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Tax Traps of Passive Foreign Investments (Reporting the Family Business)

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Many taxpayer's have interests in offshore business that they acquired through inheritance or gift. Often these interests are purely passive, in that the U.S. taxpayer does not take an active role in management but instead collects dividends, interest or royalty income from the "family holdings". Many "dual citizens" have such family holdings. To the extent that the source of the payment is either 75% or more passive income (dividends, interest or royalties) or is earned from assets which are at least 50% passive income generating assets, the source of the income is considered to be from a Passive Foreign Investment Company (PFIC) and must as a result of the HIRE Act, be reported on [IRS](#) Form 8938 (still in draft) for tax years 2011 and thereafter. As a result of the HIRE Act (and its Section 6038D) tax professionals preparing 2011 returns may be under a duty to ask specifically about PFIC income in addition to the existence of foreign controlled financial accounts, offshore trusts and other foreign holding, like Controlled Foreign Corporations (CFC's).

Taxpayers must disclose "specified foreign financial assets" which in the aggregate are \$50,000 or more on Form 8938. The failure to make the disclosure may result in a \$10,000 penalty (or more) for non-filing or incomplete filing, a suspension of the statute of limitations if the disclosure would also require other information returns, and an increase in the accuracy related penalty from 20% to 40% of the tax due. The risks of non-compliance by non-disclosure are serious and have consequences both to the taxpayer and tax preparer. Some of the consequences to taxpayers, may include income tax audit activity resulting in penalties for failure to file Reports of Foreign Gifts or Bequest, or Controlled Foreign Corporation Returns, or Transfer to Foreign corporations or to Foreign Trusts. Penalties under the Bank Secrecy Act for failure to file FBAR's are also possible.

Careful planning for the 2011 returns is certainly in order and the filing of late information returns with reasonable cause statements may be needed by some taxpayers.

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