynamic certainly exists.

As a starting point for any FATCA analysis, a practitioner should be armed with answers to a number of fact-specific questions. What type of entity is the subject of the analysis? What is the entity's ownerships structure? Is the entity foreign or domestic? How and by whom is the entity managed? What are the entity's assets and investments? The answers to these questions will serve as the basis for applying the relevant rules and definitions.

Foreign Trusts

One of the primary characteristics of an FFI is that it is a foreign entity engaged in some type of business. As such, the natural conclusion might be that a trust could never be an FFI, because its overriding purpose is to vest the management of certain property in trustees, who hold the property for the benefit of beneficiaries, and are not generally considered to be associ-

[9] §1471(d)(5)(C); Reg.§1.1471-5(e)(4)(iii), §1.1471-5(e)(4)(iv). Generally, an entity meets this definition if 50% or more of the entity's gross income during the prior three years is attributable to such activities.

[10] Reg. §1.1471-5(e)(4)(i).

[11] Reg. §1.1471-5(e)(1)(iv), §1.1471-5(e)(1)(v).

[12] Reg. §1.1471-1(b)(80).

[13] Reg. §1.1472-1(c)(1)(iv). Passive income includes investment income like dividends, interest, rents and royalties, annuities, etc., but does not include such income received from a related person or earned by a dealer entity.

[14] §1473(1)(A)(i).

[15] §1473(1)(A)(i); Reg. §1.1473-1(a).

[16] §1471(d)(7).

[17] §1473(4); Reg. §1.1473-1(d).

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ates in a joint enterprise for profit.[18] Nonetheless, the FATCA regulations take the position that a trust can be engaged primarily in the business of investing or trading in passive assets and can be classified as an investment entity and, thus, an FFI.

In order for a trust to come within the scope of FATCA, either as an FFI or an NFFE, the trust must be a foreign trust. As discussed in Part 1 of this series, §7701(a)(30) defines a ''domestic trust'' as a trust that meets both the ''court test'' and the ''control test.'' Section 7701(a)(31) defines a ''foreign trust'' in the negative — namely, a foreign trust is a trust that is not a domestic trust.[19] Accordingly, a trust will be subject to FATCA only if no U.S. court is able to exercise primary supervision over its administration or if one or more foreign persons are able to control substantial decisions regarding its administration.

The underlying investments of a foreign trust are a key component of its FATCA classification, regardless of whether an institution, individual, or closely held entity acts as its trustee. If a trust holds only nonfinancial assets (e.g., real estate, artwork, etc.), the gross income of the trust will not be primarily attributable to financial assets and, thus, the trust should be classified as an NFFE. Moreover, if a foreign trust holds stock in a foreign entity that is classified as a corporation for U.S. tax purposes, the trust may not have any taxable income unless the foreign entity makes distributions. In those circumstances, the trust arguably should also be classified as an NFFE.[20]

Foreign Trusts with Institutional Trustees. As noted above, an entity (including a foreign trust) will be treated as an FFI if it falls into one of three broad categories: depository institutions, custodial institutions, and investment entities. Trusts will almost never qualify as depository or custodial institutions, and thus generally will be FFIs only to the extent they qualify as investment entities. Accordingly, if a foreign trust derives 50% or more of its gross income from investment activities and has an institutional trustee, it will likely be treated as an FFI.[21]

Foreign Trusts with Individual Trustees. Because an individual is not an ''entity'' for FATCA purposes, a foreign trust with an individual trustee generally will not be treated as being ''managed by a financial institution,'' and thus will not be treated as an FFI even if 50% or more of its gross income is derived from investment activities.[22] Instead, foreign trusts with individual trustees generally will be treated as NFFEs. Note that if an individual trustee, or an entity owned by a foreign trust with an individual trustee, hires a financial institution to provide investment management services for the trust, the trust may be treated as an FFI.[23]

Foreign Trusts and Private Trust Companies. Where a private trust company is trustee of a foreign trust, the key determinant of whether the trust will be treated as an FFI is whether the private trust company is a financial institution. Ordinarily, a private trust company does not actually custody the financial assets of its trust and is thus not a custodial institution. Similarly, a private trust company generally is not engaged in a banking or similar business and is thus not a depository institution. However, in certain circumstances, a private trust company that receives fiduciary or management fees may be considered an investment entity by virtue of having 50% or more of its gross income attributable to managing financial assets. In such a case, the private trust company would be treated as a financial institution and, accordingly, the trusts for which it acts as trustee likewise would be treated as FFIs. Where no management or fiduciary fees are paid to a private trust company, the trusts for which it acts as trustee likely would be treated as NFFEs.

Foreign Partnerships and Corporations

It is not uncommon for foreign estate planning structures to include one or more foreign partnerships or foreign corporations. Such entities may be utilized for the purpose of consolidating related investments, segregating liabilities, providing enhanced asset protection, or serving as ''blockers'' for U.S. or foreign tax purposes. In addition, foreign corporations may be established for the purpose of serving as private trust companies or other service provider entities in estate planning structures.

The classification of holding companies under the FATCA regulations will be determined primarily by the nature of the company's assets and the manner in which it is managed. As noted above, where a foreign holding company holds only nonfinancial assets such as artwork or real estate, it will be considered an NFFE because its gross income will not be primarily

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[18] *See* Reg. §301.7701-4(a).

[19] *See also* Reg. §301.7701-7.

[20] *See* Harris & Sanna, *FATCA and Non-US Trusts: An Overview*, Trusts & Estates (May 2013).

[21] *See* Reg. §1.1471-5(e)(4)(v) *Ex.* 6. Even though Example 6 refers to a trust company that is an FFI, it appears that a U.S. financial institution acting as trustee will also cause a foreign trust to be an FFI. This is because the definition of a managed investment entity refers to management by an entity that is a financial institution, not to an entity that is an FFI. *See* Reg. §1.1471-5(e)(4)(i)(B). This may have sweeping implication for certain ''foreign domestic trusts'' that are governed by U.S. law but fail one or both of the court and control tests. These trusts are often structured in Delaware as foreign grantor trusts during the grantor's lifetime, with the intent that the trust will automatically become a U.S. trust upon the grantor's death.

[22] Reg. §1.1471-5(e)(4)(v) *Ex.* 5.

[23] Reg. §1.1471-5(e)(4)(i)(B).

