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# Selected US Tax Developments

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## ONEROUS US REPORTING REQUIREMENTS FOR US MEMBERS OF NON-US FAMILY-CONTROLLED ENTITIES: IT'S ALL IN THE FAMILY

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Family wealth and business planning often gives rise to structures that come with burdensome reporting obligations for minority US shareholders. We point out some of the cases where the burden is much larger than it should be, requiring information that would not ordinarily be shared with the younger generation.

**KEYWORDS:** REPORTING ■ INFORMATION ■ TAX PLANNING ■ FAMILY ■ ATTRIBUTION

**CONTENTS**



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## INTRODUCTION

As part of our practice, we frequently advise private clients, along with their families, in family planning for their closely held investments and business operations. Owing to the international nature of these families, this practice gives rise to fascinating cross-border tax issues. Somewhat less fascinating and more frustrating is dealing with the US information-reporting obligations applicable to US persons that own interests in non-US corporations or non-US partnerships.

These otherwise basic US information-reporting rules include some rather startling and unexpected US filing obligations by, for example, US citizens (frequently residing abroad) or US residents in younger generations who hold relatively small interests in their families' businesses after a common equity freeze and whose non-US family members hold the rest of such businesses. Understanding the broad scope and application of these information-reporting rules is necessary to avoid significant penalties, and the potential compliance burden should be considered in choosing certain transactions and structures.[1]

## UNEXPECTEDLY BURDENSOME US REPORTING REQUIREMENTS

### General

The US Internal Revenue Service (IRS) has a particular interest in the reporting requirements applicable to US persons[2] with operations or investments outside the United States. Such operations or investments can significantly affect the US tax liability of a US person, but without requiring such US person to report to the IRS information relating to its income or operations outside the United States, it would be challenging for the IRS to obtain the necessary information with respect to such overseas operations or investments to determine the accuracy of the US tax liability reported by such US person.

The Code and the regulations promulgated thereunder contain the reporting requirements applicable to US persons investing in non-US corporations and non-US partnerships, with the former being reported on form 5471, "Information Returns

1 The discussion contained herein does not focus on structuring and reporting as it relates to gift tax.

2 "US persons" refers to persons described in section 7701(a)(30) of the United States Internal Revenue Code of 1986, as amended (herein referred to as "the Code"), and includes US residents and citizens, as well as domestic corporations, partnerships, trusts, and estates.

of U.S. Persons with Respect to Certain Foreign Corporations," and the latter being reported on form 8865, "Return of U.S. Persons with Respect to Certain Foreign Partnerships."

These reporting requirements have become even more important as the IRS has become increasingly focused on ensuring proper international tax compliance. The appendix to this article provides a detailed discussion of the complex and burdensome reporting requirements, including the various ownership thresholds that trigger higher and higher levels of reporting obligations, the constructive ownership rules that will potentially attribute stock held by a non-US person to a US family member, and the limited exceptions from reporting.

As a result of this potential attribution from non-US persons to US family members, a US person with a minority interest in a non-US entity may be subject to onerous reporting obligations. Obtaining the necessary information for a US person with a minority interest in a non-US entity to properly report its interest in such non-US entity can be challenging, particularly where the non-US family member is resistant, whether because of a desire not to disclose to the IRS or because the US person is estranged from the controlling non-resident family member.

## Typical Example of Unexpected Triggering of Reporting Obligations

These types of unexpected reporting obligations often come up in common family-planning arrangements, such as preferred stock freeze transactions. In a typical preferred stock freeze transaction, the equity in a family business is recapitalized into a preferred class of stock and a common class of stock. The preferred stock, which will be retained by the older generation and may retain voting control of the company, represents most of the value of the family business, while the common stock, which will be transferred to the younger generation, represents a sliver of the current value, but any future appreciation in the family business will flow to the common stock. In this situation, if the business is organized and operated outside the United States and none of the family members are US persons, the reporting obligations discussed herein generally will not apply. If a member of the younger generation decided to move to the United States, the expectation might be that these filing obligations would not be triggered because he or she owns such a small sliver of the business. The above-mentioned family attribution rules, however, would potentially cause the shares held by the older generation to be attributed to the younger US person, thereby triggering these reporting requirements. The ability of the US person that lacks control of the business and holds just a sliver of the business to obtain the information necessary to comply with the reporting obligations is questionable at best, particularly without the cooperation of the controlling non-US family members.

