

*Presenting a live 110-minute teleconference with interactive Q&A*

## Outbound Transactions and U.S. Federal Tax

Tackling Compliance Challenges for U.S. Companies With  
Foreign-Based Income or Business Relationships

TUESDAY, JANUARY 15, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Christopher Karachale, Senior Counsel, **HansonBridgett**, San Francisco

Melinda Fellner Bramwit, Member, **Norris McLaughlin & Marcus**, Bridgewater, N.J.

Vinay Navani, Shareholder, **Wilkin & Guttenplan**, East Brunswick, N.J.

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# Outbound Transactions and U.S. Federal Tax Seminar

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Jan. 15, 2013

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Melinda Fellner Bramwit, Norris McLaughlin &  
Marcus  
[mfbramwit@nmmlaw.com](mailto:mfbramwit@nmmlaw.com)

Vinay Navani, Wilkin & Guttenplan  
[vnavani@wgcpas.com](mailto:vnavani@wgcpas.com)

Christopher Karachale, HansonBridgett  
[ckarachale@hansonbridgett.com](mailto:ckarachale@hansonbridgett.com)

# Today's Program

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Overview Of Key Concepts  
*[Melinda Fellner Bramwit]*

Slide 8 - Slide 36

Issues To Anticipate With Specific U.S. Forms And Schedules  
*[Melinda Fellner Bramwit, Vinay Navani and Christopher Karachale]*

Slide 37 - Slide 81

Using Voluntary Compliance To Correct These Forms  
*[Melinda Fellner Bramwit, Vinay Navani and Christopher Karachale]*

Slide 82 - Slide 84

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Melinda Fellner Bramwit, Norris McLaughlin & Marcus

# **OVERVIEW OF KEY CONCEPTS**

# Reorganizations, Asset Transfers And Collateral Rules

- Myriad of rules governing outbound transactions which take us out of the rules of subchapter C
- Outline of basic issues to be aware of when dealing with an outbound asset or stock deal, which come up from a practical perspective and which tie into the compliance piece we will discuss later on in the program

# Key Concepts

1. Outbound stock and asset transfers and the world of Sect. 367
2. Anti-inversion rules
3. Choice of entity
4. U.S. taxing of income, foreign tax credit availability, treaty applicability
5. CFCs, Subpart F and PFICs

# Subchapter C Basics

- Sect. 332: Liquidation of corporate subsidiary
- Sect. 351: Transfer to controlled corporation
- Sect. 355: Spin-offs
- Sect. 368: Reorganizations

# What Does Sect. 367 Do To These Provisions?

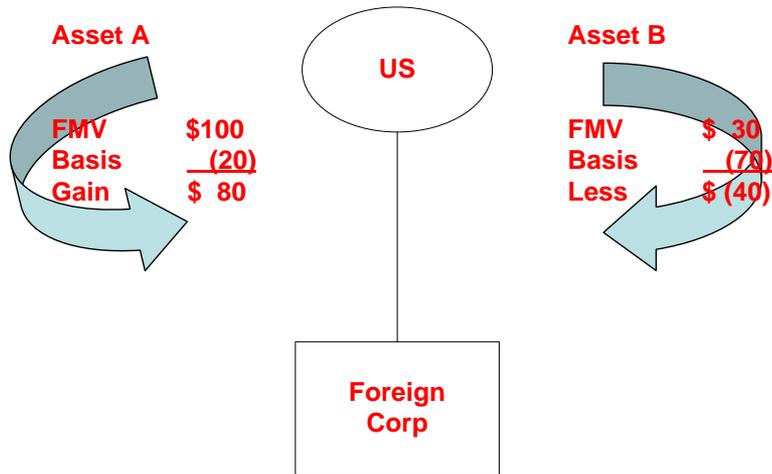
- General rule of 367(a)(1) provides that gain (but not loss) is triggered upon:
  - A transfer of property, by a U.S. person to a foreign corporation in a tax-free exchange under sections 332, 351, 354, 356 or 361
  - Note: “No loss” – no netting

## Sect. 367

- We need a U.S. person as the transferor.  
Define – include rules for partnership
- We need a transfer of property to a foreign corporation. Any transaction that is a 332, 351, 354, 355, 356 or 361 is a transfer for these purposes, and any property that is property for these code section purposes is property.
- Also triggered by outbound transfer of partnership interest - aggregate approach