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attributable to investing in financial assets. On the other hand, if a foreign holding company holds financial assets and is professionally managed by an FFI, the company itself will be consider an FFI, provided its gross income is primarily attributable to investment activities.[24]

As discussed above, where a foreign private trust company is established, the FATCA classification of a foreign trust will often turn on the classification of the foreign private trust company itself. Depending on the facts and circumstances, it may be possible to classify a private trust company as an investment entity, provided it charges fiduciary or management fees such that 50% or more of its gross income is attributable to managing financial assets held by a trust for which it acts as trustee. In such a case, the private trust company likely will be characterized as an FFI. If these circumstances are not present, the private trust company, and thus the trusts for which it acts as trustee, likely will be classified as NFFEs.

FATCA Compliance for NFFEs

A NFFE generally will be excluded from FATCA withholding if it is a so-called ''active NFFE,'' or if it provides withholding agents a written certification that either confirms that the NFFE does not have any substantial U.S. owners, or includes the name, address, and taxpayer identification number of each of its substantial U.S. owners.[25] An NFFE is an active NFFE if less than 50% of its gross income in the prior calendar year is passive income and less than 50% of its assets are held for the production of passive income.[26] Thus, appropriate compliance for NFFEs is driven in large part by understanding who qualifies as a ''substantial U.S. owner.''

''Substantial U.S. owners'' are U.S. persons who: (i) own, directly or indirectly, more than 10% (by vote or value) of the stock in a corporation, (ii) own, directly or indirectly, more than 10% of the profits interests or capital interests in a partnership, (iii) own, directly or indirectly, more than 10% of the beneficial interests in a trust, or (iv) are treated as owning the assets of a grantor trust.[27] Attribution rules apply to aggregate the ownership interests of related persons (relying on definitions under §267).[28]

With respect to interests in trust, a beneficiary is treated as holding a beneficial interest if the beneficiary has the right to receive, directly or indirectly, a mandatory distribution from the trust, or if the beneficiary may receive, directly or indirectly, a discretionary distribution from the trust.[29] In applying the percentage thresholds described above, a discretionary beneficiary who receives no distributions from the trust should not be treated as an owner.[30] Rather, a discretionary beneficiary is treated as owning a beneficial interest in a trust based on the proportionate value of distributions received.[31] Beneficiaries entitled to receive mandatory distributions are treated as owning a portion of the trust based on the value of their distribution rights under the principles of §7520.[32]

Lastly, it should be noted that a grantor or beneficiary of a trust also may be treated as the owner of the trust's underlying entities for FATCA purposes. A person treated as owning a trust under the grantor trust rules is treated as owning all the interests owned by the trust. In the case of a non-grantor trust, beneficial interests are determined based on all relevant facts and circumstances.[33]

FATCA Compliance for FFIs

A FFI generally will be excluded from FATCA withholding if it is either a ''participating FFI'' or a

[24] The more challenging classification is where the foreign holding entity owns lower-tier subsidiaries which may be professionally managed resulting in classification as FFIs. However, the upper level holding company may have no actual ''management.'' Nonetheless, the upper level holding entity may be swept into FFI classification as part of an ''expanded affiliated group'' that does not qualify for an exclusion. *See* Reg. §1.1471-5(e)(5)(i).

[25] Reg. §1.1471-3(d)(12)(iii)(A). If an NFFE is erroneously subject to withholding, it is entitled to apply for a refund. Reg. §1.1474-2(a)(3).

[26] Reg. §1.1472-1(c)(1)(iv).

[27] §1473(2)(A); Reg. §1.1473-1(b)(1)(i).

[28] Reg. §1.1473-1(b)(2)(v).

[29] Reg. §1.1473-1(b)(3). It should be noted that, for these purposes, a discretionary distribution can result from either the discretionary act of a trustee *or* the exercise of a limited power of appointment by any person. Note also that a de minimis rule provides that a discretionary beneficiary is not a substantial U.S. owner of a trust if the beneficiary receives distributions of $5,000 or less in the relevant year. Reg. §1.1473-1(v)(4)(i).

[30] Reg. §1.1471-1(b)(83). Note that a de minimis rule provides that a beneficiary is not a substantial U.S. owner of a trust if the beneficiary is entitled to receive mandatory distributions of $50,000 or less. Reg. §1.1473-1(b)(4)(i).

[31] A discretionary beneficiary is treated as owning a requisite interest in trust to the extent: (i) the fair market value of the property distributed, directly or indirectly, from the trust to such beneficiary, divided by the fair market value of all distributions made by the trust in the prior calendar year exceeds the threshold, or (ii) the fair market value of the property distributed, directly or indirectly, from the trust to such beneficiary, divided by the fair market value of all assets held by the trust at the end of the calendar year exceeds the threshold. Reg. §1.1473-1(b)(3)(ii)(A).

[32] Reg. §1.1473-1(b)(3)(ii)(B).

[33] Reg. §1.1473-1(b)(2).

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"deemed-compliant FFI."[34] A participating FFI is one that agrees to enter into a FATCA agreement that obligates the FFI to: (i) undertake sufficient due diligence to determine whether its accounts are U.S. accounts, (ii) comply with IRS information requests, (iii) obtain waivers of banking secrecy laws or close accounts for which waivers cannot be obtained, (iv) withhold 30% on pass-thru payments to recalcitrant account holders or non-compliant FFIs, and (v) report certain information to the IRS on an annual basis.[35] For this purpose, U.S. accounts consist of financial accounts held by foreign entities with one or more substantial U.S. owners (as defined above, but substituting 0% for 10% in determining the relevant ownership thresholds for substantial U.S. owners), and financial accounts held directly by U.S. persons, excluding publicly traded companies, tax-exempt organizations and charitable trusts, banks, REITs, RICs, and common trust funds.[36] Participating FFIs must register through the IRS's online portal and obtain a GIIN, which must be provided to all applicable withholding agents.

A note should be made with respect to so-called "recalcitrant account holders." A recalcitrant account holder with respect to an FFI is an account holder that is not itself an FFI and that fails to comply with FATCA information requests or waive banking secrecy.[37] Where a participating FFI is responsible for an account, it is required to deduct and withhold a 30% tax on any withholdable payment to an account held by a recalcitrant account holder or to a noncompliant FFI.[38]

Deemed-compliant FFIs can be divided into three categories: "registered deemed-compliant FFIs," "certified deemed-compliant FFIs," and "owner documented FFIs."[39] Registered deemed-compliant FFIs include two further subcategories that are common in estate planning structures — "Local FFIs" and sponsored investment entities. Local FFIs are those licensed and regulated as financial institutions in their country of incorporation, and may be an option for certain private trust companies. In addition to other requirements, Local FFIs must not have a place of business outside their country of incorporation and 98% of their accounts by value must be maintained by residents of their country of incorporation.[40] Sponsored investment entities are FFIs that enter into a sponsorship arrangement with another FFI.[41] This is often an attractive option for trusts with institutional trustees, as the trust can rely on the trustee's compliance infrastructure to optimize efficiency.

