

**"Planning Considerations for Foreign Grantor Trusts  
and  
Update on the IRS Voluntary Disclosure Program"**

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# Trends in Structuring

- Era of Transparency
- Foreign Non-grantor Trusts
- Foreign Grantor Trusts
- Cleaning Up A Messy Past – Disclosure Programs

# Era of Global Transparency

- Common Reporting Standards
  - Pretty much every legitimate jurisdiction outside the US has joined
  - US is sole “holdout” among major economies
- Foreign Account Tax Compliance Act (FATCA)
  - China: signed agreement in substance for Model 1A IGA, June 2014
  - Hong Kong: signed a Model 2 IGA, August 2016
  - Taiwan: signed a Model 2 IGA , December 2016

# Era of Global Transparency

- Anti-Money Laundering/ Know Your Customer
  - The Patriot Act amended the BSA to require that financial institutions establish AML Programs
  - Requirement of customer identification program that enables the financial institution to form a reasonable belief that it knows the true identify of its customers.
    - Check against lists of known or suspected terrorists/ terrorist organizations
    - Consult Office of Foreign Assets and Control's lists of sanctioned countries and specially designated nationals and blocked persons.
  - Enhanced due diligence for certain accounts of foreign persons.

# Trust Status – Four Quadrants to Classify Trusts

Foreign	Domestic
Grantor	Non-Grantor

- Four resulting types of trusts:
  - Foreign Grantor Trust (with Foreign Grantors; with US Grantors)
  - Foreign Non-Grantor Trust
  - Domestic Grantor Trust
  - Domestic Non-Grantor Trust

# Classification – Foreign vs Domestic

- Foreign trust versus domestic trust is determined by Section 7701-4 Regulations
- Court test
- Control test
  
- Very easy to become foreign trust
  - Give 1 decision power to NRA

# Taxation of Foreign Non-Grantor Trusts

- Income taxation of the trust
  - Taxed as if the trust were an NRA under income tax rules (so only taxed on FDAP or ECI)
  - Difference in treatment of capital gains
- Income taxation of beneficiaries
  - Trust is a conduit, so all items of income are carried out with the same character to each beneficiary, pro rata
- Draconian “throwback” rules aimed to recapture tax that was deferred offshore if later given to US beneficiaries

# Foreign Grantor Trust Planning

- Substantial opportunities for efficient tax planning for US beneficiaries
- As all income is taxable income of foreign grantor – US beneficiaries can receive distributions free of tax BUT must report receipt or substantial penalties
- Foreign grantor only taxed on ECI or US source FDAP, so trust can invest in the US and generate capital gains (excluding FIRPTA gains) and interest income, as well as non-US income, without incurring an income tax burden in the US
- Can be US transfer tax free if properly structured
- Planning necessary with respect to estate and income tax consequences following grantor's death



# Grantor Trust Status for Foreign Grantors

- Section 672(f) - special grantor trust rules apply to trusts with non-US grantors
- For non-U.S. grantors, there are generally two ways to create “Grantor Trust” status:
  - The grantor has the power to revest the property in himself – can require the consent of a related or subordinate party (power of revocation), or
  - Distribution of income or principal can only be made during the grantor’s lifetime to the grantor or the grantor’s spouse

# Planning when Foreign Grantor Dies

- Benefits of Foreign Grantor Trust cease when Grantor Dies; trust becomes a Foreign non-Grantor Trust.
- Plan to avoid the Throwback Rules and reporting requirements
  - Purge DNI each year (outright or to a “mirror” U.S. trust)
  - Domesticize the foreign trust

# Domesticating Foreign Trust

- Often done after grantor dies to prevent accumulation of income and throwback rules
- Can be as simple as removing any non-US fiduciaries and changing the governing law of the trust to a state in the US
- Will result in US tax on all income and gains except those that are distributed to a non-US beneficiary

