BOVE&LANGA
LAW FIRM

Ten Tremont Street, Suite 600 | Boston, MA 02108
www.bovelanga.com | p 617.720.6040 | f 617.720.1919

To: Clients and Friends
From: The Attorneys at Bove & Langa
Date: August 2011

THE BOVE & LANGA REPORT

FIRM UPDATE

Alexander and Melissa are pleased to announce three new members to the Bove & Langa team! Matthew Laptewicz is our newest paralegal, supporting the attorneys with drafting estate plan documents and preparing various returns. Laura Wulfson has joined the firm as an administrative assistant, handling billing matters and general client relations. And Kim McMahon is our new office administrator, helping to keep the firm up and running. Check out our website for additional details about the entire Bove & Langa team.

As for other new happenings at Bove & Langa, Alexander recently completed his term on the Executive Council of the International Academy of Estate and Trust Lawyers. He has also been invited to speak at the January 2012 meeting of the prestigious Heckerling Tax Institute in Florida on the international and domestic uses of the trust protector. Additionally, Melissa is helping to organize the new Boston chapter of the internationally focused Society of Trust & Estate Practitioners (STEP), with the inaugural event scheduled for October. She will be co-chair of the chapter. She has also been named co-vice chair of the American Bar Association's Asset Protection Committee, following in the footsteps of Alexander, who chaired the Committee in the past.

ALL THE WORLD IS A STAGE - WHAT IS YOUR PART?

At Bove & Langa, we have seen a vast increase in the international issues faced by our clients and advisor friends: "Our daughter is going to Oxford, can we open a joint bank account with her in the U.K.?" "One of my best clients loves foreign investments, do I need to worry about anything -- does the IRS care?" "Japan has suffered greatly, can I contribute to its recovery?" "I took a vacation and fell in love with Italy, are there issues to owning property in Siena?" "My gootmoeder passed away and left me an inheritance -- what now?" Read on to learn about some of the more common international issues that might impact you.

Congress Is Cracking The Foreign Whip: In recent years, it has become more and more apparent that Congress is cracking down on U.S. taxpayers with undisclosed foreign assets. The IRS has offered multiple voluntary disclosure programs to give taxpayers an opportunity to bring themselves into compliance and pay a specified penalty for their failure to previously meet tax and reporting requirements (more

on these programs below). Effective this year, there are new disclosure rules for U.S. taxpayers, which are separate from, and in addition to, the Foreign Bank Account Report (FBAR). These new disclosure rules arise under the Hiring Incentives to Restore Employment Act of 2010 (the HIRE Act). As part of the HIRE Act, Congress enacted the Foreign Account Tax Compliance Act (FATCA), which, among other things, added a new Section 6038D to the Internal Revenue Code. Section 6038D requires taxpayers with any interest in "specified foreign financial assets", which, in total, exceed $50,000, to attach a new Form 8938 (yet to be released) to their income tax return to disclose such interest. Note that the definition of specified foreign financial asset under Section 6038D differs from the definition of foreign financial account for FBAR purposes and includes any interest in a foreign entity. A taxpayer who fails to make this disclosure will face a penalty of $10,000 for that year. An additional penalty, up to a maximum of $50,000, may apply if the IRS notifies the taxpayer of the failure to disclose and noncompliance continues. This penalty will be avoided if there is reasonable cause for failure to file. Furthermore, if a taxpayer fails to report the income generated by a specified foreign financial asset, then that taxpayer will be subject to a 40% "accuracy-related" penalty on the amount of unpaid tax, in addition to interest and other penalties on the underpayment.

The new reporting rules under FATCA do not replace filing the FBAR. The obligation to file the FBAR arises under the Bank Secrecy Act (Title 31 of the United States Code), whereas the reporting rules under FATCA are part of the Internal Revenue Code (Title 26 of the United States Code). The FBAR and FATCA reports are filed in separate divisions of the Department of the Treasury, are filed at different times of the year, and have separate penalties. In addition, a taxpayer who failed to file the FBAR may have different appeals rights than a taxpayer who failed to report a specified foreign financial asset under FATCA.

In addition to increasing reporting requirements and related penalties for failure to fully disclose foreign financial assets, FATCA requires foreign financial institutions to cooperate with the IRS and provide information on accounts and other financial assets held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold substantial ownership interest. These reporting requirements for foreign financial institutions will be implemented in phases throughout 2013 and 2014. As these requirements take effect, the backlash of Congress' whip may strike some U.S. taxpayers if foreign financial institutions refuse to accept them as account holders instead of complying with the requirements under FATCA.