Certified deemed-compliant FFIs are seen less frequently in estate planning structures, with one notable exception known as the "sponsored closely held investment vehicle." The requirements for a sponsored closely held investment vehicle are very similar to those of a sponsored investment entity and may provide a suitable classification for foreign holding entities in a trust structure.[42] Certified deemed-compliant FFIs generally are not required to register with the IRS; rather, they simply provide withholding agents with certain required information and documentation.[43]

The final category of deemed-compliant FFIs not subject to FATCA withholding are owner-documented FFIs, which are unique insofar as they must qualify as FFIs solely because they are investment entities.[44] Owner-documented FFIs are required to provide withholding agents with detailed information on the reporting status of every individual (including non-U.S. individuals) and specified U.S. person that owns a direct or indirect interest in the FFI.[45] Because the 0% ownership threshold for specified U.S. persons is significantly lower for FFIs than for NFFEs, trust distributions could affect an FFIs reporting requirements from year to year and active trust structures should therefore be monitored closely. It is also important to note that this status is effective only with respect to

[34] Importantly, trusts classified as deemed-compliant FFIs are not entitled to apply for a refund of withholding unless a treaty requires it or the trust is not the beneficial owner of the income subject to the withholding. Reg. §1.1473-1(d), §1.1474-2(a)(1), §1.1471-5(a)(1). Accordingly, the trustee of a trust that is not a participating FFI should be sensitive as to trust distributions so that the beneficiary, as the beneficial owner, is entitled to claim the refund if necessary. *See* Harrison, *The Foreign Account Tax Compliance Act — Withholding Rules for Trusts and Estates*, Tr. Quarterly Rev. (Mar. 2013).

[35] Reg. §1471-1(b)(85). A draft FFI agreement was published on October 22, 2013, in IRS Notice 2013-69, 2013-46 I.R.B. 503. Reporting for participating FFIs is completed on IRS Form 8966.

[36] §1471(d), §1473(3). Note that a U.S. account does not include an account maintained by an FFI if the account holder is an individual and the aggregate value of all depository accounts held by such individual at the FFI does not exceed $50,000.

[37] §1471(d)(6); Reg. §1.1471-5(g)(2).

[38] Reg. §1.1471-4(b), §1.1471-4(d)(6).

[39] Registered deemed-compliant FFIs include: A class of FFIs defined in the regulations, FFIs that comply with the registration requirements of a Model 1 IGA, and FFIs that are treated as registered-deemed compliant FFIs under a Model 2 IGA. Reg. §1.1471-5(f)(1).

[40] Reg. §1.1471-5(f)(1)(A).

[41] Reg. §1.1471-5(f)(1)(F). The sponsoring FFI must be authorized to manage the sponsored FFI and enter into contracts on its behalf, must register with the IRS as a sponsoring FFI and must agree to perform certain due diligence, withholding, and reporting tasks.

[42] The requirements for a sponsored closely held investment vehicle can be found in Reg. §1.1471-5(f)(2)(iii).

[43] Reg. §1.1471-5(f)(2).

[44] Reg. §1.1471-5(f)(3)(ii)(A).

[45] Reg. §1.1471-3(d)(6)(iv).

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payments received from accounts held with U.S. financial institutions, participating FFIs, or certain FFIs in compliance with Model 1 IGA registration requirements.[46]

Impact of Intergovernmental Agreements

As noted above, if an applicable IGA is in place, the terms of the IGA generally control an entity's FATCA compliance, even if the terms of the IGA conflict with the provisions of the FATCA regulations. Thus, if an entity is resident in a jurisdiction with an IGA, payments made to such entity are not subject to withholding as long as the entity is in compliance with its reporting requirements under the IGA. Compliance requirements differ depending on whether the country of residence has negotiated a Model 1 IGA or a Model 2 IGA. When an estate planning structure includes entities in multiple FATCA partner jurisdictions, each entity in the structure must comply with the IGA relevant to its jurisdiction of residence.

Model 1 IGA

Model 1 IGAs are the more common IGAs, and are structured to be either ''reciprocal'' or ''non-reciprocal.'' A reciprocal IGA requires U.S. financial institutions to report information about accounts held by residents of the FATCA partner jurisdiction. Non-reciprocal IGAs contain no such requirement and apply only to financial institutions in the FATCA partner jurisdiction. The key feature of both reciprocal and non-reciprocal Model 1 IGAs is the requirement that the FATCA partner jurisdiction enact legislation requiring FFIs to report directly to local tax authorities, who then exchange information with the United States.

Under the Model 1 IGA, an FFI is treated as compliant, and is thus not subject to FATCA withholding, if it identifies U.S. accounts and reports them to the relevant authority in the FATCA partner jurisdiction.[47] The FFI need not comply with the other requirements in the FATCA regulations — it is not obligated to withhold on payments to noncompliant FFIs or recalcitrant account holders, nor is it required to close the accounts of recalcitrant account holders.[48]

If the account is owned by a U.S.-owned entity, only information about U.S. persons who are ''controlling persons'' is required to be reported.[49] In the case of a corporation or partnership, a controlling person means any individuals who exercise control over the entity. In the case of a trust, a controlling person means the settlor, trustee, beneficiary, protector, holder of a power of appointment, or any other individual exercising ultimate effective control over the trust. An account is a U.S. account, and is thus reportable under the Model 1 IGA, if it has any controlling person who is a U.S. person.

Model 2 IGA

Under the Model 2 IGA, a reporting FFI is required to report information directly to the IRS, rather than to the taxing authority in the FATCA partner jurisdiction. Accordingly, participating FFIs under the Model 2 IGA must register with the IRS and enter into an FFI agreement. The FFI agreement imposes obligations on the participating FFI with respect to due diligence, reporting, and withholding on U.S. accounts. As with the Model 1 IGA, an account is a U.S. account if it has any controlling person who is a U.S. person. Model 2 IGA FATCA partner jurisdictions are required to waive their bank secrecy laws and to provide the United States with information on recalcitrant account holders.[50] Unlike the Model 1 IGA, the Model 2 IGA requires an FFI to withhold on payments to FFIs that do not qualify as participating FFIs.

