

Tax Controversy Corner

Reporting Foreign Partnerships

By Megan L. Brackney

Over the past several years, the IRS has focused on increased enforcement in the international tax arena. As explained by IRS Commissioner John Koskinen, “[t]he IRS has made great strides over the last several years both in finding tax evaders hiding assets overseas and bringing them to justice and in encouraging people to voluntarily disclose their foreign accounts and pay the taxes they owe.”¹ High-profile prosecutions of U.S. taxpayers with foreign bank accounts and the enactment of the Foreign Account and Tax Compliance Act (FACTA) have caused thousands of taxpayers to become compliant through the IRS’s voluntary disclosure programs.² The IRS has other tools at its disposal to collect information about the offshore investments of U.S. taxpayers, including the two forms discussed here, Form 8865 and Form 8938, which require U.S. taxpayers to report their interests in, and transactions with, foreign partnerships. This column discusses the reporting requirements and the penalties and other consequences of failure to timely file these forms.

Reporting Interest in Foreign Partnerships: Forms 8865 and 8938

Certain U.S. persons must report their interests in foreign partnerships under Code Secs. 6038, 6038B and/or 6038D.³ For Form 8865, *Return of U.S. Persons with Respect to Certain Foreign Partnerships*, there are four categories of filers.⁴ The “Category 1 filer” is a U.S. person who controlled the foreign partnership at any time during the partnership’s tax year.⁵ “Control” of a partnership is ownership of more than a 50-percent interest in the partnership. A 50-percent interest in the partnership, in turn, is “an interest equal to fifty percent of the capital interest in such partnership, an interest equal to fifty percent of the profits interest in partnership, or an interest to which fifty percent of the deductions or losses of such partnership are allocated.”⁶ There may be more than one “Category 1 filer” for a partnership for a particular partnership tax year.

The “Category 2 filer” is a U.S. person who at any time during the tax year of the foreign partnership owned a 10-percent-or-greater interest in the partnership while the partnership was controlled by U.S. persons each owning at least 10-percent interests. A “10-percent interest” in a partnership is “an interest equal to ten percent of the capital interest in such partnership, an interest equal to ten



MEGAN L. BRACKNEY is a partner at Kostelanetz & Fink, LLP in New York, New York.

percent of the profits interest in such partnership, or an interest to which ten percent of the deductions or losses of such partnership are allocated.”⁷ If the foreign partnership had a Category 1 filer at any time during that tax year, no person will be considered a Category 2 filer.⁸

The “Category 3 filer” is a U.S. person who contributed property during that person’s tax year to a foreign partnership in exchange for an interest in the partnership (a Code Sec. 721⁹ transfer), if that person either:

- (i) owned directly or constructively at least a 10-percent interest in the foreign partnership immediately after the contribution; or
- (ii) the value of the property contributed (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 \$100,000.¹⁰

The value of the property is the fair market value at the time of the transfer.¹¹

If a domestic partnership contributes property to a foreign partnership, the domestic partnership’s partners are considered to have transferred a proportionate share of the contributed property to the foreign partnership.¹² However, if the domestic partnership files Form 8865 and properly reports all the required information with respect to the contribution, its partners will not be required to report the transfer.¹³ Category 3 filers also include U.S. persons that previously transferred appreciated property to a foreign partnership and the foreign partnership disposed of such property while the U.S. person remained a direct or indirect partner in the partnership.¹⁴

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The “Category 4 filer” is a U.S. person who had a “reportable event” during the tax year: *i.e.*, an acquisition of, disposition of or substantial change in the proportional interest in a foreign partnership as described in Code Sec. 6046A.¹⁵

Form 8865 is filed with the taxpayer’s income tax return on or before the due date (including valid extensions) for that return.¹⁶ A separate Form 8865 must be filed for each partnership.¹⁷ If the taxpayer is not otherwise required to

file an income tax return for the tax year during which the transfer occurred, but is required to file an information return for that year (*e.g.*, Form 1065, *U.S. Partnership Return of Income*, or Form 990, *Return of Organization Exempt from Income Tax*), the taxpayer should attach Form 8865 to its information return.¹⁸

Next, under Code Sec. 6038D, beginning in 2011, U.S. persons with interests in “specified foreign financial assets,” are required to file Form 8938, *Statement of Specified Foreign Financial Assets*.¹⁹ An interest in a foreign entity, which includes a foreign partnership, is a “specified foreign financial asset”²⁰ that must be reported if the taxpayer meets the thresholds described below.²¹

- For individuals living in the United States: The aggregate value of the individual’s interest in all specified foreign financial assets exceeds \$50,000 on the last day of the tax year, or \$75,000 at any time during the tax year.
- For married individuals filing jointly and living in the United States: If the aggregate value of specified financial assets in which either spouse has an interest that exceeds \$100,000 on the last day of the tax year or \$150,000 at any time during the tax year.
- For individuals living abroad: If the aggregate value of the individual’s interest in specified foreign financial assets exceeds \$200,000 on the last day of the tax year or \$300,000 at any time during the tax year.
- For married individuals filing jointly and living abroad: If the aggregate value of specified financial assets in which either spouse has an interest that exceeds \$400,000 on the last day of the tax year or \$600,000 at any time during the tax year.

