Tax Planning for Sexual Harassment Claims: *Foreign Trust Distributions*

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For parties involved in sexual harassment claims when payment is made to a US taxpayer (i.e. US Citizen/Income Tax Resident) from a Foreign (i.e. Non-US) Trust special tax reporting rules apply under IRC 6677. For failure to file the Form 3520 information return to report the receipt of foreign trust distribution, the IRS may assess an initial penalty equal to the greater of: $10,000 or 35% of the gross value of the distribution received. In addition criminal penalties may apply.

Additional penalties may also be imposed if the US taxpayer non-compliance (i.e. failure to file Form 3520 to report the receipt of the foreign trust distribution) continues after the IRS mails a notice of failure to comply with the required reporting. Under IRC 6677 (a)(2), if any failure continue for more than 90 days, after the day on which the Secretary of the Treasury mails notice of such failure to the person required to pay such penalty, such person shall pay a penalty (in addition to the 35 % penalty) of $10,000 for each 30 day period, during which such failure continues (after the expiration of such 90 day period). The aggregate amount of both penalties (35% of the gross value of the distribution received plus $10,000 for each 30 day period not filed) shall not exceed the "gross reportable amount" (i.e. the amount of the gross value of the distribution). The ultimate penalty for failure to file the required information return (Form 3520) may be the entire amount of the foreign trust distribution received by the US taxpayer.

In settlement of the sexual harassment claims, if the US taxpayer who is the recipient of payment is given an ownership interest in a Foreign Trust, the ownership interest must be reported by the US taxpayer on Form 3520 or a penalty is imposed for failure by the US person to report the US owner information on Form 3520. The penalty is Five per cent (5%) of the gross value of the portion of the trust's assets are treated as owned by the US taxpayer. Additional penalties (i.e. $10,000 for every 30 days of non-compliance) will be imposed if any failure continues for more than 90 days after notification from the Secretary of the Treasury.

Under IRC 672 (f) (5) (A),(B) a foreign person would be treated as the owner of any portion of a foreign trust but such trust has a beneficiary who is a US person "such beneficiary shall be treated as the grantor of such portion to the extent such beneficiary has made (directly or indirectly) transfers of property to such foreign person (other than in a sale for full and adequate consideration)".

The penalties for undisclosed foreign financial asset understatements related to foreign trust distributions or ownership interest in a Foreign Trust will not be imposed with respect to any portion of an underpayment if the US taxpayer can demonstrate that the failure to comply was due to reasonable cause and the US taxpayer acted in good faith (IRC 6662(j). Penalties will be imposed if the US taxpayer acted with "willful neglect".

For purposes of imposition of the penalty reasonable cause shall not include: the fact that a foreign country would impose penalties for disclosing the required information, reliance on a foreign fiduciary to disclose, or provisions in the trust document that prevent disclosure of required information (IRC 6677(d).

Contributions of property by foreign persons to domestic or foreign trusts that have US beneficiaries are not reportable by US beneficiaries unless they are treated as receiving the contribution in the year of the transfer. If the US beneficiary is treated as an owner of that portion of the trust under IRC 678, then the contribution must be reported by such US beneficiary under Form 3520.

A domestic (US) trust that is not treated as owned by a foreign person is required to report the receipt of a contribution to the trust from foreign person as a gift under Form 3520. If the domestic (US) trust is treated as owned by a foreign person, the domestic trust is not required to report the receipt of a contribution to the trust from a foreign person.

Under Form 3520, a US beneficiary who receives a distribution from a domestic (US) trust that is treated as owned by a foreign person, the US beneficiary must report the distribution as a gift from a foreign person (Form 3520/Part IV), rather than as a distribution to a US beneficiary (Form 3520/Part III).

Form 3520 annual information return filings are due with the US taxpayer income tax returns (including extensions of time for filing). If a complete Form 3520 filing is not filed by the due date (including extensions) the time for IRS assessment of any tax imposed will not expire "before the date that is 3 years after the date on which the required information is reported" (IRC 6501 (c) (8).