

***HOW TO AVOID PROBLEMS  
WITH THE IRS WHEN YOU  
VENTURE OFFSHORE***

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# How to Avoid Problems with the IRS When You Venture Offshore

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The goal of this presentation is to help you understand the compliance requirements for offshore entities so that you will not run afoul with the IRS.

## Introduction:

Because the IRS can't require foreign entities like corporations, partnerships or trusts to provide detailed information the way that domestic entities must, they require the US owners of foreign entities to provide the information they want in order to determine if the US owner owes any US tax on the income earned by the foreign entity. Detailed reports are required for each type of foreign entity and there are heavy penalties for a mere failure to file a report on time – even if the foreign entity had no income.

## Top 10 Ways to Avoid Tax Matter Problems When you Venture Offshore

- 1. Employer Identification Number (EIN) when required** – for example Disregarded Foreign Entities must have an EIN prior to filing Form 8832, also foreign trust need to have a EIN in order to File Form 3520-A.
- 2. Timely Elections to be a Tax Transparent Entity (DRE)**
- 3. Analysis of: Ownership (Direct and Indirect, US and Foreign, % of ownership and attribution rules if they apply)** Attribution is where an individual is considered as owning stock owned, directly or indirectly, by or for their spouse, children, grandchildren and parents.
- 4. Formation Date**
- 5. Foreign Country of Organization**
- 6. Type of Foreign Entity and Entity Classification for US tax purposes**
- 7. Functional Currency and average exchange rate** – Functional currency is defined by the Internal Revenue Code and related IRS instructions as the foreign currency that is used to record transactions for a US owned foreign entity.
- 8. Determine if Entity has US source income**
- 9. Completion of All Parts of Each Return**
- 10. Timely Filing of Required Returns with Proof of Mailing** – Proof of Mailing would be sending filings via certified mail with a return receipts, or via other mean where you can have proof of date mailed and date received.

The details about compliance with the tax rules for foreign trusts, investments and business entities owned by US persons may seem

somewhat overwhelming at first and it is not likely that your local tax preparer will know these rules. In order to be in compliance you will probably need help from tax accountants who do have experience in working with these forms.

**These are some but by no mean all of the forms that may be required for foreign entities.**

Form TD F 90-22.1 – Report of Foreign Bank and Financial Accounts

Form 3520-A – Annual Information Return of Foreign Trust With a U.S. Owner

Form 3520 - Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts

Form 8832 Entity Classification Election

Form 8858 – Information Return of US Persons With Respect to Foreign Disregarded Entities

Form 8865- Return of U.S. Persons With Respect to Certain Foreign Partnerships

Form 5471–Information Return of U.S. Persons With Respect to Certain Foreign Corporations

Form 926- Return by a U.S. Transferor of Property to a Foreign Corporation

Form 8621 – Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund

**Form TD F 90-22.1 – Report of Foreign Bank and Financial Accounts (FBAR)**

US persons who have a financial interest in or signature or other authority over any foreign financial accounts, including bank, securities, or other types of financial accounts in a foreign country, if the aggregate value of these financial accounts exceeds \$10,000 at any time during the calendar year.

**Due Date:** This form is due before June 30 of the year following the calendar year reported. There is no extension of time available for filing this report. This report is filed with the Department of the Treasury.

**Penalty:** Non-willful penalty can be up to \$10,000. Civil penalty for willfully failing to file can be as high as the greater of \$100,000 or 50% of the total balance of the foreign account. Criminal penalties, in certain circumstances are fine of not more than \$500,000 and imprisonment of not more than five years.

**What to Watch For:**

This form is Not filed with income tax return – it is to be sent to US Treasury in Detroit.

The form must be received by the US Treasury on or before June 30th, proof of mailing on the due date does not count on proof of receipt before due date will be considered as a timely filing.

Disclosure: Your Foreign Bank and Financial Accounts must be disclosed on US Tax Returns: Individuals Form 1040 Schedule B, Part III, for US Partnerships Form 1065– Question # 10 on page 3, for Estates and Trusts Form 1041, page two and Exempt Organizations Form 990 – page 3, Question 42b.

The IRS has extended the deadline for filing this report to Sept 23, 2009 in limited circumstances. Per the IRS “Some taxpayers recently learned that they have an FBAR filing obligation, but they do not have sufficient time to gather the information necessary

to properly file the FBAR by the June 30, 2009, due date,” wrote the IRS on its Web site. “Taxpayers who reported and paid tax on all their 2008 taxable income but only recently learned of their FBAR filing obligation and have insufficient time to gather the necessary information to complete the FBAR, should file the delinquent FBAR report according to the instructions and attach a statement explaining why the report is filed late.”

