The Contemporary Tax Journal

Volume 12
Issue 1 *The Contemporary Tax Journal Volume 12, No. 1 – Spring 2023*

Article 5

5-9-2023

Reporting Requirements for a Liechtenstein Foundation

Aiko Kawae
San Jose State University

Reporting Requirements for a Liechtenstein Foundation

By: Aiko Kawae, MST Student

Rost v. U.S., 130 AFTR2d 2022-5462 (5th Cir., 2022)

Introduction

This case involved whether a "Stiftung" under the laws of Liechtenstein should be treated as a foreign trust under IRC §6677 for the federal tax purposes. This paper discusses the details of how the court reached its conclusion.

Background

John H. Rebold, a United States citizen, worked as an oil and gas company executive engineer outside the U.S. In 2005, he traveled to Switzerland and formed the Enelre Foundation (the "Foundation'') as a Stiftung under the laws of Liechtenstein.[1] Rebold was the settler and primary beneficiary of the Foundation, and his children were secondary beneficiaries. He opened bank accounts for the Foundation at Credit Suisses, UBS, and Bank Wegelin. He transferred $2,000,000 and $1,000,000 to the Foundation in 2005 and 2007, respectively.

In 2010, UBS informed Rebold that they planned to report the account records to the IRS. Rebold did not disclose any information regarding the Foundation, including the money transfer to the Foundation on his federal income tax returns for the years 2005 through 2007. Immediately after the bank contacted him, he consulted an attorney. The attorney told him that the Foundation was a foreign trust, so he needed to file Forms 3520 and 3520-A to the IRS, and the attorney recommended Rebold to participate in a voluntary disclosure program to reduce the penalties.[2]

In 2013, Daphne Janette Rost, Rebold's daughter and power of attorney, filed Forms 3520 and 3520-A for the Foundation from 2005 to 2007 on Rebold's behalf. In 2014, Rebold was notified by the IRS and assessed penalties of $1,380,252.35 under §6677(a) and (b). Rebold disputed his liability and requested a collection due process hearing against the IRS. The IRS Appeals Office maintained the notice of levy but reduced the penalties by half. In 2017, Rebold paid the penalties of $596,830.00. In 2018, Rebold filed an administrative refund claim with the IRS, but he did not receive any decision from the IRS. Then, Rebold filed a refund suit against the IRS in 2019. He passed away in December 2019, and his executor, Rost, substituted as plaintiff.

The District Court

1 Stiftung is a German vocabulary and it means "foundation", "donation" or "endowment" in English. Rost v. U.S., 130 AFTR 2d 2022-5455 (5th Cir. 2021) cited German-English translation from https://en.langenscheidt.com/german-english/stiftung. The court also cited Stiftung v. Plains Mktg., L.P., 603 F.3d 295, 299 n.1 (5th Cir. 2010) and stated the plural form of Stiftung as "Stiftungen".

2 Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, Dep't Treas. & IRS (2021), https://www.irs.gov/pub/irs-pdf/f3520.pdf. Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner, Dep't Treas. & IRS (2021), https://www.irs.gov/pub/irs-pdf/f3520a.pdf.

Rebold filed a lawsuit against the IRS for the recovery in penalties and interest pursuant to §6677, and both parties moved for summary judgment. In the end, the district court granted summary judgment for the government.

The main issue in this case was whether the Foundation should be treated as a foreign trust. Section 6048 imposes reporting requirements for a United States person when a foreign trust is established, and penalties are imposed for failure to file Forms 3520 and 3520-A.[3] However, Rost argued that the Foundation was a Liechtenstein Stiftung, and there were no U.S. regulations stating that a Liechtenstein Stiftung was a foreign trust for federal tax purposes. Therefore, Rebold did not know he and the Foundation were required to file Forms and report income tax returns. Hence, Rost believed that the penalties violated the Due Process Clause of the Fifth Amendment to the United State Constitution, and it should be refunded.

First, the court noted that Rost was wrong to believe there was no reporting obligation because neither the IRC nor the U.S. tax regulations provided for special treatment for a Liechtenstein Stiftung. The district court cited §301.7701-1 and stated that "whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law."[4] Because of this reason, although the Foundation was established in Liechtenstein, this case should focus on U.S. regulations.

To answer whether the Foundation was a foreign trust, the court applied the facts-and-circumstances test to determine if the Foundation was a trust. Reg. §301.7701-4(a) defines ordinary trusts and explains the fact-and-circumstances tests. According to the test, when a trust arrangement did not include the existence of associate and business purpose, the entity should be treated as a trust. The court pointed out that the Foundation's statement of purpose was to provide education and general support for Rebold and beneficiaries. In addition, their statement of purpose clearly stated that the Foundation should not engage in any commercial trades. Following Reg. §301.7701-4(a) and prior case law, the court concluded the Foundation should be treated as a trust.[5]

Then, the court questioned whether the Foundation was a "foreign" trust for federal income tax purposes. Section 7701(a)(31)(B) defined a foreign trust as any trust other than a trust described in §7701(a)(30)(E). According to §7701(a)(30)(E), a domestic trust needs to meet both the court test and the control test. The court test is satisfied if a court within the United States could exercise primary supervision over the administration of the trust.[6] For this case, the Foundation did not satisfy the court test because any conflicts must proceed to arbitration under Liechtenstein law since it was founded in Liechtenstein. The Foundation also failed the