In order to relieve the taxpayer of duplicative reporting, a taxpayer is not required to report an interest in a foreign partnership if the taxpayer has timely filed Form 8865.²² The taxpayer must report the number of foreign information returns, including Form 8865, on Form 8938, along with any other information that is required by Form 8938, the instructions or other published guidance.²³ Even if an interest in a foreign partnership is reported on a Form 8865, the taxpayer must include the value of that asset in determining whether the taxpayer meets the threshold for filing Form 8938.

The tests for filing Form 8865 and Form 8938 may overlap, but there may be circumstances in which the taxpayer does not fall within any of the four categories of Form 8865 filers discussed above, but is nevertheless required to file Form 8938 because he or she meets the threshold for Form 8938 filing. Accordingly, the U.S. taxpayer and the advisor need to apply both tests to determine which forms are required.

Like Form 8865, Form 8938 is filed with the U.S. person's income tax return on or before the due date (including valid extensions) for that return.²⁴

Penalties and Other Adverse Consequences of the Failure to File Form 8865 or Form 8938

The penalty for failure to file a complete and accurate Form 8865 is \$10,000 for each failure.²⁵ If the taxpayer does not file Form 8865 for more than 90 days after the IRS mails notice of the failure to file to the taxpayer, there is an additional penalty of \$10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period.²⁶ This "continuation penalty," and the original penalty are capped at \$50,000.²⁷ There is an exception to the penalty for failure to file Form 8865 if the failure "is shown to be due to reasonable cause."²⁸

In addition, the failure to properly report a transfer of property to a foreign partnership as required in Code Sec. 6038D (Category 3), where the value of the property exceeds \$100,000, can be up to 10 percent of the fair market value of the property at the time of the exchange, and in the case of a contribution, the taxpayer recognizes gain as if the contributed property had been sold for such value at the time of the contribution. If the failure to report was not due to intentional disregard, the penalty cannot exceed \$100,000.²⁹ The penalty will not be imposed if the failure to report the transfer on Form 8865 was "due to reasonable cause and not to willful neglect."³⁰

Another lesser-known penalty for failure to file Form 8865 is a 10-percent reduction of the amount of foreign taxes paid or deemed paid by a U.S. person for the tax year.³¹ The reduction may increase if the taxpayer continues not to comply for more than 90 days after the date that the IRS mails a notice of failure to comply. The reductions are an additional five percent for each three-month period, or fraction thereof, during which the failure continues after the 90-day period expires.³² The total reductions are limited to the greater of \$10,000 or the income of the foreign partnership for the accounting period in which the failure occurs.³³ The reduction in foreign tax credit is reduced by the failure to file penalty discussed above.³⁴ There is a reasonable cause defense to the imposition of the reduction of the foreign tax credit penalty as well as to the failure to file penalty.³⁵

The penalty for failure to file a complete and accurate Form 8938 is \$10,000 for each failure, and if the failure continues for more than 90 days after the IRS mails notice

of such failure to the taxpayer, there is an additional penalty of \$10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period.³⁶ The continuation penalty and the original penalty are capped at \$50,000.³⁷

There also is an exception for failure to file Form 8938 if the failure "is shown to be due to reasonable cause and not due to willful neglect."³⁸ The statute specifically rejects one argument that taxpayers may have made to support a claim of reasonable cause, stating that "[t]he fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the required information is not reasonable cause."³⁹

In addition to penalties for failure to file the information return itself, after March 18, 2010,⁴⁰ the IRS can impose an accuracy-related penalty of 40 percent of the understatement of tax due to "any undisclosed foreign financial asset understatement."⁴¹ The term "undisclosed foreign financial understatement" is defined as "for any taxable year, the portion of the understatement for such taxable year which is attributable to any transaction involving an undisclosed foreign financial asset," which includes reportable interests in foreign partnerships required to be reported on Form 8865 or Form 8938.⁴² The taxpayer can avoid this penalty by showing that he or she acted with reasonable cause and in good faith.⁴³

For taxpayers who have not filed foreign information returns, ... the statute of limitations remains open, at a minimum, for items related to those forms, and at worst, for all items on the return.

