MEMBER SPOTLIGHT series

Foreign Accounts, Foreign Businesses, and the U.S. Law

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FOREIGN ACCOUNTS-

U.S. residents and citizens and U.S. entities that have financial accounts in foreign countries are subject to reporting requirements.

The reporting requirements carry significant potential penalties.

Reporting Foreign Accounts:

- Historically, the Bank Secrecy Act was the main source of reporting requirements.
- FATCA, the Foreign Account Tax Compliance Act, has added additional requirements.
- And don't overlook Schedule B (Interest and Ordinary Dividends) on the Form 1040:

You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.	Yes	No
7a At any time during 2015, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions		
If "Yes," are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements		

Bank Secrecy Act Reporting:

- Accounts are reported to FINCEN, the Financial Crimes Enforcement Network of the Treasury Department.
- An FBAR must be filed electronically by June 30, 2016 for any foreign financial accounts that exceeded $10,000 in the aggregate for the prior year.
- *No extensions* are available.

Who Might Need to File?

- U.S. Citizens;
- Resident Aliens, which includes:
  - Lawful permanent residents (the green card test);
  - Aliens with a substantial presence in the U.S.
    - At least 183 days in the U.S. over three years, including the current year;
    - Special counting rules apply for days.
- Corporations, partnerships, LLCs, and trusts formed under U.S. law.

What Type of Accounts Are Covered?

- Bank accounts;
- Securities accounts;
- "Other financial accounts," which include:
  - Someone accepting deposits as a financial agent;
  - An annuity or insurance account with cash value, an options or futures account, or a mutual fund or similar account.
- Virtual currencies, such as Bitcoin, are an emerging issue.

What Type of Interest Triggers a Duty to Report?

- Someone with a financial interest:
  - The owner of record or of legal title;
  - A U.S. person who acts through a nominee, agent, or attorney;
  - A U.S. person who controls an entity that has the account;
  - Trusts with sufficient U.S. links.
- Signature authority.

Examples- U.S. Citizens and Entities:

- U.S. Citizen establishes bank accounts in Ireland to facilitate her work as a consultant. The requirement is triggered immediately if her accounts are over $10,000 at any time.
- U.S. corporations and entities as well.
- The Panama Papers: U.S. citizen creates a shell corporation offshore that holds the relevant accounts.
  - The U.S. citizen has an "other financial interest" through the shell corporation.

Example for Aliens:

- Aliens can become subject to the filing requirement by accident;
- An Irish citizen gains a consulting contract in the U.S., and she spends:
  - 122 days in the first year;
  - 122 days in the second year; and
  - 122 days in the third year.
- She is now potentially required to report her Irish accounts.

Criminal Penalties:

- The willful failure to file an FBAR or the willful filing of a false FBAR is a crime, punishable by up to 5 years in prison and a fine of up to $250,000, 31 U.S.C. § 5322(a).
- In contrast, the willful failure to file a tax return is punishable by up to one year in prison and a fine of up to $25,000 ($100,000 for a corporation), 26 U.S.C. § 7203.

Enhanced Criminal Penalties:

- The potential criminal penalty for a willful failure to file is increased in some situations:
  - If the violation occurs when the defendant is "violating another law of the United States;" or
  - If the violation is "part of any illegal activity involving more than $100,000 in a 12-month period,"
- The penalties increase to up to 10 years in prison and a fine of up to $500,000, 31 U.S.C. § 5322(b).

Proof of a Violation:

To obtain a conviction, the government must prove that the defendant:

- Was subject to the filing requirement;
- Knew he was subject to the filing requirement;
- Knowingly and willfully failed to file or knowingly and willfully filed a false report;
- The defendant acted *willfully* if the government can show he knew the failure to file or the filing of a false report was illegal.

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Civil Penalties:

Civil penalties are also significant:

- $10,000 civil penalty for failure to file an FBAR in any given year, 31 U.S.C. § 5321(a)(5)(B)(i);
- If the taxpayer is willful, the penalty is the greater of $100,000 *or 50% of the balance for the year*, 31 U.S.C. § 5321(a)(5)(C)(i), (D)(ii).