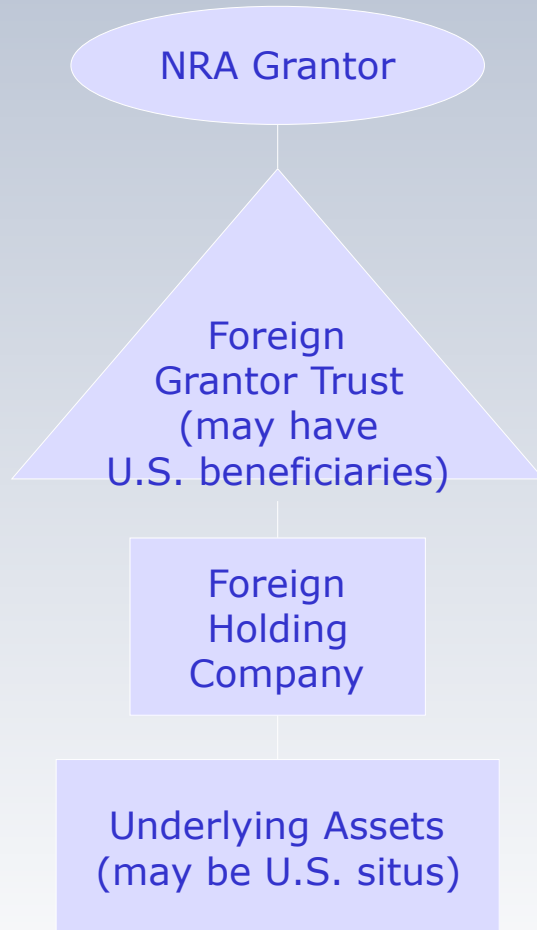
# Estate Tax Exposure of Grantor Trusts

- Section 2104(b) imposes estate tax on trusts that are includable in the estate of a NRA as a consequence of a retained interest or power.
- Tax is limited to “U.S. situs” assets.
- Use of foreign corporations as a “shield” against U.S. estate tax; as discussed above, CTB elections may be made to eliminate the foreign corporation after death of NRA grantor.

# Step up in Basis

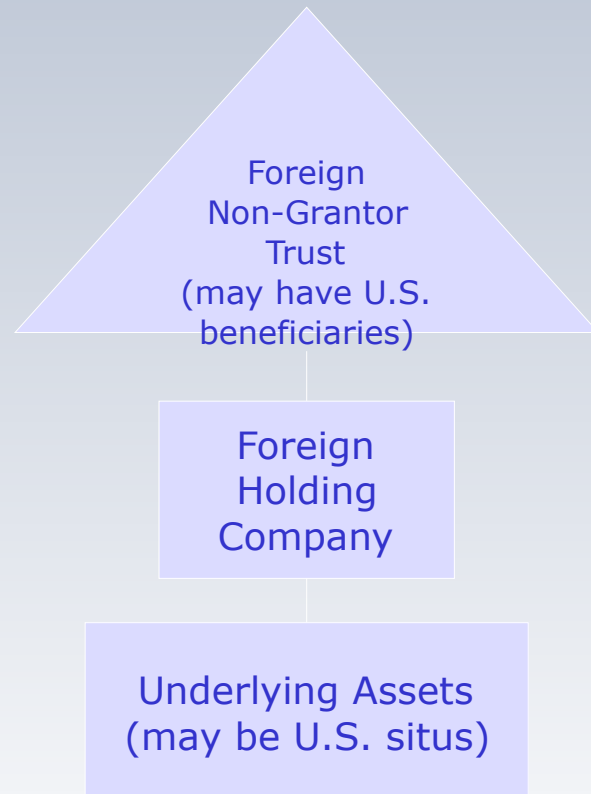
- Section 1014(b)(2) and (3) allow a basis step up for a trust that gives grantor the right to income and the power to revoke or alter beneficial enjoyment.
- Such trusts will not necessarily qualify as grantor trusts for NRA grantors.
- Revocable trusts should qualify under both rules
- Irrevocable trusts designed to qualify under section 1014(b)(3) should limit income payments to the grantor and the power to alter beneficial enjoyment to testamentary powers of appointment.

