

Offshore Funds and U.S. Form 5471

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Much of the hedge fund industry's formative years were fueled by funds formed as U.S. limited partnerships and U.S. limited liability companies. As the industry expanded offshore and attracted more institutional investors, the number of offshore funds has grown significantly. Unlike domestic funds, most offshore funds are formed as corporations in order to provide anonymity for non-U.S. investors and protection from Unrelated Business Taxable Income concerns for U.S. tax-exempts. As a result of their corporate structure, certain U.S. persons may be required to file U.S. Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations. Those potentially required to file include U.S. investors in the offshore fund (including pension plans, public charities and private foundations), as well as U.S. officers or directors and U.S.-based advisors. Considering that the penalty for not filing Form 5471 is \$10,000 for each annual accounting period of each foreign corporation, not filing Form 5471 could be an expensive oversight.

The information reported on Form 5471 includes certain general identifying information for the foreign corporation and up to 11 separate schedules. These separate schedules report information such as certain ownership information, the income statement and balance sheet, earnings and profits, related party transactions and acquisition and redemption details. The schedules that a Form 5471 filer are required to complete depend on which of the four categories a filer is considered. It is possible to fall under more than one category of filer. Form 5471 previously had five categories of filers, but Category 1 was eliminated by the American Jobs Creation Act of 2004.

Category 2 Filer

A Category 2 filer includes a U.S. citizen or resident who is an officer or director of a foreign corporation in which a "U.S. Person" has acquired shares that, when added to the shares owned on the date of acquisition, equals or exceeds 10% or more of the voting or participating shares. In addition, the acquisition of an additional 10% by the "U.S. Person" is also reportable under Category 2. It is our understanding that a direc-

tor should file Form 5471 only for years in which a reportable acquisition takes place.

Example: Many U.S. advisors will appoint a principal of the advisor as one of the directors of the advisor's offshore fund, often a foreign feeder. If a "U.S. Person" acquires a 10% or more interest in the fund, the director will be required to file Form 5471.

A "U.S. Person" in this category is generally defined as a citizen or resident of the U.S., a domestic partnership or corporation, or a domestic estate or trust. A corporation or partnership is considered "domestic" if it was organized in the U.S. or under the laws of the U.S. or of any state. A trust is considered "domestic" if a court within the U.S. is able to exercise primary supervision over the administration of the trust or one or more U.S. citizens or residents have the authority to control all substantial decisions of the trust. An estate is generally considered "domestic" if the income of the estate is subject to U.S. income tax.

Category 3 Filer

Generally, a Category 3 filer is a U.S. Person (defined the same as for Category 2) who:

- Acquires 10% of the voting or participating shares in a foreign corporation;
- Acquires voting or participating shares that, when added to the shares owned on the date of acquisition, equals or exceeds 10% or more of the voting or participating shares; or
- Disposes of voting or participating shares in a foreign corporation that reduces ownership to less than 10%.

It is our understanding that a U.S. Person should only file as a Category 3 filer in the years that an acquisition or disposition that meets the above thresholds occurs.

Example: Many established funds are widely held. However, it is quite common that when a fund first breaks escrow, it only has a few shareholders. Accordingly, it is common for initial shareholders to be

Category 3 filers. Likewise, when a fund winds down, it is common for shareholders to be Category 3 filers due to the concentrated ownership.

Category 4 Filer

A Category 4 filer is a U.S. Person (generally defined the same as for Category 2) who owned more than 50% of either the voting or participating shares of a foreign corporation for an uninterrupted period of at least 30 days during the foreign corporation's year. While Form 5471 is required for Category 2 and 3 filers only for the year in which the relevant share transactions occur, a U.S. Person should file Form 5471 for each year in which the more than 50% ownership threshold is met.

Example: Similar to the Category 3 example, when an offshore fund breaks escrow, it may break escrow with just one shareholder, which could result in a Category 4 filing requirement.

Category 5 Filer

Generally, a Category 5 filer is a "U.S. Shareholder" (as defined herein) who owned stock in a foreign corporation that is a Controlled Foreign Corporation (CFC). The stock must have been owned for at least 30 days during the year, as well as owned on the last day of the year. A U.S. Shareholder is generally defined as a U.S. Person (as defined above) who owns 10% or more of the voting shares of a CFC. Generally, a CFC is a foreign corporation that has persons qualifying as U.S. Shareholders that own more than 50% of the voting or participating stock of the corporation on any day of the year. As with the Category 4 filing requirement, a U.S. Person should file Form 5471 for each year in which the Category 5 requirement is met.

Example: Many offshore funds are structured with voting and non voting shares and it is not uncommon for the advisors or a principal of the advisor to own all of the voting shares of the offshore fund, which would result in a Category 5 filing requirement.

An advisor will have access to sufficient information to determine its Form 5471 filing requirements, as well as the filing requirements of any of its principals. Investors may not always have sufficient information to determine their Form 5471 filing requirements or they may simply be unaware of the filing requirement. Advisors should consider including discussions on Form 5471 in their offshore funds' Offering Memorandums to alert investors to the potential Form 5471 filing requirement. An advisor may consider monitoring their offshore funds' ownership activity to alert their investors of any filing requirements. Some advisors may even prepare Form 5471 on their investors' behalf to ease the compliance burden associated with investing in their funds.

The above summary briefly describes the basics of U.S. Form 5471 filing requirements. The CFC rules are complex and should be thoroughly reviewed by Category 5 filers, and a myriad of Form 5471 special rules exist including rules for multiple filers of the same information, constructive owners, dormant foreign corporations and non-U.S. shareholders of foreign corporations who become U.S. Persons. Accordingly, we suggest that each taxpayer consult his or her tax or legal advisor to review their filing requirements considering their specific facts and circumstances.

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