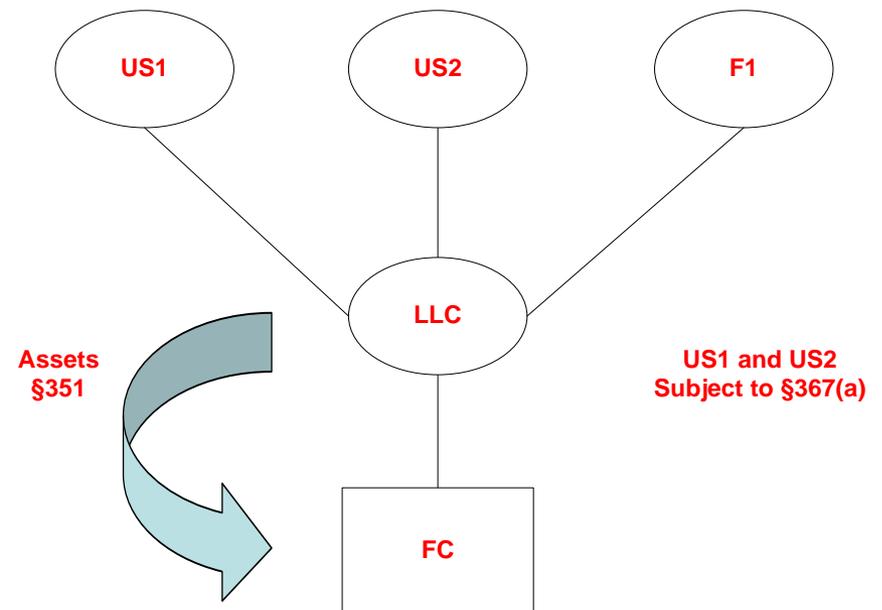
# Examples

## Recognition of Gain, But Not Loss (No Netting)



- US recognizes \$80 of gain, with no offset for unrecognized loss
- Consider taxable alternatives, e.g., sale for note if US already owns FC

## Indirect Transfer – Transfer by Partnership



# What Is Effect Of 367(a)?

- Recognition of gain with respect to transactions that would otherwise be tax-free
- Character and source are determined as if assets had been sold in a taxable transaction - no loss recognition
- Individuals and LTCG rates (fiscal cliff developments)

# Exceptions To 367(a)(1)

- Active trade or business outside the U.S. - 367(a)(3)
  - Exception for rule of automatic gain recognition, when assets are used in active trade or business outside the U.S.
    - Certain tainted assets do not qualify.
    - Strict tests, examples and notes

# Exceptions To 367(a)(1), Cont.

- Exchange of stock or securities – target is foreign - not taxable to shareholders whose ownership is less than 5% of the transferee; if greater than 5%, must enter into a gain recognition agreement or taxable
- If target is domestic, exchange is generally taxable, subject to certain rules.
- Description of gain recognition agreement

# Outbound Transfers Of Intangible Property - 367(d)

- Touch on this briefly because it is an important issue with outbound reorganizations, though not big compliance piece. This can occur in connection with a 351
- General rule

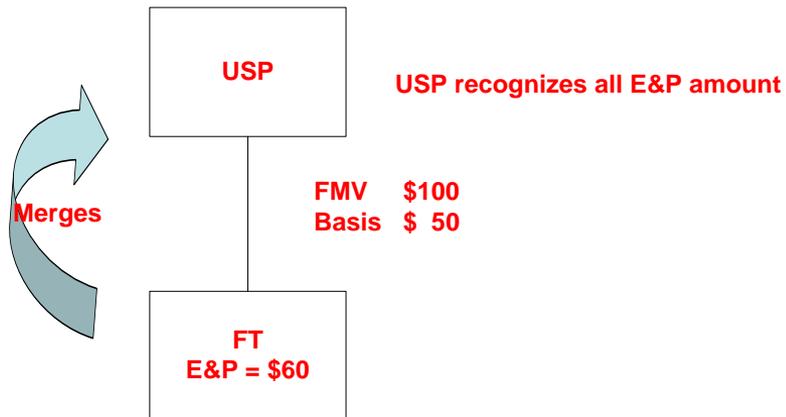
## Sect. 367(b)

- Inbound transfers, foreign to foreign transfers and certain spinoffs
- Full discussion of 367(b) beyond the scope of this presentation
- Relevant in certain inbound non-recognition transactions (332 and A C D or F reorganizations), as well as foreign-to-foreign reorganizations and 351 and spin-offs
- If you are within 367(b), what would be a non-recognition transaction triggers gain, depending on the transaction.