The failure to timely file Form 8865 and/or Form 8938 has other serious consequences beyond the potential penalties discussed above. Since March 18, 2010 (the effective date of the statute),⁴⁴ the time for assessment of tax with respect to a tax return does not expire until three years after the date that Form 8865 or Form 8938 is filed.⁴⁵ Accordingly, for tax returns for which the general three-year statute of limitations for assessment had not yet expired before March 18, 2010, and all returns filed after March 18, 2010, the statute of limitations for assessment is open for all items on the return until the form is filed. If the taxpayer had reasonable cause for failure to file, only the items affected by the failure to provide

the required information remain open. For tax years for which the statute of limitations would have expired before March 18, 2010, the statute of limitations remains open with respect to any items related to failure to furnish the required information until three years after the required form is filed.⁴⁶

A Chief Counsel Advisory (CCA) addressing the effective date of Code Sec. 6501(c)(8) provides two examples to illustrate the above-described rules. In the first example, the taxpayer timely filed tax returns for 2004 through 2009, but did not include a required foreign information return with each return. For the 2004 and 2005 tax years, the general three-year statute of limitations of assessment would have expired before March 18, 2010. Accordingly, the statute of limitations remains open for these tax years only with respect to items related to the failure to provide the required information. For the 2006 through 2009 tax years, the statute of limitations was still open as of March 18, 2010, and thus remains open with respect to all items on the tax returns. If the taxpayer can establish that the failure to file the form was due to reasonable cause and not willful neglect, the limitations period is extended only for the items related to the failure to provide the required information.

For taxpayers who have not filed foreign information returns, such as Form 8865 or Form 8938, regardless of the reason for not filing, the statute of limitations remains open, at a minimum, for items related to those forms, and at worst, for all items on the return. Accordingly, in most situations, taxpayers should be advised to amend their tax returns to include any required foreign information returns. If those returns are filed, the statute of limitations will begin to run, and the IRS will have three years to assess additional tax.⁴⁷

In another CCA,⁴⁸ the IRS explains the standard for reasonable cause in the context of failure to file foreign information returns. The CCA specifically addresses the failure to file Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, but the rationale is the same and can be applied to the failure to file Forms 8865 and 8938. The CCA observes that there are different reasonable-cause standards for different penalties, but looks to the reasonable-cause standards for

failure to file income tax returns under Code Sec. 6651, explaining that reasonable cause requires that the taxpayer exercised ordinary business care and prudence. The CCA refers to the Internal Revenue Manual provision that defines “ordinary business care and prudence,” as “making provisions for business obligations to be met when reasonably foreseeable events occur ... (taking that degree of care that a reasonably prudent person would exercise), but nevertheless were unable to comply with the law.”⁴⁹

In deciding whether the taxpayer exercised ordinary care and business prudence, the IRS will consider the taxpayer’s explanations for the failure to file, the taxpayer’s compliance history, length of time between the event cited as a reason for the noncompliance and subsequent compliance, whether there were circumstances beyond the taxpayer’s control and, in some cases, the taxpayer’s ignorance of the law or inability to get records.⁵⁰ However, the IRS has also stated that taxpayers who conduct business or transactions offshore or in foreign countries have a responsibility to exercise ordinary business care and prudence in determining their filing obligations and other requirements. It is not reasonable or prudent for taxpayers to have no knowledge of, or to solely rely on others for, international transactions.⁵¹

The deficiency procedures of Code Secs. 6212–6215 do not apply to penalties for failure to file foreign information returns, including Forms 8865 and 8938.⁵² Therefore, the penalties may be assessed without prior notice⁵³ and cannot be challenged in Tax Court.⁵⁴ After the failure to file penalty has been assessed, however, the taxpayer may contest the penalty on a pre-payment basis.⁵⁵ For taxpayers with assets in excess of \$100 million and certain other taxpayers that have been specifically designated by mutual agreement between Compliance and Appeals (“eligible taxpayers”), the taxpayer may appeal a penalty assessed during an examination to the Appeals Office on an accelerated basis.⁵⁶ If an eligible taxpayer elects not to appeal the penalty, the taxpayer may challenge the penalty by paying and following the procedures for a refund claim.⁵⁷ For all other taxpayers, and for eligible taxpayers who are assessed the above penalties at the conclusion of an examination, the penalties may be appealed after assessment but before payment on a nonaccelerated basis.⁵⁸

ENDNOTES

¹ Written Testimony of John A. Koskinen before the House Oversight and Government Reform Committee on the Government Accountability Office’s High Risk List, Reprinted by Tax Analysts, 2015 TNT 29-67 (Feb. 11, 2015).

² *Id.*

³ For these purposes, “U.S. person” is defined by

reference to Code Sec. 7701(a)(30): (A) a citizen or resident of the United States; (B) a domestic partnership; (C) a domestic corporation; (D) any estate (other than a foreign estate, within the meaning of paragraph (31)); and (E) any trust if—(i) a court within the United States is able to exercise primary supervision over the

administration of the trust and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust. See Reg. §1.6038-3(b)(6).