The delinquent FBAR, along with a copy of the 2008 tax return, and a statement explaining why the report is late, is supposed to be sent by Sept. 23 to the IRS’s Philadelphia Offshore Identification Unit.

The IRS said it would not impose a penalty for failure to file the FBAR, especially when the taxpayer only recently learned of the need to file an FBAR.

IRS has also temporarily suspended the reporting requirement for Persons who are not Citizens, residents or Domestic Entities this is effective for filing due June 30 2009, they will issue additional guidance for subsequent years.

For more specific information on filing a FBAR see Vern Jacob’s Guide to Reporting Foreign Financial Accounts. See - [www.offshorepress.com](http://www.offshorepress.com)

## **Foreign Trust**

### **3520-A – Annual Information Return of Foreign Trust With a U.S. Owner**

A U.S. person who forms a foreign trust that has any present or future U.S. beneficiary is treated as the owner of the assets in the trust for tax purposes.

Each U.S. person treated as an owner of any portion of the foreign trust is responsible for ensuring that foreign trust files Form 3520-A and furnishes the required annual statements to the U.S. Owner and U.S. Beneficiaries.

**Due Date:** Form 3520-A as well as the Foreign Grantor Trust Owner Statement and the Foreign Grantor Trust Beneficiary Statements are filed with the IRS by the 15<sup>th</sup> day of the 3<sup>rd</sup> month after the end of the trust’s tax year - which is March 15 for calendar year taxpayers. The Foreign Grantor Trust Owner Statement and Beneficiary Statement must also be supplied to the U.S. Owners and U.S. Beneficiaries for inclusion in their personal tax returns.

Extensions may be granted. For extension, file form 7004 Application for Automatic Extension of Time to File Certain Business Income Tax, Information and Other Returns

**Penalty:** Penalty applies if failed to file a timely Form 3520-A or if all required information is not furnished. The U.S. owner is subject to a penalty equal to 5% of the gross value of the portion of the trust’s assets treated as owned by the U.S. person at the close of that year. Additional penalties may be imposed if noncompliance continues after the IRS mails a notice of failure to comply with required reporting.

Criminal penalties may be imposed for a willful failure to file on time or for filing a false or fraudulent return.

**Reasonable Cause:** No penalties will be imposed if the taxpayer can demonstrate that the failure to comply was due to reasonable cause and not willful neglect.

**What to Watch For:**

Authorized Agent – The Trust needs to Authorize a US Agent, the US grantor, US Beneficiary or a domestic corporation controlled by the grantor or beneficiary may act as US agent.

The format of the authorization is on the Instruction for this form – If no authorized agent is named, then you will need to provide with Form 3520-A a summary of all written and oral agreements and understandings relating to the trust, a copy of all the trust documents and any revisions.

Disclosures: Make sure that all disclosures are included with filing. Such as a Trust transferring property to any other person during tax year is required to provide detailed disclosure on transfers – Specific directions can be found on instructions for this form.

Income Statement: Include all income from US and non-US sources

Foreign Trust Balance Sheet – All assets and liabilities of the trust including any portion that is not treated as owned by a US person must be reflected.

The Trust's Balance Sheet – must reflect Fair Market Value.

**Form 3520 - Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts**

Filed by the responsible party for reporting a reportable event (i.e. contribution to a Foreign Trust) that occurred during the current tax year or you held an outstanding obligation of a related foreign trust.

Also, file by the following:

- An US person who during the current tax year is treated as the owner of any part of the assets of a foreign trust under the grantor trust rules
- An US person who received (directly or indirectly) a distribution from a foreign trust, or a related foreign trust held an outstanding obligation issued by you that you've treated as a qualified obligation
- An US person who received:

More than \$100,000 from a nonresident alien individual or a foreign estate that you treated as a gift or bequest or

More than \$13,561 from foreign corporations or foreign partnerships that you treated as gifts (This changes each year because of inflation.)