# 367(b) Issues

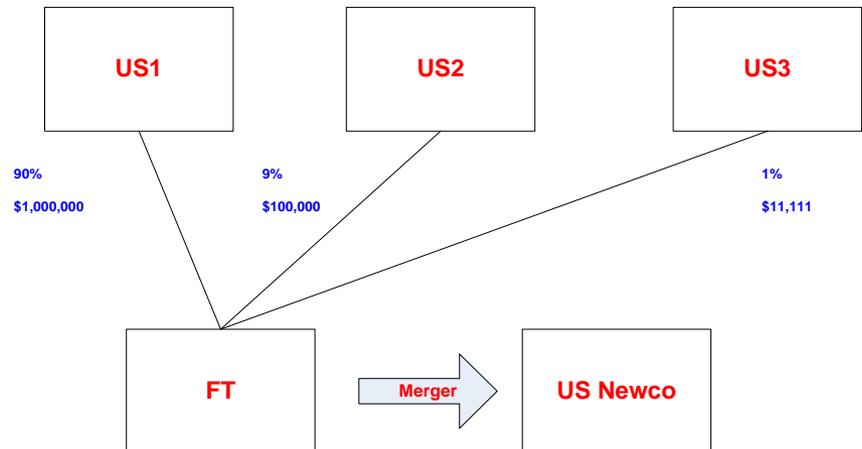
## Inbound Nonrecognition Transactions - 10% U.S. Shareholders

- 10% U.S. shareholders include all E&P amount
  - All E&P attributable to shares disposed of (excluding subs)
  - Not limited to \$1248 amount
  - Treated as deemed dividend
- Inclusion also required for FC with 10% U.S. shareholders



## Inbound Nonrecognition Transactions - Less Than 10% U.S. Shareholders

US2 Recognizes Gain (or elects all E&P); US3 Exempt



# 367(b) Transactions

- For our purposes, what is important is that certain of these transactions affect shareholders of controlled foreign corporations and may affect the reporting requirements we will discuss.

# Anti-Inversion Rules

- What is an inversion?
  - In a typical inversion, you have a new Foreignco that acquires a domestic entity. Owners of the domestic entity exchange their domestic stock for stock of the new Foreignco.
  - In 2004, Congress added Sect. 7874 to fight the perceived abuse at play here of inverting the U.S. company into the foreign company, to escape U.S. tax.

# 7874 Inversions

- Final regulations on this, issued on June 7, 2012, essentially finalize the temporary and proposed regulations from 2009, with minor changes.
- Regulations carry out the intent of Sect. 7874 by operating to prevent these transactions, by taxing the “inversion gain” or treating the foreign acquirer as a domestic acquirer, for U.S. income tax purposes (“surrogate foreign corporation”).
- 7874 applies, generally, if pursuant to a plan or related transaction, (a) a foreign corporation acquires substantially all the assets of a U.S. entity, (b) the former owners of the U.S. entity hold at least 60% (vote or value) of the stock of foreign corporation after the deal and (c) the expanded affiliated group that includes the foreign acquirer does not have substantial business activities in the foreign country where it is incorporated.

# Choice Of Entity

- For foreign entities, determining what they are for U.S. tax purposes is critical.
- Why? Same reasons as entity is important for U.S. entities - corporation vs. partnership etc.
- Check-the-box regulations contain a “per se” list in 301.7701-2(b)(8) of certain foreign entities that will automatically be treated as corporations for U.S. tax purposes, subject to some exceptions.

# Choice Of Entity (Cont.)

- After *per se* list, query becomes: Are you a corporation by default - old rules?
- Have you checked the box to be treated as a corporation (Form 8832, which we will address later)?
- Are you a non-*per se* corporation, so that you are a foreign partnership? Two or more members? Have you checked the box?

# Choice Of Entity (Cont.)

- Check-the-box entity
  - Elected out of your default classification
- Foreign trust
- Foreign estate
- All have complex reporting requirements that we will discuss.