In the civil context, willful conduct may mean a failure to answer the questions on Schedule B of Form 1040 accurately.

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Compare Civil Penalties in the Tax Context:

Civil tax penalties are tied to the amount of tax avoided:

- If a taxpayer fails to file a tax return, the penalty will be 5% of the tax per month up to 25%, or a minimum of $205.00, 26 U.S.C. § 6651(a).
- A taxpayer who commits fraud will be subject to a 75% penalty. 26 U.S.C. § 6663.

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FATCA Reporting- the Basics:

FATCA operates by threatening foreign institutions with 30% withholding if they don't cooperate; this is applied to "withholdable payments," which include

- U.S. sourced payments of interest, dividends and other payments;
- Proceeds from disposition of assets that produce U.S. dividend or interest income.

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FATCA's Impact on FFIs:

They need to enter into an agreement with the IRS to turn over information on U.S. accounts:

- Must agree to comply with U.S. due diligence standards and agree to comply with additional information requests;
- Must request that holders of U.S. accounts waive the benefits of foreign laws that would bar compliance; and
- Must withhold 30% from recalcitrant customers.

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Accounts Covered By FATCA:

The covered "United States accounts" are financial accounts owned by "specified United States persons" or by United States owned foreign entities.

- Accounts associated with a "United States person"(citizens and resident aliens, as well as domestic entities); but
- Public companies (and members of an affiliated group), tax-exempt entities, retirement plans, governmental entities, banks, REITs, mutual funds and similar entities are carved out.

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Accounts Covered By FATCA (cont.):

Accounts held by foreign entities are also covered if they have "one or more substantial United States owners," 26 U.S.C. § 1471(d)(3). These include:

- A corporation, if a "specified United States person" owns 10% or more of its stock, directly or indirectly;
- Partnerships and trusts are also covered if they meet a similar ownership standard.

Small accounts of individuals under $50,000 need not be reported.

What Must Be Reported Under FATCA?

- For accounts held by a "specified United States person," name, address, and TIN;
- For accounts held by a U.S. owned foreign entity, name, address and TIN of each substantial U.S. owner;
- For all accounts, account number, balance, receipts, withdrawals and payments.

Result: the IRS will be able to track foreign payments just as it does with 1099s for U.S. payments.

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Inter-Governmental Agreements:

FATCA is fairly intrusive.

As a means of addressing both sovereignty concerns and issues about privacy laws in other countries, inter-governmental agreements have been developed:

- Model 1 agreements provide for the foreign bank to report to its government, which then passes data along to the U.S.;
- In Model 2 agreements, the foreign government authorizes reporting by its domestic institutions.

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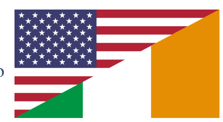
IGA Between the U.S. and Ireland:

In late 2012, the U.S. and the Irish government entered into a Model 1 IGA, which provides for reciprocal reporting:



- Irish financial institutions will be reporting data on U.S. accounts to the Irish government, which then provides the data to the U.S. government; and
- U.S. financial institutions will be reporting data to the federal government for transmission to Ireland.

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FATCA Impact on U.S. Taxpayers:

- You may find it more difficult to open or maintain an account overseas. Anecdotal evidence suggests some institutions are rejecting new U.S. customers and closing existing accounts.
- Individuals face additional reporting requirements under Section 6038D of the Code, which requires disclosures of "specified foreign financial assets."
- The disclosures are made on Form 8938.

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Filing Thresholds:

Disclosure under Section 6038D is required if:

- Foreign assets exceed $50,000 at the end of the year or $75,000 at any time during it;
- Married filing jointly, $100,000 at the end of the year or $150,000 at any time during the year;
- Living abroad, $200,000 at the end of the year or $300,000 at any time during the year; and
- Married filing jointly and living abroad, $400,000 at the end of the year or $600,000 at any time during the year.

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What Is Covered?

Taxpayer's disclosure obligations reach a financial account with a foreign financial institution; they also reach assets held outside of an account:

- Stocks or other securities issued by foreign issuers;
- A financial instrument or contract held for investment if the counterparty is a non-U.S. person;
- An interest in a foreign entity.