**Due Date:** Form is due on the date that your income tax return is due, including extensions.

**Penalty:** Penalty applies if Form 3520 is not timely filed or if the information is incomplete or incorrect. Generally, the penalty is:

- 35% of the gross value of any property transferred to a foreign trust for failure by a U.S. transferor to report the transfer,
- 35% of the of the gross value of the distribution received from a foreign trust for failure by a U.S. person to report receipt of a distribution, or
- 5% of the amount of certain foreign gifts for each month for which the failure to report continues (not to exceed a total of 25% of the gift).

Additional penalties may be imposed if noncompliance continues after the IRS notice of failure to comply is received. Penalty may not exceed the gross reportable amount.

**Reasonable Cause:** No penalties will be imposed if the taxpayer can demonstrate that the failure to comply was due to reasonable cause and not willful neglect.

**What to Watch For:**

Joint Returns – Two transferors or grantors of the same foreign trust, or two US Beneficiaries of the same foreign trust, may file a joint Form 3520, but only if they file a joint income tax return.

Attach a copy of the Foreign Grantor Trust Owner Statement from the Foreign Trust Form 3520

Authorized Agent – An Authorized Agent must be established by the time the US person files Form 3520.

**Foreign Disregarded Entity**

**Form 8832 - Entity Classification Election**

There is a procedure whereby taxpayers can check a box to elect how their foreign entity is to be taxed – whether as a corporation, as a foreign partnership or as a disregarded entity similar to a branch office.

Eligible entities include LLCs, partnerships, and any foreign entity that is not identified as a per se corporation. A per se corporation is one that is listed in the IRS regulations and on the instructions to Form 8832 as not being eligible to be treated differently.

(See Form 8832 for Foreign Entities Classified as Corporations for Federal Tax Purposes)

**Due Date:** Election cannot take effect more than 75 days prior to the date the election is filed, nor can it take effect later than 12 months after the date the election is filed. This usually means that the election must be made no later than 75 days after the formation of the foreign entity.

**Late Election Relief:** Entity may be eligible for late election relief: If the Entity failed to obtain its desired classification solely because Form 8832 was not timely filed, the due date for the entity's desired classification tax return (**excluding extensions**) for the tax year beginning with the entity's formation date has not passed and the entity has reasonable cause for its failure to make a timely election.

**What to Watch For:**

Form 8832 needs to be attached to the entities federal tax return for the tax year of the election.

**Form 8858 - Information Return of US Persons With Respect to Foreign Disregarded Entities (FDE)**

This form is filed by:

- US persons that are tax owners of FDEs or that own certain interests in foreign tax owner of FDEs (i.e. a person or company that owns a controlling interest in another company that owns a FDE.)
- Certain US Persons that are required to file Form 5471 (CFC) that is a tax owner of an FDE

- Certain US Persons that are required to file Form 8865 (CFP) that is a tax owner of the FDE

**Due Date:** Due when your income tax return or information return is due, including extensions.

**Penalty:** A \$10,000 penalty is imposed for each annual accounting period for failure to furnish the required information. Any person who fails to file or report all of the information required will be subject to a reduction of 10% of the foreign taxes available for credit. Criminal Penalties may apply for a willful failure to file the information required.

**What to Watch For:**

**Attachments:** Must attach an organizational chart that includes the chain of ownership between the tax owner and the FDE and the chain of ownership between the FDE and all entities in which the FDE has a 10% or more direct or indirect interest. Also, you must provide the name and % ownership, tax identification number of all entities and the country under whose law each entity is organized.

Amounts are reported in functional currency and then translated into US dollars in accordance with US GAAP.

Foreign book income or (loss) must conform to US GAAP and to US tax accounting principles. Adjustments to book income may include: Capital Gains and Losses, Depreciation, amortization, Investments, charges to statutory reserves, inventory adjustments and taxes.

Schedule M - Must be included if there are transactions between FDE of a Foreign tax owner and the Filer, or Other Related Entities.

**Form 8865 - Return of U.S. Persons With Respect to Certain Foreign Partnerships (CFP)**

This form is filed by:

- US person who controlled more than 50% interest
- US Person who owned a 10% or greater interest (in some cases).
- US Person who contributed property in exchange for an interest in the partnership
- US person that had a reportable event during tax year (i.e. acquisitions, dispositions and changes in proportional interests).

**Due Date:** Form 8865 is due with your income tax return, or if applicable, partnership or exempt organization return, including extensions for that return.

