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Evolving Concept of

FOREIGN TRUSTS

and Potential Relief for Taxpayers

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Creating foreign entities to safeguard assets is not necessarily problematic for U.S. taxpayers, but failing to characterize them appropriately sure is. Taxpayers have utilized foreign vehicles called "stiftungs" for decades. Although no tax provision or regulation expressly holds that *all* stiftungs must be classified as foreign trusts for U.S. purposes, various court decisions and administrative rulings over the years have concluded that certain stiftungs should be treated as trusts. This triggers the duty for taxpayers to file with the Internal Revenue Service ("IRS") several information returns, the most critical of which being Forms 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts) and Forms 3520-A (Annual Information Return of Foreign Trust with a U.S. Owner). Violations lead to large penalties, endless assessment-periods, and other things taxpayers want to avoid.

This article identifies obligations associated with having foreign assets, activities or income, defines the concept of foreign trusts, chronicles the major cases and IRS rulings on this issue from 1955 to the present, explains the IRS's current foreign trust compliance campaign, and explores potential relief for taxpayers thanks to a recent Revenue Procedure.

Overview of Tax and Information-Reporting

Individual taxpayers ordinarily must do several things with the IRS when they have assets, activities and/or income abroad, including the following:

1. They must declare on Form 1040 (U.S. Individual Income Tax Return) income derived from all sources, including passive and active income generated abroad;
2. They must disclose on Schedule B (Interest and Ordinary Dividends) to Form 1040 the existence and location of foreign accounts, as well as various links to foreign trusts;
3. They must electronically file a FinCEN Form 114 ("FBAR") to provide more details about foreign accounts;
4. They must report foreign financial assets, as this term is expansively defined, on Form 8938 (Statement of Specified Foreign Financial Assets);
5. They must file a Form 8833 (Treaty-Based Return Position Disclosure) if they are claiming that the application of a treaty between the United States and another country modifies normal treatment; and
6. In situations where taxpayers hold interests in and/or have certain other connections with foreign entities, they must report them on the appropriate information return, such as Form 3520 and Form 3520-A.[1]

Focus on Foreign Trusts

This article centers on foreign trusts, so more detail is warranted on these entities.

Different Roles, Different Duties. A "responsible party" generally must file a Form 3520 within 90 days of certain "reportable events."[2] For these purposes, the term "responsible party" means (i) the grantor, in cases involving the creation of an inter vivos trust, (ii) the transferor, where there is a reportable event other than a transfer upon death, and (iii) the executor of a decedent's estate.[3] The term "reportable event" includes the establishment of a foreign trust by a U.S. person, the transfer of money or other property to a foreign trust by a U.S. person, and the death of a U.S. person, if such person was treated as the "owner" of any portion of the foreign trust under the grantor trust rules or if any portion of the foreign trust was included in the person's gross estate.[4]

If a U.S. person is treated as the "owner" of any portion of a foreign trust under the grantor trust rules at any time during a year, then the person (i) "shall submit" such information as the IRS prescribes with respect to the trust, and (ii) "shall be responsible to ensure" that the trust files Form 3520-A and furnishes the information required to each U.S. person who is the owner of any portion of the trust, or who receives any distribution from the trust.[5] Finally, a U.S. person ordinarily must file a Form 3520 if such person receives during the year any "distribution" from a foreign trust, as this concept is broadly delineated.[6]

Penalties for Transgressions. The penalty for not filing a timely, complete, accurate Form 3520 is $10,000 or 35 percent of the so-called "gross reportable amount," whichever is larger.[7] If the violation involves Form 3520-A (pertaining to owners of foreign trusts) instead of Form 3520 (pertaining to responsible parties and beneficiaries), the penalty decreases from 35 percent to five percent.[8] Taxpayers might also be hit with a so-called "continuation penalty," if they fail to submit the necessary Forms 3520 and/or Forms 3520-A after the IRS notifies them of the infraction. Specifically, if taxpayers refuse to become compliant within 90 days of notice, then the IRS will assess an additional penalty of $10,000 per month.[9]

In determining the penalty, the key is calculating the "gross reportable amount." This term has three different meanings. First, in the case of a violation by a "responsible party" to file a Form 3520, it means "the gross value of the property involved in the [reportable] event (determined as of the date of the [reportable] event)."[10] Second, in instances when an owner does not file a Form 3520-A, it means "the gross value of the portion of the trust's assets at the close of the year treated as owned" by the U.S. person.[11] Lastly, where a U.S. beneficiary overlooks Form 3520, it means "the gross amount of the distributions."[12]