# Typical Structure – During Grantor’s Life



- Foreign holding company avoids U.S. estate tax
- Foreign **grantor** trust (with a foreign grantor) avoids PFIC and CFC issues

# Typical Structure – After Grantor’s Death



Foreign holding company may be treated as a PFIC or CFC

- Use of check-the-box elections after the death of the NRA or foreign grantor
  - Can be used retroactively up to at least 75 days before filing date
  - Careful of U.S. situs assets


Foreign Non-Grantor Trust may be subject to Throwback rules

- Purge trust of DNI each year or domesticate the trust

# Cleaning Up A Messy Past – Disclosure Programs



## Today's Options Available For U.S. Taxpayers with Undisclosed Foreign Financial Assets

- Offshore Voluntary Disclosure Program
  - Streamlined Filing Compliance Procedures
  - Delinquent FBAR submission procedures
  - Delinquent international information return submission procedures
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- Today's Focus

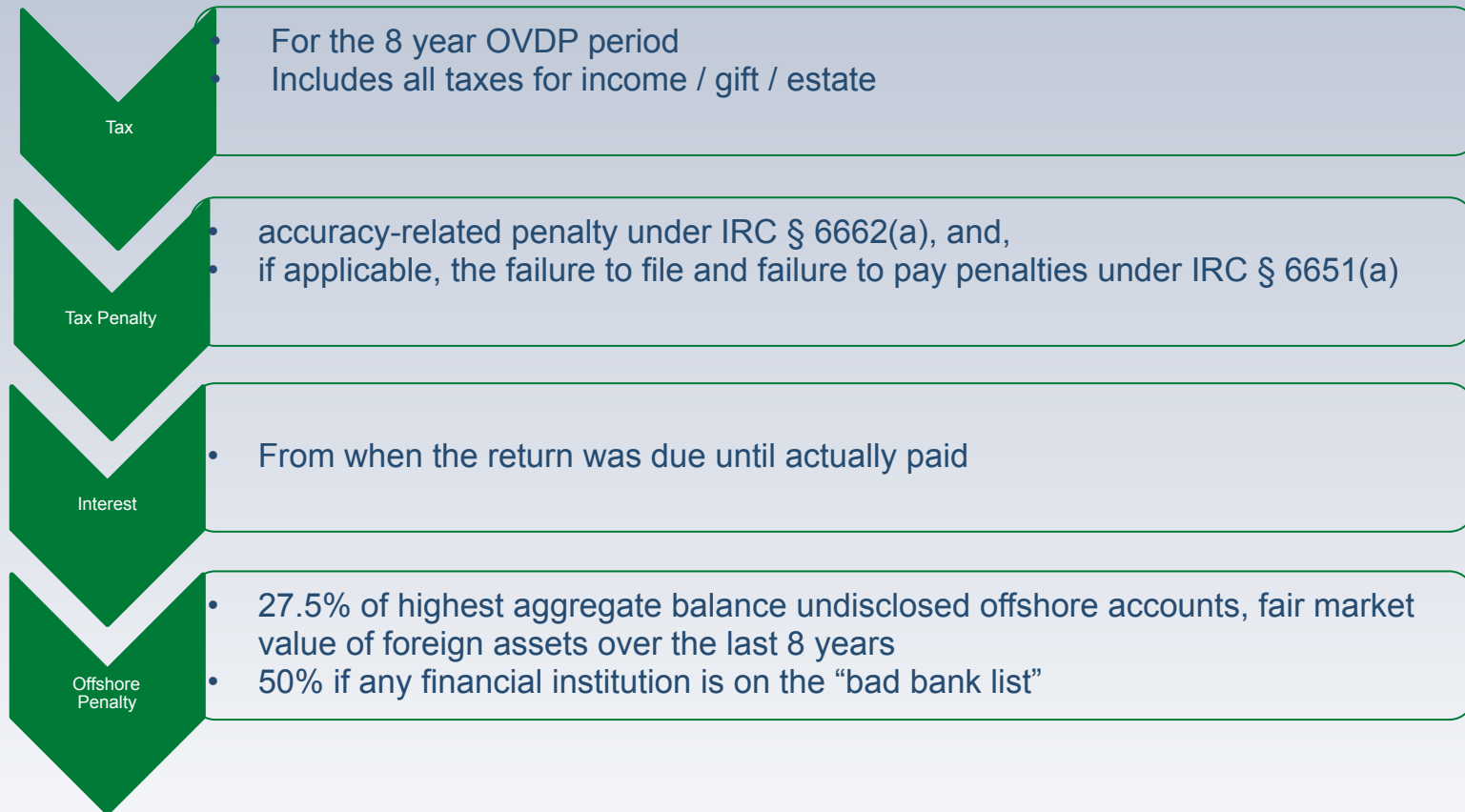
## Offshore Voluntary Disclosure Program

