

U.S. Tax Filings for Foreign Entities

PROFESSIONALS

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U.S. persons who directly, indirectly, or constructively own foreign entities are required to file special forms with the IRS. This filing requirement applies to all U.S. persons including U.S. individuals who are citizens or residents of the United States, U.S. corporations, U.S. partnerships, U.S. estates, and U.S. non-grantor trusts.

A Taxpayer's foreign filing requirements depend on the type of the foreign entity owned. For this purpose, foreign entities are classified into three different types: corporation, partnership, or disregarded entity. The filing requirements for these entity types are discussed below after the rules for determining ownership percentage in a foreign entity.

Please note that ownership in a foreign entity may implicate other foreign filing requirements not addressed below including but not limited to Forms 114, 8938, 3520, 3520-A, 5472, and 926. For example, ownership in a foreign entity is also considered to be ownership in a specified foreign financial asset that is reportable on Form 8938. Also, if you own more than 50% of a foreign entity, you may be required to report its foreign bank information on Form 114, commonly referred to as the Foreign Bank Account Report or "FBAR."

The penalty for failure to file these forms timely is generally \$10,000 per form, so it is very important that these filings are not overlooked. Additionally, failure to file these forms will hold open the statute of limitations on your entire tax return indefinitely. This gives the IRS the ability to audit your entire return at any time to make adjustments or to apply penalties. The IRS has programs for Taxpayers who have missed foreign filings on prior year's returns to help them become compliant.

Determining Ownership Percentage in a Foreign Entity

Foreign filing requirements apply to U.S. persons who own foreign entities directly, indirectly, and constructively. Taxpayers may be considered to own a foreign entity indirectly through another domestic or foreign entity. The Taxpayer's ownership is generally determined based on the proportionate share of ownership. For example, if a Taxpayer owns 80% of a U.S. partnership that owns 80% of a foreign corporation. The Taxpayer is considered to own 64% of the foreign corporation.

Taxpayers may also be considered to own a foreign entity constructively through another person such as a spouse, parent, child, or other family members depending on the circumstances. In other words, a taxpayer will generally be considered to own shares in a foreign corporation that is owned by a parent even if they have no direct ownership in the foreign corporation. Constructive ownership rules can also apply to attribute ownership from a partnership, corporation, estate, and trust to a taxpayer when determining foreign filing requirements.

Foreign Corporation

Passive Foreign Investment Company ("PFIC") – Form 8621

A PFIC generally is any foreign corporation if: (1) at least 75% of its gross income for the year is passive; or (2) at least 50% of the assets it held during the year produce passive income or are held for the production of passive income. Common types of passive income may include rent, royalty, dividends, and interest. PFICs are commonly found as investments in foreign mutual funds or owned through investment partnerships. Special rules apply to PFICs when they make distributions to U.S. persons or if a U.S. person sells an interest in a PFIC. The taxation of income related to PFIC stock is complex and generally punitive compared to regular rules.

In prior years, PFIC reporting was only required on Form 8621 when an election is made to treat the PFIC as a Qualified Electing Fund ("QEF"), a Mark-To-Market ("MTM") election was made, the PFIC made a distribution, or if PFIC stock was disposed. The IRS issued rules in December 2013 that require annual filing of Form 8621 for many direct and indirect shareholders of PFICs on Form 8621 beginning in the 2013 tax year for calendar year taxpayers. These rules significantly increase the Form 8621 filing requirements for Taxpayers who hold PFIC interests.

There currently is no penalty for failure to file the Form 8621; however, failure to file this form will hold open the statute of limitations on your entire tax return indefinitely.

Foreign Corporation that is not a PFIC- Form 5471

U.S. persons are generally required to file Form 5471 related to their ownership in a foreign corporation when their ownership exceeds 10%. To determine your ownership interest percentage in a foreign corporation, you need to consider your direct, indirect, and constructive ownership in the entity.

Extensive reporting on Form 5471 is required for Taxpayers with ownership in a foreign corporation that is a Controlled Foreign Corporation (“CFC”). A foreign corporation is considered to be a CFC if it is more than 50% owned by U.S. shareholders. U.S. shareholders are U.S. persons (U.S. citizens or residents, domestic partnerships, domestic corporations, or non-foreign estates or trusts) that own 10% or more of the stock of a foreign corporation by vote or value.

The information required to be reported on Form 5471 depends on whether the foreign corporation is a CFC and the Taxpayer’s ownership percentage in the CFC. A Taxpayer with control (>50% ownership) over a CFC, is generally required to report all financial information related to the foreign corporation including an income statement, balance sheet, related party transactions, and information on the purchase and sale of the entity. A \$10,000 penalty per Form 5471 may be imposed for every year the Taxpayer fails to furnish the required information by the due date of the tax return.

Foreign Partnership – Form 8865

U.S. persons are generally required to file Form 8865 related to their ownership in a foreign partnership when their ownership exceeds 10%. A 10% interest in the foreign partnership is considered an interest in 10% of the capital, profits, or deductions or losses of the partnership. To determine your ownership interest percentage in a foreign partnership, you need to consider your direct, indirect, and constructive ownership in the entity.

Extensive reporting on Form 8865 is required for Taxpayers with ownership in a foreign partnership that is a Controlled Foreign Partnership (“CFP”). A foreign partnership is considered to be a CFP if it is owned than 50% owned by U.S. persons. A U.S. person is considered U.S. citizens or residents, domestic partnerships, domestic corporations, or non-foreign estates or trusts.

The information required to be reported on Form 8865 depends on whether the foreign partnership is a CFP and the Taxpayer’s ownership percentage in the CFP. A Taxpayer with control (>50% ownership) in a CFP, is generally required to report all financial information related to the foreign partnership including an ownership affiliation schedule, income statement, computation of partners’ distributive share items, balance sheet, analysis of partners’ capital accounts, related party transactions, and information on the purchase and sale of the entity. A \$10,000 penalty per Form 8865 may be imposed for every year the Taxpayer fails to furnish the required information by the due date of the tax return.

Foreign Disregarded Entity (“DRE”) – Form 8858

A foreign disregarded entity or “DRE” exists when a Taxpayer makes an election to treat a foreign entity with a single owner as disregarded from its owner (i.e., a branch) for U.S. tax purposes. The election is commonly referred to as a “check-the-box election” and is made on Form 8832.

U.S. persons are generally required to file Form 8858 related to their direct ownership in a DRE. To determine if you have ownership of a DRE, you need to consider your direct, indirect, and constructive ownership in the DRE. For example, if you own CFC or CFP that owns a DRE, then you will be required to file Form 8858 for the DRE, as well as the Form 5471 for the CFC or Form 8865 for the CFP. A \$10,000 penalty per Form 8858 may be imposed for every year the Taxpayer fails to furnish the required information by the due date of the tax return.

Conclusion

U.S. persons with ownership in foreign entities should determine their U.S. tax foreign filing requirements or be ready to face steep penalties. If you have any questions about U.S. filing requirements for foreign entities please contact Curt Giles (curt.giles@hcv.com or 714-361-7670) or Michele Carter (michele.carter@hcv.com or 714-361-7627) for a consultation.