

The Boogey Man – Informational Reporting of International Transactions and the Hefty Penalty Provisions

**8th Annual San Diego Tax and Accounting Institute
November 11, 2004**

Reporting Overview for Foreign Transactions

I. In-Bound Informational Tax Reporting Requirements

- A. Domestic corporations that are 25% foreign owned - §6038A
- B. Foreign corporations engaged in a U.S. trade or business - §6038C
- C. Foreign persons who own direct interest in U.S. real property - §6039C
- D. Applying for U.S. Passport or legal residency - §6039E
- D. Large gifts received by U.S. persons from foreign persons - §6039F
- E. Distributions received by U.S. persons from foreign trusts - §6048(c)

II. Out-Bound Informational Tax Reporting Requirements

- A. U.S. persons who are officers, directors or 10% shareholders of a FPHC - §6035
- B. U.S. persons who control foreign corporations or partnerships - §6038
- C. Nonrecognition transfers to foreign corporations or partnerships - §6038B
- D. Losing U.S. citizenship or long-term resident status - §6039G
- E. U.S. persons who become officers or directors of a foreign corporation - §6046
- F. U.S. persons who acquire any interest in a foreign partnership - §6046A
- G. Gratuitous transfers to foreign trusts and U.S. owners of foreign trusts - §6048(a), (b)

III. Non-Tax Reporting Requirements (FBARs)

- A. Foreign bank account reporting requirements of the Bank Secrecy Act/USA Patriot Act

In-Bound Transactions

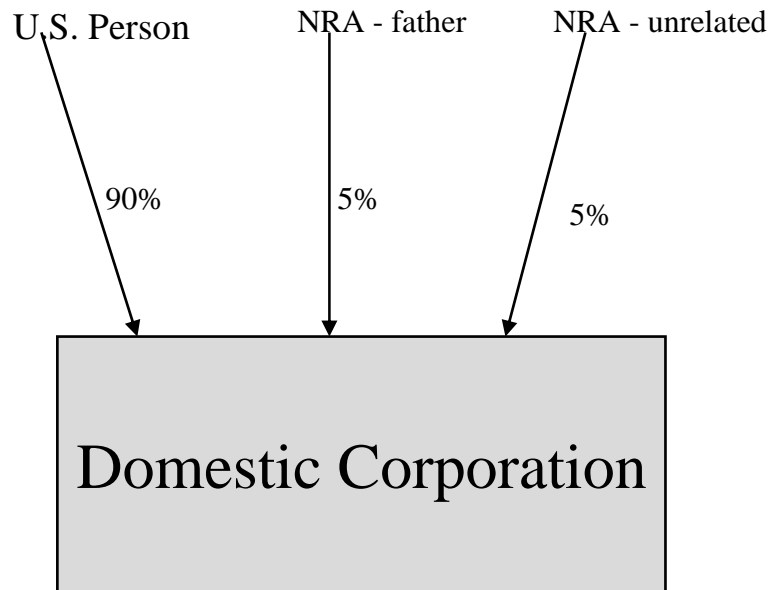
§6038A – Information With Respect To Certain Foreign Owned Corporations

- Domestic corporations that are 25% or more foreign owned, by vote or value, must file Form 5472 to report transactions with “related parties”; maintain records
- Complex ownership attribution rules of §§318 and 267(c) apply to determine direct or indirect foreign ownership
- Foreign related party includes (1) 25% foreign shareholder, (2) any person related (within the meaning of §267(b) or §707(b)(1)) to the domestic corporation or the foreign shareholder, and (3) any person related within the meaning of §482
- Penalty of \$10,000 for failure to file Form 5472 for any tax year, with additional \$10,000 penalties each 30-day period during which failure continues after expiration of 90-day IRS notice period (no limit); reasonable cause exception
- IRS: over-reporting and “substantially incomplete” Form 5472. CCA 200429007
- IRS: no statute of limitations concerning 5472 transactions. §6501(c)(8), CCA 200024051