The IRS will not assert penalties where there is "reasonable cause" for the violation and it was not due to "willful neglect."[13] Because the IRS has never issued regulations explaining the significance of "reasonable cause" for purposes of Form 3520 and Form 3520-A, the courts have been receptive to arguments applying the reasonable cause standards set forth elsewhere in the Internal Revenue Code.[14] Importantly, unlike the long list of penalties that are linked to tax returns, Form 3520 and Form 3520-A penalties are "assessable" penalties. This means that the IRS immediately imposes them and starts collection actions, and the normal deficiency procedures do not govern.[15]

Is an Entity a Trust?

Specific regulations, generally referred to as the entity-classification rules, govern how organizations recognized as separate legal entities are treated for U.S. tax purposes.[16] They provide that a "business entity" is any entity recognized for tax purposes, other than a trust.[17] With respect to trusts, the regulations start by indicating that an "Ordinary Trust" is an arrangement, created either by a will or by an *inter vivos* declaration, whereby trustees take title to property for purposes of protecting or conserving it for the beneficiaries.[18] The beneficiaries of an Ordinary Trust limit themselves to accepting the

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benefits thereof; they normally do not plan or create the Ordinary Trust in the first place.[19] The IRS tends to treat an arrangement as an Ordinary Trust if its purpose is to vest in the trustees responsibility for the protection or conservation of property for beneficiaries, who are not involved with such responsibility, and who are not associates in a joint enterprise designed to conduct business for profit.[20]

Private letter rulings ("PLRs") about entity classification often focus on the fiduciary duties that a trustee undertakes, as well as the separation of the beneficial enjoyment of the trust assets from their management. For example, in PLR 200508004, the IRS concluded that a foreign entity with the following characteristics should treated as an Ordinary Trust: (i) The entity was formed under the laws of a foreign country to provide pension benefits to certain employees and their families; (ii) The governing instrument empowered the fiduciaries to engage in any legal activity in the foreign country, provided that they protected the accumulated employee benefits of the entity; (iii) The entity primarily was funded by contributions from employees and the employer; (iv) The fiduciaries were required to invest all funds responsibly, pursuant to an annual plan; and (v) The employees and other beneficiaries could not unilaterally transfer their pension benefits to another person.[21]

The regulations describe several other types of trusts, including so-called "Business Trusts."[22] These arrangements also involve the transfer of legal title to property to trustees for the benefit of beneficiaries, but they are different from Ordinary Trusts in that the beneficiaries usually create them as a way to carry on a for-profit endeavor that would normally occur through a corporation, partnership, or other business entity.[23]

Is the Trust Foreign?

If an entity is a "trust" for U.S. tax purposes, the next question is whether it is domestic or foreign. This inquiry is more complicated that one would anticipate, of course. A trust will be treated as domestic if a U.S. court can exercise primary supervision over the administration of the trust ("Court Test") *and* at least one U.S. person has authority to control all substantial decisions of the trust ("Control Test").[24] A trust satisfies the Court Test if the governing document, like the trust deed, does not expressly state that the trust will be administered outside the United States, the trust is administered exclusively in the United States, and the trust is not subject to an "automatic migration provision," which would move the trust outside the United States if a U.S. court were to attempt to assert jurisdiction or otherwise supervise the administration of the trust.[25] For purposes of the Control Test, the term "control" means having the power, by vote or otherwise, to make all substantial decisions of the trust, with no other person having the power to veto such decisions.[26] This encompasses all persons with decision-making authority, not just trust fiduciaries.[27] The term "substantial decision," for its part, means any decision allowed or required under the terms of the trust deed and relevant law.[28] The following are considered substantial decisions in this context:

- Whether and when to distribute income or corpus of the trust;
- The amount of any distributions;
- The selection of a beneficiary;
- Whether to remove, add, or replace a trustee; and
- Whether to terminate the trust.[29]

Any trust that fails to meet both the Court Test and the Control Test is a foreign trust.[30]