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# U.S. Taxing Of Income; Foreign Tax Credit Availability Treaty Applicability

- The U.S. taxes citizens/residents on “worldwide income.”
- How does the U.S. tax foreign persons?
  - Generally not taxed in U.S., subject to five exceptions
  - ECI, FDAP, branch profits tax, net capital gains, and dispositions of U.S. real property interests

# U.S. Shareholders: Foreign Corporations Earning Income Outside U.S.

- Foreign corporation is generally not subject to U.S. tax on its income (subject to the preceding five exceptions)
- U.S. shareholder is not subject to U.S. tax on the income of the foreign corporation, until the corporation pays a dividend or shareholder sells the stock.

# U.S. Mechanism For Avoiding Double-Tax: FTC

- FTC- foreign tax credit
- U.S. gives a credit against U.S. income tax liability for foreign tax paid by U.S. taxpayers.
- Direct foreign taxes or deemed-paid foreign taxes
- Only certain taxes are eligible for this credit - based on net income.

# Deemed-Paid Foreign Tax

- In general, the U.S. corporation is deemed to have paid some of the foreign tax paid by a 10% foreign, subject to ownership percentages.

# Treaties

- Treaties help - can't hurt taxpayer position
- Operate to reduce or eliminate the U.S. tax that could be imposed
- To avail yourself of treaty benefits, a taxpayer must reside in the other country and must also meet the limitation-on-benefits provision that most treaties have.

# CFCs And PFICs

- At the outset, we addressed transactions that can create possible reporting issues.
  - I.e., outbound asset transfers and stock transfers
- But, what is the treatment of these newfound foreign entities, for U.S. purposes?
- We just discussed that certain foreign corporations that don't have ECI, FDAP and other types of income may not be taxed.
- However, the U.S. has adopted certain anti-deferral provisions that specifically apply when U.S. shareholders may put a foreign corporation in a jurisdiction with low tax rates solely to earn and retain income there.

# CFCs

- In general, certain types of income of a controlled foreign corporation (CFC) are includible in the income of the U.S. shareholder in the year earned.
- Prevent deferral abroad
- Define CFC
- Define U.S. shareholder

## CFC (Cont.)

- A U.S. shareholder of a CFC includes in gross income its pro rata share of Subpart F income, previously excluded Subpart F income withdrawn from lesser developed countries, previously excluded Subpart F income withdrawn from shipping operations, and any increase in earnings invested in U.S. property
- Must be U.S. shareholder on last day of taxable year of CFC

# PFICs

- What are they?
- Foreign corporation that meets either the passive income or passive assets test
- What happens if you are a PFIC?
- Taxed under one of three possible regimes

Melinda Fellner Bramwit, Norris McLaughlin & Marcus  
Vinay Navani, Wilkin & Guttenplan  
Christopher Karachale, HansonBridgett

# **ISSUES TO ANTICIPATE WITH SPECIFIC U.S. FORMS AND SCHEDULES**

Information return of U.S. persons with respect to certain foreign corporations

# FORM 5471

# Form 5471 Hot Issues

- Category of filer
- Who must file
- Year end of reporting corporation
- Reporting on U.S. GAAP basis
- CFC reporting issues
- Related party transactions
- Capital changes

# Category Of Filer

- Category 1: Not applicable
- Category 2: U.S. officer/director who owns  $\geq 10\%$
- Category 3: U.S. person who acquires in current year 10% or disposes in the current year of 10%
- Category 4: U.S. person who had control for 30 days or more
- Category 5: Foreign corporation that is a CFC

# Who Must File

- Multiple people can have same Form 5471 requirement.
- Can file on behalf of others on Page 1, Part D
- Recipients need to attach statement to their return.

# Year-End Of Reporting Corporation

- Generally, IRC §898
- Applies to CFCs
- Usually relates to year-end of majority U.S. owner
- May be different from tax year of taxpayer filing Form 5471

# Reporting Issues

- Schedule C: Income statement on U.S. GAAP basis
- Schedule F: Balance sheet on U.S. GAAP basis
- Schedule H: E&P starts with income per foreign books of account
- Schedule H: Adjustments made to get to U.S. E&P basis

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# Reporting Issues: Subpart F/Earnings And Profits

- Current Subpart F income reported on Schedule I
  - Computed on worksheet found in instructions
- Accumulated earnings and profits are reported on Schedule J.
  - Make sure E&P rolls year by year
  - Ending E&P is important, as it determines the extent of a taxable dividend.