Déjà Vu For Foreign Financial Accounts: As mentioned above, in addition to the new reporting requirements associated with specified foreign financial assets under FATCA, U.S. taxpayers who own or have signatory authority over foreign financial accounts have long been required to file the FBAR with the Department of Treasury for each year that the total of all such accounts combined exceeds $10,000. Intentional failure to file this report can result in huge penalties.

In earlier Bove & Langa Reports, we discussed the IRS Offshore Voluntary Disclosure Program (OVDP), which offered a special deal to U.S. taxpayers who held such foreign accounts but failed to report them on the FBAR or report the income generated by them. The OVDP deal was a penalty of 20% of the highest amount in the account over the previous six years, together with taxes owed on the income plus certain penalties. Considering the possible huge penalties that could result if the failure to report was found to be willful by the taxpayer, the 20% was a real bargain. The OVDP ended on October 15, 2009, but was such a huge success that in February 2011, the IRS offered a second, very similar program for foreign account holders [this one called the Offshore Voluntary Disclosure Initiative (OVDI)], but upped the penalty to 25%. One of the major differences between the two disclosure programs is the information that must be filed along with the application to enter the program. With the OVDI, the taxpayer must submit, among other things, all amended income returns for the years 2003-2010 (or 2009, if the foreign accounts were disclosed for 2010), together with

completed FBARs, and, of course, full payment of the taxes due with interest and penalties, and payment of the 25% penalty, as well. The filing deadline for this program is August 31, 2011, with an additional 90 day extension available in certain cases.

In deciding whether to apply for the OVDI program, taxpayers should keep in mind that in order for the IRS to impose the heavy penalties for failure to file the FBAR, they must prove "willfulness" on the part of the taxpayer (but don't forget, the tax on the income is due no matter what). Certainly, in some cases, the failure may be willful, but in many cases, the taxpayer simply did not know of the requirement to file the FBAR, or as is often the case, they were actually told by their tax preparer that no reports were due. What is also quite common is that the taxpayer was never asked by her preparer whether there was a foreign account and the relevant question on Schedule B of the taxpayer's tax return was therefore "automatically" answered in the negative. If the failure to file is not willful and was due to reasonable cause, there will be no penalties at all (other than those associated with not timely paying the income tax on the income from the accounts). Thus, for a taxpayer with a foreign account that had a high value of, say, $800,000, and whose failure to file was clearly not willful, the $200,000 penalty imposed by the OVDI program would be avoided altogether. In such a case, the taxpayer would complete and file all amended income tax returns reporting the income from the foreign accounts, complete and file all FBAR for the appropriate years (generally, each year of the previous six years the accounts exceeded $10,000 in total), and pay the income tax, interest, and penalties due. The "package" would be filed with the IRS together with a detailed statement of the taxpayer's situation, origin of the funds in the account, and the reasons for failure to file. This is called a "quiet disclosure". There is one additional and, in some cases, significant potential benefit to the quiet disclosure. For taxpayers who enter the OVDI program, it is IRS policy to include in the computation of the 25% penalty the market value of the taxpayer's income-producing real estate in the foreign country if the taxpayer has not fully reported the rental income. This could add a huge amount to the penalty payment even though the real estate does not represent an actual cash or financial account. With a quiet disclosure, real estate is not included.

It must be noted and it is critical to understand that the IRS has warned that such quiet disclosures will be carefully scrutinized and the taxpayer may be selected for audit of the years in question. Accordingly, if you have serious issues with either the amended or the originally filed returns, or with the source of funds in the foreign accounts, it would be wise to get an expert review of your case before you make a quiet disclosure. Otherwise, the déjà vu may be writing check after check to the IRS and your attorney.

