

Fideicomisos, Foreign Trust Reporting, and the Sphinx

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A Rude Awakening

One Sunday in late February 2012, my wife walks into the home office and points me to a tax attorney's website about fideicomisos, foreign trusts, and Form 3520 / 3520-A—and ruins my whole summer.

A few years back, we bought a condo in Mexico. A Notaria Publica caused a Mexican bank to hold our property title “in trust” so that we could not petition like Texas settlers for the USA to annex beautiful Banderas Bay. I was perfectly happy with this limited understanding until that morning when I became suddenly aware of the possibility that the IRS could seize 35% of our Mexico paradise in penalties for never filing 3520[-A]s (since 2007).

The problem stems from this: only a Mexican citizen or a business controlled by Mexican citizens is allowed by Mexico's constitution to directly own real estate in the so-called restricted zones, within 50 km of coastline or 100 km of a national border. So, to allow non-Mexicans to invest in these desirable zones, a legal arrangement known as a real estate fideicomiso (or trust, in English) was developed in the 1970s. It is a contract between an authorized Mexican bank (fiduciary or trustee) that holds legal title to the real estate, a (beneficial) owner of the real estate, and a grantor that transfers legal title to the trustee in exchange for fair market value paid by the new “owner.” Is this really a trust for which foreign-trust reporting is required?

I briefly explain below why I have respectfully informed the IRS that I will not burden them with Forms 3520 and 3520-A in the future, and why I will not seek a Private Letter Ruling granting me permission not to file (for a mere \$7,000 plus in IRS and attorney fees). Obviously, I'm in no position to advise you; I'm simply sharing my own experience and reasoning.

The Firm Encourages . . . Fees

For the past decade, a number of U.S. attorneys and law firms have advised that U.S. owners of real estate fideicomisos are subject to foreign trust reporting requirements and must file annual Forms 3520 and 3520-A. Penalty warnings are softened by assurance that the attorney or firm may be able to reduce penalties already “owed” for prior noncompliance.

In March, we contacted several attorneys who advertise expertise in foreign trust reporting for fideicomiso owners. One offered an initial half-hour consultation for \$300. Another offered to fill out our forms for \$500 each, or \$5,000 for the ten 3520[-A] forms that were due in mid-April. We declined.

As I waded through Forms 3520, 3520-A, and related websites during the summer, I felt some of the resentments expressed by other real estate fideicomiso owners on websites and blogs:

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- I doubted the IRS “paperwork reduction” initiative: to think that I could be severely penalized for not manually copying and pasting property improvements and rental-based depreciation from my TurboTax-generated 1040 Schedule E into Form 3520-A and filing it separately!
- I wondered whether foreign trust reporting requirements might be doing more to depress restricted-zone real estate values than the occasional headless body. I envied my U.S. friend with real estate a few miles inland, who paid half what I paid for his fee-simple title and has no reporting burden other than Form 1040.
- Reading this comment on a CPA blog,

The IRS is wrong. No reporting is required for being a trust beneficiary But, for us CPA’s this is one more opportunity for more income. We really do love the IRS. So, I say file the form and make some more money.

I even wondered (along with several website commenters) whether the IRS might be part of a Mafia-like protection racket with attorneys and CPAs on the street.

The Sphinx

In the wee hours of October 15, I had an epiphany that would cause me to realize that the IRS is not the mastermind behind a grand fee-generating conspiracy after all. No, it is a Sphinx—posing a riddle to all who dare venture into foreign-trust filings.

I was almost done completing the forms. There remained only one “minor” 3520-A requirement:

Attach an explanation of the facts and law (including the section of the Internal Revenue Code) that establishes that the foreign trust (or portion of the foreign trust) is treated for U.S. tax principles as owned by the U.S. person.

In other words, *prove that you have any business filing these forms, or you shall be devoured by unnecessary paperwork and terrifying penalty notices for imperfect or late filings.*

Solving this riddle should have been my *first* step, not my very last. Form 3520[-A] Instructions (and documents cited therein) were unhelpful: *a foreign trust is any trust other than a domestic trust; a domestic trust is any trust if a U.S. court can supervise it and yada yada yada.*

What on Earth is *any trust* (for U.S. federal tax purposes)? I Google “IRS trust definition” to find Reg. 301.7701-4(a). While that definition tells me what arrangements *are* trusts, I need a more definitive statement of what is *not* a trust.

Definitions such as this are clarified by Revenue Rulings. I Google “301.7701-4 revenue ruling” to find Rev. Rul. 92-105, 11/19/92, whose holding concludes by clearly defining what is *not* a trust:

This revenue ruling also applies to an interest in a similar [trust-like] arrangement created under the laws of any state, pursuant to which (1) the trustee has title to real property, (2) the beneficiary (or a designee of the beneficiary) has the exclusive right to direct or control the trustee

in dealing with the title to the property, and (3) the beneficiary has the exclusive control of the management of the property, the exclusive right to the earnings and proceeds from the property, and the obligation to pay any taxes and liabilities relating to the property.