1 Other common international information returns related to entities are Forms 5471 (Information Return of U.S. Persons with Respect to Certain Foreign Corporations), Forms 8865 (Return of U.S. Persons with Respect to Certain Foreign Partnerships), and Forms 8858 (Information Return of U.S. Persons with Respect to Foreign Disregarded Entities and Foreign Branches).
2 Section 6048(a)(1).
3 Section 6048(a)(4).
4 Section 6048(a)(3)(A). The "grantor trust rules" are located in Sections 671 through 679.
5 Section 6048(b)(1); Notice 97-34, Section IV.
6 Section 6048(c)(1); Notice 97-34, Section V.
7 Section 6677(a).
8 Section 6677(b).
9 Section 6677(a).
10 Section 6677(c)(1); Section 6048(a).
11 Section 6677(c)(2); Section 6048(b).
12 Section 6677(c)(3); Section 6048(c).
13 Section 6677(d); Notice 97-34, Section VII.
14 *James v. United States*, 100 AFTR 2d 2012-5587 (Aug. 14, 2012).
15 Section 6677(e).
16 Treas. Reg. § 301.7701-1(a) and (b).
17 Treas. Reg. § 301.7701-2(a).
18 Treas. Reg. § 301.7701-4(a).
19 Id.
20 Id.
21 PLR 200508004 (Feb. 25, 2005).
22 Treas. Reg. § 301.7701-4. The regulation also defines Investment Trusts, Liquidating Trusts, and Environmental Remediation Trusts.
23 Treas. Reg. § 301.7701-4(b).
24 Treas. Reg. § 301.7701-7(a). All key terms pertaining to the Court Test, including "court," "United States," "able to exercise," "primary supervision," and "administration," are found in Treas. Reg. § 301.7701-7(c)(3).
25 Treas. Reg. § 301.7701-7(c)(1) and (c)(4)(ii).
26 Treas. Reg. § 301.7701-7(d)(1)(iii).
27 Id.
28 Treas. Reg. § 301.7701-7(d)(1)(ii).
29 Treas. Reg. § 301.7701-7(d)(1)(ii). This is a non-exhaustive list.
30 Section 7701(a)(31)(B); Treas. Reg. § 301.7701-7(a)(2).

Past Court Decisions and IRS Rulings

Foreign stiftungs are not new, yet court decisions and IRS rulings regarding their characterization for U.S. purposes are scarce.[31] The main ones are described below in chronological order.

Estate of Swan v. Commissioner (1955). The most famous case involving classification of stiftungs is, without a doubt, *Estate of Swan v. Commissioner*.[32] This case concerned a deceased individual, who was not a U.S. citizen or resident, who had previously created a Swiss stiftung and Liechtenstein stiftung. These two entities held various assets at the time of his death, including financial accounts in the United States. The critical issue was whether such accounts were subject to U.S. estate taxes. Representatives of the decedent argued that the financial accounts held by the foreign stiftungs were not part of the gross estate because stiftungs should be considered foreign corporations, not foreign trusts. The representatives acknowledged that the stiftungs in question never issued stock, as corporations normally do, but suggested that the articles of foundation and other organizational documents should be deemed stock for these purposes.

The Tax Court observed that, under both Swiss and Liechtenstein law, a stiftung is a separate legal entity created by designating and transferring property for a specific public, charitable, or private purpose. It then emphasized that the concept of trusts is not recognized under local law. Importantly, the Tax Court underscored the novel nature of the issue, stating that "[t]he precise nature of the foreign stiftung for United States purposes, and in particular for federal estate tax purposes, has not been determined in a number of respects."[33] The Tax Court conceded that the stiftungs under scrutiny resembled corporations in various manners. For instance, they had perpetual existence, were managed by a board, did not create personal liability for the beneficiaries, could engage in certain business activities, were governed by documents similar to articles and bylaws, constituted separate legal entities, could sue and get sued, and paid income taxes. On the other hand, noted the Tax Court, no certificates of ownership (such as shares of stock) existed, the interests of the beneficiaries were non-transferable, and the governing documents contained many provisions similar to those typically in a trust deed.[34]

The Tax Court then put aside the formalities of stiftungs, focusing instead on their "most significant features." These consisted of the following: The decedent created the stiftungs as family foundations, their purpose was to fund the care and education of family members, the decedent retained authority during his lifetime to amend the articles of foundation and to revoke the stiftungs altogether, and the stiftungs did not engage in any business activities.[35] The Tax Court next explained the two pertinent tax provisions in effect at that time. First, the gross estate of a decedent generally encompassed the value of any property transferred by the decedent "by trust or otherwise," where the decedent retained until his death the power to alter, amend, revoke or terminate the trust or other instrument.[36] Second, property transferred by a nonresident alien decedent was considered to be within the United States, and thus subject to estate taxes, if such property was so located when the decedent made the transfer or when he died.[37]

