

The New Exemption from Required Information Reporting

Revenue Procedure 2020-17 Provides Relief for Certain Tax-Favored Foreign Trusts

By Nicholas S. Bahnsen

In March 2020, the IRS announced an exemption to the information reporting requirements applicable to foreign trusts. Under this exemption, qualified individuals no longer need to report transactions with or ownership of applicable tax-favored foreign trusts on Forms 3520 and 3520-A. This article outlines the new exemption and the special procedures for requesting an abatement or refund of penalties previously assessed with respect to these tax-favored foreign trusts, and serves as a reminder that taxpayers may have still other filing and reporting requirements related to these trusts that remain unaffected by the exemption.

Background

Taxpayers are generally required to report, on an annual basis, information related to transfers of money or other property to or from, ownership of, or distributions from foreign trusts. This

information is reported on Forms 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, and 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner [under Section 6048(b)].

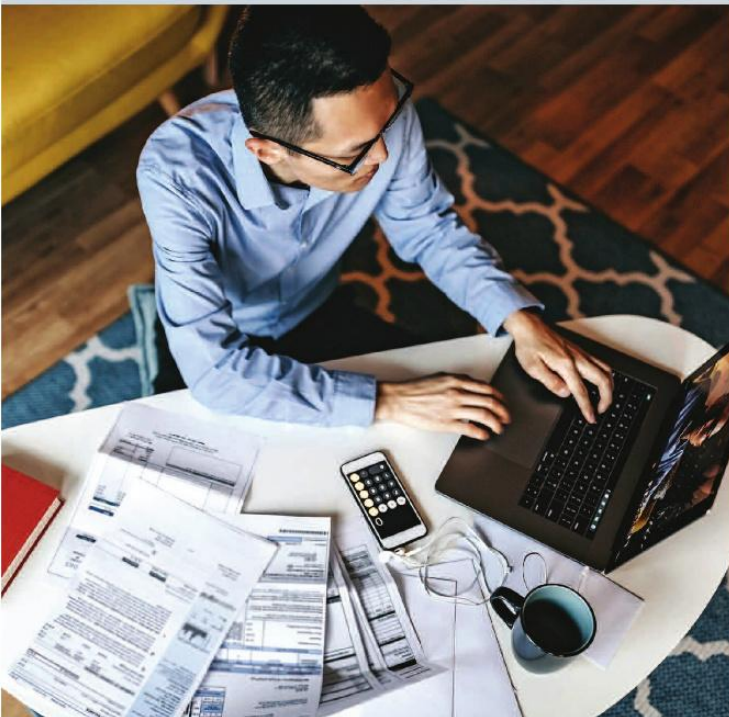
A taxpayer who fails to comply with the reporting requirements may be liable for significant civil penalties. Indeed, the penalty for failing to make a required report is the greater of \$10,000 or 35% of the gross value of the property that should have been reported. A taxpayer failing to report an ownership interest in a foreign trust may be liable for the greater of \$10,000 or 5% of the gross value of the taxpayer's proportional interest in the trust assets as of the end of the year.

The Treasury Department has determined that certain tax-favored foreign trusts are appropriately exempted from these annual information reporting requirements and the penalties that accompany noncompliance. One reason is that such tax-favored foreign trusts are already subject to written restrictions, including contribution limitations, conditions for withdrawal, and information reporting requirements under the laws of the foreign country in which the trust was established. In addition, individuals with an interest in these trusts may have an independent obligation to disclose that interest to U.S. authorities on Form 8938 as an interest in a specified foreign financial asset or on a Report of Foreign Bank and Financial Accounts (FBAR, FinCEN Form 114).

Revenue Procedure 2020-17, effective as of March 16, 2020, provides an exemption to the information reporting requirements for qualified individuals who would otherwise have a reporting obligation under Internal Revenue Code (IRC) section 6048 with respect to an applicable tax-favored foreign trust. Accordingly, the penalties under IRC section 6677 for failing to comply with the reporting obligations of section 6048 will not apply to a qualified individual's failure to report transactions involving, or an ownership interest in, an applicable tax-favored foreign trust.