- 2014 Program does not have a set closing date (but the IRS may end the program at any time)
- Designed for taxpayers with exposure to potential criminal liability and/or substantial civil penalties due to a willful failure to report foreign financial assets and pay all tax due in respect of those assets.
- When a taxpayer truthfully, timely, and completely complies with all provisions of the voluntary disclosure practice, the IRS will not recommend criminal prosecution to the Department of Justice for any issue relating to tax noncompliance or failure to file FBAR
- In contrast, taxpayers simply filing amended returns or filing through the Streamlined Filing Compliance Procedures do not eliminate the risk of criminal prosecution.

from IRS.gov

Available at <https://www.irs.gov/individuals/international-taxpayers/options-available-for-u-s-taxpayers-with-undisclosed-foreign-financial-assets>

## Offshore Voluntary Disclosure Program - Payments



# “Bad Bank” List

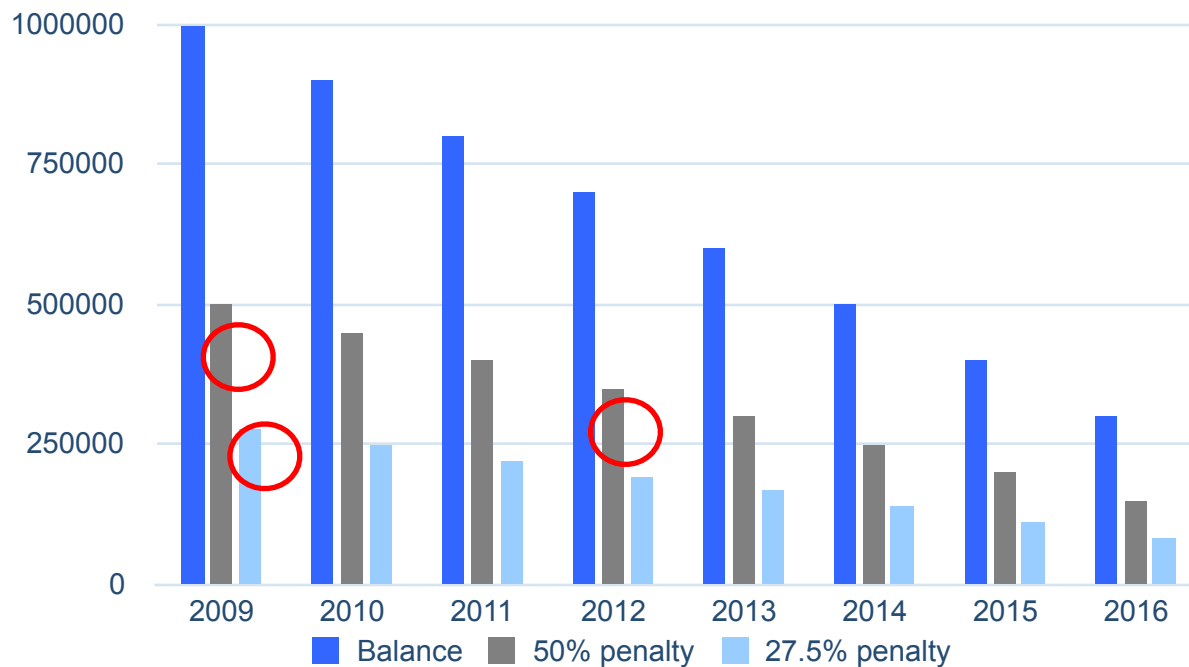
Currently 146 names on IRS list of **“Foreign Financial Institutions or Facilitators”** (as of 8 September 2017)

**Approximately 105 banks and 41 individuals**

**If taxpayer had any money in an account at one of these banks, then the Highest Aggregate Balance Penalty will be computed at a 50% rate rather than a 27.5% rate**

**The majority of the banks are located in Switzerland, but there are also “bad banks” from Israel, Liechtenstein, Curacao, Belize, Cayman Islands, India and Bermuda**

## Offshore Voluntary Disclosure Program - Payment Example



- Client had \$1 million abroad, using 100k/year.
- Penalty assessed on the biggest value (2009)
  - At 50% \$500,000
  - At 27.5% \$275,000
- Total value of account in 2017 is \$200,000
- Compare to a single 50% actual penalty based on the SoL (2011 FBAR ran June 30, 2017)

