



Business Law Section Newsletter

Vol. 40, No. 2 — October 2016

U.S. Reporting Requirements for Foreign Financial Accounts and Investments: What Businesses and Business Owners Need to Know

by Gerald A. Shanker

U.S. Reporting Requirements for Foreign Financial Accounts and Investments: What Businesses and Business Owners Need to Know

by Gerald A. Shanker

The Foreign Tax Compliance Act (FATCA), which became law in March 2010, targets tax non-compliance by U.S. individual taxpayers with foreign financial accounts and other foreign assets.¹ FATCA focuses on reporting by: 1) U.S. individual taxpayers regarding certain foreign financial accounts and offshore assets, 2) foreign financial institutions regarding financial accounts held by U.S. taxpayers, and 3) foreign entities in which U.S. taxpayers hold a substantial ownership interest. This article presents an overview of U.S. reporting requirements for foreign financial accounts and investments and the penalties for noncompliance. It is crucial for businesses and business owners to understand their obligations under FATCA.²

Most tax professionals and taxpayers should be aware of the requirement to file FinCEN Report 114 (Report of Foreign Bank and Financial Accounts (FBAR)). Taxpayers having a financial interest or signature authority over a foreign financial account, including a brokerage account, mutual fund, trust or other type of foreign financial account exceeding certain thresholds are required to annually report the account to the Department of the Treasury by electronically filing FinCEN Form 114 (Report of Foreign Bank and Financial Accounts).³ This form is required to be filed by U.S. persons, which include U.S. citizens, resident aliens, trusts, estates, and domestic entities that have an interest in or signature authority over foreign financial accounts, the balance of which was \$10,000 or more at any time during the calendar year.

A taxpayer has a financial interest if the taxpayer or the taxpayer's agent is owner of record or holder of legal title or the taxpayer or the taxpayer's agent has a sufficient interest in the entity that is the owner of record or holder of legal title.⁴

Following is a list of the types of foreign assets requiring Form 114 reporting:

- Financial accounts held at a foreign financial institution
- Financial accounts held at a foreign branch of a U.S. financial institution
- Foreign financial accounts for which the taxpayer has signature authority
- Foreign stock or securities held in a financial account at a foreign financial institution
- Indirect interests in foreign assets through an entity
- Foreign mutual funds
- Foreign issued life insurance or annuity contracts with a cash value

Excluded from the FBAR filing requirements are: 1) financial accounts held at a U.S. branch of a foreign financial institution, 2) foreign stock or securities not held in a financial account, 3) domestic mutual funds investing in foreign stocks and securities, 4) foreign hedge and private equity funds, and 5) foreign currency held directly.⁵

Penalties for noncompliance are substantial. If the noncompliance is non-willful, a penalty of up to \$10,000 may be imposed on any person who violates or causes any violation of the FBAR filing and record-keeping requirements. The penalty may be imposed for each year of noncompliance; however, Internal Revenue Service (IRS) guidance provides that a single \$10,000 penalty may be imposed that covers all noncompliance.⁶ A determination regarding the penalty is made based on the specific facts and circumstances and the conduct of the person that was required to file. Penalties may be avoided if there is reasonable cause for noncompliance and the taxpayer later files correct and complete FBARs.

The penalty for willful noncompliance is equal to the greater of \$100,000 or 50 percent of the balance in the account at the time of the violation. Under IRS guid-

ance, the willfulness penalty is limited to 50 percent of the highest aggregate balance of all unreported foreign financial accounts during the years under examination.⁷

In addition to a FBAR, taxpayers may also be required to file the following additional forms:

- 8938—Statement of Specified Foreign Financial Assets
- 3520—Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts
- 3520-A—Annual Information Return of Foreign Trust with a U.S. Owner
- 5471—Information Return of U.S. Persons with Respect to Certain Foreign Corporations
- 8621—Information Return by a Shareholder of a Passive Foreign Investment Company
- 8865—Return of U.S. Persons with Respect to Certain Foreign Partnerships

This article provides a summary of each of these reporting requirements and the penalties for non-compliance.

Form 8938

Form 8938 (Statement of Specified Foreign Financial Assets) is filed by U.S. individual taxpayers to report specified foreign assets they have an interest in during the tax year. This form needs to be filed if the total value of all the specified foreign assets in which the individual taxpayer has an interest exceeds certain monetary reporting thresholds. As indicated below, the thresholds differ depending upon whether the taxpayer resided in the United States or abroad for a certain period of time.⁸

Taxpayer Residence	United States		Abroad	
	LAST DAY OF TAX YEAR	ANY TIME DURING TAX YEAR	LAST DAY OF TAX YEAR	ANY TIME DURING TAX YEAR
Unmarried	\$ 50,000	\$ 75,000	\$ 200,000	\$ 300,000
Married Joint Return	\$ 100,000	\$ 150,000	\$ 400,000	\$ 600,000
Married Separate Return	\$ 50,000	\$ 75,000	\$ 200,000	\$ 300,000

A U.S. citizen will satisfy the presence abroad test if he or she: 1) has been a *bona fide* resident of a foreign country for an uninterrupted period that includes an entire year, or 2) is present in a foreign country or countries at least 330 days during any period of 12 consecutive months that ends in the tax year being reported.