In-Bound Transactions

§6038A – Information With Respect To Certain Foreign Owned Corporations (Example)



- Under ownership attribution rules, stock owned by U.S. Person is attributed to NRA – father. Because a foreign person (NRA – father) is treated as directly and constructively owning 25% or more of Domestic Corporation, Domestic Corporation is a “reporting corporation” for purposes of §6038A and must file Form 5472 each year to report related party transactions

- If Domestic Corporation inadvertently fails to timely file Form 5472 for a given year, a \$10,000 penalty can be imposed, and, if Domestic Corporation receives notice of failure from the IRS, additional \$10,000 penalties can be imposed for each 30-day period during which failure continues after expiration of the 90-day notice period

In-Bound Transactions

§6038C – Information With Respect To Foreign Corporations Engaged In U.S. Business

- Foreign corporations engaged in U.S. trade or business must file Form 5472 to report transactions with “related parties”; maintain certain records
- Same definition of “related party” as §6038A
- Intended to assist with §482 enforcement and access to records
- Provision applies to foreign corporations from treaty countries who take position that U.S.-source income is not taxable because no “permanent establishment” (and thus file no income tax return)
- Penalty of \$10,000 for failure to file Form 5472 for any tax year, with additional \$10,000 penalties each 30-day period during which failure continues after expiration of 90-day IRS notice period (no limit); reasonable cause exception

In-Bound Transactions

§6039C – Returns With Respect To Foreign Persons Holding Direct Investments In U.S. Real Property Interests

- IRS is authorized to require foreign persons who are not engaged in a U.S. trade or business but who own direct interests in U.S. real estate with a fair market value of \$50,000 or more to report information concerning the real estate
- ***NOT IMPLEMENTED – YET***
- Buyer or transferee that is required to withhold tax must still file Forms 8288 and 8288-A to report withholding information



In-Bound Transactions

§6039E – Information Concerning Resident Status

- Individual who applies for U.S. passport (including renewal) must supply a statement including taxpayer identification number (“TIN”), any foreign country in which residing, home or mailing address in that country, and date of birth
- Individual applying to become legal U.S. resident (green card) must supply statement including TIN (if any), address within U.S. or other home address, date of birth, statement as to whether he had U.S.-source income during most recent three tax years, and statement whether he was present in U.S. for more than 182 days in those years
- Information is collected by agencies administering the passport and legal residency programs, and then shared with the IRS
- Penalty of \$500 for each failure to supply information; reasonable cause exception



In-Bound Transactions

§6039F – Notice Of Large Gifts Received From Foreign Persons

- U.S. persons who receive aggregate foreign gifts or bequests of more than \$10,000 (adjusted for inflation) during any tax year are required to file Form 3520 so the IRS can evaluate whether the amount is a gift or income
- Under Notice 97-34, gifts received from non-resident aliens or foreign estates are required to be reported only if the aggregate amounts received from one person or estate exceeds \$100,000 during a tax year; while gifts from foreign corporations or partnerships must be reported if the aggregate amount received from all corporations and partnerships exceeds \$10,000
- IRS can recharacterize purported gifts from foreign corporations and partnerships
- If gift is from a foreign trust, reporting required under the rules of §6048(c)
- Penalty for failure to file Form 3520 is 5% of the gift for each month failure continues, not to exceed 25% of gift; reasonable cause exception

In-Bound Transactions

§6048(c) – Information With Respect To Certain Foreign Trusts

- U.S. beneficiaries who receive any direct or indirect (e.g., loan) distributions from a foreign trust during any tax year are required to file Form 3520 so IRS can evaluate whether distribution is taxable (e.g., distribution of income or corpus)
- If Form 3520 not filed, entire distribution is included in beneficiary's income as accumulation distribution subject to throwback rules and compound interest charge
- Beneficiary should obtain from the trust a Foreign Nongrantor Trust Beneficiary Statement (or a Foreign Grantor Trust Beneficiary Statement) and attach to Form 3520 to avoid default treatment as accumulation distribution. Notices 97-34
- Penalty for failure to file Form 3520 is 35% of the distribution (even if distribution was non-taxable), with additional \$10,000 penalties for each 30-day period failure continues after 90-day notice period, not to exceed amount of distribution; reasonable cause exception. §6677
- Statute of limitations does not commence until Form 3520 filed. §6501(c)(8), CCA 200024051



