
MEMORANDUM

RE: INTERNATIONAL TAX COMPLIANCE
 FOREIGN ASSETS (U.S. TAXPAYERS)
 #7: FOREIGN CORPORATION (FORM 5471)
 FOREIGN PARTNERSHIP (FORM 8865)

Control Rules

Any U.S. Person who *controls* a foreign corporation or foreign partnership during the tax year must file a Form 5471 (for a corporation) or Form 8865 (for a partnership). (IRC §6038.) These forms must be filed with the U.S. Person's timely filed federal tax return (including extensions).

For foreign corporations, *control* means ownership (direct or indirect) of more than 50 percent of the outstanding stock or voting power for at least 30 consecutive days during the year. Treas. Reg. §1.6038-2. For foreign partnerships, *control* means direct or indirect ownership of a more than 50 percent interest in partnership profits, capital, or deductions or losses. It also includes certain groups of U.S. Persons, who collectively own more than a 50 percent and individually own more than a 10 percent interest in the foreign partnership.

Attribution and constructive ownership rules apply (a taxpayer with no direct ownership in the foreign corporation or partnership could potentially have a reporting obligation).

The check-the-box regulations provide default corporate status for certain foreign limited liability entities. A U.S. Person's involvement with a foreign entity that does not resemble a corporation under local law may trigger a foreign corporation reporting obligation.

Penalties

A violation of the Control Rule-, (i.e., failure to timely file a Form 5471 or Form 8865) has a double-penalty impact. First, the U.S. Person's foreign tax amount used to compute the foreign tax credit is

reduced by 10 percent. Second, the U.S. Person is subject to a flat \$10,000 penalty.

Additional penalties apply if the violation continues for 90 days after IRS notice: (i) the foreign tax reduction increases by five percent for each three-month period, and (ii) there are additional \$10,000 penalties for each 30-day period, up to \$60,000 (\$10,000 initial penalty and \$50,000 maximum additional penalties). When both penalties apply, however, the foreign-tax penalty is reduced by the amount of the fixed-dollar penalty imposed.

The IRS must follow deficiency procedures and issue a notice of deficiency to the taxpayer with respect to the foreign tax credit reduction. The IRS may summarily assess the other penalties and collect them upon notice and demand.

These penalties may be avoided when the taxpayer proves that the failure was due to reasonable cause and not willful neglect.

Special Rules For Officers And Directors

Special rules apply for directors and officers of foreign corporations. A U.S. Person who becomes an officer or director of a foreign corporation, and owns at least 10 percent of the corporation's stock (by value or vote), must also file a Form 5471. (IRC §6046.) Constructive stock ownership rules apply, although this rule generally requires that the U.S. Person directly own some amount of stock. The Form 5471 must be filed with the U.S. Person's timely filed federal tax return, including extensions. In the absence of reasonable cause, the penalty for failure to timely file is \$ 10,000, with additional penalties up to \$50,000 for failure to cure the violation after IRS notice.

Rules For Property Transfers

Subject to certain exceptions, transfers of property by U.S. Persons to foreign corporations must be reported to the IRS. IRC §6038B. The U.S. Person must file a Form 926 with its timely filed income tax return for the year in which the transfer occurred. Transfers of cash to a foreign corporation are also reportable,

provided that (i) immediately after the transfer the U.S. Person owns 10 percent (by vote or value) of the corporation, or (ii) the amount of cash transferred by the U.S. Person during the preceding 12 months collectively exceeds \$ 100,000.

A reportable transfer by a partnership to a foreign corporation must be reported by each individual partner. The partnership cannot file a single Form 926 and satisfy this obligation on all the partners' behalf.

Transfers by U.S. Persons to foreign partnerships are subject to reporting. A reportable transfer occurs when (1) immediately after the transfer, the person holds, directly or constructively, a 10 percent or greater interest in the partnership, or (ii) the value of the property transferred, when added to the value of the property previously transferred by the person (or related person) to the foreign partnership over the last 12 months, exceeds \$100,000. IRC §6038B. The U.S. Person must report the transfer on a Form 8865, which is filed with the person's timely filed federal tax return (including extensions).

If a domestic partnership contributes property to a foreign partnership, the partners of the domestic partnership are each treated as transferring their proportionate share of the contributed property. Each partner has an obligation to file a Form 8865. Unlike the Form 926 discussed above, however, the domestic partnership itself may file the Form 8865 and satisfy the reporting requirements of its partners.

The penalty for failure to file a Form 5471 or Form 8865 is equal to 10 percent of the fair market value of the property at the time of the exchange/ transfer. The penalty will not apply if the failure to comply is due to reasonable cause and not willful neglect. The penalty is also limited to \$100,000 unless the failure to comply was due to intentional disregard.

Rules For Ownership Transfers

Reporting rules apply to the transfer of *ownership* in a foreign corporation or foreign partnership.

With respect to a foreign corporation, a U.S. Person must file a Form 5471 if any of the following occurred during the tax year: (1) the person acquired stock and thereafter possessed a 10 percent

ownership interest (by vote or value) in the foreign corporation, (2) the person acquired a 10 percent or more stock ownership interest, or (3) the person disposes of sufficient stock to reduce the person's interest below 10 percent ownership. IRC §6046.

These rules do not require that the transfer occur in a single transaction. Rather, a reporting obligation arises if this threshold is met as a result of one or more transactions during the tax year.

Similar rules apply to foreign partnerships. A U.S. Person must file a Form 8865 if during the tax year (1) the person acquires or disposes of an interest in the foreign partnership, and before or after the transfer the person holds (directly or indirectly) a 10 percent interest in the partnership, or (2) the person's proportional interest in the partnership changes by 10 percent or more. (IRC §6046A.)

Both Form 5471 and Form 8865 must be filed with the U.S. Person's timely filed tax return (including extensions).

A fixed \$ 10,000 penalty is imposed on any failure to disclose a reportable transfer. If the failure continues for more than 90 days after IRS notice, an additional penalty of \$ 10,000 will apply for each 30-day period (or fraction thereof) during which the failure continues, up to \$50,000. IRC §6679.

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