Penalties:

No special criminal penalties, but tax evasion or filing of a false return could potentially be applied to a willful failure to file Form 8938.

Civil Penalties:

- Basic failure to file Form 8938 triggers $10,000 penalty;
- Failure to file within 90 days of request from the IRS triggers enhanced penalties;
- There is a reasonable cause defense to the penalties.

Foreign Businesses:

- Individuals and entities who are based in the U.S. face additional tax issues, both here and abroad if they engage in international business.
- Aliens and foreign corporations also face complications when they transact business or own assets in the U.S.

The Risk of Double Taxation:

U.S. tax system reaches world-wide income of citizens and residents.

- The same income may also be taxable in the countries where it is earned.
- The Code provides credits and deductions to limit the impact of double taxation.
- There are some income exclusions for individual U.S. taxpayers who live overseas.
- There also may be treaty benefits available in particular countries.

The Foreign Tax Credit:

Section 901 of the Internal Revenue Code provides for a credit for those that pay foreign income taxes.

- A tax is a compulsory payment under the foreign country's taxing power, not a fine or customs duty.
- Must have "the predominant character of an income tax in the U.S. sense," Treas. Reg. § 1-901-2(a)(1)(ii).
- No offsetting economic benefit in return.

Credit for Income Taxes:

A tax will be an "income tax" subject to potential credit if it reaches "net gain." Three tests apply:

- Realization requirement-tax liability is triggered by the type of events that trigger U.S. tax liability;
- Gross receipts requirement-the tax is imposed on the basis of gross receipts or a reasonable equivalent;
- Net income requirement-permits recovery of costs.

Special Rules for the Foreign Tax Credit:

- A "soak-up tax" won't qualify, such as a higher rate that is imposed on U.S. taxpayers because of the credit.
- Applies in proportion to foreign income as a percentage of total income.

The alternative to the credit is a deduction, which is generally less valuable:

- $1000 tax would yield a credit of up to $1000;
- $1000 tax would yield a deduction of up to $396.

Deductions for Foreign Taxes:

Section 164(a) of the Code provides a deduction for

- Foreign real property taxes;
- Foreign "income, war profits, and excess profits taxes," I.R.C. § 164(a)(3);
- The deduction also applies to foreign taxes paid or accrued in carrying on a trade or business.

Special Rules for Foreign Income Taxes:

- A taxpayer cannot take any deduction for foreign income taxes if he opts for the credit.
- Normally the credit is more valuable;
- Because the credit is applied proportionally, a very high rate of tax on a small portion of income might change the picture.
- Electing the credit on income taxes does not alter the taxpayer's ability to deduct other taxes such as foreign property taxes.

Special Rules for Property Taxes:

If the tax is for "local benefits" that are specific to certain properties, then it is not deductible;

- This rule applies to both foreign and domestic property taxes.
- The rule is aimed at taxes that look more like property-specific assessments for sidewalks, sewer hook-ups and the like.
- Examples-
  - Tennessee levee tax;
  - California irrigation tax.

Other Tax Benefits:

U.S. citizens and resident aliens may also qualify for other tax benefits if they are posted overseas:

- Foreign income exclusion;
- Housing allowance exclusion.

The foreign income exclusion covers income received from sources in a foreign country for services rendered while there, up to $100,800.

The housing exclusion covers payments made by an employer up to $16,128.

Who qualifies?

- U.S. Citizen who establishes that she was a bona fide resident of a foreign country for an uninterrupted period, including the current tax year.
  - Visits to the U.S. don't count against you;
  - Don't tell the host country you're a non-resident.
- U.S. Citizen or resident alien who is in one or more foreign countries for 330 days out of 12 consecutive months.

U.S. Corporations Doing Business Abroad:

- Credit for foreign income taxes applies;
- Deductions remain available for foreign taxes;

Corporations that do business abroad through foreign affiliates will face increased scrutiny on transfer pricing.

