

Frequently Asked Questions Pertaining to the 5-percent Miscellaneous Offshore Penalty

While the 5-percent miscellaneous offshore penalty is imposed on a broader base of foreign assets than just an unreported offshore bank account, this is only the tip of the iceberg. Below are some of the more cumbersome questions relating to this topic that have pushed many a taxpayer to the brink of insanity. These come directly from an IRS memo entitled, “Streamlined Filing Compliance Procedures for U.S. Taxpayers Residing in the United States Frequently Asked Questions and Answers.”

- a. Rule: The penalty does not apply to assets in which the taxpayer has no *personal* financial interest.
 - i. Q: Is the 5-percent penalty intended to reach foreign financial assets in which the taxpayer has *no* personal financial interest or only a partial interest?
 - ii. A: No. The penalty is *not* intended to reach assets in which the taxpayer has no financial interest, such as an employer’s account over which the taxpayer had only signature authority, or portions of assets in which the taxpayer had no *personal* financial interest. In order to address questions left open by the brief definition of assets in the penalty base in the Streamlined Domestic Procedures, the IRS honors the protocol laid out in OVDP FAQs 31 through 33, 35.1, and 38 through 41.
- b. Rule: The value of foreign rental real estate is not included in the penalty base. However, the net rental income is subject to U.S. tax.
 - i. Q: I am a U.S. resident making a streamlined domestic submission. In addition to foreign financial accounts and assets, I own an income producing rental property in a foreign country that is *not* reportable on my FBAR or Form 8938. Must I include the real estate in the streamlined domestic offshore penalty base? Because the rental property is *not* reportable on an FBAR or

Form 8938, this question assumes that the rental

property is *not* held through a foreign entity, such as a corporation or partnership. Thus, this question applies only to those scenarios in which the taxpayer holds the rental property *directly*, as opposed to indirectly.

- ii. A: No. Any asset that is not the kind of asset reportable on either an FBAR or Form 8938 need not be included in the penalty base for purposes of calculating the miscellaneous offshore penalty under the streamlined domestic procedures.
- c. The taxpayer is the sole owner of an incorporated business that owns various assets, including foreign financial accounts.
 - i. Does the 5-percent penalty base include the stock in the corporation or just the underlying foreign financial accounts?
 - ii. The penalty base includes the stock in the corporation – and not the underlying financial accounts – unless the corporation is a *disregarded entity*. Pursuant to the instructions for Form 8938, stock in a foreign corporation is classified as a specified foreign financial asset. Whether the stock in the foreign corporation or the underlying foreign financial accounts must be reported on Form 8938, and therefore included in the penalty base, depends on whether the corporation is a disregarded entity.
 - iii. Let's take a short digression into disregarded entities. A disregarded entity is a business entity that is separate from its owner but which elects *not* to be treated as separate from its owner for federal tax purposes. If this sounds like a double negative, it is. According to the IRS, "If a 'disregarded entity' is owned by an individual, it is treated as a sole proprietor. If the 'disregarded entity' is owned by any other entity, it is treated as a branch or division of its owner." Thus, a disregarded entity is considered the *same* entity as the owner for tax purposes, but not for liability purposes.

- iv. What type of business satisfies the conditions for being a disregarded entity? None, other than a single-member LLC. Here's a brief explanation why. The Internal Revenue Code states that a business entity is a corporation by default. If the entity is *not* a corporation, it is an "eligible entity" and it can independently elect its classification for federal tax purposes. The Code says, "an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner." The only business type that satisfies all of the conditions for being a disregarded entity as per the IRC is a single-member LLC. A sole proprietorship is not a disregarded entity because the business is not separate from its owner.
 - v. If the corporation is a disregarded entity, then the underlying foreign financial accounts must (1) be reported on Form 8938 and (2) be included in the penalty base. However, if the corporation is *not* a disregarded entity, then the taxpayer is *not* considered to be the owner of the underlying assets merely because of his status as a shareholder. The same principle applies to assets that are held in a foreign partnership or trust.
- d. Generally speaking, closely held foreign corporations must be reported on Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*. To the extent that the corporate stock of such a corporation has already been reported on Form 5471, duplicate reporting on Form 8938 is *not* required. What if this stock was not reported on Form 5471 and Form 8938? Must it be included in the 5% penalty base? Until now, there has been no guidance. The IRS has since weighed in and its answer is not favorable for taxpayers. Because closely held stock in a foreign corporation is classified as a "specified foreign financial asset," to the extent that it has *not* been reported on a timely filed Form 8938 or Form 5471, then it must be included in the 5% penalty base.

- i. Q: The streamlined domestic offshore procedures explicitly state that foreign financial assets subject to the 5-percent penalty include assets that should have been, but were not, reported on Form 8938. The instructions for Form 8938 state that any assets reported on a timely filed Form 3520 or 5471 need not be reported on Form 8938 for the same tax year. Are assets that I have reported on a *delinquent* Form 3520 or 5471 excluded from the 5-percent penalty base?
 - ii. A: No. This instruction was designed to ease the burden of duplicate reporting and does not affect the definition of “foreign financial asset.” All assets that satisfy the definition of “foreign financial asset” in the Form 8938 instructions and that were not reported on that form must be included in the 5-percent penalty base, *unless* the taxpayer reported them on a *timely* filed Form 3520 or 5471.
- e. For all publicly traded assets, *market value* is generally used for the penalty calculation.
 - i. Q: How should I value stock in a foreign corporation that is included in the 5-percent penalty base for Streamlined Domestic Offshore filers?
 - ii. A: Any reasonable method for valuing the stock, such as using the balance sheet on Form 5471 is appropriate. No valuation discounts may be taken on foreign financial assets subject to the 5-percent penalty. The principles established in 2014 OVDP FAQ 35.1 are applied to Streamlined Domestic Offshore submissions.