Compliance Challenges for Withholding Agents

Implementation with the FATCA regulations has been ongoing for several years, but strict compliance remains burdensome and, in some circumstances, nearly impossible. Acknowledging some of the practical challenges presented to withholding agents obligated to obtain and report required information, in particular foreign tax identification numbers and dates of birth, the IRS issued on September 25, 2017, Notice 2017-46,[51] in which it relaxed certain rules under §1471 and announced its intention to amend the existing temporary regulations thereunder. In the Notice, the IRS indicated its intention to carve back the circumstances in which such information is required to be provided by a withholding agent, enumerate certain exceptions for the provision of foreign taxpayer identification numbers for certain account holders and

[46] Reg. §1.1471-5(f)(3)(i).

[47] Model 1 IGA, Article 4(1).

[48] Note that some Model 1 IGAs allow FFIs to elect to apply the FATCA regulations instead of the IGA, if desired.

[49] Model 1 IGA, Article 2(2).

[50] As with the Model 1 IGA, an FFI is not required to withhold on payments to recalcitrant account holders or close their accounts. However, the FFI is required to report payments to accounts of recalcitrant account holders and FFIs other than participating FFIs that refuse to allow information to be provided to the IRS. The IRS then must apply to the FATCA partner jurisdiction under procedures governing the exchange of information. *See* Model 2 IGA Article 2(1).

[51] 2017-41 I.R.B. 275.

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provide for a period of time for such rules to apply, and provide for a grandfathering rule for the provision of date of birth information for withholding certificates signed prior to 2018.

Implications for Future International Tax Planning

The continued implementation of FATCA will further shape the landscape of international tax planning in the years to come. FATCA has made life abroad, as well as cross-border business and investing, significantly more challenging for U.S. persons. Although many institutions have adapted to FATCA compliance obligations, others remain wholly unwilling to service U.S. persons. From a broader policy perspective, FATCA represents the cornerstone of a new and unprecedented era of international cooperation in financial transparency and tax information sharing, requiring internationally mobile clients to recalibrate their expectations for privacy in financial matters. Complete transparency also brings with it onerous reporting obligations that increase the cost and risk associated with international planning transactions and require practitioners to integrate an additional layer of complexity into the planning process.

THE COMMON REPORTING STANDARD

The umbrage expressed upon the introduction of FACTA quickly gave way to imitation as the sincerest form of flattery. Having spent years trying to combat cross-border tax evasion with the common understanding that ''countries have a shared interest in maintaining the integrity of their tax systems,'' OECD member countries quickly concluded that FATCA could be an effective blueprint to establish a multilateral information exchange regime.[52] The result of this revelation came in the form of the OECD's Common Reporting Standards (CRS).[53] CRS takes its cues from FATCA's reciprocal Model 1 IGA, in which taxpayers report certain information to local authorities, who then coordinate information exchange on an intergovernmental basis.[54]

This structure was driven in part by the ability of OECD member countries to leverage the investments made in the implementation of FATCA IGAs by utilizing similar infrastructure to facilitate broader information exchange relationships.[55] However, the OECD model also sought to improve upon the Model 1 IGA in ways it hoped would optimize efficiency and reduce the compliance costs borne by financial institutions, including by tailoring CRS more closely to concepts applicable in the global tax paradigm, such as territorial taxation.[56] The ultimate goal of these modifications was to ensure financial institutions were producing a consistent quantity and quality of information so as to enhance compliance across signatory countries through the use of data analytics and other modern tools.

CRS envisions the implementation of its provisions through bilateral agreements among signatory countries. In other words, it is intended that each CRS signatory will enter in to an agreement with each other signatory to implement the automatic exchange of information pursuant to CRS. These agreements generally are based on the OECD's model competent authority agreement (subject to jurisdiction-specific modifications). Each jurisdiction is responsible for establishing a legal basis for information exchange and for implementing sufficient internal procedures to address privacy and data protection laws and other potential impediments.

As of the time of this writing, 102 countries have committed to participating in CRS, and over 2,000 bilateral relationships have been established among CRS signatory countries.[57] Forty-nine such countries (the so-called ''early adopters'') committed to an initial exchange of information in September 2017, with the remaining 53 such countries (the so-called ''late adopters'') committing to an initial exchange of information by September 2018.

Conceptual Approaches

Although FATCA served as a catalyst for the creation of CRS, and there are certainly overlapping con-

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[52] *Standard for Automatic Exchange of Financial Information in Tax Matters: Implementation Handbook*, Organization for Economic Cooperation and Development, *available at* http://www.oecd.org/ctp/exchange-of-tax-information/implementation-handbook-standard-for-automatic-exchange-of-financial-account-information-in-tax-matters.htm [hereinafter ''OECD CRS Handbook''].

[53] *Standard for Automatic Exchange of Financial Account Information in Tax Matters*, Organization for Economic Cooperation and Development, available at http://dx.doi.org/10.1787/9789264216525-en [hereinafter ''OECD Common Reporting Standard''].

[54] *See* M. Read Moore, *A New World Order for Estate Planners or Why Is It So Difficult to Open a Bank Account?* 50th Annual Heckerling Institute on Estate Planning (Jan. 2016). *See also* OECD CRS Handbook, at 5 (''Many jurisdictions have opted to implement FATCA on an intergovernmental basis and, more specifically, to collect and exchange the information required to be reported under FATCA on the basis of a Model 1 FATCA Intergovernmental Agreement'').

[55] OECD CRS Handbook.

[56] OECD CRS Handbook, at 22.

[57] *AEOI: Status of Commitments*, Organization for Economic Cooperation and Development (Aug. 2017), available at https://www.oecd.org/tax/transparency/AEOI-commitments.pdf.

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cepts, the two regimes take different approaches in several key respects. Perhaps the most important is in enforcement. The stick wielded by FATCA is a mandatory 30% withholding tax. CRS, by contrast, does not call for a uniform enforcement mechanism. Rather, it leaves participating jurisdictions to impose appropriate consequences for noncompliance through the enactment of local laws.

Another fundamental difference between the two regimes is the approach taken in identifying tax non-compliance. FATCA's aim is to identify underlying U.S. beneficial ownership of passive assets held in non-U.S. accounts. This is sensible from a U.S. perspective, as U.S. persons are subject to tax on a worldwide basis. CRS, by contrast, seeks to identify ''controlling persons'' with respect to assets held in participating jurisdictions. This is because of a policy choice on the part of the OECD to target widespread sources of systematic tax non-compliance, which the OECD believed would be better accomplished by identifying control nodes rather than beneficial owners.

