Staying clear of the IRS

Tips for estate planning and tax law compliance in a global economy

Do you own a vacation home in Mexico? Have a bank account in Hong Kong? Has your spouse retained Canadian citizenship? Are you a long-term U.S. resident who was born in the U.K.? Is your brother-in-law, who is a citizen and resident of Ireland, the successor trustee of your revocable trust?

Each of these scenarios raises complex tax issues that, without proper planning, could have disastrous and costly consequences.

Smart Business spoke to Laura A. Zwicker, chair of Greenberg Glusker's Family/Strategic Wealth Planning Group, about how to stay out of the IRS's crosshairs by being aware.

Homes in Mexico

Most of us would contact a tax professional before establishing a trust in the Cayman Islands. But, we wouldn't necessarily see the need when buying a vacation home in, say, Cancun, especially since vacationing in Mexico has become as commonplace as visiting Hawaii or Florida.

Because coastal and border land in Mexico can only be directly owned by Mexican citizens and certain Mexican entities, a condo in Cancun is likely to be acquired through a fideicomiso, similar to a trust. The IRS takes the position that a fideicomiso is a trust subject to all foreign trust reporting requirements.

Thus, a Cancun condo purchaser must file both Form 3520 and 3520-A with the IRS annually or be subject to significant civil penalties. To make matters worse, after March 18, 2010, if our Cancun condo purchaser actually uses the condo, or lets a relative use the condo, the fair rental value for the period of use is subject to U.S. income tax.

The 2011 Offshore Voluntary Disclosure Initiative offers the opportunity to come into compliance, possibly without penalties, if delinquent returns are filed by August 31, 2011.

Overseas bank accounts

Whether you're hiding hundreds of millions in a Swiss account or simply maintaining a U.K. account to pay bills while in your London office, the Financial Crimes Enforcement Network of the Treasury Department is looking for you.

For almost 40 years, there have been reporting requirements for U.S. citizens and residents holding interests in foreign financial accounts. However, those requirements were largely unenforced until three years ago.

If you have an interest in or signatory power over any financial account in any foreign country, disclosure is required on your personal income tax return. Additionally, if the account had a balance of $10,000 USD or more in any given year, a Report of Foreign Bank and Financial Accounts (FBAR) is required. Failure to file a FBAR can result in significant civil and criminal penalties.

Laura A. Zwicker
Chair, Family/Strategic Wealth Planning Group
Greenberg Glusker Fields Claman & Machtinger

Worse than having failed to file FBARs is having both failed to file FBARs and failed to report the income generated by a foreign account on U.S. income tax returns, which results in additional underpayment, failure to file and fraud penalties.

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My spouse is not a U.S. citizen

Spouses are generally able to transfer assets to each other, both during lifetime and at death, without tax consequences. If your spouse is not a U.S. citizen, things get a little more complicated without proper planning.

Lifetime gifts to a non-U.S. citizen spouse are limited to $130,00 per year before using your credit against gift tax. Gifts at death to a non-citizen spouse begin using estate tax credit immediately, unless the assets pass to a Qualified Domestic Trust (QDoT). Proper planning with life insurance and QDoTs can prove helpful in lowering your tax bill and preserving your credit against gift and estate tax to pass assets to your children.

Special issues for U.K. persons

You have lived in the U.S. for 15 years and have homes, bank accounts and other ties to the U.S., but are not a U.S. citizen. No complications, right? Maybe!

For individuals born in the U.K. who have retained their U.K. "domicile of origin," engaging in ordinary estate planning in the U.S. could have unexpected and costly U.K. inheritance tax (IHT) consequences. If a U.S. resident with a U.K. domicile of origin transfers assets to a U.S. revocable trust, which most U.S. lawyers would advise, and the value of the assets exceeds the U.K. nil rate band, an immediate U.K. tax of 20 percent on that excess value is imposed. Additionally, a U.K. tax of 6 percent of the value of the trust assets is charged every 10 years during a lifetime.

Moreover, if the U.S. resident is still deemed a U.K. domiciliary at death, the value of the trust would be taxed again by the U.K. at a rate of 40 percent. Thus, without appropriate planning, this taxpayer could pay a cumulative tax approaching 75 percent on assets that should have been taxed once at a rate of 40 percent.

Naming a foreigner as successor trustee

You and your spouse are U.S. citizens and neither of you owns a vacation home or holds financial accounts outside the U.S. You have nothing to worry about, right? Perhaps, but if the brother-in-law, best friend, or business manager named as successor trustee of your revocable trust is a citizen and resident of a foreign country, once that successor trustee begins to serve, your trust suddenly transforms into a foreign trust for tax purposes.

While it is unlikely that the trust will be subject to an expatriation tax, the trust will be subject to all of the reporting requirements described above with respect to Mexican fideicomisos, as well as additional income tax reporting on any income generated.

In our global society, information and assets move ever more quickly and easily across borders; however, the road to properly complying with reporting requirements and carefully engaging in gift and estate tax planning is becoming more complex. Although the immediate cost of expert legal and accounting advice may be off-putting, the ultimate cost of proceeding without it could be devastating. <<

LAURA A. ZWICKER chairs Greenberg Glusker Fields Claman & Machtinger LLP's Family/Strategic Wealth Planning Group. She regularly counsels high net worth individuals and their families in connection with domestic and international estate and tax planning issues. She can be reached at (310) 785-6819 or LZwicker@greenbergglusker.com.