- The concern is that related entities may set pricing for transactions at unrealistic levels for tax reasons;
- Arms' length standard applies.

Owning a Foreign Entity:

To facilitate business in a foreign country, establishment of a separate entity under local law is a common step, but there are a variety of complications, which include-

- Special tax rules;
- Special tax reporting requirements.

The complications arise right away.

Setting up a Foreign Corporation:

If a taxpayer sets up a corporation in the United States, he can contribute property to it without recognizing gain or loss on the transaction under Section 351 of the Code.

- Contribution of property to a foreign corporation will trigger gain recognition, but not loss recognition under Section 367 of the Code;
- There is a limited exception to this rule for property that will be actively used in conducting a trade or business outside the U.S.

Setting up a Foreign Partnership:

Normally, the contribution of property to a partnership does not trigger recognition of gain or loss under Section 721 of the Code. Different rules may apply to a partnership that involves foreigners:

- Last summer, the IRS announced new rules for domestic and foreign partnerships that include foreign partners;
- Transfer of appreciated property may trigger gain if there are related foreign partners.

Reporting Requirements for Foreign Entities:

Transfers of property to a foreign corporation generally trigger reporting requirements on Form 926;

A transfer of property to a partnership must be reported on Form 8865 if

- It results in an ownership interest of at least 10%, or
- More than $100,000 is transferred in a 12 month period.

Additional Reporting- Foreign Corporations:

Reporting required on Form 5471:

- Upon becoming an officer or director of a foreign corporation in which a U.S. person owns at least 10%;
- Upon becoming an owner of 10% or more;
- Upon becoming a citizen or resident alien if 10% or more of a foreign corporation is owned; and
- Dispositions must be reported if the taxpayer drops below 10%.
- Additional reporting if corporation is controlled.

Additional Reporting- Foreign Partnerships:

Special reporting requirements on Form 8865 are tied to acquisitions, dispositions or changes in proportionate interest:

- A 10% change in interest must be reported;
- The 10% standard is applied to capital, profits and share of deductions and losses;
- There are additional requirements if the foreign partnership is controlled by the taxpayer.

Controlled Foreign Corporations:

Controlled foreign corporations have special tax rules that may require certain shareholders to recognize undistributed income.

- A controlled foreign corporation has over 50% of its stock owned by "U.S. shareholders";
- "U.S. shareholders" is defined to eliminate holders of less than a 10% interest;
- Rules for income recognition are complex;
- Investment in a U.S. company can also trigger income recognition.

Foreign Legal Issues:

- Tax issues include potential requirements to register; for VAT, registration may be desirable, even where it is not required.
- What are the residency standards; Ireland's individual standards:
  - 183 days in a year;
  - 280 days over 2 years or statement of intent;

  Source: Tax Consolidation Act of 1997, § 819.
- Business licensing requirements.
- Customs and immigration requirements.

Taxation of Aliens:

Individual taxation is determined by residence; resident aliens and non-resident aliens are treated differently.

- Resident aliens include green card holders;
- Resident aliens also include those with a substantial presence in the U.S. which is 183 days over a three year period;
  - Standard can be met by accident;
  - Could have dual residence status.
- Resident aliens are taxed like citizens.

Non-resident Aliens:

An individual who is not a citizen or a resident alien is a non-resident alien, subject to unique tax regime of 30% on all U.S. income:

- Capital gains are taxed only if in the U.S. for 183 days or more in the current tax year.
- Non-resident alien who conducts a trade or business in the U.S. will be taxed like a citizen if they have income associated with the business.
- Non-resident alien has the option to treat income from real estate the same way.

Conducting a Trade or Business in the U.S.:

- The trade or business can include rendering personal services here, with exceptions for
  - Services rendered to non-resident aliens and foreign entities that don't do business here; and
  - Short-term stays for overseas branches of U.S. businesses.
- Generally, securities and commodities trading will not qualify without a fixed place of business.

"Effectively Connected" Income

- Tests for effectively connected income:
  - Was the income derived from assets held for use in the business?
  - Were business activities a material factor in generating gain or loss?
- If a non-resident alien has income that is effectively connected with a U.S. trade or business, all other U.S. sourced income is treated that way.