In addition, these unexpected reporting obligations can occur even if the non-US corporation or partnership is held indirectly through a trust or holding company as a result of the broad constructive ownership rules that apply to determine whether a US person has a reporting obligation.

### Penalties

Between the varying filing category requirements and constructive ownership rules (discussed in the appendix), the unsuspecting US person can find himself or herself with an unexpected form 5471 or form 8865 filing obligation. Failure to meet such obligation could subject the non-compliant US person to significant penalties.

Specifically, a $10,000 penalty is imposed for each annual accounting period of each non-US corporation or partnership for failure to timely file a properly completed form 5471 or form 8865, unless the failure to file is due to reasonable cause. If the failure to file continues for more than 90 days after the date on which the IRS mails notice of the failure, there is an additional penalty of $10,000 for each 30-day period during which the failure to file continues after the 90-day period has expired (up to a maximum of $50,000 for each failure). In addition, a US person that fails to file a properly completed form 5471 or form 8865 may, in certain circumstances, lose the benefit of foreign tax credits.

## KEY POINTS

As discussed above, the broad attribution rules relating to non-US family members can give rise to unexpected reporting obligations for US persons with minority interests in non-US businesses, and compliance with these obligations may be challenging at best. Specifically, in the non-US corporation context and the non-US partnership context, a US person with a small interest in a non-US entity that has a filing obligation as a result of attribution from a non-US family member needs to obtain the necessary information to facilitate completion and reporting of an income statement and a balance sheet of the non-US entity. In the corporate context, the US person will also need to provide a description of each class of stock of the non-US corporation, any taxes paid by the non-US corporation, and information regarding certain other US persons that own shares of the non-US corporation. In the non-US partnership context, the US person will need to provide information about certain other partners of the non-US partnership, information regarding certain partnerships owned by the non-US partnership, and a reconciliation of book income or loss to taxable income or loss.

We recommend reasonable modifications to these reporting rules to reflect the practicality of whether a US person would be able to or should be required to comply with these reporting obligations, and to help the IRS to more narrowly focus its informational return requests to facilitate compliance by US persons where such US persons will actually have or be able to obtain the required information. For example, does it really make sense that a US person owning no shares of a family-owned business would have no reporting obligations, but a US person owning 1 percent of a family business would be required to provide the IRS with detailed financial information for the business?

In *Estate of N.S. Miller v. Commissioner*,[3] the Tax Court held that for the purposes of the repealed foreign personal holding company rules, the constructive ownership

3 43 TC 760 (1965).

rules should not cause shares in a Canadian corporation held by two Canadian sisters to be attributed to a US sibling for the purposes of treating the Canadian corporation as a foreign personal holding company, where the US sibling did not directly own any shares of the Canadian corporation. Although the constructive ownership rules would have required such attribution, on the basis of concepts of fairness, the Tax Court understood that such broad attribution rules would give rise to unexpected and overly burdensome tax costs and compliance issues. The foreign personal holding company rules considered in *Estate of N.S. Miller* no longer exist. Indeed, the controlled foreign corporation (CFC) rules[4] (and the subpart F income regime applicable to US shareholders of a CFC)[5] that remain generally prevent attribution to a US person from his or her non-resident-alien family members. Reporting is often technically required despite this limitation on the operation of the subpart F rules.

One area that could be used as a point of comparison is the application of the passive foreign investment company (PFIC) rules.[6] The PFIC rules are a US anti-deferral regime that generally requires a US person that owns shares of a PFIC to be subject to tax at ordinary income rates on certain distributions from and dispositions of a PFIC, with such amounts being subject to an interest charge based on the US person's holding period in such shares. The PFIC rules apply to US persons that are direct or indirect shareholders in a PFIC. For the purposes of determining whether a US person is an indirect shareholder of a PFIC, (1) if a person owns 50 percent or more in value of the stock of a non-US corporation that is not a PFIC, such person is treated as owning his or her proportionate share of any stock owned directly or indirectly by that corporation; and (2) if a person owns stock of a PFIC, such person is treated as owning his or her proportionate share of any stock held by such PFIC (without regard to the 50 percent requirement). Therefore, for PFIC purposes, lower-tier reporting is not required if the top-tier entity is not a PFIC and the US person owns less than 50 percent of the top-tier entity. By analogy, limiting detailed non-US-entity reporting requirements of US persons to (1) entities in which the US person owns a direct 50 percent or greater interest and (2) any entity owned by such top-tier entity would be reasonable from a compliance perspective since the US person would have the ability to obtain the desired information or control the investments of the top-tier entity.