Form 8938 requires the taxpayer to calculate the total value of the specified foreign financial assets in which he or she has an interest to determine if the filing threshold applies. Specified foreign financial assets include financial accounts maintained by a foreign financial institution and the following foreign financial assets if they are held for investment and not held in an account maintained by a financial institution:⁹

- Stock or securities issued by someone that is not a U.S. person;
- Any interest in a foreign entity;
- Any financial instrument or contract that has an issuer or counterparty that is not a U.S. person;
- A capital or profits interest in a foreign partnership;
- A note, bond, debenture, or other form of indebtedness issued by a foreign person;
- An interest in a foreign trust or foreign estate; and
- Any option or other derivative instrument with respect to any currency or commodity that is entered into with a foreign counterparty or issuer.

An asset is considered to be 'held for investment' if it is not used or held for use in the conduct of any trade or business.¹⁰

Form 8938 requires reporting the maximum value during the tax year of each specified foreign financial asset. In most cases, the value of the specified foreign financial asset is its fair market value.

Failure to file Form 8938 by the due date may subject the taxpayer to a penalty of \$10,000. If Form 8938 is not filed within 90 days after the IRS mails the taxpayer a notice of the failure to file, additional penalties of \$10,000 will apply for each 30-day period during which the failure to file continues, up to a maximum \$50,000 penalty. The statute of limitations for failure to file Form 8938 or failure to report a specific foreign financial asset is three years after the date on which Form 8938 is filed (or should have been filed).

Form 3520

Form 3520 is required to be filed by U.S. persons (which, as previously indicated, includes U.S. entities) and estates of U.S. decedents to report certain transactions (referred to as reportable events) with foreign trusts, ownership of foreign trusts, and receipt of certain large gifts or bequests from certain foreign persons. A reportable event includes:

- the creation of a foreign trust by a U.S. person;
- the transfer of any money or property, directly

or indirectly, to a foreign trust by a U.S. person, including a transfer by reason of death; and

- the death of a citizen or resident of the United States if the decedent was treated as the owner of any portion of a foreign trust under the rules of IRC sections 671 through 679 or any portion of a foreign trust was included in the estate of the decedent.

A reportable event does not include any transfer of property to a foreign trust in exchange for consideration of at least the fair market value of the transferred property.

Form 3520 is also required to be filed by a U.S. person who:

- during the current tax year is treated as the owner of any part of the assets of a foreign trust under the rules of IRC sections 671 through 679;
- received, directly or indirectly, a distribution from a foreign trust;
- received more than \$100,000 from a nonresident alien individual or foreign estate that was treated as a gift or bequest; or
- received more than \$15,601 from foreign corporations or partnerships or foreign persons related to such foreign corporations or partnerships that were treated as gifts.

Penalties for failure to file, late filing, or incomplete or incorrect filing are equal to the greater of \$10,000 or 35 percent of the gross value of any property transferred to or received from the foreign trust, or five percent of the gross value of the trust assets treated as owned by the taxpayer.

Form 3520-A

Form 3520-A is the annual information return of a foreign trust with at least one U.S. owner (including a U.S. entity). The form provides information about the foreign trust, its U.S. beneficiaries, and any U.S. person who is treated as an owner of any portion of the foreign trust under the grantor trust rules.¹¹ Each U.S. person treated as an owner of any portion of a foreign trust is responsible for ensuring the foreign trust files Form 3520-A.

Form 3520-A requires completion of an income statement and balance sheet from the books and records of the foreign trust, as well as information regarding the fair market value of distributions from the trust to all persons, whether U.S. or foreign. The form also requires information identifying the owners and beneficiaries

of the foreign trust, as well as information regarding foreign trust income attributable to a U.S. owner.

Failure to timely file form 3520-A, or filing an incomplete or incorrect form, subjects the U.S. owner to an initial penalty of the greater of \$10,000 or five percent of the gross value of the trust's assets treated as owned by the U.S. person at the close of the taxable year. Additional penalties will be imposed if noncompliance continues for more than 90 days after the IRS mails a notice of failure to comply with required reporting.