# Related Party Transactions

- Reported on Schedule M
- Broad range of related parties
- Transfer pricing concerns?

# Capital Changes

- Reported on Schedule O
  - Acquisition
  - Disposition
  - Reorganization
  - Chain-of-ownership chart

Return by a U.S. transferor of property to a foreign corporation

# FORM 926

# Form 926, Generally

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- Form 926 is a tax reporting form to be filed by certain U.S. transferors of tangible and intangible property to foreign corporations.
- Statutory and regulatory framework
  - Any U.S. person making a transfer described in IRC 6038B(a)(1)(A), 367(d) or 367(e) must supply the required information on Form 926. Treas. Reg. 1.6038-1(b)
  - What this means in practice: The IRS wants taxpayers to report transfers that might avoid the IRC 367 net, even if those transfers do not give rise to a taxable transaction.

# Types Of Transfers Reportable On Form 926

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- **Transfers of cash to a foreign corporation:** If the transferor holds least 10% of the total voting power or the total value of the foreign corporation; or the amount of cash transferred by the transferor during the 12-month period ending on the date of the transfer exceeds \$100,000. Statutory and regulatory framework
- **Transfers of stock, securities to a foreign corporation:** If, generally, the transfer is made pursuant to a non-recognition transaction (IRC 351, 354, 356, 361)
- **Certain spin-offs under IRC 355:** If a U.S. corporation distributes stock or securities of a CFC to non-U.S. persons
- **Certain liquidations under IRC 332:** If a U.S. corporate subsidiary liquidates into a foreign corporate parent, then the liquidating U.S. corporate must complete portions of Form 926.
- **Transfers of other tangible and intangible property**

# General Exceptions From Form 926 Filing Requirement

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- U.S. person transfers stock or securities to a foreign corporation and owns *less than* 5% of the transferee foreign corporation.
- U.S. person transfers stock or securities, owns *more than* 5% of transferee foreign corporation *and recognizes gain* with respect to the transferred stock (immediately or through a gain recognition agreement).
- U.S. person exchanges stock in a foreign corporation pursuant to a reorganization under IRC 368(a)(1)(E).
- U.S. person exchanges stock in a domestic or foreign corporation for stock in another foreign corporation pursuant to an asset reorganization - provided there is no indirect stock transfer under Treas. Reg. 1.367(a)-3(d).

# Special Observations Regarding Form 926

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## Partnerships and S corporations:

- Treas. Reg. 1.367(a)-1T(c)(3) provides that when a partnership transfers property to a foreign corporation, the *partners*, not the partnership, are treated as proportionate transferors. Each partner must file a Form 926.
- Legal Advice 2008-006 provides that individual partner filings are required even if the partnership is a TERFA partnership.
- Compare forms 5471 when a partnership can file on behalf of partners.
- S corps and trusts file Form 926 (not shareholders or beneficiaries).

# Penalties For Failure To File Form 926

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If a person fails to file a Form 926 regarding some or all of the property transferred, then:

- The active conduct of trade or business exception does not apply and gain must be recognized.
- The U.S. person must pay a penalty equal to 10% of the FMV of the property on the date of transfer, not to exceed \$100,000, unless the failure was due to intentional disregard.

## Reasonable cause exception

- Penalties do not apply if the transferor can demonstrate that the failure to comply was due to reasonable cause.
- But, see FSA 2001322029, in which the IRS determined a domestic parent company failed to exercise ordinary business care and prudence despite the fact that (1) it received written advice that the transaction was not taxable, (2) the company's CFO became ill, (3) there was confusion about which year to report the transaction, and (4) the company later filed the required Form 926.

# Procedural Issues For Form 926

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- The Form 926 is part of a taxpayer's return, not a separate filing like the FBAR.
- Consider state reporting Issues: Cal Rev. & Tax Code 19141.5 incorporates the IRC 6038B disclosure requirements into California law.
- Remember that the Form 926 is just a reporting form. It does not show tax liability. **But, be careful:** The information return reports basis, gain and other information that may affect the actual tax return.
- As an information return, consider over-disclosing if you have doubts about whether the form needs to be filed.