Referencing the "most significant features" of the two relevant stiftungs, the Tax Court determined that they gave the decedent the power to control the enjoyment of the property held by the stiftungs, including the U.S. financial accounts. The purpose of the law, explained the Tax Court, was to prevent decedents from avoiding estate taxes by making *inter vivos* transfers of property, to a trust or other entity, while allowing the decedent to still maintain control over the ultimate enjoyment of such property. The element of ongoing control was decisive, said the Tax Court. It then concluded that (i) the key features "give the stiftungs a character which in both purpose and function very closely resembles the private trust which is organized and used solely for family purposes," (ii) "the difference between the trust as we conceive it and these particular stiftungs is merely one of formal organization under differing legal systems," (iii) disparities between civil law used in many foreign countries and U.S. law "must be handled in a practical way," and (iv) "for federal estate tax purposes, we must look to the essence of the foreign organization, its functional features, and treat it accordingly."[38]

Kraus v. Commissioner (1973). The issue of whether a stiftung was a trust for U.S. tax purposes was not the central issue in *Kraus v. Commissioner*; the stiftung was merely a shareholder in the foreign corporation under attack by the IRS.[39] However, what the Tax Court observed about the stiftung was important: "A stiftung is a creation of the laws of Liechtenstein or Switzerland, resembling a trust, but not limited to specific lives in being. A stiftung can own property and is controlled by an administrator… whose powers and duties are comparable to [those of] at trustee."[40]

Private Letter Rulings (2002 through 2009). The IRS issued three PLRs involving, to varying degrees, the proper classification of foreign stiftungs.[41] The IRS referenced in each PLR the holding in *Estate of Swan v. Commissioner*, concluded that the pertinent entity was a charitable trust, and underscored that such classification was appropriate because the stiftung "lacks associates and will not engage in the conduct of business for profit."[42]

Chief Counsel Advice AM-2009-012 (2009). This Chief Counsel Advice ("CCA") addressed two issues, one of which was whether a stiftung formed in Liechtenstein should be classified as a business entity or a trust for U.S. tax purposes. The CCA explained that the stiftung in question had the following characteristics: (i) It did not have members or a Board of Directors; (ii) The founder

transferred assets to the stiftung, at which time he no longer had legal title; (iii) The founder set the initial objectives of the stiftung; (iv) The founder could appoint and discharge the administrators, and could make himself one of the administrators; (v) The administrators could invest assets, make distributions to beneficiaries, and implement other actions within their authority; (vi) In doing so, the administrators, pursuant to the articles of the stiftung and local law, were obligated to properly manage and conserve the assets; (vii) Local law prevented the stiftung from actively conducting business for profit; (viii) The stiftung could be a family foundation whose purpose was to provide benefits to family members, charities, or religious organizations; (ix) The stiftung could be created by the founder filing a charter with the relevant authorities or by will; (x) The stiftung was required to have a minimum amount of initial capital; and (xi) The legal liability of the stiftung was limited to its capital contribution and net assets.

The CCA set the stage by summarizing the entity-classification regulations, described earlier in this article, and *Estate of Swan v. Commissioner.* The CCA then explained that Liechtenstein stiftungs generally should be treated as trusts under the regulations, largely because their primary purpose is to protect or conserve property of the stiftung for its beneficiaries, not to actively conduct for-profit business activities. The CCA warned, however, that if the facts and circumstances of a particular case show that a stiftung was formed primarily for commercial purposes, then it will be classified as a business entity (such a corporation or partnership) instead of a trust. The CCA concluded with the following admonition: "[I]t is important to analyze the facts and circumstances of each case to determine whether a particular stiftung was established to protect and conserve property of the stiftung or, alternatively, was created as a device to carry on a trade or business."

Berik Stiftung v. Plains Marketing, LP (2010). Taxes were not an issue in *Berik Stiftung v. Plains Marketing LP*, but the proper treatment of a foreign stiftung was fundamental to the case nonetheless.[43] The focus was on whether the court had authority to decide the case, under the legal concept known as diversity jurisdiction. The court, in summary, could not resolve the case unless the plaintiff, a stiftung created in Liechtenstein, was considered a foreign citizen. The stiftung argued that it was similar to a trust under the U.S. system, such that the citizenship of its beneficiaries determined whether it would be treated as domestic or foreign. Since the beneficiaries were two U.S. citizens and residents, the stiftung should be deemed a domestic trust, not a foreign trust, concluded the stiftung.