Out-Bound Transactions

§6035 – Returns Of Officers, Directors And Shareholders Of Foreign Personal Holding Companies (“FPHC”)

- U.S. person who is an officer, director or 10% shareholder of any FPHC must file Form 5471 to report shareholder, income and other information concerning the FPHC
- FPHC is any foreign corporation if (1) at any time during the year more than 50% of the vote or value is owned directly or indirectly by a group of five or fewer U.S. persons, and (2) at least 60% of the corporation’s gross income is passive
- Penalty for failure to timely file Form 5471 for any tax year is \$1,000; reasonable cause exception
- ***THE AMERICAN JOBS CREATION ACT OF 2004 (P.L. 108-357) REPEALED §6035 AND THE FPHC PROVISIONS FOR TAXABLE YEARS OF FOREIGN CORPORATIONS BEGINNING AFTER 12/31/04***



Out-Bound Transactions

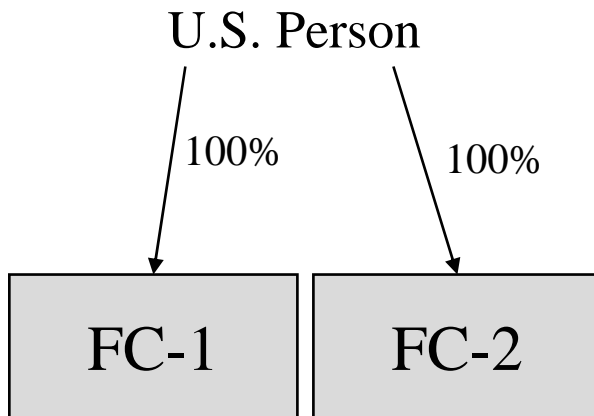
§6038 – Information With Respect To Certain Foreign Corporations And Partnerships

- U.S. person who “controls” a foreign corporation or partnership (50%), or who is a 10% shareholder of a “controlled foreign corporation,” must file Form 5471 to report certain information concerning the foreign corporation or partnership
- Complex ownership attribution rules apply
- Penalty for failure to timely file Form 5471 for any tax year is \$10,000, with additional \$10,000 penalties for continued failure after notice by the IRS, up to a maximum of \$50,000 per year; reasonable cause exception
- Penalty may also include reduction of foreign tax credit
- As with Form 5472, statute of limitations with respect to reportable items does not commence until Form 5471 is filed. §6501(c)(8), CCA 200024051
- Penalty exposure may be eliminated if foreign corporation has single owner, is an “eligible entity,” and can make check-the-box election to be disregarded entity; PLR?



Out-Bound Transactions

§6038 – Information With Respect To Certain Foreign Corporations And Partnerships (Example)



- U.S. Person forms FC-1 and FC-2 in 2001 (through the internet) but inadvertently fails to file Forms 5471 for tax years 2001, 2002 and 2003
- US. Person exposed to \$60,000 in penalties
- If FC-1 and FC-2 are not “per se” corporations, possible to eliminate penalty exposure with favorable private letter ruling granting extension to file Form 8832 check-the-box election for disregarded entity treatment



Out-Bound Transactions

§6038B – Notice Of Certain Transfers To Foreign Persons

- U.S. person who transfers property to a foreign corporation in a nonrecognition transaction (§§332, 351, 354, 355, 356, 361), or to a foreign partnership in a nonrecognition transaction (§721), must file Form 956 in the case of corporations, and Form 8865 in the case of partnerships, to report information concerning the transfer
- U.S. corporation's liquidation distribution (§336) to foreign person must also be reported by filing Form 956
- Penalty for failure to timely file applicable form is 10% of the fair market value of the property, not to exceed \$100,000; in the case of a contribution to a foreign partnership, the transfer is treated as a sale for fair market value
- Statute of limitations with respect to reportable items does not commence until applicable form is filed. §6501(c)(8), CCA 200024051