⁴ See Instructions to Form 8865, at www.irs.gov/pub/irs-pdf/i8865.pdf.

⁵ Reg. §1.6038-3(a)(1).

- ⁶ Reg. §1.6038-3(b)(2).
⁷ Reg. §1.6038-3(b)(3).
⁸ Reg. §1.6038-3(c).
⁹ Code Sec. 721(a) (“no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.”).
¹⁰ Code Sec. 6038B(a)(1)(B); Reg. §1.6038B-2(a)(1); IRM 20.1.9.71(4) (Mar. 21, 2013).
¹¹ *Id.*
¹² Reg. §1.6038B-2(a)(2).
¹³ *Id.*
¹⁴ Reg. §1.6038B-2(a)(4).
¹⁵ Code Sec. 6046A; Reg. §1.6046A-1(a).
¹⁶ Reg. §1.6038-3(i).
¹⁷ Reg. §1.6038B-2(a)(6).
¹⁸ Reg. §1.6038B-2(a)(5).
¹⁹ Code Sec. 6038D; Act Sec. 511 of The Hiring Incentives to Restore Employment (“HIRE”) Act (P.L. 111-147), 124 Stat. 71 (Mar. 18, 2011).
²⁰ Reg. §1.6038D-3(b)(1)(iii).
²¹ Code Sec. 6038D(b)(2)(C); see also Instructions for Form 8938 at www.irs.gov/pub/irs-pdf/i8938.pdf. These values are the assets’ fair market value. Reg. §§1.6038D-2(a)(1)-(3); 1.6038D-5(a).
²² Reg. §1.6038D-7(a)(1)(i)(D).
²³ Reg. §§1.6038D-4(a)(10) and 1.6038D-4(a)(11).
²⁴ Reg. §1.6038D-2(a).
²⁵ Code Sec. 6038(b)(1).
²⁶ Code Sec. 6038(b)(2).
²⁷ *Id.*
²⁸ Reg. §1.6038-3(k)(4).
²⁹ Code Sec. 6038B(c)(1) and 6038B(c)(3).
³⁰ Code Sec. 6038B(c)(2).
³¹ Reg. §1.6038-3(k)(3)(ii)(A). Foreign tax credits under Code Sec. 904(c) (carryback and carryover of excess tax paid) are not reduced under this provision. *Id.*
³² Reg. §1.6038-3(k)(3)(ii)(B).
³³ Reg. §1.6038-3(k)(3)(ii)(C).
³⁴ Reg. §1.6038-3(k)(3)(ii)(D).
³⁵ Code Sec. 6038(c)(4); Reg. §1.6038-3(k)(4).
³⁶ Code Sec. 6038D(d)(1) and (2).
³⁷ *Id.*
³⁸ Code Sec. 6038D(g).
³⁹ *Id.*
⁴⁰ HIRE Act, §512, P.L.111-147, 124 Stat. 71 (Mar. 18, 2010).
⁴¹ Code Sec. 6662(b)(7) and (j)(3).
⁴² Code Sec. 6662(j)(1) and (2).
⁴³ Code Sec. 6662(c).
⁴⁴ See Education Job Fund; State Fiscal Relief, §218, P.L. 111-226, 124 Stat. 2389 (Aug. 10, 2010); HIRE Act, §512, P. L. 111-147, 124 Stat. 71 (Mar. 18, 2010).
⁴⁵ Code Sec. 6501(c)(8). This exception to the statute of limitations applies to other foreign information returns, such as Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, and Form 3521, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, among others.
⁴⁶ CCA 201147030 (Aug. 22, 2011).
⁴⁷ Code Sec. 6501(c)(8)(A).
⁴⁸ CCA 200748006 (Nov. 30, 2007).
⁴⁹ IRM 20.1.1.3.2.2 (Feb. 22, 2008).
⁵⁰ *Id.*
⁵¹ IRM 20.1.9.1.1(4) (March 21, 2013).
⁵² Code Secs. 6212(a), 6213(a), 6679(b).
⁵³ IRM 20.1.9.1.1(2) (March 21, 2013).
⁵⁴ See *S.G. Smith*, 133 TC 424, 428-430, CCH Dec. 58,028 (2009); *J. B. Williams*, 131 TC 54, CCH Dec. 57,547 (2008).
⁵⁵ IRM 8.11.5.1 (Aug. 27, 2010); IRM 8.11.5.2.2(1) (Aug. 27, 2010).
⁵⁶ IRM 8.11.5.2.1 (Aug. 27, 2010).
⁵⁷ IRM 8.11.5.2.2(4) (Aug. 27, 2010).
⁵⁸ IRM 8.11.5.3.1 (Aug. 27, 2010).

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