How Will They Know? What happens when your favorite Russian uncle gives you his palatial Siberian "ski shack"? Or, your favorite Japanese aunt leaves you an investment account that holds investment assets worth $1 million? Will the IRS know about the foreign gift or inheritance? The answers are elementary…or are they? As a U.S. person, you can gratuitously receive property (including cash and any other valuable assets) from a foreign person, foreign business entity, or a foreign trust, whether by gift or by inheritance, the receipt of which is a non-taxable event for U.S. purposes, meaning you will not be charged income, gift, or estate tax on the receipt of the property. However, if you inherit or receive gifts from a foreign trust, regardless of the value thereof, or if the total aggregate annual value of gifts and/or inheritance received from foreign individuals exceeds $100,000 (or, if the total aggregate annual value of gifts and/or inheritance received from foreign partnerships or corporations exceeds $14,375), you are required to report the gifts and/or inheritance to the IRS on a Form 3520, which is an informational return that reports transactions with foreign trusts and receipt of foreign gifts (either by lifetime gift or by inheritance). So, the IRS knows because you have a duty to disclose.

The filing of the Form 3520 to report a gift or inheritance is a one-time filing – only for the year that you received the gift or inheritance. However, if you received an interest in a foreign financial account, then you will also be required to file the FBAR (discussed above) for the year in which the gift or inheritance was received as well as in each year going forward in which the aggregate of all such accounts is $10,000 or more. If you would like to avoid this additional annual reporting, you should consider moving the assets to an investment account located in the U.S.

Your Secret Hideaway in the Caribbean – Can you Keep it Secret? More and more U.S. persons are purchasing foreign time-shares, condos, and even villas. As always, if these vacation properties are rented to third parties, you definitely have to report the rental income, even if there is no loss after deducting expenses. Whether a loss is deductible to you depends on certain factors that your accountant will know. But now, with all the hulla-balloo over foreign accounts, reporting, and penalties, are foreign vacation properties going to present additional problems as well? The answer is an unequivocal maybe.

On the one hand, reporting property held in a foreign entity, such as a corporation or partnership, has always been problematic. If you (and your family) own or control more than 50% of the corporation or more than 10% of the partnership, then there are forms that must be filed with the IRS on formation (or contribution of funds) and each year thereafter. Failure to file these forms can result in expensive penalties. Note that these rules apply to time-shares as well, but in the typical case, you would neither have control over nor own more than 10% of the whole property, so time-shares are generally not a reporting problem. On the other hand, there has never been a reporting requirement for a foreign vacation property that is personally owned and not rented. In that case, the law provided that your secret hideaway was safe.

But, the hulla-balloo may create a hulla-va change! As discussed earlier in the Report, Section 6038D imposes additional reporting requirements on a taxpayer's interest foreign entities. The real surprise here is that the IRS is considering using its regulatory authority to include personally owned vacation property under the definition of "specified foreign financial asset", thus triggering a reporting requirement under 6038D regardless of whether or not the home is rented. So, until the IRS makes up its mind, the biggest problem at your Caribbean hideaway will be how to keep the pina coladas cold.

So You Own Or May Own Foreign Real Estate? Many people have an ownership interest in, or may inherit an interest in, foreign real estate. Can it be incorporated into an estate plan? Since our advice is often to hold U.S. real estate in trust or possibly a limited liability company, you might think that those concepts would apply to foreign real estate as well. But, as noted above, introducing an entity to own the foreign real estate can result in complex and onerous U.S. tax and informational reporting requirements, so as you can see, the answer can be complicated. It is also important to confer with legal counsel in the country where the real estate is located, as the laws of other countries can be very different for ownership and inheritance purposes. For example, some countries don't allow foreigners to directly own real estate and, therefore, the real estate must actually be owned by an agent with whom the U.S. owner would enter into a contract in order to use and control the property. In other countries, trusts are not recognized and, therefore, a trust could not be used to own or control the disposition of the property. You may be surprised to learn that in many countries local law controls the disposition of real estate, regardless of your estate plan, with the result being that your children may inherit the property rather than your spouse, or worse, relatives you may not know can receive an ownership interest in your real estate upon your death. Therefore, when undertaking estate planning, make sure to let your attorney know if you have an interest in any foreign real estate or expect to acquire or inherit one.