In making this argument, the stiftung underscored that the Tax Court in *Estate of Swan v. Commissioner*, and the IRS in the three PLRs referenced above, have already held that a Liechtenstein stiftung should be treated as a trust, at least for certain tax purposes.[44] The defendant, for its part, countered that the stiftung was a legal entity, created under foreign law, and thus a foreign citizen for purposes of deciding questions of a court's jurisdiction. The defendant added that "[w]hether a stiftung most closely resembles a trust, or any other entity under U.S. law, is irrelevant."[45] The court analyzed Liechtenstein law and noted that a stiftung is a "legally and economically independent entity" and thus a foreign citizen when it comes to issues of diversity jurisdiction.[46] It then emphasized that different terms, have different significance, in different contexts. Specifically, the court said that "[w]hether a stiftung is characterized as a trust for estate tax purposes has no bearing on whether a stiftung is a foreign citizen for diversity jurisdiction purposes."[47]

United States v. Garrity (2018). Synthesizing multiple court documents and making some basic assumptions, the key facts in *United States v. Garrity* were as follows.[48] The taxpayer, a U.S. citizen and resident, founded Garrity Industries, Inc. ("Domestic

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[31] Von E. Sanborn et al., "Classifying Trusts, Anstalts, and Stiftungs – When Is a Trust Not a Trust?" American Law Institute – American Bar Association Course of Study, SL0003 ALI-ABA 293 (July 2005) (explaining that the stiftung has been described as "one of the few trust-like entities whose U.S. tax treatment has been examined by a U.S. court").

[32] *Estate of Swan v. Commissioner*, 24 T.C. 829 (1955), affirmed in part and reversed in part on other grounds, 247 F.2d 144 (2nd Cir. 1957).

[33] *Estate of Swan v. Commissioner*, 24 T.C. 829, 856 (1955).

[34] Id.

[35] Id.

[36] *Estate of Swan v. Commissioner*, 24 T.C. 829, 853-854 (1955) (citing Section 811(d)).

[37] *Estate of Swan v. Commissioner*, 24 T.C. 829, 854 (1955) (citing Section 862(b)).

[38] *Estate of Swan v. Commissioner*, 24 T.C. 829, 857-858 (1955).

[39] *Kraus v. Commissioner*, 59 T.C. 681 (1973).

[40] *Kraus v. Commissioner*, 59 T.C. 681, 685 (1973).

[41] PLR 2002260012, PLR 200302005, and 200901023.

[42] Id.

[43] *Berik Stiftung v. Plains Marketing, LP*, 603 F.3d 295 (5th Cir. 2010).

[44] *Berik Stiftung v. Plains Marketing, LP*, 603 F.3d 295, 299 (5th Cir. 2010).

[45] *Berik Stiftung v. Plains Marketing, LP*, 603 F.3d 295, 298 (5th Cir. 2010).

[46] *Berik Stiftung v. Plains Marketing, LP*, 603 F.3d 295, 298-299 (5th Cir. 2010).

[47] *Berik Stiftung v. Plains Marketing, LP*, 603 F.3d 295, 299 (5th Cir. 2010).

[48] *United States v. Garrity*, 117 AFTR 2d 2016-1809 (D.C. Conn. 2016); *United States v. Garrity*, 121 AFTR 2d 2018-1342 (D.C. Conn. 2018); *United States v. Garrity*, 121 AFTR 2d 2018-1976 (D.C. Conn. 2018); *United States v. Garrity*, 123 AFTR 2d 2019-941 (D.C. Conn. 2019).

Company"), which manufactured and sold lighting products. About two decades later, in 1989, the taxpayer established the Lion Rock Foundation, a stiftung in Liechtenstein ("Lion Rock"). Interestingly, neither the taxpayer nor the government challenged the characterization of the stiftung as a foreign trust for purposes of U.S. income taxes and information-reporting penalties. The taxpayer was the primary beneficiary of Lion Rock from inception, and, during his lifetime, he retained the right to amend or revoke the governing documents. The taxpayer entered into an agreement with a foreign trust company ("Trustee"), whereby it would appoint the Board of Directors for Lion Rock. The agreement with the Trustee expressly mandated that all members of the Board of Directors act in accordance with instructions from the taxpayer or anyone authorized to act on his behalf. In 1989, the taxpayer opened an account in Liechtenstein in the name of Lion Rock ("First Foreign Account"). The next year, Lion Rock formed a company in the British Virgin Islands ("Foreign Corporation"), under which it opened another account ("Second Foreign Account"). The government alleged that all documents related to this international structure were either signed or initialed by the taxpayer.

