Estate & Succession Planning Corner

By Lawrence I. Richman

An Introduction to FBAR Reporting Obligations for Foreign *Situs* Trusts With U.S. Beneficiaries

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The Treasury Department Regulation requiring reports of foreign financial accounts is short and seemingly simple. In its entirety it reads as follows:

> Each person subject to the jurisdiction of the United States (except a foreign subsidiary of a U.S. person) having a financial interest in, or signature or other authority over, a bank, securities or other financial account in a foreign country shall report such relationship to the Commissioner of the Internal Revenue for each year in which such relationship exists, and shall provide such information as shall be specified in a reporting form prescribed by the Secretary to be filed by such persons. Persons having a financial interest in 25 or more foreign financial accounts need only note that fact on the form. Such persons will be required to provide detailed information concerning each account when so requested by the Secretary or his delegate.[1]

The format for the required report is Form TD F 90-22.1, entitled "Report of Foreign Bank and Financial Accounts," or simply FBAR for short. Given (a) the sparseness of the Treasury Regulation; (b) the fact that it uses undefined terms like "financial interest," "signature or other authority," and "bank, securities or other financial account;" and (c) that it advises U.S. taxpayers to just follow instructions in a form, it is no wonder that the FBAR Form and its accompanying instructions provide more legislative guidance (and arguably more rule making) than any other form taxpayers file with the Internal Revenue Service. In

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fact, it is the October 2008 release of the revised Form TD F 90-22.1 and its accompanying instructions coupled with the Obama administration's focus and tough stance on compliance, particularly involving offshore assets of U.S. taxpayers,[2] that has caused U.S. beneficiaries of foreign *situs* trusts to rethink whether they have FBAR reporting obligations.

Historically, if a U.S. person was a discretionary beneficiary of a foreign *situs* trust which was not established by a U.S. person and which in a given year made no distributions to such beneficiary, the U.S. beneficiary generally made no FBAR filing on the basis that the beneficiary had no reportable financial interest in or signature authority over a bank account in a foreign country. This view often was buttressed by the fact that unless there was an actual distribution from the trust during the year (in which case the beneficiary would receive a Form 3520 reporting the transfer of funds), the U.S. beneficiary had limited or no information with respect to any bank or securities account maintained by the foreign *situs* trustee.

> Such guidance is important because a taxpayer's failure to comply with FBAR reporting requirements can result in substantial fines and even criminal penalties.

The October 2008 revisions to the FBAR reporting form have led to a re-examination of this historic approach. First, it is important to review what has not changed. Reporting remains required only if the value of the trust exceeds $10,000 at some point during the year. Thus, the fact that the trust's investments may have become virtually worthless during the course of the year or the fact that the trust terminated during the year in, and of itself, does not excuse an FBAR filing requirement. If reporting is required, the person who potentially has a reporting responsibility is and remains the U. S. beneficiary of the foreign *situs* trust.

Because FBAR reporting depends on the determination of whether a U.S. beneficiary has authority over a foreign financial account or whether a U.S. beneficiary has a financial interest in a foreign account, understanding the meaning of these terms is critical in determining whether a reporting requirement exists. In the context of trusts, it is equally important to determine whether the trust itself is a foreign financial account. The definition of financial account in the FBAR form does not say that a foreign *situs* trust itself is a foreign financial account. While the definition says that the terms financial account "includes any bank…or other financial instruments or accounts," many foreign *situs* trustees are not banks and deposit trust funds in commingled bank accounts at various banks in the U.S. or elsewhere. Language in the FBAR instructions stating that financial accounts "generally also encompass any accounts in which the assets are held in a commingled fund, and the account owner holds an equity interest in the fund…" lends support to the view that a foreign *situs* trust itself would be considered a foreign financial account.

Complementing that view are the references to (foreign *situs*) trusts in the instructions to the definition of what constitutes a financial interest in a foreign account. It would appear that a trust would have to be considered a foreign account in order for a beneficiary to have a financial interest in a foreign account that would trigger FBAR reporting. The FBAR instructions state that a U.S. person has a financial interest "in each…financial account in a foreign country for which the…holder of legal title is…a person acting…in some…capacity on behalf of the U.S. person…" In addition, the FBAR instructions explicitly state that a U.S. person has a financial interest in "a trust in which the United States person either has a present beneficial interest, either directly or indirectly, in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income."