3 Section 6048(b), as amended by Congress in 2010, provides that the owner of a foreign trust must file a return annually.
4 Reg. §301.7701-1.
5 The district court cited cases to explain fact and circumstances test; see Elm Street Realty Trust v. Commissioner, 76 T.C. 803, 818 (1981); Estate of Bedell Trust v. Commissioner, 86 T.C. 1207, 1218 (1986); Morrissey v. Commissioner, 296 U.S. 344 (1935).
6 §7701(a)(30)(E)(i).

https://scholarworks.sjsu.edu/sjsumstjournal/vol12/iss1/5
DOI: 10.31979/2381-3679.2023.120105

control test. The control test is satisfied when one or more United States persons have power to control all decisions of the trust.[7] Reg. §301.7701-7(d)(1)(3) says "the term control means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions." According to the trust arrangement, Rebold waived all the rights to the Foundation and the board of the Foundation had decision making authority. Since the Foundation failed both tests, the district court concluded that the Foundation was a foreign trust for federal tax purposes.

Rost also complained that imposition of penalties pursuant to §6677 violated the Administrative Procedure Act ("APA"). Her claim was that Rebold could not have known that he had a reporting obligation because the IRS had not posted any comments or notices that the Liechtenstein Stiftungen could be treated as a foreign trust. She argued that it was improper to impose penalties unless the law was known or provided before Rebold established the Foundation. She also asserted that the penalties violated the Due Process Clause because Rebold was subject to the penalties without clearly explaining the prohibited circumstances. The district court reminded Rost that not all Liechtenstein Stiftungen were treated as foreign trust, and each Liechtenstein Stiftung must be analyzed on its own fact-and-circumstances tests to determine whether they should be treated as a foreign trust. For the reasons stated above, in the case of Rebold, their Liechtenstein Stiftung should be treated as a foreign trust. The district court believed that §§7701(a)(30)(E) and 7701(a)(31)(B), Reg. §301.7701-4(a), and Notice 97-34 provided enough information regarding the filing requirements for foreign trusts. Hence the court concluded that penalties were not violated by both the APA and Fifth Amendment.

Lastly, Rost asserted that Rebold failed to file forms in issues because he was unwell and lacked mental capacity. She claimed that §6677(d) stated that no penalty should be imposed if it was proven that the negligence was due to reasonable cause and not willful neglect. According to Rost, Rebold was diagnosed with clinical depression after his wife passed away in 2002, resulting in various cognitive issues. To determine whether §6677(d) applied to this case, the court stated that all facts and circumstances must be considered. The court cited *Montgomery v. Commissioner* that "'the pertinent fact and circumstances' include 'the taxpayer's efforts to assess his or her proper tax liability, the knowledge and experience of the taxpayer, and the reliance on advice of a professional."[8] In the case of Rebold, the court believed that Rost had the burden of proof that Rebold had attempted to fulfill his obligations as a taxpayer. However, the court believed that Rost had not sufficiently established reasonable cause. The court concluded that, although Rebold might have suffered from depression, he was mentally capable of making his own decisions. For example, Rebold reported Foreign Bank and Financial Accounts ("FBAR") and filed forms with his signatures in 2007. Rebold was also able to file his 2005 and 2006 federal taxes with his signature by due dates. Although his wife's death affected Rebold's state of mind, the court concluded that Rost did not present sufficient evidence for §6677(d) to apply.

7 §7701(a)(30)(E)(ii).

8 Montgomery v. Commissioner, 127 T.C. 43,67 (2006).

Hence, the court confirmed that failure to report required forms and ownership of the Foundation to be properly subject to civil penalties incurred, pursuant to §§6048 and 6677. The court granted the United States' motion for summary judgment on September 22, 2021.

The Fifth Circuit

Rost appealed the district court's ruling, but the Fifth Circuit Court of Appeals affirmed the lower court's decision for the government.

Rost claimed that the tax rules did not explicitly classify the Liechtensteinian Stiftungen as foreign trusts. Therefore, the Foundation could be a corporation, partnership, or other entity. She cited *Oak Commercial Corp. v. Commissioner*, 9 T.C. 947 (1947), noting that the Tax Court and the Second Circuit viewed Stiftungen as a foreign corporation. She further challenged the facts-and-circumstances test adopted by the district court. The Fifth Circuit accepted her argument but determined that the Foundation was treated as a foreign trust because the Foundation was a trust under §301.7701-4(a). For federal tax purposes, the court and control test under §7701(a)(30)(E) determined it was a foreign trust as well. Most importantly, Rost had not presented any evidence or proof that it should be classified as anything other than a foreign trust.

Again, Rost asserted that the penalties were not appropriate because Rebold had failed in his obligation for mental reasons; however, the Fifth Circuit affirmed the district court's ruling.

On August 11, 2022, the Fifth Court of Appeals concluded that the district court's judgment was correct, and on October 11, 2022, the Fifth Court of Appeals denied Rost's petition for rehearing.

https://scholarworks.sjsu.edu/sjsumstjournal/vol12/iss1/5
DOI: 10.31979/2381-3679.2023.120105