Out-Bound Transactions

§6039G – Information On Individuals Losing U.S. Citizenship

- Reporting requirement imposed in connection with rules on expatriation to avoid tax under §§877 and 2107
 - Old law: Individual who loses U.S. citizenship or long-term resident status (greencard) must report for the year of expatriation: taxpayer identification number; mailing address of principal foreign residence; foreign country of citizenship; and, if net worth exceeds \$500,000 (adjusted for inflation; i.e., \$622,000 for 2004), information detailing assets and liabilities (Form 8854)
 - Penalty for each year of the ten-year period beginning with the loss citizenship or resident status equal to greater of \$1,000, or 5% of tax to which individual subject under §877; reasonable cause exception
- American Jobs Creation Act of 2004 amended §6039G to require annual reporting for each year taxpayer is subject to §877 (§877 also amended; applies if 5-year average annual net income tax is greater than \$124,000, or net worth in excess of \$2,000,000)
- Penalty increased to \$10,000 for each failure to file; reasonable cause exception



Out-Bound Transactions

§6046 – Returns As To Organization Or Reorganization Of Foreign Corporations And As To Acquisitions Of Their Stock

- The following U.S. persons are required to file Form 5471 (1) U.S. persons who become officers or directors of a foreign corporation if a U.S. person owns 10% of its stock, (2) U.S. persons who acquire stock that causes them to own 10% of a foreign corporation, (3) U.S. persons who dispose of enough stock in a foreign corporation to reduce his interest to less than 10%, and (4) other U.S. persons who are treated as U.S. stockholders of foreign corporations under the captive insurance rules of §953(c)
- Complex ownership attribution rules apply
- Penalty for failure to timely file Form 5471 is \$10,000, with additional \$10,000 penalties for continued failure after notice up to \$50,000; reasonable cause exception
- Statute of limitations with respect to reportable items does not commence until Form 5471 is filed. §6501(c)(8), CCA 200024051

Out-Bound Transactions

§6046A – Returns As To Interests In Foreign Partnerships

- U.S. person who acquires any interest in a foreign partnership or disposes of any portion of an interest in a foreign partnership must file Form 8865 if they own at least a 10% interest in a foreign partnership before or after the change
- Reporting is also required if their proportional interest in a foreign partnership changes substantially (10%)
- Penalty for failure to timely file Form 8865 is \$10,000, with additional \$10,000 penalties for continued failure after notice up to \$50,000; reasonable cause exception
- Statute of limitations with respect to reportable items does not commence until Form 8865 is filed. §6501(c)(8), CCA 200024051

Out-Bound Transactions

§6048(a), (b) – Information With Respect To Certain Foreign Trusts

- Gratuitous transfers by U.S. persons to foreign trusts (e.g., creation of foreign trust) must be reported by the transferor on Form 3520
- If trust is treated as having a U.S. owner, U.S. owner required to annually file Form 3520-A to report trust information; U.S. owner should also appoint a U.S. person to act as trust's limited agent regarding requests by the IRS to examine records and/or produce testimony, otherwise IRS can unilaterally determine amount U.S. owner is required to take into income
- Failure to file Forms 3520 or 3520-A results in penalty equal to 35% of the reportable amount, with additional \$10,000 penalties for continued failure after notice up to a maximum of the reportable amount

USA PATRIOT Act

Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism

- Passed October 26, 2001
- Compliance Reporting Requirements
- Treasury Obligations to Study Methods for Improving Compliance with Reporting Requirements of Section 5314 of title 31 (Bank Secrecy Act)
- Art 4 of US/Mex Treaty: Broader Scope