In dealing with foreign *situs* discretionary trusts that are not established by a U.S. person, the instructions make reporting dependent upon the U.S. beneficiary (a) having a greater than 50 percent beneficial interest or (b) receiving greater than 50 percent of the current income. Definitional guidance is limited or nonexistent. With respect to resolving whether a U.S. beneficiary has received more than 50 percent of the current income, the term "income" is undefined, so beneficiaries cannot with certainty know whether the term "income" refers to trust accounting income, distributable net income or taxable income. FBAR reporting is not an Internal Revenue Code required reporting obligation,[3] so reliance on how the Code uses terms like income does not appear warranted without guidance from Treasury so stating.

Similarly, resolving whether a U.S. beneficiary has a greater than 50 percent beneficial interest is challenging given the absence of guidance on how that

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beneficial interest should be calculated. Even if there is only one current discretionary beneficiary, that person's beneficial interest could be less than 50 percent if the valuation of the interest is done on an actuarial basis. In a situation involving multiple current discretionary beneficiaries, is the beneficial interest simply divided by the number of beneficiaries or, as was reportedly suggested orally by the IRS,[4] should discretionary beneficiaries assume the maximum exercise of discretion in their favor, thereby causing all discretionary U.S. beneficiaries to be treated as having a financial interest in the trust?

If the foreign *situs* trust was established by a U.S. person and there is a trust protector responsible for monitoring the trustee with the authority to influence its decisions or who can replace or recommend the replacement of the trustee, then the U.S. beneficiary has a financial interest in the foreign trust and its financial accounts.

Historically, discretionary trust beneficiaries did not consider themselves as having signature authority over a foreign financial account, because it was the trustee, not the beneficiary, who was the signatory on any of the trust's financial accounts. This was in accordance with the FBAR instructions, which provide that "a person has signature authority over an account if such person can control the disposition of money or other property in it by delivery of a document containing his or her signature…to the bank or other person with whom the account is maintained." The October 2008 instructions expanded the concept of signature authority to include "other authority over an account." "Other authority" is defined to "exist(s) in a person who can exercise comparable power over an account by communication with the bank or other person with whom the account is maintained either directly or though an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person, either orally or by some other means." In the context of a foreign *situs* trust, the immediate question is whether other authority encompasses a power of appointment. Limited nontaxable powers of appointment frequently appear in foreign *situs* trusts for reasons much like those in domestically *sitused* trusts: they provide flexibility to respond to changes in the personal circumstances of current or future/remainder beneficiaries of the trust. The holder of such a power of appointment may be a beneficiary of the trust or may be someone who is not a beneficiary of the trust, such as a parent, relative or friend of the trust beneficiaries. An argument could be made that because a limited power of appointment grants the donee of the power the right to direct the foreign *situs* trustee to dispose of trust property by directing it to take certain actions with respect to accounts controlled by the foreign trustee, the donee of a power of appointment has "other authority" over a financial account. While a beneficiary of a foreign trust may already be reporting his or her interest in the trust under the financial interest rules, a holder of a limited power of appointment who is not a beneficiary may have little or no information regarding the trust accounts and may not have access to such information. Accordingly, specific guidance on this issue is warranted.

Such guidance is important because a taxpayer's failure to comply with FBAR reporting requirements can result in substantial fines and even criminal penalties. Furthermore, our tax and reporting systems are based upon voluntary compliance. In order to voluntarily comply, taxpayers need clear rules and a body of authority upon which to make reasoned judgments. In the FBAR arena, Treasury has an obligation to assist taxpayers and their advisers by making such information readily available.

Endnotes

1 31 CFR §103.24(a).

2 Laura Sanders, *IRS Gets Tougher on Offshore Tax Evaders*, Wall St. J., Jul. 20, 2009, at C1.

3 FBAR technically is part of Title 31 (Bank Secrecy Act) instead of Title 26 (Internal Revenue Code).

4 ABA/AICPA Teleconference, June 12, 2009.

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