Form 5471

Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) is a complex form that is used by certain U.S. citizens who are officers, directors, or shareholders in certain foreign corporations. There were previously five categories of filers but the category one filing requirement was repealed by the American Jobs Creation Act of 2004. The remaining four filer categories retained their pre-repeal identification.

Following is a summary of the filing categories:

- **Category 1 Filer**—repealed.
- **Category 2 Filer**—a U.S. citizen or resident who is an officer or director of a foreign corporation in which a U.S. person has acquired 10 percent ownership or an additional 10 percent or more in value or voting power of the outstanding stock of the foreign corporation.
- **Category 3 Filer**—a U.S. person who acquires stock in a foreign corporation, which when added to any stock owned on the date of acquisition, meets the 10 percent stock ownership requirement or a U.S. person who acquires stock which, without regard to stock already owned on the date of purchase, meets the 10 percent stock ownership requirement.
- **Category 4 Filer**—a U.S. person who had control of a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the foreign corporation.
- **Category 5 Filer**—a U.S. shareholder who owns stock in a foreign corporation that is a controlled foreign corporation for an uninterrupted period of 30 days or more during any tax year of the foreign corporation, and who owned that stock on the last day of that year.

A controlled foreign corporation is a foreign corporation that has U.S. shareholders that own, directly, indirectly, or constructively, on any day of the tax year

of the foreign corporation, more than 50 percent of the combined voting power of all classes of its voting stock or the total value of the stock of the corporation.¹²

Compliance by Category 2 and Category 5 filers may be difficult or impossible because the potential filers may not have sufficient information to determine if they are required to file. For example, an officer or director of a foreign corporation may not know or have the ability to find out if a U.S. person has acquired a 10 percent interest in the foreign corporation. Likewise, a U.S. shareholder of a foreign corporation may not know the identity of the other shareholders and will, therefore, be unable to determine if the foreign corporation is a controlled foreign corporation.

A \$10,000 penalty is imposed for failure to furnish the required information for each foreign corporation. Additional penalties reduce the U.S. taxpayer's foreign tax credit.

Form 8621

Form 8621 is required to be filed by U.S. shareholders of passive foreign investment companies (PFICs). A foreign corporation is a PFIC if 75 percent or more of the corporation's gross income for its taxable year is passive income or at least 50 percent of the average percentage of assets held by the foreign corporation during the taxable year are assets that produce passive income or are held for the production of passive income.¹³

A U.S. person (including a U.S. entity) that is a direct or indirect shareholder of a PFIC must file Form 8621 if the U.S. person receives certain direct or indirect distributions from a PFIC or recognizes gain on a direct or indirect disposition of PFIC stock. Other filing requirements related to tax elections and annual reports are beyond the scope of this article.

The application of passive foreign investment company rules and Form 8621 filing requirements are more far reaching than many taxpayers and advisors are aware. PFICs are investments registered outside the U.S. and

include mutual funds, hedge funds, insurance products, and non-U.S. pension plans. Compliance with filing requirements for PFICs is extremely complex. U.S. tax law imposes tax at the highest marginal rates, plus an interest charge, on distributions and dispositions of PFIC stock.

Form 8865

Form 8865 is similar to Form 5471, except that Form 8865 is filed by U.S. partners of foreign partnerships. Form 8865 is required to be filed by U.S. persons (including U.S. entities) that controlled a foreign partnership, owned a 10 percent interest while the partnership was controlled by a U.S. person, contributed property to the partnership in exchange for a 10 percent interest, or had a reportable event with respect to the partnership.¹⁴ Generally, reportable events are changes in partnership structure resulting in the U.S. person owning a 10 percent or greater interest after the change.

Form 8865 requires complete financial and nonfinancial information about the partnership. Form 8865 compliance has the same problem as Form 5471 compliance, that is, a partner in a foreign partnership may not possess or be able to obtain information sufficient to determine if the partnership is controlled by U.S. persons.

Conclusion

This article is intended to provide the reader with a general overview of U.S. tax compliance requirements for taxpayers who are investors in foreign financial assets and businesses. The requirements, rules, and definitions are complex, and compliance requirements are fact sensitive. Many taxpayers are unaware of their noncompliance. Any U.S. taxpayer investing in foreign financial assets or businesses should consult a tax professional to determine compliance requirements. The penalties for failure to comply are substantial. ■

Gerald A. Shanker, CPA/ABV, is a member of Kreinco Rollins & Shanker, LLC in Paramus.

Endnotes

1. I.R.C. § 6038D.
2. I.R.C. § 6038D. Certain of the reporting requirements discussed in this article apply to U.S. individuals (as opposed to U.S. entities). Nonetheless, business lawyers and accountants should be familiar with these requirements to best serve their business clients.
3. 31 U.S.C. § 5314.