It should be noted that, to date, the United States has not become a signatory to CRS, which has drawn widespread criticism from the international community. This has resulted in speculation that, despite the various reporting regimes described in this article, the United States may be on the path to becoming a hub for international financial privacy, which has resulted in a recent influx of trusts and other entities migrating to the United States to avoid the expansion of reporting and disclosure regimes in foreign jurisdictions.[58]

Basic Rules and Application of CRS

In broad form, the objective of CRS is to implement a system of automatic exchange of financial information between signatory countries. This is accomplished through the requirement that financial institutions (FIs) resident or having a branch in a participating jurisdiction engage in due diligence and report certain information regarding their ''financial accounts'' to local authorities, which then transfer that information to other signatory countries. As noted above, CRS does not provide a specified penalty for non-compliance.

As in the case of FATCA, the mechanics of CRS rely on the application of various defined terms, and the CRS lexicon divides every entity in the world into one of two — ''financial institutions'' (FIs) and ''non-financial entities'' (NFEs). Reporting FIs are required to review their financial accounts, undertake certain due diligence activities to identify reportable accounts and report relevant information to local authorities.

Financial Institutions and Non-Financial Entities

The category of FIs, which are subject to CRS reporting and due diligence rules, embraces a broad class of entities, and shares some common traits with the definition of an FFI under FATCA. More specifically, the following entities are classified as FIs under CRS: (i) entities accepting deposits in the ordinary course of a banking or similar business (referred to as ''depository institutions''), (ii) entities deriving 20% or more of their gross income from holding financial assets for others or providing related financial services (referred to as ''custodial institutions''), (iii) entities deriving 50% or more of their gross income from providing certain investment services to customers, or entities managed by an FI that derive 50% or more of their gross income from investment activities (referred to as ''investment entities''), (iv) certain insurance companies.[59]

Any entity that is not classified as an FI is labeled an NFE. Borrowing from the categories in FATCA, NFEs are deemed to be either ''active NFEs'' or ''passive NFEs.'' Active NFEs are those that own primarily active assets and derive primarily active income, certain publicly traded entities, holding companies that are members of a nonfinancial group, start-up companies, and other specified categories.[60] Passive NFEs are defined in the negative to include all NFEs other than active NFEs, as well as professionally managed investment entities that would otherwise be classified as FIs but for their residence in a nonparticipating jurisdiction.

Treatment of Trusts

Generally speaking, a trust is treated as resident in any country in which one or more of its trustees is resident, meaning a trust with trustees in multiple jurisdictions could theoretically be subject to duplicative reporting. However, if a trust is itself resident for tax purposes in a participating country, then all CRS information reporting with respect to the trust is accomplished in the participating country in which the trust has its tax residence.

Trusts are most commonly classified for CRS purposes as either reporting FIs or passive NFEs. If a trust is a reporting FI, its trustees will be obliged to report certain information directly to the relevant lo-

[58] European Parliamentary Research Service, *EU-US trade and investment relations: effects on tax evasion, money laundering and tax transparency*, PE 598.602 (Mar. 2017) (''The United States of America is seen as an emerging leading tax and secrecy haven for rich foreigners'').

[59] OECD Common Reporting Standard, at 15. Note that certain entities are considered to present a low risk of being used for evading tax and are thus excluded from reporting.

[60] *Id.* at 59.

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cal authorities. If the trust is a passive NFE, its trustees will be obliged to disclose certain information to FIs with which the trust maintains reportable accounts.

As with FATCA, a trust will be treated as an FI if its gross income is primarily attributable to investments in financial assets and if it is managed by another FI. A trust is treated as being managed by another FI if its trustee itself is classified as an FI (for example, an institutional trustee or certain private trust companies), or if its trustees (or the managers of an underlying holding entity) have delegated certain asset management authority to one or more FIs.[61]

Trusts that do not meet these criteria generally will be treated as passive NFEs. It is important to note that CRS includes as passive NFEs investment entities that are resident in nonparticipating jurisdictions. This means that even a trust that would otherwise qualify as an FI under the test described above could nonetheless be treated as a passive NFE if the trust is resident in a non-participating jurisdiction.

CRS Reporting Obligations

As noted above, FIs are required to undertake due diligence procedures and to report certain information to local authorities regarding ''financial accounts'' held by persons or entities resident in a participating jurisdiction. For these purposes, ''financial accounts'' include depository and custodial accounts, equity and debt interests in certain investment entities (including certain trusts), cash value insurance contracts, and annuity contracts. Where trusts are concerned, an equity interest is considered to be held by any settlor or beneficiary of the trust, or by any other natural person exercising ultimate effective control over the trust, and a debt interest is treated as being held by any person who has made a loan to the trust.[62] Discretionary beneficiaries of a trust should not be treated as holding an equity interest in the trust's financial accounts unless they have received a distribution in a particular reporting period.

FIs are required to furnish the following information in respect of their reportable financial accounts: (i) account numbers, if any; (ii) the name and identifying number of the reporting FI; (iii) the account balance or value and the gross amount of income, including interest, dividends and redemption proceeds paid or credited to the account on an annual basis; and (iv) the name, address, taxpayer identification number, jurisdiction of residence, and, in the case of an individual, date and place of birth of each account holder resident in a participating jurisdiction.

Passive NFEs are subject to similar reporting, which is carried out by the FIs with which they maintain accounts, with respect to ''controlling persons'' resident in participating jurisdictions. ''Controlling persons'' are generally natural persons who exercise control over the entity. Where companies are involved, this is typically determined by reference to ownership, which may itself vary depending on the ownership structure of the company, or if no natural person exercises control through ownership, by reference to managerial control. In the case of a trust, controlling persons include the settlor, trustees, protector, beneficiaries, and ''any other natural person exercising ultimate effective control over the trust.''[63] The inclusion of protectors in the class of reportable persons with respect to a trust account is one key difference between the treatment of trusts under FATCA and the treatment of trusts under CRS.

The categories of reportable persons under CRS are, like FATCA, incredibly broad and have the potential to produce counterintuitive results. For example, individuals involved in a fiduciary or managerial capacity in a client's estate planning structure may be subject to CRS reporting even if the client's structure is established in a nonparticipating jurisdiction, but maintains accounts in a participating jurisdiction. For this reason, where controlling reporting exposure is a factor, careful attention should be paid to the location of the individuals, entities, and financial institutions involved.