## CONCLUSIONS

In a perfect world, we would say that the IRS has identified the compliance challenges that the information-reporting requirements are creating for US persons that own minority interests in non-US entities and is in the process of addressing them. Perhaps these challenges could be addressed by modifying the rules to reflect something more similar to the indirect shareholder rules in the PFIC context, extending

4 Section 957(a) of the Code.

5 Section 951(a) of the Code.

6 Section 1297 of the Code.

the non-resident attribution exception for CFC purposes to the other filing categories for non-US corporations and non-US partnerships, or expanding the exception from non-resident attribution for US family members that do not own a direct interest in the non-US entity to include US family members that own less than a certain threshold interest (for example, 10 percent). But we do not live in a perfect world; in fact, in the world we live in, the IRS is looking to expand, not limit, reporting requirements, particularly as they relate to non-US persons and entities.

The point of this discussion is really to increase awareness of the various ways in which family investments in non-US entities that are not controlled by US persons can create onerous and unexpected US filing obligations and, if not complied with, give rise to potentially costly US tax penalties. Making sure that families understand these potential US obligations ahead of time can allow families to plan for whether they want to enter into a structure that will give rise to such obligations, and if so, whether minority US family members will be provided with the information necessary to comply with these reporting obligations.

There are many reasons to reach out to estranged family members to resolve issues and heal wounds. Although admittedly low in priority, perhaps we can add to that list the importance of ensuring that non-US controlling interest holders are willing to provide entity information to US family members necessary for those family members to comply with US reporting requirements. In that way, we can think of these US reporting requirements as bringing families together, one form 5471 or form 8865 at a time.

## APPENDIX OVERVIEW OF US REPORTING REQUIREMENTS

## US Owners of Non-US Corporations

A brief overview of the form 5471 filing categories applicable to US persons that own shares of a non-US corporation is set forth below.[7]

### Category 2

#### *General Rules*

A US person will have a category 2 filing obligation if such US person is a citizen or resident of the United States that is an officer or director of the non-US corporation, and, during the time that such US person is an officer or director, *any* US person (that is, not necessarily the officer or director) (1) acquires outstanding stock that when added to such US person's stock represents 10 percent or more of the total value or voting power of such corporation ("the 10 percent stock ownership requirement") or (2) acquires additional stock that on its own satisfies the 10 percent stock ownership requirement.

7 There were previously five categories of form 5471 filers, but one such category, category 1, became obsolete with the 2004 repeal of the foreign personal holding company rules.

### *Constructive Ownership Rules*

For the purposes of determining whether the 10 percent stock ownership requirement is satisfied, the following constructive ownership rules apply:

- *Entity attribution.* Stock owned directly or indirectly by or for a non-US corporation or a non-US partnership is considered to be owned proportionately by its shareholders or partners.
- *Family attribution.* A US person is considered to own the stock owned directly or indirectly by his or her siblings, spouse, ancestors, and lineal descendants (but there is no reattribution under this family attribution rule).

## Category 3

### *General Rules*

Category 3 imposes a filing obligation on a US person that (1) acquires outstanding stock that when added to such US person's stock meets the 10 percent stock ownership requirement; (2) acquires additional stock that on its own satisfies the 10 percent stock ownership requirement; (3) is treated as a US shareholder of such corporation for subpart F purposes solely because of the related-party insurance rules applicable to captive insurance companies;[8] (4) becomes a US person while meeting the 10 percent stock ownership requirement; or (5) disposes of sufficient stock in the corporation to reduce such US person's interest to less than the 10 percent stock ownership requirement.

### *Constructive Ownership Rules*

For the purposes of determining whether the 10 percent stock ownership requirement is satisfied, the following constructive ownership rules apply:

- *Entity attribution.* Stock owned directly or indirectly by or for a non-US corporation or a non-US partnership is considered to be owned proportionately by its shareholders or partners.
- *Family attribution.* A US person is considered to own the stock owned directly or indirectly by his or her siblings, spouse, ancestors, and lineal descendants (but there is no reattribution under these family attribution rules).

