The Many Faces of Form 3520

By Ian Weinstock

Form 3520 is an information return for a U.S. person to report certain transactions with foreign trusts [as defined in Internal Revenue Code (IRC) section 7701(a)(31)] or to report the receipt of certain foreign gifts or bequests. More specifically, Form 3520 is required to be filed in the following four loosely related contexts (the first three of which are specified in IRC section 6048, and the fourth in IRC section 6039F):

- By a "responsible person" when a "reportable event" occurs; that is, by 1) a U.S. grantor of a foreign trust to report the creation of the trust, 2) a U.S. transferor to report a gratuitous transfer (or a transfer in exchange for an obligation) to a foreign trust, or 3) the executor of a U.S. decedent who was treated as the owner of a foreign trust, in whose estate a foreign trust is included for estate tax purposes, or who makes a transfer to a foreign trust at death (Part I of the form must be completed);
- By a U.S. owner of a foreign trust to report the income and assets of the trust (Part II of the form must be completed);
- By a U.S. beneficiary of a foreign trust to report distributions from the trust (including constructive distributions, such as the use of trust-owned assets) or a loan from the trust (Part III of the form must be completed); or
- By a U.S. person to report the receipt of certain gifts or bequests from foreign trusts or estates (Part IV of the form must be completed).

The form is due at the same time as the U.S. person's income tax return for the year in which the event being reported occurs, including extensions, but is filed separately from the income tax return. In the case of multiple trusts, a separate Form 3520 must be filed to report transactions with each, though all foreign gifts can be reported on one form.

Penalties under IRC section 6677 for failure to timely file the form are potentially severe: the greater of $10,000 and 1) 35% of the value of property transferred to the trust or distributed from the trust or 2) 5% of the value of the trust's assets owned by a U.S. person. Penalties under IRC section 6039F for failure to timely file the form are similarly severe: 5% per month of lateness, up to a maximum of 25%, of the value of any gift or bequest. Penalties will not be imposed if the taxpayer had reasonable cause.

If the form is being filed because of some foreign trust issue—that is, not a Part IV situation—it is generally advisable for the foreign trust to designate a U.S. agent to provide information to the IRS; otherwise, additional background information and documentation about the trust (e.g., regarding trustees, beneficiaries, assets) must be provided when the form is filed. Assuming a U.S. agent is being appointed, the instructions to Form 3520 require that the agent be formally appointed via an Authorization of Agent (a form of which is included in the instructions to Form 3520-A, discussed below) and for a copy of the Authorization to be attached to the Form 3520 when it is filed.

Married taxpayers can file a joint Form 3520 only if they file a joint income tax return and only if Part I, II or III applies to them jointly (e.g., they are joint transferors to one trust); according to the instructions, joint filing for a Part IV circumstance is not permitted.

A Deeper Dive

To better understand the mechanics of Form 3520, it is helpful to keep in mind the policy rationale underlying the required reporting in each of the contexts covered by the different parts of the form.

Part I. As noted above, Part I must be completed upon a "reportable event," which itself covers a number of different contexts. In examining those contexts, it is not entirely clear why the mere creation of a foreign trust by a U.S. person should require reporting if there is no transfer to the trust. The case for requiring reporting of the other reportable events is clearer. A transfer by a U.S. person to a foreign trust is a gain recognition event under IRC section 684, so reporting is necessary to police compliance with that section. The death of a U.S. owner of a foreign trust will trigger a change in the income tax treatment of the trust from a grantor trust to a non-grantor trust, which is likely to be relevant to the IRS. Finally, the death of a U.S. person in whose estate a foreign trust is included for estate tax purposes is a triggering event for both a step-up in cost basis under IRC section 1014 and possible estate tax under any of the so-called retained string provisions of Chapter 11 of the IRC (e.g., sections 2036, 2038, 2041).

Part II. Also as noted above, Part II must be completed by the U.S. owner of a foreign trust. The rationale for requiring Part II reporting is fairly clear: to make sure that the owner pays tax on the trust's income. It may not be obvious at first blush, however, how the owner obtains sufficient information from the trustee of the foreign trust to complete Form 3520 properly. The answer is supplied by Form 3520-A, which the trustee of a foreign trust with a U.S. owner is required to file in order to report to the IRS, and to the U.S. owner, via a Foreign Grantor Trust Owner Statement—see the instructions to Form 3520-A— all of the information the U.S. owner needs to complete Form 3520. It is worth noting that the U.S. owner is obligated to require the trustee to file Form 3520-A, and a separate penalty (also the greater of $10,000 and 5% of the assets of the trust) is imposed on the U.S. owner if the trustee fails to timely file Form 3520-A over and above the penalty to timely file Form 3520 itself.

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Part III. The rationale for requiring Part III reporting—for a U.S. Recipient of distributions from a foreign trust—can also be compelling, though less so where the trust is a grantor trust. All income, gains, and losses of a grantor trust are taxable directly to the grantor, regardless of whether anything is distributed from the trust to the grantor or to anyone else. Therefore, distributions from foreign grantor trusts will not be taxable to the beneficiary because all income is taxed to the owner. Even if there is no direct tax consequence to receiving distributions from a foreign grantor trust, however, a U.S. beneficiary of a foreign grantor trust is still required to complete Part III of Form 3520 to report those distributions, and the trustee is still required, pursuant to Form 3520-A, to provide the U.S. beneficiary with sufficient information to permit him to do so by delivering to the U.S. beneficiary a Foreign Grantor Trust Beneficiary Statement.