# Form 926, Current Issues: I

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The Foreign Account Tax Compliance Act (FATCA) affects the penalties and statute of limitations for Forms 926 beginning March 2010.

- IRC 6662(j) provides a penalty of 40% on underpayment of tax attributable to a transaction involving an undisclosed financial asset that should have been reported on a Form 926 pursuant to IRC 6038B.
- IRC 6501(c)(8) effectively tolls the statute of limitations for the entire tax return, if a taxpayer fails to include a Form. See IRS CCA 201147030 (Aug. 22, 2011). However, a reasonable cause exception is available. See IRC 6501(c)(8)(B)
- Form 8938: Individuals must now report ownership interest in stock issued by a foreign corporation.

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# Form 926 Current Issues: II

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## Voluntary disclosure

- Form 926 listed as one of the forms for which penalties can be avoided, if a taxpayer enters a program. FAQ 5 of the 2012 FAQs. If a taxpayer has unreported income, it can presumably go into the 2012 OVDP, pay the penalty and correct delinquent Form 926 filings.
- As an information reporting form, it may be possible to cleanse failures to file forms 926 with a FAQ 18 disclosure.

Return of U.S. persons with respect to certain foreign partnerships

# FORM 8865

# Form 8865

- Foreign partnership – partnership not created or organized under the laws of the U.S. or any state
- Usually, U.S. partner files Form 8865 unless:
  - Foreign partnership has ECI or gross income from U.S. sources => file Form 1065 instead
  - Certain exceptions apply
- Basic Subchapter K concepts and partner level reporting apply to foreign partnerships as well.

# Form 8865 Filing Categories

- Category 1: U.S. person who owns  $> 50\%$  of partnership; can be more than one Category 1 filer
- Category 2: U.S. person owns  $\geq 10\%$  of the partnership, and partnership was controlled by U.S. persons each owning at least a 10% interest.

# Form 8865 Filing Categories (Cont.)

- Category 3: U.S. person who contributes property in a §721 transaction and owns at least 10% partnership interest or contributes > \$100,000 of capital
- Category 4: U.S. person who (1) acquires 10% or more of partnership, (2) disposes 10% or more of partnership, or (3) undergoes change in proportional interest equivalent to 10% of partnership.

# Form 8865: Accounting Period

- Accounting period
  - Reflect annual accounting period on Form 8865
  - Category 1 and 2 filers report information for the partnership's tax year, which ends with or within the U.S. partner's tax year.
  - Category 3 and 4 filer report transactions that occur during the U.S. partner's tax year.

# Form 8865: Schedule K-1

- Must prepare Schedule K-1s for:
  - Category 1 filer
  - Category 2 filer
- Note: Many foreign partnerships with U.S. partners provide partners with a Schedule K-1 for U.S. reporting; can be attached to Form 8865.

# Form 8865 (Cont.)

- Schedule B: Income statement
- Schedule K: Partners' distributive share items
- Schedule L: Balance sheet
- Schedule M-1: Reconciliation of income
- Schedule M-2: Analysis of partners' capital accounts
- Schedule K-1: Partner's share of income, deductions, credits, etc.

Substantially same as Form 1065

# Form 8865 (Cont.)

- Schedule O: Transfer of property to a foreign partnership
  - Comparable to Form 926
  - Required by Category 3 filers
- Schedule P: Acquisitions, dispositions and changes of interests in a foreign partnership
  - Reported by Category 4 filers to provide required information

# Form 8865 (Cont.)

- Schedule N: Transactions between controlled foreign partnership and partners or other related entities
  - Required for Category 1 and 2 filers
  - Broad range of related parties
  - Transfer pricing concerns

One-time dividends-received deduction for certain cash dividends from CFCs

# FORM 8895

# Form 8895, Generally

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Form 8895 was used by U.S. corporations to claim a one-time dividends-received reduction (DRD) equal to 85% of certain cash dividends received from their CFCs for accounting periods ending between October 2004 and October 2006.

- IRC 965, enacted as part of the American Jobs Creation Act of 2004, provided this temporary safe harbor to encourage U.S. corporations to repatriate their foreign earnings.
- The earnings repatriated through the DRD had to be reinvested in domestic activity pursuant to a written domestic reinvestment plan (DRIP), adopted prior to the payment of the dividend.