Special Rules:

- Non-U.S. source income will not be treated as effectively connected in most instances, but this rule won't apply to
  - Royalties associated with U.S. intellectual property derived in the conduct of the trade or business;
  - Dividends, interest or fee income associated with conducting a financial business in the U.S.;
  - Certain sales of inventory outside the U.S.

Foreign Corporations:

- Classification is governed by regulation:
  - Some foreign entities are deemed to be corporations;
  - Others can elect status, just like a U.S. LLC.
- Irish Public Limited Corporation or PLC is a corporation, Treas. Reg. § 301.7701-2(b)(8).
- Other types of Irish companies, such as a private company limited by shares (LTD) can elect how they are classified.

Election Options for Foreign Entities:

- Single member LTD can elect to be treated as a corporation or a disregarded entity;
- Multi-member LTD can elect to be treated as a partnership or a corporation.
- Defaults are different for foreign entities:
  - Treated as a partnership if there are two or more members and one has unlimited liability;
  - Disregarded if only one member and liability is unlimited.

The Accidental Corporation:

The other alternative default:

- An Irish LTD or similar entity will be treated as a corporation "if all members have limited liability." Treas. Reg. § 301.7701-3(b)(2)(B).
- A missed opportunity to elect disregarded entity status or partnership status;
- Likely to miss the opportunity to elect S Corporation status;

Result: Double taxation as a C Corporation.

Tax Treatment of Foreign Corporations:

As with non-resident aliens, the dividing line is whether they are engaged in a trade or business here.

- A foreign corporation with U.S. source income that is not connected with a U.S. trade or business will pay 30% tax on that income.
- Can elect to have income from real property treated as if effectively connected with a U.S. trade or business.

Tax Treatment of Foreign Corporations (cont.):

A foreign corporation that does business here will generally be treated like a U.S. corporation-

- It will be taxed on its income that is connected with the U.S. business and other U.S. source income;
- It will be entitled to deductions that are connected to the U.S. business, subject to allocation and apportionment rules; and
- It is entitled to charitable deductions.

Tax Treaties:

U.S. tax policy is to establish bi-lateral tax treaties with a variety of countries; there are 68 in force currently.

- The goal of these arrangements is to limit double taxation.
- Although derived from a model, each treaty is country-specific.
- Treaty benefits are not automatic.

U.S. Treatment of Tax Treaties:

In the U.S., a treaty does not trump the Internal Revenue Code:

- The IRS is to apply the Code "with due regard to any treaty obligation of the United States . . . ," I.R.C. § 894(a)(1).
- Treaties and the provisions of the U.S. Code stand on an equal footing, which means Congress can unilaterally abrogate a treaty by enacting an inconsistent statute.

The United States and Ireland:

The current treaty went in place in 1997 and was amended in 1999.

- Covers U.S. federal income tax, the excise tax on foreign insurers (both with exceptions), and the excise tax on private foundations;
- Covers Irish income tax, corporations tax, and capital gains tax.

In both countries, subsequent substitutes for those taxes are automatically covered.

Key Concept-Residence:

A key focus is residency, covered by Article 4.

- Generally a resident is someone who is subject to tax here or in Ireland based upon domicile, residence, place of incorporation or the like.
- U.S. citizens and green card holders are residents if they have a substantial presence, permanent home, or habitual abode in the U.S.
- Generally, the treaty ties tax to residence with certain exceptions.

Residency Can Be Complicated:

- As discussed earlier, an Irish citizen can become a resident alien in the U.S. by spending 122 days there for three straight years. The U.S. will tax her world-wide income.
- Meanwhile, she may still be an Irish resident and be subject to tax on all of her income in Ireland.

Consequently, there are tie-breaker rules.

Key Concept- A "Permanent Establishment":

Tax treatment of income earned by a non-resident will be taxed in the host country if it is associated with a permanent establishment there, such as

- An office or other place of management;
- A factory or workshop; or
- A mine, quarry, gas well or oil well.

A building site or a construction or installation project is a permanent establishment if it is in place for 12 months.