Double Taxation?!? As you know by now (having dutifully read past Bove & Langa Reports), the U.S. imposes three types of transfer tax: estate tax, gift tax, and generation skipping transfer tax. Additionally, the U.S. imposes these transfer taxes on *worldwide* assets. Therefore, if you are a U.S. citizen who owns a vacation home in Thailand and you make a gift of the home to your children during your lifetime, that gift is subject to gift tax in the U.S. But, what if Thailand also taxes gifts of this kind? You could be faced with gift tax consequences in both the U.S. and Thailand (i.e., double taxation on the same transfer). In recognition of this type of potential double taxation, the U.S. has entered into treaties with a few countries (18 currently) which operate to avoid double taxation on the same transaction. Some treaties only help to avoid double estate taxation; others help to avoid double gift and generation skipping transfer taxation; and, finally, a few treaties operate to avoid double taxation on all three types of transfer tax. Therefore, before you make any transfers of foreign property during your life and while structuring your estate plan to control the disposition of foreign assets upon your death, we recommend that you and your advisors look into the laws of the foreign jurisdiction to determine if you or your estate will be faced with double taxation issues, in the hope that one of the treaties mentioned above will save the day. If not, there may be other special planning opportunities in the foreign jurisdiction, which foreign counsel can assist you and your advisors with.

Do I Get A Credit For Foreign Estate Taxes? If my father owns real estate in a foreign country and the estate has to pay foreign estate taxes, surely the estate can get a credit for federal and Massachusetts estate tax purposes – correct? Actually, for federal estate tax purposes, the answer is "It depends," and for Massachusetts estate tax purposes, the answer is "No!" Federally, a credit may be obtained for foreign estate tax paid, if allowed pursuant to a tax treaty with the country, as mentioned above, or if allowed under Section 2014 of the Internal Revenue Code. Section 2014 was enacted to eliminate the unfairness of double estate taxation on the same property by different jurisdictions. If an estate qualifies for a credit under Section 2014 and under an estate tax treaty, then the estate may take whichever credit is more beneficial. In applying the credit, a separate form must be submitted with the U.S. estate tax return with proof of the payment to the foreign jurisdiction. For Massachusetts, no credit for foreign estate tax paid is allowed. Although there is no specific regulation that clearly sets forth this rule, the answer can be determined from the Massachusetts estate tax return and instructions. Although too complex to explain in detail in this Report, the method of determining the Massachusetts estate tax owed does not take into consideration any foreign estate tax paid.

A Non-Citizen Surviving Spouse Can Benefit From The Estate Tax Marital Deduction – With A Trust Of Course: As many of you know, estate planning for married couples often incorporates the concept of the unlimited estate tax marital deduction. This deduction allows property in the estate of the first spouse to die to pass to the surviving spouse free of any estate tax. However, part of the rationale for allowing the marital deduction is that upon the death of the surviving spouse, the property that passes to her under the marital deduction will be included in her taxable estate to the extent her estate exceeds her estate tax exemption. But what if the surviving spouse is not a U.S. citizen? The grieving non-citizen spouse may leave the U.S. with all the assets she inherits, and upon her death, would not be subject to the U.S. estate tax because nothing has been left in the U.S. Given this concern, the marital deduction is denied to the estate of the U.S. citizen spouse, unless certain requirements are met. The primary requirement is that the

property for which the marital deduction will be elected must be held in a certain type of trust, known as a Qualified Domestic Trust (QDOT). Among the many requirements for a QDOT, at least one trustee must be either a U.S. citizen or a domestic corporation. Generally, the QDOT must require that if principal is distributed to the surviving non-citizen spouse, the trustee must withhold and pay the equivalent of the estate tax that would have been imposed on the principal distributed. But what if the decedent didn't have a QDOT? The good news is that even if a decedent failed to create a QDOT prior to his death, a QDOT can be established by the executor or surviving spouse provided that the assets from the deceased spouse are transferred to the QDOT prior to the estate tax return due date, including extensions.

The Accidental Foreign Trust: You and your spouse are U.S. citizens and have crafted and implemented a modern estate plan using multiple trusts to achieve all your goals, including privacy, incapacity planning, reduction of estate taxes, and asset protection for your children, and perhaps yourselves. You have carefully selected who will serve as trustee if you are unable to do so, deciding that one of your cousins is an excellent choice: thoughtful, thorough, and trustworthy. She is also nearby, just over the border in Toronto. Caution! When Tabetha Toronto takes over as trustee, your trust will become a "foreign trust" under the U.S. tax code, triggering additional tax reporting requirements and onerous income tax rules if income is accumulated within the trust (as is often the case, especially where there are minor beneficiaries). Would it make a difference if cousin Peter from Puerto Rico was chosen? Maybe not, and this is a trap for the unwary. If judicial supervision of the trust switched to Puerto Rico along with the trustee change, then the trust would still become a foreign trust despite Peter's connection to the U.S.