Impact on International Estate Planning

The initial shockwave of FATCA, which reshaped the landscape of international tax planning in the U.S. context, has taken on global proportions with the enactment of CRS. Many CRS signatory countries established themselves as market leaders in fiduciary services, investment services, and other industries relevant to international estate planning due to strong local protections and favorable taxation. With this new wave of cross-border compliance and disclosure activity, the looming question is whether offshore structures will now find a reason to come back ashore or to migrate to places like the United States. Despite the existence of FATCA, the United States' unwillingness to participate in CRS could result in a net privacy gain for particular clients.

SELECTED REPORTING REQUIREMENTS

In addition to the disclosure requirements imposed under FATCA and CRS, taxpayers with ties to the

[61] *Id.* at 152 (noting that an entity is ''managed by'' another entity if the other entity performs certain services ''either directly or through another service provider'').

[62] *Id.* at 51.

[63] *Id.* at 57.

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United States are also subject to a number of other information reporting and disclosure obligations. These requirements are aimed primarily at providing U.S. tax authorities access to sufficient information regarding U.S. ownership of foreign entities and assets to allow them to effectively enforce the worldwide tax obligations of U.S. citizens and residents. While an exhaustive discussion of these information reporting requirements is beyond the scope of this series, what follows is a brief description of the most common types encountered in the international estate planning context.

Form 3520 — Transactions with Foreign Trusts and Receipt of Foreign Gifts

Form 3520 is an information return that is required to be filed by U.S. persons who enter into certain transactions with foreign trusts, or who receive certain gifts from foreign persons. More particularly, the form applies to any U.S. person who: (i) received a gift of more than $100,000 from a nonresident alien or foreign estate; (ii) received a gift of more than $15,797 (for 2017) from a foreign corporation or partnership; (iii) received a distribution from any foreign trust or estate; (iv) created or funded a foreign trust; (v) is treated as the owner of any foreign trust under §671 through §679; or (vi) dies as the owner of a foreign trust or with assets of the foreign trust includible in his estate.[64] Note that loans to foreign trusts other than those constituting qualified obligations can also trigger a reporting obligation on Form 3520.

Where transactions with foreign trusts are concerned, the trustee may wish to consider appointing a U.S. agent to provide relevant information to the IRS. This will prevent the need to provide additional information and documentation regarding the trust on Form 3520, which would be required in the absence of such an appointment. Suggested language for an appointment of a U.S. agent, as well as other information regarding Form 3520 reporting, can be found in Notice 97-34.

Form 3520 is due on the same date as the filing of the U.S. person's income tax return (including extensions).[65] Although no tax is due in connection with the filing of Form 3520, there are, nonetheless, potentially harsh penalties for the failure to file the form, or for the filing of a form with incomplete or incorrect information.[66] The initial penalty is the greater of $10,000 or: (i) 35% of the gross value of property transferred to, or of distributions received from, a foreign trust, or (ii) 5% of the gross value of the assets of a foreign grantor trust.[67] Where gifts are concerned, a penalty of 5% of the amount of unreported foreign gifts applies for each month that noncompliance continues, subject to a maximum of 25%.[68] Furthermore, penalties may be imposed under §6662(j) for undisclosed foreign financial asset understatements. The statute of limitations for the assessment of any tax imposed with respect to any tax event, return or period reportable on Form 3520 (as well as most other forms described in this section) is tolled until three years after the date on which the return is filed.[69]

Form 3520-A — Annual Reporting of Foreign Trusts With U.S. Grantors

Form 3520-A must be filed by the trustee of any foreign trust that has at least one U.S. owner under the grantor trust rules so as to enable the U.S. grantor to comply with his or her individual reporting obligations. Each U.S. grantor is responsible for ensuring that the foreign trustee timely files Form 3520-A and provides annual statements to its U.S. grantors and U.S. beneficiaries. Form 3520-A must be filed by the 15th day of the third month following the end of the trust's tax year, and the trustee must provide copies of the component ''foreign grantor trust owner statement'' and ''foreign grantor trust beneficiary statement'' to any U.S. grantor or U.S. beneficiary by the same day.[70]

The initial penalty for the foreign trust's failure to file, incorrect filing, or failure to furnish required information is the greater of $10,000 or 5% of the gross value of the portion of the trust treated as owned by a U.S. grantor. U.S. grantors themselves are also subject to the penalties described above for their failure to timely file Form 3520. Further penalties may apply for continued noncompliance more than 90 days after issuance by the IRS of notice of failure to comply. In addition, possible criminal penalties may be imposed

[64] Gifts received from related parties must be aggregated for purposes of determining whether the applicable reporting threshold has been met.

[65] In the case of a U.S. decedent, Form 3520 is due on the date that Form 706 is due (including extensions), or the date that Form 706 would be due if such a return were required.

[66] §6677. A reasonable cause exception can apply if the taxpayer can establish that the failure to file or include required information was not due to willful neglect. However, a foreign fiduciary's failure to provide required information or reliance on a provision in the trust instrument prohibiting disclosure is not considered to be reasonable cause.

[67] Gross value for these purposes is determined using the principles of §2512.

[68] §6039F.

[69] §6501(c)(8).

[70] Extensions may be sought by filing Form 7004 (filing an extension for the trust's income tax return will not be sufficient).

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for willful failure to file on time or for filing a fraudulent return.[71] As with Form 3520, the reasonable cause exception may apply and the taxpayer may avoid imposition of such penalties upon showing that the failure to comply was due to reasonable cause and not willful neglect.[72]

Form 8621 — PFIC or QEF Shareholders

Form 8621 must be filed by a U.S. person who is a direct or indirect shareholder of a PFIC, if such person: (i) receives distributions from a PFIC, (ii) recognizes gain on a disposition of PFIC stock, (iii) is reporting information with respect to a QEF election under §1295 or a mark-to-market election under §1296, (iv) is making certain elections for annual reporting with respect to PFIC stock, or (v) is required to file an annual report pursuant to §1298(f). A separate Form 8621 must be filed for each PFIC in which the U.S. person holds stock and for each PFIC in the chain of ownership. The extent of the percentage of ownership in the PFIC by the U.S. person is not a factor in filing Form 8621.

Form 8621 must be attached to the shareholder's U.S. federal income tax return, or if no return is required, it may be filed directly. There are no explicit penalties for a failure to file Form 8621, but such a failure could prevent the statute of limitations from running with respect to the shareholder's entire federal income tax return. Nevertheless, it is often to the advantage of a U.S. taxpayer to file Form 8621 to make a QEF election to pay taxes on the current income of the PFIC. If no QEF election is made, future distributions may be recharacterized as ordinary income and subjected to the punitive tax on excess distributions, as described in Part 2 of this series.

