IRS/Panama Papers: US Tax Compliance & Foreign Entities

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IRS/Panama Papers: US Tax Compliance & Foreign Entities

The Panama Papers revealed up to 3000 US taxpayers with offshore accounts held through foreign entities for purposes of anonymity. If the foreign entities were used for tax evasion or money laundering the US taxpayer may be subject to multiple felonies for tax evasion (i.e. tax crimes) and if the funds were wired (or interstate telephones were used) or mailed, two additional 20-year felonies for wire fraud and mail fraud may be subject of US Dept. of Justice criminal prosecution.

Whether or not the offshore accounts if held through shell companies with nominee officers, directors or nominee shareholders are subject to criminal tax evasion or other felonies is a different issue from the extensive US tax compliance required for foreign corporations or partnerships that are more that 50% owned by US persons.

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.

Tax Compliance: Controlled Foreign Corporation

The Internal Revenue Code limits tax-deferral on foreign-based income realized by U.S. shareholders of foreign corporations. Undistributed foreign corporation income is taxed either annually, or upon investment sale.

There are two primary anti-tax deferral regimes: Controlled Foreign Corporation ("CFC") and Passive Foreign Investment Company ("PFIC"), the CFC rules control.

Controlled Foreign Corporation ("CFC") Annual Tax

U.S. shareholder pays annual income tax on pro-rata share of CFC's income, and files IRS Form 5471.

A U.S. shareholder of a foreign corporation, that is a "controlled foreign corporation" (CFC) for an uninterrupted period of 30 days or more during the tax year, and is a shareholder on the last day of the CFC's tax year, must include in gross income its proportionate share of the CFC's "Subpart F income" (whether distributed or not) (IRC Sec. 951).

A CFC's Subpart F income is limited for any tax year to its total earnings and profits for that year. The income is treated as a deemed dividend.

A foreign corporation is a CFC if more than 50 percent of its total voting power or value is owned by U.S. shareholders (IRC Sec. 957). A "U.S. shareholder" is any U.S. person (citizen, resident, domestic corporation, partnership, estate or trust) that owns 10 percent or more of the total combined voting power of the foreign corporation. Ownership may be direct, indirect, or constructive with certain exceptions (IRC Sec. 958).

The U.S. shareholders of a CFC are taxed on earnings, which are undistributed, if the CFC earns "tainted income", (i.e., subpart F Foreign Base Company Income). CFC subpart F income is the sum of the corporation's insurance income, foreign base company income, boycott income, illegal payments and income from countries not diplomatically recognized by the U.S. government (IRC Sec. 952).

CFC income does not include income from sources within the U.S. that is effectively connected with the conduct of a trade or business by the corporation in the United States, unless that income is exempt from tax or taxed at a reduced rate pursuant to a treaty.

Subpart F income is limited to the CFC's total earnings and profits for that year, and may be reduced in certain circumstances to accumulated deficits of earnings and profits.

Foreign Base income of a CFC is made up of income from foreign personal holding company (FPHC) and foreign base company sales, services and oil-related income (IRC Sec. 954).

FPHC income is the major component of foreign base income. FPHC income includes: dividends, interest (including otherwise tax-exempt interest), rents, royalties and annuities.

FPHC income does not include rents and royalties from an active trade or business.

Tainted CFC Income attributed to U.S. shareholders includes:

1. Foreign Personal Holding Company Income (IRC Sec. 954(c)): dividends, interest, royalties and other types of passive income, including gains from stock and commodity sale.

2. Foreign Base Company Sales Income: (IRC Sec. 954(d)(3)); i.e. sale of personal property sold for use outside the CFC's country of incorporation.

3. Foreign Base Company Services Income: (IRC Sec. 954(c)): income from the performance of technical, managerial, engineering or commercial services performed outside the CFC's country of incorporation for a related person.

4. Foreign Base Company Income includes: shipping and oil-related income.

5. Increase in Earnings Invested in U.S. Property: Excess of CFC earnings invested in U.S. property at year end, over earnings so invested at the beginning of the year (IRC Sec. 956).

Regarding FHPC Income, the sale of a partnership interest by a CFC is treated as a sale of the proportionate share of partnership assets attributable to that interest (including subpart F income).

U.S. shareholders of a CFC are taxed on their pro-rata share of the CFC's earnings which are invested in U.S. property during the tax year and which are not distributed or otherwise taxed (IRC Sec. 956). The amount of earnings invested in U.S. property is a "dividend deemed paid" to the corporation's U.S. shareholder. U.S. property includes: tangible real or personal property located in the U.S., stock of domestic corporations, obligations of U.S. persons, and the right to use a patent, copyright or invention in the U.S.

If a U.S. shareholder sells CFC stock, recognized gain will be included in taxpayer's gross income as an ordinary dividend to the extent of the foreign corporation's earnings and profits allocable to the stock (IRC Sec. 1248). Any gain exceeding the CFC's earnings and profits is treated as capital gain. The shareholder may claim a foreign tax credit for the taxes the CFC paid on the income.

Every U.S. person (i.e. taxpayer) who is a U.S. shareholder of a CFC must file an annual Form 5471 (IRC Sec. 6038) or be subject to penalties and a reduced foreign tax credit.

CFC investments in U.S. property include: tangible property, stock of a domestic corporation an obligation of a U.S. person.

Investments not included: U.S. bonds, U.S. bank deposits, debts arising in the ordinary course of business from the sale of property.

"Repatriated" earnings of offshore corporation will be deemed taxable subpart F income.

To prevent double taxation, the basis of the U.S. shareholder’s CFC stock, (and basis in property the shareholder is considered owning through the CFC), is increased by the amount of subpart F income required to be included in income and decreased by any distribution that is excluded from income (IRC Sec. 961).

A U.S. shareholder of a CFC that is a domestic corporation is allowed a foreign tax credit for any foreign taxes paid (or deemed paid) by the CFC for income that is attributed or distributed to it as a U.S. shareholder (IRC Sec. 960).

Effective for tax years beginning after December 31, 2010, the credit is limited to taxes that would have been deemed paid if the foreign corporation had made an actual distribution to the domestic corporation.

A “deemed-paid’ credit is available to any individual U.S. shareholder who elects to be taxed at domestic corporate rates on amounts included in gross income (IRC Sec. 962).