## Category 4

### *General Rules*

Category 4 imposes a filing obligation on a US person that has "control" of a non-US corporation for an uninterrupted period of at least 30 days during the annual accounting period of such corporation. A US person is treated as having control of a

8 A discussion of these rules is beyond the scope of this article.

non-US corporation if such person owns (1) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or (2) more than 50 percent of the total value of shares of all classes of stock of the non-US corporation. If a US person is in control of a corporation, and such person is in control of a lower-tier corporation, the US person will be treated as being in control of such lower-tier corporation.

### *Constructive Ownership Rules*

For the purposes of determining whether a US person has "control" of a non-US corporation, the following constructive ownership rules apply:

- *Attribution from entities*
  - Stock owned by a partnership or an estate is considered to be owned proportionately by its partners or beneficiaries.
  - Stock owned by a trust generally is considered to be owned by the trust's beneficiaries in proportion to their actuarial interest in the trust.
  - Stock owned by a grantor trust is considered to be owned by the owner of the grantor trust.
  - Stock owned directly or indirectly by or for a non-US corporation or a non-US partnership is considered to be owned proportionately by its shareholders or partners.
  - Stock owned by a corporation is considered to be owned proportionately by any shareholder that holds stock representing at least 10 percent of the value of the corporation.
- *Attribution to entities.* Except to the extent that the attribution rules below would apply to treat a US person as owning stock of a person that is not a US person,
  - stock owned by a partner or beneficiary of an estate is considered to be owned by the partnership or the estate;
  - stock owned by a beneficiary of a trust generally is considered to be owned by the trust; and
  - stock owned by a person that owns stock of a corporation representing at least 50 percent of the value of such corporation will be treated as being owned by such corporation.
- *Family attribution.* A US person is considered to own the stock owned directly or indirectly by his or her spouse, children, grandchildren, and parents.

## Category 5

### *General*

Category 5 imposes a filing obligation on every "United States shareholder" ("US shareholder") that owns stock of a controlled foreign corporation (CFC) for an uninterrupted period of 30 days or more during any tax year of such corporation, and that owned such stock on the last day of that year. A US shareholder is a US person that owns directly, indirectly, or constructively 10 percent or more of the total combined voting power of all classes of voting stock of a CFC. A CFC is a non-US corporation that has US shareholders that own (directly, indirectly, or constructively) on any day of the tax year of such non-US corporation, more than 50 percent of (1) the total combined voting power of all classes of its voting stock or (2) the total value of the stock of such corporation.

### *Constructive Ownership Rules*

For the purposes of determining whether a non-US corporation is a CFC and whether a US person is a US shareholder, the following constructive ownership rules apply:

- *Attribution from entities*
  – Stock owned by a partnership or an estate is considered to be owned proportionately by its partners or beneficiaries.
  – Stock owned by a trust generally is considered to be owned by the trust's beneficiaries in proportion to their actuarial interest in the trust.
  – Stock owned by a grantor trust is considered to be owned by the owner of the grantor trust.
  – Stock owned directly or indirectly by or for a non-US corporation, a non-US partnership, a non-US trust, or a non-US estate is considered to be owned proportionately by its shareholders, partners, or beneficiaries, respectively.
  – Stock owned by a corporation is considered to be owned proportionately by any shareholder that holds stock representing at least 10 percent of the value of the corporation.
- *Attribution to entities.* Except to the extent that the attribution rules below would apply to treat a US person as owning stock of a person that is not a US person,
  – stock owned by a partner or beneficiary of an estate is considered to be owned by the partnership or the estate;
  – stock owned by a beneficiary of a trust generally is considered to be owned by the trust; and
  – stock owned by a person that owns stock of a corporation representing at least 50 percent of the value of such corporation will be treated as being owned by such corporation.
- *Family attribution.* A US person is considered to own the stock owned directly or indirectly by his or her spouse, children, grandchildren, and parents, except that *stock owned by a non-resident alien individual will not be attributed to a US person under this family attribution rule.*

### Exceptions from Filing

The reporting regulations provide certain exceptions intended to grant relief from filing in situations where filing is not feasible or to eliminate the need for duplicate filings.