FBAR

- ❑ FinCEN's Role
- ❑ FinCEN's Report to Congress – April 2002
- ❑ Delegation of Authority to IRS - April 2003

FBAR Overview

- ❑ 31 U.S.C. § 5314 - Authority
- ❑ 31 C.F.R. § 103.24 – Reporting
- ❑ 31 C.F.R. § 103.32 – Recordkeeping
- ❑ 31 C.F.R. § 103.27(c) – Due Date
- ❑ FBAR Instructions – Additional Guidance

Bank Secrecy Act (“BSA”)


BSA Authorized Treasury to issue Regulations

— 31 CFR 103.24

- (a) Each person subject to the jurisdiction of the United States (except a foreign subsidiary of a U.S. person) having a financial interest in, or signature or other authority over, a bank, securities or other financial account in a foreign country shall report such relationship to the Commissioner of the Internal Revenue for each year in which such relationship exists, and shall provide such information as shall be specified in a reporting form . . .

— Form is TD F 90-22.1

This is an FBAR

Department of the Treasury TD F 90-22.1 (Rev. 7/00) SUPERSEDES ALL PREVIOUS EDITIONS		REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS Do NOT file with your Federal Tax Return			1 OMB No. 1506-0009
1 Filing for Calendar Year Y Y Y Y		2 Type of Filer a <input type="checkbox"/> Individual b <input type="checkbox"/> Partnership c <input type="checkbox"/> Corporation d <input type="checkbox"/> Fiduciary		3 Taxpayer Identification Number 	
Part I Filer Information					
4 Last Name or Organization Name			5 First Name		6 Middle Initial
7 Address (Number, Street, and Apt. or Suite No.)					8 Date of Birth M M D D Y Y Y Y
9 City		10 State	11 Zip/Postal Code	12 Country	13 Title (Not necessary if reporting a personal account)
14 Are these accounts jointly owned? a <input type="checkbox"/> Yes b <input type="checkbox"/> No		15 Number of joint owners	16 Taxpayer Identification Number of joint owner (if known)		
17 Last Name or Organization Name			18 First Name		19 Middle Initial
Part II Information on Financial Accounts					
20 Number of Foreign Financial Accounts in which a financial interest is held		21 Type of account a <input type="checkbox"/> Bank b <input type="checkbox"/> Securities c <input type="checkbox"/> Other			
22 Maximum value of account a <input type="checkbox"/> Under \$10,000 b <input type="checkbox"/> \$10,000 to \$99,999 c <input type="checkbox"/> \$100,000 to \$1,000,000 d <input type="checkbox"/> Over \$1,000,000		23 Account Number or other designation			
24 Name of Financial Institution with which account is held			25 Country in which account is held		
26 Does the filer have a financial interest in this account? a <input type="checkbox"/> Yes b <input type="checkbox"/> No If no, complete boxes 27-35.			27 Last Name or Organization Name of Account Holder		
28 First Name		29 Middle Initial		30 Taxpayer Identification Number	
31 Address (Number, Street, and Apt. or Suite No.)					32 City
33 State	34 Zip/Postal Code	35 Country			
36 Signature					37 Date M M D D Y Y Y Y

This form should be used to report a financial interest in, signature authority, or other authority over one or more financial accounts in foreign countries, as required by the Department of the Treasury Regulations (31 CFR 103). No report is required if the aggregate value of the accounts did not exceed \$10,000. SEE INSTRUCTIONS FOR DEFINITION. File this form with:

U.S. Department of the Treasury, P.O. Box 32621, Detroit, MI 48232-0621.

PRIVACY ACT NOTIFICATION

Pursuant to the requirements of Public Law 93-579 (Privacy Act of 1974), notice is hereby given that the authority to collect information on TD F 90-22.1 in accordance with 5 USC 552a(e) is Public Law 91-508; 31 USC 5314; 5 USC 301; 31 CFR 103.