The taxpayer instructed Lion Rock to arrange for "suitable documentation" between the Domestic Company and the Foreign Corporation, showing that the former was supposedly paying the latter "inspection fees." It appears that the money flowed in the following manner: The Foreign Corporation sent invoices to the Domestic Company for "inspection services" provided; the Domestic Company sent payments to the Second Foreign Account; and the funds were then transferred to the First Foreign Account, held by Lion Rock. The government claimed that the Foreign Corporation never performed any "inspection services," and the purpose of the foreign entities, accounts, and transactions was simply to "disguise" transfers of pre-tax funds from the Domestic Company to the taxpayer. The IRS later audited the taxpayer. He faced troubles from multiple angles, including penalties related to Lion Rock. The government took the position that the taxpayer "exercised complete control" over Lion Rock, and it should be treated as a foreign grantor trust for U.S. tax purposes, necessitating the filing of Form 3520 and Form 3520-A. The government imposed penalties for multiple years. When representatives of the taxpayer's estate refused to pay, the government filed a collection lawsuit in District Court, seeking over $1.5 million.

Representatives of the estate challenged the government on two grounds. First, with respect to Form 3520, they argued that the government failed to allege any facts in its Complaint establishing precisely which "reportable transactions" occurred during the relevant years. Second, representatives claimed that "stacking penalties" against the taxpayer was unconstitutional in that it violated the Eighth Amendment prohibition against excessive fines. Representatives cited to the proposed FBAR penalties of approximately $1.1 million (addressed in a separate District Court action), accuracy-related penalties of about $13,000 (addressed in a separate Tax Court action), and the Form 3520 and Form 3520-A penalties surpassing $1.5 million. Representatives urged the District Court to hold that the government "unconstitutionally stacked" penalties in connection with the same activities, entities, and funds. Representatives ultimately settled the Lion Rock matters without a trial, agreeing to pay approximately 50 percent of the total Form 3520 and Form 3520-A penalties.

Most Recent Case

The newest precedent, *Estate of Rebold v. United States*, focuses on penalties for unfiled international information returns related to foreign trusts.[49]

Basic Facts. The taxpayer was a U.S. citizen who worked as an overseas oil executive for many years. He created a stiftung in Liechtenstein, and then funded it with two major transfers, in 2005 and 2007. He did not file a Form 3520 in 2005 to report the formation of the stiftung, did not file a Form 3520 in 2005 and 2007 to disclose the transfers of money abroad, and did not file a Form 3520-A in 2005, 2006 or 2007 in his capacity as owner of the stiftung. The IRS audited the taxpayer, discovered the violations, and assessed substantial penalties. The taxpayer begrudgingly paid the IRS in full, filed a Suit for Refund in District Court, and then died.

The executor of his estate assumed the reigns from that point forward. He filed a Motion for Summary Judgment asking the District Court to determine that the IRS was unjustified in assessing penalties for unfiled Forms 3520 and Forms 3520-A because the stiftung was not a "foreign trust."

Analysis by Court. The District Court began by reviewing the regulations about entity-classification, which were previously covered in this article. Then, turning to a number of cases focused on trust matters generally, the District Court explained that it must look at various factors, such as whether members, partners, shareholders or other business associates existed, and whether the entity carried on a business and divided the profits. The government argued that the stiftung was a trust for U.S. tax purposes because it was designed to defray the cost of education, training, and support of the beneficiaries, it lacked business associates, it could not legally conduct a business, and it paid the independent trustee a fee. The District Court agreed that, based on these factors, the stiftung constituted a foreign trust. Extending this line of reasoning, the District Court concluded that because the stiftung was a foreign trust, because U.S. persons who create foreign trusts and/or transfer money to foreign trusts must file Form 3520, because U.S. persons who are owners of foreign trusts must file Form 3520-A, and because the taxpayer failed to make such filings, the IRS was correct in assessing various penalties for 2005, 2006, and 2007.