Form 5471 — Certain Foreign Corporations

Form 5471 must be filed by certain U.S. citizens and residents who are officers, directors, or shareholders of certain foreign corporations. The individuals required to file the form are divided into four separate categories, each with distinct information reporting obligations, based on whether the filer is a shareholder, officer, or director of the foreign corporation. Generally speaking, Form 5471 requires the disclosure of detailed information regarding the corporation, its shareholders, its assets, and its financial performance in the previous tax year. In addition to filing Form 5471, a U.S. shareholder of a CFC is required to disclose any reportable transactions[73] by filing Form 8886.

As with Form 8621, a separate Form 5471 must be filed for each foreign corporation by attaching same to the income tax return of the filer. A $10,000 penalty is imposed for failure to timely file.[74] An additional $10,000 penalty per foreign corporation is charged 90 days after the IRS's issuance of a notice of failure, and for each 30-day period thereafter, subject to a maximum of $50,000. Moreover, the foreign corporation itself is subject to a reduction of 10% of the foreign taxes available for credit.[75] As above, penalties can be avoided to the extent the taxpayer can establish that the failure was due to reasonable cause and not willful neglect.

Form 5472 — Foreign-Owned U.S. Corporations and Foreign Corporation Engaged in a U.S. Trade or Business

Form 5472 is generally required with respect to U.S. corporations with at least 25% non-U.S. ownership and foreign corporations engaged in a trade or business in the United States, to the extent the corporation engages in a ''reportable transaction'' with a related party. For these purposes, ''reportable transactions'' are defined broadly to include not only monetary transactions, but also less direct transactions like the use of corporate assets or the provision of services.[76] Various exceptions, including exceptions for certain small corporations and *de minimis* transactions with related parties, may apply and forestall a filing obligation.

Form 5472 is filed by attaching same to the income tax return of the reporting corporation and is due on the same date as the corporation's income tax return (including extensions). A separate Form 5472 is required for each foreign or domestic related party with which the reporting corporation had a reportable transaction. In addition to the filing of Form 5472, a reporting corporation must maintain the permanent

[71] §7203, §7206, §7207.

[72] Again, a foreign fiduciary's failure to provide required information or reliance on a provision in the trust instrument prohibiting such disclosure is not considered to be reasonable cause

[73] §6011; Reg. §1.6011-4(c)(3)(i)(G).

[74] As with Form 8621, failure to file Form 5471 will result in the statute of limitations failing to run with respect to the taxpayer's entire return.

[75] An additional 5% reduction is made 90 days after the issuance by the IRS of a notice of failure and for each 30-day period thereafter it continues, subject to a maximum of the greater of $10,000 or the annual income of the foreign corporation per failure.

[76] Reg. §1.6038A-2(b)(3), §1.482-1(i)(7).

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books of account or records sufficient to establish the correctness of its income tax return.[77]

A reporting corporation is subject to a penalty of $10,000 if it fails to timely file a complete Form 5472 or fails to maintain records as required. An additional $10,000 penalty is charged after 90 days of the IRS's issuance of a notice of failure, and for each 30-day period thereafter. Furthermore, criminal penalties may be imposed for willful failure to file or for filing false or fraudulent information.

For tax years beginning on or after January 1, 2017, new regulations require Form 5472 to be filed with respect to any domestic disregarded entity that is wholly owned by a foreign person and engages in any reportable transaction with a related party. Under the new regulations, the generally applicable exceptions to the requirements of §6038A do not apply to a domestic disregarded entity that is wholly owned by a foreign person, meaning (among other things) that there is no *de minimis* exception for small transactions with related parties. At the time of writing this article, there remains some uncertainty as to the timing and manner in which Form 5472 should be filed when the foreign owner of a domestic disregarded entity is not required to file a U.S. tax return. Neither Form 5472 nor the instructions thereto have been updated to reflect the new regulations.

Form 8938 — Foreign Financial Assets

U.S. persons are required to disclose on Form 8938 any interests they own in ''specified foreign financial assets'' if the value of such assets exceeds an applicable reporting threshold. The applicable reporting thresholds are different for taxpayers living inside the United States and outside the United States, and for married taxpayers and single taxpayers. ''Specified foreign financial assets'' are defined broadly to include items like non-U.S. bank accounts, stocks, mutual funds, interests in trusts or other entities, financial instruments, and contracts. Importantly, foreign real estate generally is excluded from the reporting obligation. Information to be reported on Form 8938 includes an asset's date of acquisition, cost basis, income or gains, maximum value, and foreign currency denomination.

Form 8938 must be filed by attaching same to the taxpayer's annual income return and is due on the same date as the filing of that return (including extensions). Form 8938 need not be filed if the specified person does not have to file an income tax return, even if the value of such persons' specified foreign financial assets exceeds the applicable reporting threshold. A partial reporting exemption does apply if the taxpayer's interest in a specified foreign financial assets was already required to be reported on another IRS form (e.g., Form 8621, Form 5471, etc.).

A penalty of $10,000 is imposed for failure to timely file a complete and correct Form 8938. An additional $10,000 penalty is charged 90 days after the IRS's issuance of a notice of failure, and for each 30-day period thereafter, up to a maximum of $50,000. The penalty may be avoided if the taxpayer can establish that such failure was due to reasonable cause and not willful neglect. An underpayment due to transactions involving an undisclosed specified foreign financial asset may result in an additional penalty equal to 40% of such underpayment. If the underpayment is due to fraud, the penalty is increased to 75% of the underpayment. In addition, criminal penalties may be imposed for willful failure to file or to report an asset.

FinCEN Form 114 — FBAR

A U.S. person that has financial interest in or signature authority over one or more financial accounts outside of the U.S. must file a FinCEN Form 114 (previously known as the ''foreign bank account report,'' or ''FBAR'') if the aggregate maximum value of such foreign financial accounts exceeds $10,000 at any time during the calendar year. Financial account includes bank accounts, securities accounts, commodity futures or options accounts, insurance policies with a cash value, mutual funds or similar pooled funds, and any other accounts maintained by a foreign financial institution.

FBARs are required under the Bank Secrecy Act, not under the Code, and are administered by the Department of Treasury's Financial Crimes Enforcement Network (FinCEN). FBARs must be filed electronically through FinCEN's BSA E-Filing System on or before April 15 of the year following the calendar year being reported. However, an automatic six-month extension is granted to those who fail to meet the due date.