The principal purpose for collecting the information is to assure maintenance of reports where such reports or records have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings. The information collected may be provided to those officers and employees of any constituent unit of the Department of the Treasury who have a need for the records in the performance of their duties. The records may be referred to any other department or agency of the United States upon the request of the head of such department or agency for use in a criminal, tax, or regulatory investigation or proceeding. The information collected may also be provided to appropriate state, local, and foreign law enforcement and regulatory personnel in the performance of their official duties.

Disclosure of this information is mandatory. Civil and criminal penalties, including in certain circumstances a fine of not more than \$500,000 and imprisonment of not more than five years, are provided for failure to file a report, supply information, and for filing a false or fraudulent report. Disclosure of the Social Security number is mandatory. The authority to collect is 31 CFR 103. The Social Security number will be used as a means to identify the individual who files the report.

Civil Penalties for FBAR Violations

- ❑ Section 5321(a)(5)(A) – Penalty Authorized
- ❑ Section 5321(a)(5)(B) – Any Violation
- ❑ Section 5321(a)(5)(C) – Willful Violations
- ❑ Section 5321(a)(6)(A) – Negligence
- ❑ Section 5321(a)(6)(B) – Pattern of Negligent Activity

Civil Penalties for FBAR Violations

- Section 5321(a)(5)(A)
 - Penalty for violating, or causing a violation of, any provision of section 5314 of Title 31 (the FBAR reporting and recordkeeping requirements)

Civil Penalties for FBAR Violations

- Section 5321(a)(5)(B) – Any violation
 - Penalty not to exceed \$10,000 per violation
 - Waived if violation was due to reasonable cause and amount of transaction or account balance at time of transaction was properly reported

Civil Penalties for FBAR Violations

- Section 5321(a)(5)(C) – Willful violation
 - Penalty not to exceed the greater of \$100,000 or 50% of balance in account at the time of the violation
 - Previously, the penalty was limited to the greater of an amount (not to exceed \$100,000) equal to the balance in the account at the time of the violation or \$25,000

Negligence and Pattern of Negligent Activity Penalties

- Generally only applies to businesses
 - 5321(a)(6)(A) - Up to \$500 per violation for negligence
 - 5321(a)(6)(B) - Up to \$50,000 for a pattern of negligent activity

FBAR Violations

- ❑ Jointly Owned Accounts
- ❑ Multiple Violations
- ❑ Mitigation Guidelines

Low Compliance with Form 90-22.1?

- **Report to Congress under USA PATRIOT Act**
 - IRS - Detroit Computing Center
 - “DCC”
 - Financial Crimes Enforcement Network
 - “FinCEN”



Compliance with BSA

- **Nearly 1 Million Audits** (1999-2001 Annually)
 - 1996-1998 - Nine Indictments
 - 1999-2000 - Zero Indictments
 - Only 3 Convictions Since 1995
 - U.S. Customs

Compliance with BSA

Are Non-residents Subject to 31 CFR 103.24?

- Regulations provides “Each person subject to the jurisdiction of the United States”
- U.S. Jurisdiction (Person & Matter)

U.S. PATRIOT Act

- New Regulations - Regarding Financial Institutions (Not Applicable to Lawyers?)
 - Applicable to Brokers/Dealers
 - Reporting of Suspicious Activity Required
 - Report “Known or Suspected” Criminal Activity

USA PATRIOT Act

- Report Required (2nd Scenario) – **Non-Lawyers**
 - “knows, suspects, or has reason to suspect” that a transaction meets the reporting requirements
 - (i.e., of “Known or Suspected” Criminal Activity)
- Report is filed within 30 days to SEC
- SAR - Reporting
- Broker/Dealer cannot Disclose fact of SAR

USA PATRIOT Act

- Government's Gatekeeper Initiative (**Lawyer Duties**) – arising out of
 - Gatekeeper is an effort of the government to work with
 - lawyers and
 - accountants (to detect and prevent money laundering)
- See – Zacharias – *Lawyers as Gatekeepers*, University of San Diego School of Law – Legal Research and Paper Series (September 2004) - <http://law.bepress.com/cgi/viewcontent.cgi?article=1018&context=sandiegolwps>
- ABA Amendment to Rule of Confidentiality – 1.6