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# Form 8895, In Retrospect And Today

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- IRC 965 and Form 8858 were a boon to taxpayers. IRC 965 effectively allowed corporations to repatriate foreign earnings at a tax rate of 5.25% rather than 35%.
- The window for using IRC 965 (and the related Form 8858) is now closed. Congress may allow such “one-time” repatriation again; however, the American Taxpayer Relief Act of 2012 contained no such repatriation holiday.

Information return of U.S. persons with respect to  
foreign disregarded entities

# FORM 8858

# Form 8858, Generally

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Form 8858 is an information reporting form to be filed by U.S. direct and indirect owners of foreign disregarded entities (FDEs).

- An FDE is an entity that is (1) created or organized in a foreign jurisdiction, and (2) is disregarded as separate from its owner for U.S. income tax purposes under Treas. Reg. 301.7701-2 and -3.
- The Form 8858 must be filed by:
  - U.S. persons who directly own FDEs
  - U.S. persons who are required to file forms 5471 with respect to a CFC (category 4 and 5 filers), when the CFC is the tax owner of an FDE
  - U.S. persons who are required to file forms 8865 with respect to a CFP (category 1 and 2 filers), when the CFC is the tax owner of an FDE

# Particular Filing Considerations For Form 8858

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The Form 8858 includes a number of complicated sections:

- Schedule C-1 requires taxpayers to engage in complicated analysis of currency gain and loss under IRC 987, when the FDE uses a different functional currency from its owner.
- Schedule M is a separate schedule that must be included by certain Form 8858 filers (cf. Schedule O for Form 5471). Schedule M allows taxpayers to report the transactions that the FDE undertook during the tax year.
- For general information on the Form 8858, see IRS Announcement 2004-4

# Form 8858 Procedural Issues

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- A separate Form 8858 must be filed for each FDE.
- The Form 8858 is part of a taxpayer's return, not a separate information return like the FBAR.
- Parts of the Form 8858 are used to compute taxable income and E&P from FDEs; this information will flow through to the tax return.
- In the case of ownership through a CFC or a CFP, one person may file Form 8858 on behalf of other persons who have the same filing obligation.

# Penalties For Failure To File Form 8858

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- Penalties for failure to file Form 8858 are imported from penalties for failure to file Forms 5471 and 8865. See IRC 6038. There is a \$10,000 penalty per failure to timely file complete and accurate information on each Form 5471 or Form 8865, including forms 8858 for FDE.
- Reasonable cause exceptions to penalties for failure to file forms 5471 and 8865 exist and presumably would flow through to a failure to file a Form 8858.

# Current Issues For Form 8858

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- Effective Jan. 1, 2012, taxpayers that file Form 8865 (as well as forms 5471 and 8858) must provide a unique reference identification (URI) number for the foreign entity for which reporting is required, when no EIN is provided.
- A failure to file Form 8858, connected to unreported income, can be corrected through the 2012 OVDP. Potentially, FAQ 18 corrections are available as well.

Entity classification election

# FORM 8832

# Form 8832

- When do you use it?
- Planning and pitfalls

# **FBAR-RELATED FORMS**

# FBAR Background

- Imposed under Bank Secrecy Act, not Internal Revenue Code
- Significant penalties for not filing
- Information reporting only; no tax
- Not consistent with tax filings
- Aggregate value of all foreign accounts exceeds \$10,000 at any point during year.

# Types Of Filers

- Financial interest in foreign bank account
  - Indirect ownership of account
    - U.S. corporation that owns foreign subsidiary, which owns foreign bank accounts
  - Direct ownership of account
    - U.S. corporation that owns foreign bank accounts
- Signatory authority
  - Required even if no filer has financial interest in the account
    - Corporate controller

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# **USING VOLUNTARY COMPLIANCE TO CORRECT THESE FORMS**

# Plan For This Section

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In this short section of the program, our speakers will share thoughts and experiences about leveraging voluntary compliance programs with these outbound transaction forms.

# Failure To File Required Information Forms

- OVDP FAQ 17 – FBAR relief
- OVDP FAQ 18 – information tax returns relief (forms 5471, 8865, etc.)
- Special filing instructions