Qualified Individuals

Only qualified individuals may take advantage of the exemption. Revenue Procedure 2020-17 defines a qualified individual as a U.S. citizen or resident who is compliant with, or comes into compliance with, all U.S. federal income tax return filing requirements for all open tax periods, and who has, to the extent required, reported as income the contributions to, earnings of, or



distributions from an applicable tax-favored foreign trust. Notably, a qualified individual does not include a partnership, corporation, estate, or other trust. To the extent such an entity has reportable transactions or an ownership interest in an otherwise applicable tax-favored foreign trust, it must continue to comply with the information reporting requirements and file the appropriate information return.

Applicable Tax-Favored Foreign Trusts

The exemption is only applicable to certain tax-favored foreign trusts. Specifically, the revenue procedure identifies tax-favored foreign retirement trusts and tax-favored nonretirement savings trusts. In addition, a trust must feature certain limitations on its purpose, contributions made to it, and distributions or withdrawals from it. Annual information reporting with respect to the trust, its participants, or its beneficiaries must also be provided or available under the law of the trust's jurisdiction.

A retirement or savings trust will be considered tax-favored if it is generally exempt from income tax or receives some form of tax-favored treatment under the law of the trust's jurisdiction. Tax-favored treatment must include—

- a deduction or exclusion from income for contributions to the trust;
- a reduced tax rate applicable to contributions;
- eligibility for a tax credit or other tax benefit related to contributions;
- deferred taxation of trust-earned investment income until distribution; or
- taxation of trust-earned investment income at a reduced rate.

A qualifying retirement trust must operate exclusively, or nearly exclusively, to provide pension or retirement benefits and ancillary or incidental benefits. Contributions to retirement trusts may only be made from income earned from the performance of personal services, and are further limited to a percentage of earned income, up to an annual limit of \$50,000 or a lifetime limit of \$1,000,000. An

employer-maintained trust must be open to a wide range of employees, must actually provide significant benefits to a substantial majority of eligible employees, and must have nondiscriminatory benefits. Withdrawals and distributions from qualifying retirement trusts must be conditioned upon reaching a specified retirement age, disability, or death, and premature withdrawals must be subject to penalties. A trust that permits loans for hardship, educational purposes, or the purchase of a primary residence will not violate the withdrawal requirements.

While the exemption established by Revenue Procedure 2020-17 may provide some relief to taxpayers, it is important to note that it is limited in scope.

A qualifying nonretirement trust must operate exclusively, or nearly exclusively, to provide medical, disability, or educational benefits. Contributions to a nonretirement trust must be limited to \$10,000 or less annually, or \$200,000 on a lifetime basis. Withdrawals and distributions must be conditioned upon the provision of medical, disability, or educational benefits, or else be subject to penalty. There is no allowance for loans related to the purchase of a primary residence.

Otherwise qualifying retirement and savings trusts that receive rollovers from another tax-favored foreign trust will not be disqualified from recognition as a tax-favored foreign trust due to this feature.

Penalty Abatement

Revenue Procedure 2020-17 also provides that eligible individuals who have been assessed a penalty under IRC section 6677 for failing to comply with the information reporting requirements with respect to an applicable tax-favored foreign trust may seek relief in the form of an abatement of penalties assessed or a refund of penalties already paid. This relief is available to all prior open taxable years, subject to the limitations on refunds and overpayments in IRC section 6511.

To seek penalty relief, an individual must file Form 843, Claim for Refund and Request for Abatement, with the IRS's Ogden, Utah campus (84201-0027). The taxpayer should be sure to write in Line 7 of Form 843 "Relief pursuant to Revenue Procedure 2020-17" and include an explanation as to why both the individual and the foreign trust qualify for the exemption under the terms of the revenue procedure.

Penalty relief is subject to the Treasury Secretary's authority to credit any overpayment due to a taxpayer against any liability owed. Any balance remaining may be refunded to the taxpayer.

No Relief from Other Filing Requirements

While the exemption established by Revenue Procedure 2020-17 may provide some relief to taxpayers, it is important to note that it is limited in scope. It does not extend to any other return filing or information reporting requirement that may apply with respect to the tax-favored foreign trust. Crucially, taxpayers may still have a reporting requirement under IRC section 6038D (related to an interest in a specified foreign financial asset) and may still have an obligation to file an FBAR under 31 USC 5314 and the related regulations. These obligations arise independently and are unaffected by the provisions of Revenue Procedure 2020-17. □

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