**Penalty:** A \$10,000 penalty is imposed for each tax year of each foreign partnership for failure to furnish the required information. An additional \$10,000 is added for each month the failure continues after notification up to a maximum of \$50,000 per return. Any person who fails to file or report all of the information required will be subject to a reduction of 10% of the foreign taxes available for credit. Criminal Penalties may apply for a willful failure to file or for filing false or fraudulent information.

**What to Watch For:**

Ownership % and how it affects the owner's filing requirements.

Constructive ownership or ownership by attribution – i.e. certain relatives

All amounts must be stated in US dollars. Exchange Rate – must be reported using the “divide- by convention”.

Schedule K-1 reports must be provided to each Partner so that they can include the information in their personal tax returns.

**Foreign Corporation****Form 5471 – Information Return of U.S. Persons With Respect to Certain Foreign Corporations (CFC)**

This form is filed by US citizen and residents who are officers, directors, or shareholders in certain foreign corporations. Generally, US persons who own – directly or indirectly – more than 50% of the stock of a foreign corporation are required to file, but anyone who owns more than 10% of a foreign corporation should study the filing requirements.

**Due Date:** Form 5471 is due with your income tax return or, if applicable, partnership or exempt organization return, including extension for that return.

**Penalty:** For failure to file a \$10,000 penalty is imposed for each annual accounting period of each foreign corporation. An additional \$10,000 is added for each month the failure continues after notification with a maximum of \$50,000 per return. Any person who fails to file or report all of the information required will be subject to a reduction of 10% of the foreign taxes available for credit. Criminal Penalties may apply for willful failure to file the information required.

**What to Watch For:**

Categories of Filers: Be sure to carefully determine which categories apply. Be sure to include not only the required forms but to also include any additional statements, schedules or other disclosures that are required.

Foreign Books must conform to US GAAP and to US Tax accounting principles.

Dormant Foreign Corporations: Summary filing for Corporation that has less than \$5,000 of income AND less than \$5,000 of expenses AND less than \$100,000 of gross assets.

**Form 926 - Return by a U.S. Transferor of Property to a Foreign Corporation**

This form is used to report certain transfers of tangible and intangible property to a foreign corporation. Filed by a US citizen or resident, a domestic corporation, or a domestic estate or trust must file to report certain transfers of property to a foreign corporation

**Due Date:** Form 926 must be filed with the U.S. transferor's income tax return for the tax year that includes the date of the transfer.

**Penalty:** For failure to file the penalty equals 10% of the fair market value of the property at the time of the transfer. Penalty is limited to \$100,000 unless the failure to comply was due to intentional disregard.

**Reasonable Cause:** The penalty will not apply if the failure to comply is due to reasonable cause and not willful neglect.

**What to Watch For:** Special Rules for Transfers by partnerships, transfers by a husband and wife, and transfers of cash.

There are certain exceptions to filing.

All amount on the form are reported in US Dollars

**Form 8621 - Return by a Shareholder of a Passive Foreign Investment Company (PFIC) or Qualified Electing Fund (QEF)**

This is filed by a US Person that is a direct or indirect shareholder of a PFIC who recognized gain on a direct or indirect disposition of PFIC stock, received certain direct or indirect distributions from a PFIC or makes an election to be taxed currently on the owner's share of the income or the gain in market price.

A foreign corporation is a PFIC if it meets either the income or the asset test. Income – 75% or more of the corporation's gross income for taxable year is passive income, or at least 50% of the average percentage of assets produce passive income or are held to produce passive income.

**Due Date:** Form 8621 is attached to the shareholder's tax return and due by the due date of the income tax return including extensions.

**What to Watch For:** Mark to Market Election - To make election the PFIC needs to be traded on a national securities exchange. Gains are recognized an ordinary and losses are limited to gains previously recognized.

QEF – Qualified Electing Fund – shareholder must report as income their pro rata share of the earnings and capital gains of the QEF for the taxable year. This election is only allowed if the PFIC complies with the IRS information disclosure requirements which allow the IRS to determine the PFIC's ordinary earnings and capital gains.

Default rule – Involves complex multi-year allocation of any gains (but not losses) that are taxed at the top tax rate in the rate brackets. For multiple year accumulations, this can turn into a very nasty trap.

**Conclusion:**

**What to Watch For:** What do all of the forms have in common? **PENALTIES**

- Penalties for not filing forms on a timely basis
- Penalties for failure to file the forms.
- Penalties for not reasonably disclosing all material information

**Non-compliance can be very costly.**

## **TAX ADVICE NOTICE**

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