In contrast, reporting is particularly important for foreign non-grantor trusts, because distributions from foreign non-grantor trusts carry out not only the trust's current year's income and gains, but also prior years' accumulated income, which is taxed—and subject to an interest charge—according to the "throwback rules" in IRC sections 666–668. Furthermore, Form 3520 is the only place where information about so-called "accumulation distributions" can be reported in sufficient detail to enable the IRS to enforce the throwback rules.

Notwithstanding the importance of proper reporting in the Part III context, there is no counterpart to Form 3520-A for foreign non-grantor trusts; there is an analogous Foreign Nongrantor Trust Beneficiary Statement (see IRS Notice 97-34, IRB 1997-25), but there is no requirement for the trustee to provide it, and no direct penalty on the U.S. beneficiary for failing to compel the trustee to do so. Instead, the U.S. beneficiary has incentive to compel the trustee to provide the Foreign Nongrantor Trust Beneficiary Statement because without the Statement, the beneficiary may need to treat all (or at least a larger proportion) of any distribution as an accumulation distribution subject to the throwback rules.

Part IV. The rationale for Part IV reporting is not obvious. Outside of a very obscure circumstance, there is no tax on the receipt of a true gift or bequest, because gifts and bequests are not income; if gift or estate tax applies, it is payable by the donor or the decedent's estate, not the recipient. Presumably, the IRS uses Part IV reporting to detect disguised income payments. Nonetheless, the harshness of the penalties in this context can be quite jarring, particularly because reporting by the recipient of a gift or bequests is not required in almost any other context at the federal level. It may therefore come as a shock to many taxpayers that they should be telling their accountants about receiving foreign gifts or bequests even when they do not need to do so with respect to domestic gifts or bequests.

A few quirks about Part IV reporting are worth noting. First, even though IRC section 6039F requires reporting gifts from a single foreign donor or from multiple, related foreign donors that aggregate $10,000 per year, the IRS has administratively increased the reporting threshold to $100,000 (IRS Notice 97-34). The threshold for reporting gifts from foreign corporations or foreign partnerships, however, is still $10,000–$15,671 in 2016, taking into account inflation adjustments. Second, although Part IV reporting generally involves gifts, and although the definition of "foreign person" is different for U.S. gift tax purposes than it is for U.S. income tax purposes, it is the income tax status of both the donor and the donee that matter. Third, the identity of the donor need not be reported, only the date, value, and nature of the gift.

Tiebreaker Rules

What if, under the circumstances, more than one aspect of a transaction triggers a Form 3520 filing requirement, such that more than one part of the form must be filed? Or, what if there is uncertainty as to whether a grantor trust should be treated as a trust or, because for income tax purposes a grantor trust is largely indistinguishable from its owner, as an individual (i.e., the owner of the trust)?

If both Part I and either Part II or Part III apply (for example, if a U.S. person transfers assets to a foreign grantor trust she is treated as owning, Part I applies to report the transfer and Part II applies because the U.S. person is treated as owning the trust), both parts must be completed. If both Part II and Part III apply because there is a distribution from a U.S.-owned foreign grantor trust to the U.S. grantor, logically, only Part II should be completed, because the distribution is irrelevant for tax purposes—the grantor is taxed on all of the trust's income no matter what—and the IRS is getting all the information it needs on Part II. Although the instructions used to be express that only Part II applied, in 2016 the instructions were changed to delete that express language. So, while there is nothing that *requires* completing both parts under this circumstance, relying solely on logic and ascribing no significance to the deletion of this express language from the 2016 instructions is an uncertain proposition. Note that, as mentioned above, if there is a distribution from a U.S.-owned foreign grantor trust to someone *other than* the grantor, it has been, and remains, clear that both Part II and Part III must be completed.

What if both Part III and Part IV apply, that is, if there is a distribution from a foreign grantor trust to a U.S. beneficiary? Here, the instructions are express that only Part III must be completed. In other words, where a grantor trust is a foreign trust, it is treated as a trust for purposes of Form 3520 rather than as an individual.

Where a U.S. trust is treated as owned by a foreign person, Parts I, II, and III of the form do not apply because the trust is not foreign. Nonetheless, where a U.S. person receives a distribution from such a trust, Part IV may need to be completed, because that distribution is treated as a gift from the foreign owner for purposes of Form 3520. Similarly, where there is a contribution by a foreign person to a trust that is treated as owned by a U.S. person, the U.S. person must report the contribution on Part IV as a direct gift from the foreign person. In other words, where a grantor trust is a U.S. trust, it is treated as an individual for purposes of Form 3520 rather than as a trust.

In some ways, it could be viewed as convenient to have all of the different reporting contexts discussed above addressed in a single form. It is likely, however, that most people find it more confusing than convenient, and would prefer having multiple forms, each one covering a different context, as was largely the case before the law changed in 1996. Nonetheless, it seems unlikely that there will be any drastic changes to the structure of the form anytime soon. It therefore behooves practitioners to "play the ball as it lies" and overcome the potential confusion of the form—not only through a careful review of the instructions, but also through understanding the policy rationale underlying the different reporting requirements. ❑

Ian Weinstock, JD, *is a partner at Kostelanetz & Fink, LLP, New York, N.Y.*