New Jersey Law Journal

VOL. 215 - NO 8 MONDAY, FEBRUARY 24, 2014 ESTABLISHED 1878

Wealth Management

Foreign Assets: To Disclose or Not To Disclose?

That is the question for your estate-planning attorney

By Jay J. Freireich

Estate planners are aware that the federal estate tax law was made permanent and applies when assets exceed $5 million, as indexed for inflation. For the year 2014, the amount that can pass tax free is $5.34 million. Assets transferred in excess of that amount to anyone other than a spouse will be subject to federal estate tax at the rate of 40 percent. This tax is on top of the New Jersey estate tax that starts at a mere $675,000, though the rates are considerably lower.

What some may not realize is that U.S. citizens and U.S. residents are subject to federal estate tax on their worldwide estate. Section 2031(a) of the Internal Revenue Code states that the gross estate includes all property wherever situated. "Wherever situated" includes not only domestically held assets, but also assets held in foreign countries. The estate tax on worldwide assets is ameliorated when any "estate, inheritance, legacy or succession taxes" are actually paid to any foreign country with respect to any properties situated within such foreign country and included in the gross estate. But many foreign countries do not impose such taxes, so the federal estate tax must be fully paid to our U.S. Treasury.

Freireich is a member of the trusts and estates practice of Brach Eichler in Roseland.

There are reporting requirements of foreign assets that have been greatly ignored by many U.S. taxpayers, assuming that the feds would never notice. These requirements include filing new Form 114 electronically, known as the "Report of Foreign Bank and Financial Accounts" (FBAR) filed with the Financial Crimes Enforcement Network ("FinCEN"), due on June 30 for the year previous, and Form 8938 Statement of Specified Financial Assets due to the Internal Revenue Service with the taxpayer's income tax return.

Assets that have been declared through reporting of income of assets on Federal Income Tax Returns and on FBAR forms, and assets held in foreign trusts that have been reported on either Form 3520 or 3520A, will certainly be reported on the Federal Estate Tax Form 706. There are, however, a large number of U.S. persons who might prefer not to disclose their foreign assets. While a great number of U.S. persons were doing this for many years, there has been a major crackdown on U.S. persons with foreign assets. The U.S. government is entering into agreements with banks in many foreign countries that have previously kept these accounts secret. Most recently, Switzerland has succumbed to U.S. pressures. The avalanche started in 2009, when UBS agreed to disclose the names of its customers in the United States. Banks in Israel and Asia have since followed. Some clients may even be receiving letters from their Swiss banks, advising them of the availability of the Offshore Voluntary Disclosure Program (OVDP), which comes as a result of deals struck with the U.S. Department of Justice. Accordingly, planning for U.S. persons who have not yet come forward as part of their estate plan should certainly strongly consider this now.

The types of assets held outside the country are generally either financial assets or tangible assets, such as real estate. For financial assets, the FBAR form and 8938 form are required to be filed every year and of course, the income and gains from the foreign asset must be reported on the taxpayer's income tax return. For tangible assets individually held outside our borders, there is no reporting requirement of the assets themselves, but rents or other income earned from those tangible assets held outside the country must be reported on the taxpayer's income tax return.

There have been a series of OVDPs, which started in 2009. We are currently in the third iteration of these programs. The essential difference between the three programs is in the amount of the penalty, which has increased in each successive program. The initial 2009 program came with a 20 percent penalty. That program closed on Oct. 15, 2009, and was replaced with the 2011 initiative, which came with a 25 percent penalty. After the 2011 initiative closed on Sept. 9, 2011, on Jan. 9, 2012, the current program, with its 27.5 percent penalty, was instituted. The current program has no end date but can be terminated at any time and without notice. As with the previous programs, entry into the program comes with peace of mind. Assuming all disclosures are fully accurate, there is a promise of no federal prosecution.

Any practitioner who is doing estate planning for a client must certainly ask specifically whether or not the client has assets outside of the country. If the answer is yes, the practitioner must advise of the various requirements to disclose these assets and plan accordingly.

If the client decides to enter into the OVDP, he should be aware that he will need to file the previous eight years of tax returns and FBARs, pay the taxes, interest and penalties and also pay an additional penalty of 27.5 percent on the highest balance in the accounts during the eight-year period. There are exceptions in unusual cases that permit the penalty to be reduced from 27.5 percent to either 5 or 12.5 percent, depending on the circumstances. By entering into this program, a person avoids criminal prosecution and penalties. Generally speaking, the penalties would be far less than would be required had the person not entered the program and was discovered. The penalty for intentionally failing to file the FBAR is the greater of 50 percent of the asset or $100,000 per year of violation.

It should come as no surprise that the executor of the estate of a decedent, who knowingly fails to report assets held outside of the country, may also be subject to prosecution under 26 U.S.C. § 7201 (evasion), § 7206(1) (filing false return) and/or § 7203 (failure to file a return), and 31 U.S.C. § 5322, which provides for fines and imprisonment. While some U.S. taxpayers may be willing to risk prosecution during their lifetimes, the executor is most likely unwilling to take such a risk him/herself. Consideration into entering the program should be made at each level. Thus, if there was no disclosure during the taxpayer's lifetime, then upon death, the executor must consider entering into the offshore disclosure program.

The first step generally used in entering the program is providing information such as the name, date of birth and Social Security number of the taxpayer. Second, one must ask the Internal Revenue Service for permission to enter the program. This permission will be granted as long as the taxpayer is not currently under investigation by the IRS for possible assets held outside the country. Thereafter, the taxpayer will typically need to make full disclosure of all assets and hire an accountant to prepare all of the back tax returns, as well as to pay the taxes, interest and penalties associated with those returns.

The question of how to address New Jersey income tax returns is also significant. New Jersey just recently set forth its own voluntary disclosure program as of June 13, 2013. Our state and federal governments do share information. New Jersey income tax returns will need to be amended to include the additional income. Similar to the Federal OVDP, to enter the New Jersey Offshore Voluntary Compliance Initiative, New Jersey requires name and address, types of tax and years affected, state and federal returns and amended returns, an explanation of the circumstances, whether there was a federal OVDP and certification that the applicant will fully cooperate.

The current federal penalty, in addition to all other penalties, is 27.5 percent of the highest aggregate balance in foreign accounts during the eight full tax years prior to the disclosure. The exception to this penalty is if the person did not set up the account, i.e., he is the executor of an estate, and if certain criteria are met, the penalty is only 5 percent. Those criteria are: (a) the taxpayer did not open or cause the account to be opened; (b) he has exercised minimal, infrequent contact with the account; (c) except for a withdrawal closing the account and transferring the funds to an account in the U.S., not withdrawing more than $1,000 from the account in any year; and (d) he can establish that all applicable U.S. taxes have been paid on the funds deposited to the account (only account earnings have escaped U.S. taxation). IRS OVDP Q&A 52.

Thus, from a planning standpoint, if a taxpayer is extremely elderly or ill with a short life expectancy, it might be prudent to wait and let the executor of the estate enter the program. Of course, waiting might be a very risky strategy, as it seems that every day another bank is turning over information to the United States.

In conclusion, estate planners must question the existence of foreign assets, and if there are any assets held outside the country, a discussion on the merits and pitfalls of entering the current OVDP should be conducted. ■