Unsuccessful Arguments by the Taxpayer. The taxpayer raised several arguments to defend his position that the stiftung was not a foreign trust, and even if it were, he should still not be penalized. The taxpayer maintained that no statute, regulation, or case cited by the government specifically states that a Liechtenstein stiftung always qualifies as a foreign trust. The District Court agreed, but still rejected the argument. It explained that the relevant precedent generally supports the application of a facts-and-circumstances test to determine whether an entity meets the definition of foreign trust, and the label given to a particular entity in the country of formation "is unimportant for tax purposes."

The taxpayer also contended that the imposition of Form 3520 and Form 3520-A penalties violated the Due Process Clause of the U.S. Constitution because the IRS supposedly failed to provide the taxpayer with adequate notice that he should treat the stiftung as a foreign trust. The District Court began by stating that the taxpayer framed the legal issue incorrectly because no law categorically provides that a stiftung always qualifies as a foreign trust for U.S. tax purposes and the IRS did not blindly label the Liechtenstein stiftung as such. Rather, the IRS scrutinized the relevant facts and circumstances and made a determination unique to the taxpayer's case. The relevant statutes, regulations, and IRS rulings defining a foreign trust, the validity of which the taxpayer did not challenge, "gave [the taxpayer] adequate notice of the relevant filing requirements for foreign trusts."

The supposed lack of clarity about what type of entity the IRS considers a foreign trust fueled the taxpayer's next argument, which was that the penalties violated the Fifth Amendment to the U.S Constitution. The taxpayer maintained that the applicable law, regulations, and IRS rulings should be invalid because they are "impermissibly vague." The District Court, relying on several cases, explained that a rule meets this level of ambiguity only if it fails to provide a person of ordinary intelligence fair notice or would permit seriously discriminatory enforcement actions. It emphasized, though, that perfect clarity and precise guidance were not necessary to overcome a challenged based on vagueness. The District Court pointed out that the taxpayer was a sophisticated international businessman. Therefore, he could not claim that he or his tax advisors were unable to locate and review the data indicating that a Liechtenstein stiftung likely would qualify as a foreign trust. The District Court went on to state that a reasonable U.S. citizen placing his money abroad would have inquired about the proper treatment of the stiftung beforehand. Finally, in concluding that the relevant rules defining the term foreign trust are not void for vagueness, the District Court emphasized that the government was not required to identify and specifically list every entity that might be treated as a foreign trust.

The Eighth Amendment to the U.S. Constitution states that "[e]xcessive bail shall not be required, *nor excessive fines imposed*, nor cruel and unusual punishments inflicted." Under the relevant two-prong standard developed by the Supreme Court, the Eighth Amendment will invalidate a penalty if it is at least partly punitive and it is "grossly disproportional" to the level of the violation. The taxpayer initially suggested that the large sanctions for unfiled Form 3520 and Form 3520-A were excessive. The government countered that the penalties were remedial in nature, not punitive, such that the Eighth Amendment was inapplicable. The taxpayer apparently dropped the argument at that point.

Foreign Trust Compliance Campaign

The IRS has been aggressively targeting various international tax compliance matters in recent years. Case in point, in 2018, the IRS introduced a "compliance campaign" centered on foreign trusts, Form 3520, and Form 3520-A. According to the IRS, the campaign involves "a multifaceted approach to improving compliance with respect to the timely and accurate filing of information returns reporting ownership of, and transactions with, foreign trusts."[50]

Potential Salvation via Revenue Procedure. The bad news, as examined above, is that stiftungs are often considered foreign trusts to the surprise of many taxpayers, and the IRS has implemented a compliance campaign to catch violators. There is some good news, though. The IRS recently issued Revenue Procedure 2020-17, which offers beneficial treatment to certain U.S. individuals with interests in "applicable tax-favored foreign trusts."[51] As explained further below, this term broadly encompasses foreign trusts, plans, funds, accounts, and other arrangements, which provide pension, retirement, medical, disability, or educational benefits.

General Background. The IRS's primary purpose in releasing Revenue Procedure 2020-17 was to create an exemption from certain information-reporting requirements

[49] *Estate of Rebold v. United States*, 2021 BL 435976 (W.D. Tex. Sept. 22, 2021).

[50] *See www.irs.gov/businesses/corporations/lbi-active-campaigns*.

[51] Revenue Procedure 2020-17; Annagabriella Colon. "IRS Guidance Eases U.S. Taxpayers' Information Reporting Duty," 2020 Tax Notes Today Federal 42-3, Document 2020-8022 (March 3, 2020).