Services- "a fixed base."

Exceptions:

Certain facilities in the host country will not create a permanent establishment:

- A facility for display, storage or delivery of goods or merchandise;
- A fixed place of business for purchasing goods or acquiring information;
- A fixed location for carrying on preparatory activities.

Maintaining goods in the host country for processing also is an exception.

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Limitations on Treaty Benefits for Entities:

Individuals always qualify based on their residence, but there are complex rules for entities.

- Private entities generally are tested for ownership by residents of a treaty state; to qualify for benefits,
    - A titular U.S. entity would have to have 50% U.S. ownership, and
    - A titular Irish entity would have to have 50% Irish ownership.

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Other Qualification Standards for Entities:

- Publicly-traded entities are not subject to the ownership tests.
- An entity that fails the ownership test may still qualify for benefits in one country for income connected with a permanent establishment;
- Special rules apply to income that is spread across three or more countries.

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The Savings Clause-

The U.S. and Ireland retain the right to tax their own citizens and residents as if the treaty was not in force, restricting treaty benefits to situations in which a taxpayer is doing business away from home.

- There are exceptions to this savings clause for items such as transfer pricing, the credit requirements, and the antidiscrimination requirements.
- This clause also applies to former citizens if they terminated citizenship to avoid taxation.

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Associated Enterprises-Transfer Pricing:

Article 9 of the Treaty puts a transfer pricing regime in place with arms'-length standards; this applies if

- An entity in one country participates directly or indirectly in the management, control or capital of an enterprise in another state, or
- The same people participate directly or indirectly in the management, control, or capital of businesses in both countries.

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Transfer Pricing (cont.):

The treaty contemplates that where one country imposes additional tax based on transfer pricing concerns, the affected business should get the benefit of an adjustment in the other country.

- Any adjustment is premised upon an agreement between the U.S. and Ireland;
- Advance pricing agreements are contemplated under Section 26 of the treaty, which may eliminate uncertainty.

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Business Profits:

Generally, business profits will be taxed in the home country, unless there is a permanent establishment in the host country-

- Profits associated with a permanent establishment will be taxed in the host country;
- Profits are calculated as if the permanent establishment was an independent enterprise;
- Profits are to be calculated with an appropriate deduction for a share of enterprise-wide costs.

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Dividends:

The treaty contemplates some double taxation:

- Dividends are taxable in the country where the beneficial owner resides;
- Dividends are also taxable in the country where the payor is based:
  - Up to 5% if the beneficial owner holds 10% or more of the voting stock in a corporation (not a REIT or mutual fund);
  - Up to 15% in all other cases.

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Special Rules for Dividends:

- Special rules apply to Irish companies to account for dividend credit to put U.S. residents on an equal footing with Irish residents.
- Other special benefits:
  - A U.S. company that owns 10% of more of an Irish company that pays dividends gets credit for the Irish tax paid on the profits that were the source of the dividend;
  - The same rule applies if an Irish company owns 10% or more of a U.S. company.

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Income from Real Property:

Income from real property is taxed in the state where it is located-

- This rule applied to rent;
- It also applies to agricultural income.
- Gains from disposition of real property are treated under a separate article.

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Capital Gains from Real Property:

Location drives taxation of gains from real property.

- In Ireland, real property includes shares or other securities tied to the value of real estate unless listed on an exchange;
- For U.S. property, the standard is a U.S. real property interest under Section 897, which includes personal property associated with the use of real property;
- A company with sufficient real estate holdings.

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Other Gains:

- Gains from the disposition of movable property associated with a fixed base or permanent establishment are taxable in the host country.
- Gains from the disposition of ships, planes and containers and associated personal property are taxed in the home country;
- All other gains are taxed where the taxpayer resides.

Fees for Services and Wages:

- Independent service providers will be taxed in their home country unless they have a "fixed base" in the host country.
- Wages are taxed where the taxpayer is employed, unless
  - The taxpayer spends less than 183 days in the host country in a tax year;
  - The employer is a non-resident; and
  - There is no permanent establishment or fixed base in the host country.