If there is any more direct and concise argument that real estate fideicomisos are not trusts, I do not know where or what is. It's burdensome enough for those Mexican banks to store our fideicomiso instruments (contract photocopies) for only \$500/year. These trust instruments are quite careful to assert points (1), (2), and (3) of the Revenue Ruling, thereby relieving the trustee of duties toward, or liabilities from, us.

On this basis I filed my 3520[-A] package with the required attachment – citing 301.7701-4(a) and Rev. Rul. 92-105 to argue that our real estate fideicomiso is not a trust and we were never required to file!

Ice Cream for Me

Apparently my midnight Sphinx-epiphany and web searches had subconscious guidance, Amy Jetel's redacted Private Letter Ruling in favor of a client (PLR 201245003, www.irs.gov/pub/irs-wd/1245003.pdf). While writing this article, I discovered that I had retrieved that ruling in a web search, attached it to an October 4 email and forgotten about it (preoccupied with unrelated work). I must have read it before "solving" the Sphinx's riddle on October 15. Thus convicted of midnight plagiarism, I seize the proverbial cone and smash it against my forehead.

Jetel's discussion of this PLR appears in the November issue of *Trusts & Estates Magazine* (Fideicomisos: Clarity at Last?), concluding with the observation that, while PLRs cannot be cited as precedent, her fellow attorneys may apply 301.7701-4(a) and Rev. Rul. 92-105 to their clients' cases and achieve the same result.

In her April 2009 *Trusts & Estates* article ("What's a Fideicomiso?", www.tinyurl.com/whatsafidei), Jetel argues that even if your fideicomiso *is* a trust, the foreign-trust reporting requirements are subject to "fair market value" exceptions that apply to obviate filing Forms 3520 and 3520-A. Taken together, these two articles nicely cover the issues.

Ice Cream for All?

The Sphinx-epiphany leaves me with a nagging observation that, while valid, may be controversial:

No Form 3520-A has ever been completely and correctly filed for a real estate fideicomiso.

If *complete*, then a required attachment contains an argument that the real estate fideicomiso is a trust. However, no such argument can be *correct* because its conclusion is false by Rev. Rul. 92-105.

The Sphinx's riddle has literally *instructed* us all these years to refrain from inundating her with inappropriate paperwork, yet for reasons best left for the reader to supply, we persisted in doing so! For this, we all deserve a face-full of ice cream.

After the Party

I have apologized to the Sphinx and promised to refrain from filing 3520[-A]s in the future. I have exonerated her for not issuing redundant Revenue Rulings, arguing that Rev. Rul. 92-105 has been perfectly adequate since 1992 and no more PLRs on this subject are necessary.

The PLR for Amy Jetel's pioneering client provided useful guidance on how to frame my follow-up argument for IRS. This argument is based on a certified English translation of our fideicomiso instrument – a good investment in view of my limited Spanish and the fact that I'm wagering a good part of my condo's gross value on it. You may find more economical ways to assure yourself (and the IRS if necessary) that yours is a real estate fideicomiso and not a trust for U.S. federal tax purposes.

I have also responded to *Proposed Collection; Comment Request for Form 3520-A* in the Federal Register, recommending that the Instructions cite Rev. Rul. 92-105 specifically.

Recently, I replied to our March attorney contacts with two questions "to help me evaluate" their offers:

- Where does the IRC define "trust" (certainly not 3520[-A] or any document cited therein)?
- Are there any relevant Revenue Rulings that might have bearing on whether my simple fideicomiso, created by [grantor] purely for the purpose of having [trustee] hold legal title to my restricted-zone property, is in fact a trust for U.S. federal tax purposes?

Neither attorney mentioned 301.7701-4(a) or acknowledged existence of any revenue ruling that might be relevant. How could they possibly serve *my* interests?

Conclusions

The Sphinx holds you, dear reader, firmly in her paperwork-reduction talons:

Under penalties of perjury, I declare that I have examined this return, including any accompanying reports, schedules, or statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Sign that 3520[-A] for a real estate fideicomiso – and weep.

No cognizant attorney, having verified that yours is in fact a real estate fideicomiso, can lawfully advise you to file Forms 3520[-A] or file on your behalf: better to offer assistance in verification, obtaining retractions of penalty notices mistakenly issued, and convincing the IRS that previous 3520[-A] submissions were erroneous and should be discontinued.

Some attorneys *do* put the interests of prospective and actual clients first. Others can change, given a few good examples.

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