(but not from income-reporting and tax-payment requirements) for U.S. individuals with respect to their ownership of, and transactions with, certain types of foreign trusts.[52] How can the IRS do this? Well, the law states that the IRS can unilaterally suspend or modify information-reporting duties, if it determines that it "has no significant tax interest" in obtaining the relevant data.[53]

Eligible Individuals. An "eligible individual" is a U.S. citizen or U.S. resident who was compliant or "comes into compliance" with his duty to file tax returns for all years whose general assessment-period remains open, and who reported as income on such returns all contributions to, accumulated income in, and/or actual distributions from an "applicable tax-favored foreign trust."[54] Put another way, only individuals who paid all income taxes related to foreign trusts are in a position to derive the benefits of Revenue Procedure 2020-17.[55]

Two Types of Trusts. An "applicable tax-favored foreign trust" includes both "tax-favored foreign retirement trust" and "tax-favored foreign non-retirement trust."[56] A "tax-favored *retirement* trust" means (i) a trust, plan, fund, scheme, or other arrangement, (ii) established under the laws of a foreign country (iii) to operate exclusively (or almost exclusively) to provide, or to earn income for the provision of, pension or retirement benefits, and (iv) meets a long list of requirements under local law, the most important of which being that the trust is tax-exempt or tax-favored, annual information returns must be filed, contributions are limited, and distributions are contingent upon death, disability, or reaching a particular age.[57] A "tax-favored *non-retirement* savings trust" is largely the same, except that its purpose is to provide, or to earn income for the provision of, medical, disability, or educational benefits.[58]

Prospective Benefit. The IRS waives the duty of "eligible individuals" to file Form 3520 and Form 3520-A with respect to "applicable tax-favored foreign trusts." Its rationale for doing so is two-fold: These items are restricted under foreign law, and taxpayers already report them to the IRS on other international information returns, such as Form 8938.[59]

Retrospective Benefit. Generally, any "eligible individual" against whom the IRS has already assessed Form 3520 and/or Form 3520-A penalties with respect to "applicable tax-favored foreign trusts" can seek an abatement or a refund, as appropriate, by filing a Form 843 (Claim for Refund and Request for Abatement).[60] As one would expect, the period for seeking relief from the IRS is narrow. Revenue Procedure 2020-17 only applies to years whose general refund period has not expired.[61] A taxpayer normally must file a claim for refund within three years from the time that he filed the relevant tax return, or within two years from the time that he paid the relevant amount, whichever period expires later.[62]

Conclusion

As this article demonstrates, while there is no fixed rule, and while the particular facts and circumstances of each situation must be analyzed, several court decisions and IRS rulings over the past seven decades have concluded that stiftungs generally should be treated as foreign trusts for U.S. tax purposes. This prompts, among other things, the duty to file Form 3520 and Form 3250-A, depending on whether somebody is a responsible party, beneficiary and/or owner of a foreign trust. Penalties can be high, and the IRS is on the outlook for violations as part of its ongoing compliance campaign. Certain taxpayers might find refuge in Revenue Procedure 2020-17, but eligibility for the benefits is far from given. Thus, taxpayers with links to stiftungs need to remain vigilant, of both evolving legal precedent and IRS enforcement actions. In other words, achtung with your stiftung. ●

52 Revenue Procedure 2020-17, Section 1.
53 Revenue Procedure 2020-17, Section 2.01 (referencing Section 6048(d)(4)).
54 Revenue Procedure 2020-17; Section 5.02. The IRS expressly states that in determining the open period taxpayers do not need to consider the limitless assessment-period rule in Section 6501(c)(8) applicable when taxpayers fail to file certain international information returns.
55 Revenue Procedure 2020-17, Section 1 (explaining that "[o]nly eligible individuals . . . (generally U.S. individuals who have been compliant with respect to their income tax obligations related to such trusts) may rely on the new IRS guidance").
56 Revenue Procedure 2020-17; Section 5.01.
57 Revenue Procedure 2020-17; Section 5.03.
58 Revenue Procedure 2020-17; Section 5.04.
59 Revenue Procedure 2020-17, Section 3.
60 Revenue Procedure 2020-17, Section 6.01.
61 Revenue Procedure 2020-17, Section 7.
62 Section 6511(a); Treas. Reg. § 301.6511(a)-1(a).