One such exception provides that a US person that would otherwise be required to file under category 3, category 4, or category 5 will not be so required if (1) the US person does not own a direct interest in the non-US corporation; (2) the US person's filing requirement is solely due to constructive ownership through another US person; and (3) the US person through which the indirect shareholder constructively owns an interest in the non-US corporation files form 5471 reporting all of the required information.

Another exception worth noting applies with respect to category 4 and category 5. Under this exception, a US person that would otherwise be required to file under category 4 or category 5 will not be so required if the US person (1) does not own a direct or indirect interest in the non-US corporation and (2) is required to file form 5471 solely because of constructive ownership through a non-resident alien (that is, pursuant to the family attribution rules). This exception is of limited value with respect to category 5 filers because the category 5 constructive ownership rules already provide that the family attribution rules will not apply to cause a US person to be treated as owning stock held by a non-US family member. However, because category 4 contains no such non-resident alien attribution prohibition, this exception does provide some relief for US persons that would otherwise have a category 4 filing obligation as a result of attribution of shares held by non-US family members.

## US Owners of Non-US Partnerships

A brief overview of the form 8865 filing categories applicable to US persons that own shares of a non-US corporation is set forth below.

### Category 1

A US person will have a category 1 filing obligation if such US person is a "controlling fifty-percent partner," which is to say that such US person controlled the non-US partnership at any time during the partnership's taxable year. For the purposes of this category, "control" is defined as ownership of more than 50 percent of the capital or more than 50 percent of the profits, or ownership of an interest to which more than 50 percent of the deductions or losses are allocated.

### Category 2

A US person will have a category 2 filing obligation if (1) such US person at any time during the taxable year of the non-US partnership owns at least 10 percent of the capital or profits of the partnership or is allocated at least 10 percent of the losses and deductions of the partnership (a "10 percent partnership interest"); and (2) more than 50 percent of the capital or profits of the partnership are owned by, or more than 50 percent of the losses and deductions of the partnership are allocated to, one or more US persons each of whom satisfies the 10 percent partnership interest requirement.

### Category 3

A US person will have a category 3 filing obligation if such US person contributed property during the taxable year to a non-US partnership in exchange for an interest in the partnership and either (1) the US person owned directly or constructively at least a 10 percent partnership interest in the non-US partnership immediately after the contribution; or (2) the value of the property contributed by that person, when added to the value of any other property contributed to the partnership by such person (or any related person) during the 12-month period ending on the date of transfer, exceeds $100,000.

### Category 4

A US person will have a category 4 filing obligation if such US person engages in certain "reportable events" with respect to a non-US partnership during the year, including (1) an acquisition by the US person of a 10 percent partnership interest in a non-US partnership (without regard to any interest already owned); (2) an acquisition by the US person that does not have a 10 percent partnership interest if following such acquisition, the US person has a 10 percent partnership interest (taking into account any interest already owned); (3) a disposition of a 10 percent partnership interest by a US partner; or (4) a disposition that causes a US partner that held a 10 percent partnership interest prior to the disposition to no longer have a 10 percent partnership interest after the disposition.

### Constructive Ownership Rules

A single set of constructive ownership rules applies to determine whether a US person has a form 8865 filing obligation. These rules provide as follows:

- *Attribution from entities.* Partnership interests owned directly or indirectly by a corporation, partnership, estate, or trust are considered to be owned proportionately by its shareholders, partners, or beneficiaries, respectively.
- *Attribution to entities.* There is no attribution of partnership interests held by a shareholder, partner, or beneficiary to a corporation, partnership, estate, or trust, respectively.
- *Family attribution.* A US person is considered to own partnership interests owned directly or indirectly by his or her spouse, children, grandchildren, and parents, except that attribution from a non-resident family member to a US person can apply only if the US person owns a direct or an indirect interest in the partnership.

### Exceptions from Filing

As in the case of the form 5471 filing requirements, the reporting regulations provide certain exceptions to the form 8865 filing requirements.

One such exception provides that a US person that would otherwise be required to file under category 1 or category 2 will not be so required if (1) the US person does not own a direct interest in the non-US corporation; (2) the US person's filing requirement is solely due to constructive ownership through another US person; and (3) another US person satisfies the form 8865 filing requirement. This exception, however, is limited to attribution through a US person that will otherwise be able to comply with the US reporting requirements, and provides no relief for a US person where an interest in the non-US partnership is attributed through a non-US family member.