Broadly speaking, the failure to file an FBAR may subject a taxpayer to one of two civil penalties: (i) where the failure is non-willful, a penalty of up to $10,000 per violation, or (ii) where the failure is willful, a penalty equal to the greater of $100,000 or 50% of the balance of each unreported account, per violation. Criminal penalties may also apply to willful violations, and may result in fines of up to $500,000 and imprisonment for up to 10 years, depending on the circumstances.

Pending Form 708 — Covered Gifts and Bequests

In 2015, the IRS published proposed regulations regarding §2801, which imposes a tax on U.S. citizens

[77] *See* Reg. §1.6038A-3.

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and residents (including certain trusts) who receive certain gifts or bequests from covered expatriates. The tax applies regardless of the situs of the property and regardless of whether the transferred property was acquired by the covered expatriate before or after his or her expatriation date. The §2801 tax is imposed at the highest applicable gift and estate tax rate in effect at the time of the transfer, and is supposed to be payable with a timely filed Form 708. While the filing and tax payment requirements have been stayed pending the issuance of final regulations, the proposed regulations provide that certain elections (including elections by foreign trusts wishing to be treated as U.S. trusts) are to be made on Form 708. This requirement notwithstanding, the IRS has not, as of the time of writing this article, issued Form 708, even in draft form.

REMEDIAL COMPLIANCE PROGRAMS

Throughout this series of articles, the authors have endeavored to identify the many U.S. tax rules that apply to international taxpayers in unintuitive or unexpected ways. The natural result of this complexity is that even the most diligent taxpayers, in the absence of expert counsel, can run afoul of their U.S. tax or reporting obligations. As such, it is not uncommon for internationally mobile clients to seek advice on the ways in which they can come back into compliance. A number of remedial compliance programs are available to such taxpayers, and the ones they choose to participate (or not participate) in will be driven in large part by the facts and circumstances of a particular case. A full discussion of this specialized field is beyond the scope of this series, but what follows is a brief description of four common avenues for compliance: (i) a so-called ''quiet'' disclosure, (ii) formal participation in the IRS's offshore voluntary disclosure program (the ''OVDP''), (iii) utilization of the IRS's streamlined filing compliance procedures, and (iv) utilization of the IRS's delinquent international information return submission procedures.

"Quiet" Disclosure

A quiet disclosure generally involves simply submitting all required historical filings and paying any past-due tax, with interest, for the past six years (the statute of limitations for FBAR penalties is generally six years from the filing deadline). While this option comes with the advantage of deferring (or potentially avoiding) any substantial asset-based penalty, it also comes with several disadvantages: (i) it does not provide any cap on the amount of additional liabilities the IRS might impose for failure to comply with, for example, information filing obligations, (ii) it provides no protection from possible criminal prosecution for willful reporting failures, and (iii) if audited, the IRS may require additional back filings, as the statute of limitations on a tax return generally does not begin to run if the original return was not filed or contains substantial omissions. The IRS has also made public statements that it takes a negative view of quiet disclosures due to its establishment of formal compliance programs.

Offshore Voluntary Disclosure Program

Participation in the IRS's offshore voluntary disclosure program (OVDP) allows U.S. taxpayers to make necessary information filings with respect to their non-U.S. assets, file past-due tax returns for the previous eight years, and pay any back taxes, together with interest, penalties, and a ''miscellaneous offshore penalty.'' In return, the IRS will issue a closing agreement certifying compliance and will not pursue criminal prosecution or revisit past filings unless it uncovers information that the taxpayer failed to disclose relevant information or took fraudulent positions during the OVDP process. The ''miscellaneous offshore penalty'' is generally 27.5% of the highest aggregate value of all of the taxpayer's offshore assets that are related in any way to tax noncompliance. The penalty can increase to 50% for assets held with foreign financial institutions that are under investigation by the IRS or are cooperating with the IRS. The current OVDP is open for an indefinite period, although the IRS makes periodic modifications to the terms of the program by amending its ''frequently asked questions'' webpage.

Streamlined Filing Compliance Procedures

The IRS's streamlined filing compliance procedures (the ''Streamlined Program'') are aimed at taxpayers who are able to certify that their tax compliance in relation to non-U.S. assets was not the result of willful conduct. For non-U.S. residents, the Streamlined Program requires filing amended U.S. federal income tax and information returns for the most recent three tax years, filing FBARs for the six most recent years, and submitting a detailed statement describing the basis for a nonwillful determination. Payment of all back taxes is required, with interest, but participation in the Streamlined Program for non-U.S. residents generally does not subject participants to further penalties. For U.S. residents, the Streamlined Program is available on similar terms; however, U.S. residents must also pay a miscellaneous offshore penalty equal to 5% of the highest aggregate balance of the taxpayer's unreported non-U.S. assets during the disclosure period.

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Because no formal closing agreement is entered into in connection with the Streamlined Program, this process is best suited for taxpayers who can readily substantiate the reasons for their non-willful failure to comply with applicable U.S. tax and reporting obligations.

Delinquent International Information Return Submission Procedures

Where a taxpayer's noncompliance extends only to FBARs or other information returns, the IRS has provided a less burdensome alternative to the OVDP and Streamlined Program. These procedures are generally available to U.S. taxpayers who do not need to use the OVDP or Streamlined Program to pay back taxes, have not filed required FBARs or information returns, are not under examination by the IRS, and have not been contacted by the IRS regarding their delinquent FBARs or information returns. If eligible, simply filing the missing returns or FBARs along with a statement setting forth a reasonable cause for the failure to file completes the process. Delinquent FBARs or information returns are not automatically subject to audit according to the IRS, but may be examined in the course of the ordinary audit selection process.

CONCLUSION

This concludes the third and final installment in this series of articles providing a primer on international planning for domestic estate planners and practitioners. The authors have endeavored in this series to provide an overview of the general tax landscape for international estate planning, to discuss some of the specialized regimes that apply to internationally mobile clients, and to address the increasingly complex field of international tax reporting, disclosure, and compliance. As the world becomes increasingly global, there is no doubt that a working knowledge of these rules will become a necessity for U.S. estate planners and tax practitioners. A holistic awareness of the structure of these regimes and the potential pitfalls present in international planning can allow practitioners to skillfully and proactively navigate the rules in a way that can provide an incredible benefit to clients engaged in cross-border transactions.

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