Gatekeeper Initiative

- Government Considers Lawyers and Accountants are uniquely positioned to
 - Facilitate or deter and detect money laundering
- DOJ, Treasury & Financial Action Task Force (FATF)
- See - **USA PATRIOT Act and the Gatekeeper Initiative: Surprising Implications for Transactional Lawyers**, By Kevin L. Shepherd (ABA - Section of Real Property, Probate, and Trust Law -
<http://www.abanet.org/rppt/publications/magazine/2002/so/shepherd.html>

USA PATRIOT Act – Application to Lawyers

- I USA PATRIOT Act Monitor News Release: Real Estate Closers (Lawyers?)
4/10/2003 7:30:45 PM Eastern Daylight Time
- I Financial institutions, for purposes of the anti-money laundering program requirements, include **"persons involved in real estate closings and settlements."** Following the rulemaking pattern previously used for vehicle dealers and travel agencies, FinCEN has issued an advance notice of proposed rulemaking which is a set of questions designed to help the agency determine what the rules should be. (68 Fed. Reg. 177569 (April 10, 2003).) The release lists some "red flags" that have been identified by the American Land Title Association as possibly justifying filing of suspicious activity reports. The preamble indicates that lawyers, as persons "involved" in real estate closings, may be covered by prospective rules. "FinCEN ... does not believe that application of section 352 requirements to attorneys in connection with activities relating to real estate closings or settlements raises issues of, or poses obligations inconsistent with, the attorney-client privilege." FinCEN refers to the ABA's Task Force on Gatekeeper Regulation and the Profession to the effect that "reasonable compliance training and due diligence" should minimize risk of lawyers' involvement in money laundering activities.

Gatekeeper Initiative vs. Lawyers Duty of Confidentiality

- ABA Model Rule 1.6 – Was recently amended to permit (but not require) disclosure beyond the crime exception rule “to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the services of the lawyer’s services . . . “
 - Not the Law in California
- California Rule – California Business & Professions Code § 6068(e) requires a lawyer to "maintain inviolate the confidence, and at every peril to himself or herself to preserve" clients' secrets.

Suspicious Activity Reporting in Other Countries

- South Africa, Great Britain, Switzerland and the Channel Islands
 - Currently Require Accountants and Attorneys to file SARs in various types of transactions
- EU Amended Directive
 - Requires Attorneys to file SARs when assist clients plan or execute various transactions

See - Nicole M. Healy, "*The Impact of September 11th on Anti-Money Laundering Efforts, and the European Union and Commonwealth Gatekeeper Initiatives*," 36 *International Lawyer* 733-49 (2002).

EU Amended Directive

- Reportable Transactions:
 - Buying and selling Real Estate
 - Managing client money, securities or assets
 - Opening or managing bank, savings and securities accounts
 - Arranging contributions necessary for creation of companies
 - Creating, operating or managing trusts or similar structures

- U.S. Reporting Obligations
 - (Not Generally Applicable to the Practice of Law – except for those requirements, that include "**persons involved in real estate closings and settlements.**")



Trend Towards More Disclosure

- Vs. Fiduciary Duties to Clients (Client Confidences)
- Historical Example of Impotence - TD F
 - Disclosure of TD F 90-22.1 (FBAR) to the World?
 - No Anti-Disclosure Protection under IRC Section 6103?

Conclusion

- Lawyers and accountants need to bear in mind the host of reporting requirements where U.S. clients are making transfers to, acquiring interests in, or receiving distributions from, foreign entities, or where U.S. corporate clients are foreign owned
- Lawyers and accountants should clearly define who is responsible for preparing and filing the various forms and coordinate the filing with the client in order to avoid the hefty penalty provisions



The End