## Offshore Voluntary Disclosure Program – What am I in for?

- Provide statute extensions for 8 years even if the year has closed
- Verification review of 8 years of returns and reporting forms
- Known “cooperation” items including providing information on foreign accounts and assets, institutions and facilitators and, if implicated, friends and family
- Unspecified “cooperation” items in that you agree to cooperate with IRS and Department of Justice offshore enforcement efforts, if requested, by providing information about financial institutions and other facilitators who helped the taxpayer establish or maintain an offshore arrangement.
- But you do get
  - A closing agreement (eventually)

## Streamlined Filing Compliance Procedures

- During 2014, the IRS significantly expanded eligibility
- Designed to provide a reduced penalty and streamlined process to taxpayers who can certify that their failure to report foreign financial assets and pay all tax due in respect of those assets did not result from willful conduct

### Streamlined Foreign Offshore Procedures

- Asset based penalty waived (no FBAR penalties or informational return penalties)
- 3 years of income tax returns (no late filing penalties or accuracy related penalties)
- 6 years of FBARS
- **Physically outside the US 330 days in at least 1 of the last 3 years**

### Streamlined Domestic Offshore Procedures

- Asset based penalty –the “miscellaneous offshore penalty” equal to 5% of the foreign financial assets that gave rise to the tax compliance issue
- 3 years of income tax returns (no late filing penalties or accuracy related penalties)
- 6 years of FBARS

## Streamlined Filing Compliance Procedures – Who is Eligible?

- Stated policy is it is for individuals and estate of individuals only (not entities)
- Not under civil or criminal examination
- Must have a valid SSN / ITIN
- Must certify that the failure to report all income, pay all tax and submit all required information returns, including FBARs was due to non-willful conduct
  - The certification must set forth specific reasons for the failure to report
  - No protection from criminal – risks of this application discussed in more detail later



## Streamlined Filing Compliance Procedures – What Happens?

- Tax returns submitted under either the Streamlined Foreign Offshore Procedures or the Streamlined Domestic Offshore Procedures will be processed like any other return submitted to the IRS
  - Not subject to audit automatically
  - May be selected for audit
  - May also be subject to verification procedures in that the accuracy and completeness of submissions may be checked against information received from banks, financial advisors, and other sources
- Receipt of the returns will not be acknowledged by the IRS
- Streamlined filing process will not culminate in the signing of a closing agreement with the IRS
- Streamlined Domestic Offshore Procedures filers will get a penalty computation notice

## Recent Criminal Prosecutions

- *United States v. Khalili et al.* (C.D. Cal.): Two brothers and brother-in-law pleaded guilty to failing to file FBARs for accounts in Switzerland and Israel; FBAR penalty of nearly \$5 million collectively. Sentenced to 12, 8, and 8 months in prison, respectively.
- *United States v. Horsky* (E.D. Va.): Pleaded guilty to defrauding IRS through secret accounts at Credit Suisse; tax loss of \$100 million; FBAR penalty of \$100 million. Sentenced to 7 months in prison.
- *United States v. Hager* (E.D.N.Y.): Pleaded guilty to filing false tax returns based upon undisclosed accounts containing \$7 million in various Swiss and Israeli banks. Sentenced to 6 months in prison.

## Criminal Enforcement Actions Against Banks

- UBS AG (Switzerland) – February 2009; deferred prosecution agreement.
- Wegelin Bank (Switzerland) – January 2013; guilty plea. \$58 penalty and \$16.2 forfeiture.
- LLB-Vaduz (Liechtenstein) – July 2013; non-prosecution agreement. \$23 million penalty.
- Credit Suisse (Switzerland) – May 2014; guilty plea. \$2.6 billion penalty.
- Bank Leumi (Israel) – December 2014; deferred prosecution agreement. \$270 million penalty and turnover of more than 1,500 names of account holders.
- Bank Julius Baer (Switzerland) – February 2016; deferred prosecution agreement. \$547 million penalty.
- Cayman National Securities Ltd. *et al.* (Cayman Islands) – March 2016; guilty plea. \$6 million penalty.