It may be that Tabetha is the right choice, and that is fine, as long as the tax and reporting consequences are discussed beforehand, and not a shock. (As would be the case if the Blue Jays swept the Red Sox.....). And since shocking events do occur, remember that if a trust inadvertently becomes a foreign trust, the tax code grants a 12 month grace period to do what is necessary to remain a domestic trust.

Are Citizens Of U.S. Possessions Taxed The Same As U.S. Citizens? After reading about the QDOT and the potential trap of an accidental foreign trust, what other international citizenship issues are advisors looking out for? Cousin Peter from Puerto Rico (remember, the one you were considering to serve as trustee of your trust) comes into our office for a consultation regarding U.S. estate and gift taxes. Peter was born in Puerto Rico, has lived there for his entire life, and continues to live there now. If Peter died while living in Puerto Rico and his U.S. citizenship was acquired solely by reason of his birth in Puerto Rico, then, upon his death, Peter would be a "nonresident not a citizen" (NRNC) of the United States. The NRNC designation is given to a U.S. citizen who dies a resident of a U.S. possession and whose U.S. citizenship derived solely from either (i) being a citizen of such U.S. possession or (ii) his birth within such U.S. possession. As an NRNC, only Peter's assets situated in the United States (the 50 states plus Washington, D.C.) would be subject to the federal estate tax, however, the federal estate tax exemption available to Peter is significantly lower than the $5 million currently available to U.S. citizens.

What about gift taxes? If, while residing in Puerto Rico, Peter made a lifetime gift of his Cape house to you, a U.S. citizen, then this would be a taxable gift and Peter would pay a gift tax on the transfer. If the donor of the gift is a resident of a U.S. possession and his U.S. citizenship is derived solely from either (i) being a citizen of such U.S. possession or (ii) his birth within such U.S. possession, then the donor is an NRNC for gift tax purposes. An NRNC is subject to gift tax on gifts of real, tangible, and some intangible property located within the United States. Unfortunately, the gift tax lifetime exclusion amount only applies to citizens and residents of

the U.S., not to an NRNC, but an NRNC can take advantage of the gift tax annual exclusion amount ($13,000 in 2011).

The fact patterns above are dependent upon Peter remaining in Puerto Rico for his entire life. What if you were able to convince him to move to Massachusetts so that he could serve as trustee of your trust without creating an accidental foreign trust? In that case, Peter would not be considered an NRNC for estate or gift tax purposes and he would be subject to the estate and gift tax laws applicable to U.S. citizens and residents. Note that in all cases, Peter may be subject to separate estate, inheritance, and/or gift tax under the laws of Puerto Rico.

Cross-Border Philanthropy: Do you have a gootmoeder? A bobe? A nonna? An ouma? Americans are generous, and many have immigrant roots that foster a worldview when it comes to philanthropy. But, slow down at that border! If you want to preserve your charitable deduction you must comply with rules more restrictive than applicable to domestic charitable gifts. Want to make it easy? You (or your private family charitable foundation) can contribute to a U.S. public charity that does the foreign work you wish to support and target your gift for that purpose. For example, if you want to support planting trees to preserve the rainforest in Brazil, check out The Nature Conservancy. Another easy alternative is to find a U.S. "Friends of" the foreign charity. As long as certain legal requirements are met, including maintaining its independence from the foreign charity, contributions to the U.S. "Friends of" charity will be deductible. Further still, your "donor advised fund" might permit international contributions, but not all do, so if this is important to you, make sure you ask questions before opening the fund. What if you don't care about the tax deduction, and would rather directly send money abroad in support of a specific purpose? That is fine, but you must take care to avoid funding a terrorist organization. The 48 organizations identified by the Department of State's Office of the Coordinator for Counterterrorism may seem like no brainers to steer clear of, but did you know there is also a 512 page "Specially Designated Nationals List" published by the U.S. Treasury that identifies potentially problematic recipients? Make your ouma proud, be a worldwide citizen, but do it responsibly.

SUMMARY

We hope you have found the Bove & Langa Report informative. We continuously seek to include material that is useful and profitable for you, and perhaps even a little entertaining. We always welcome your comments, and stand ready to advise you regarding your international trust, estate, and philanthropy issues.