Many IRS foreign reporting requirements were originally intended to curb offshore tax avoidance by U.S. residents and multinational companies, but they are increasingly being felt by nonprofit organizations. The penalties for failure to file can be significant, ranging from $10,000 per filing per tax year to $100,000 or more in cases of willful failure to file. Therefore, it’s vital for organizations to assess their compliance with these requirements and to minimize compliance risk.

The most common filing requirements include:

- Transfers of property to, or ownership interests in, foreign entities
- Financial interest in, or signature authority over, foreign bank, securities, and financial accounts
- Certain payments of U.S. source income to foreign persons

This white paper explores three of the more common filing situations, summarizes typical filing requirements for nonprofits, and provides steps to minimize compliance risk.

Common situations where reporting may be required

Alternative investments

In an effort to build a diverse investment portfolio, many nonprofits choose alternative investments consisting mainly of limited partnerships and hedge funds. Each of these investments may generate slightly different foreign reporting requirements, depending on the legal structure of the respective entities.
**Limited partnerships** — For tax purposes, all activities of a partnership are passed through to its partners and reported on their respective tax returns as though the partners conducted the activity, including transfers by the partnership to entities domiciled in foreign countries. Each partner should receive an annual Schedule K-1 from the partnership showing its allocable share of the partnership’s transfers to such entities. If the organization’s allocable share of the partnership’s transfers exceeds the filing thresholds, the organization is required to file the relevant form (typically Form 926, 8865, or 5471).

In addition, if the investment partnership itself is domiciled outside of the United States, any capital contributions made directly from the organization to the partnership in excess of the filing thresholds will also generate a filing requirement (typically Form 8865). As a result, it’s not uncommon for a single partnership K-1 to generate multiple foreign filings for its partners.

**Hedge funds** — Many hedge funds are structured as foreign corporations in order to shelter their tax-exempt investors from unrelated business income. As a result, these hedge funds aren’t required to report the same level of detail to their investors that limited partnerships are required to report to partners. However, any transfers made directly from the organization to the hedge fund in excess of the relevant filing thresholds will need to be reported, usually on Forms 926 or 5471, even though the fund isn’t required to provide a K-1 to investors. In this case, the organization must work with its investment advisor or the hedge fund manager directly to obtain the necessary information to complete the filings.

**Payments to non-U.S. taxpayers**

At this time, the **Foreign Account Tax Compliance Act** (FATCA), which is described below, is a relatively low risk regime for U.S. tax-exempt organizations unless they have significant activities along borders with Canada or Mexico, or the organization outsources services to non-U.S. payees that are performed in the United States.

Some examples of payments that could generate a reporting requirement under FATCA include:

- Renting real property that is located in the United States but has a non-U.S. owner.
- Royalty payments to a non-U.S. person for reprint permissions, licensing rights, or software use if the intangible is used within the United States.
- Honoraria payments to non-U.S. professors or speakers if the service or speaking engagement is performed in the U.S.
- Nonqualified scholarship, fellowship, or stipend payments to non-U.S. persons if studying or working in the United States.
- Payments to service providers who are non-U.S. persons performing services within the United States such as transportation and professional services (i.e., legal, architectural, installation, training, and education).
- Grants, awards, or contributions to non-U.S. organizations — even if the organization has tax exemption within the home country — if a portion of the charitable activity may be performed in the United States.
- Intercompany payments to non-U.S. branches or separate legal entities of the exempt organizations in the United States.

**International operations**

Organizations with operations outside of the United States are occasionally required to establish separate legal entities in the country of operation in order to comply with local laws with respect to property ownership, corporate structure, and other matters, or as part of a joint venture with other organizations.

A separately incorporated affiliate may not operate any differently from its U.S.-based parent such that it’s not apparent that the affiliate is actually a foreign corporation. However, if the organization controls its affiliate, either by ownership of more than 50 percent of outstanding stock or capital interest, or more than 50 percent of the voting power on the board of directors, Form 5471 will likely be required.

On the other hand, many organizations do not establish separately incorporated entities and instead register in the country of operation as a branch of the U.S.-based entity. In the absence of a separate foreign corporation or partnership, it would appear that the Form 5471 and 8865 filing requirements noted above would not apply to branches. That said, the ability to register as a branch versus incorporating a separate legal entity will depend on the laws in the country of operation. Also, while a separate branch of a U.S.-based organization may not generate foreign entity reporting requirements, if the branch has a separate bank, securities, or financial account held outside of the United States, it may have to file the Report of Foreign Bank and Financial Accounts (FBAR), which is described below, to report that account if the balance exceeded $10,000 at any point during the year.
Payments to non-U.S. individuals require documentation regarding the nature and location of services provided, since the rules regarding the tax status of individuals defaults to U.S. taxpayer unless documentation is provided to support the taxpayer’s status with another country.

**Key IRS forms and filing requirements**

This list of forms and their related requirements is not exhaustive, but it includes some of the most common reporting issues for nonprofits. Every situation is different so it is important to seek the assistance of a tax advisor.

**Form 926 — Return by a U.S. Transferor of Property to a Foreign Corporation**

This form is used to report transfers of cash or property to foreign corporations, generally if the organization holds at least 10 percent of the total voting power or total value of the foreign corporation immediately after the transfer (either directly or indirectly), or the amount of cash transferred by the organization during the 12-month period ending on the date of the transfer is more than $100,000.

There is an exception for tax-exempt organizations that transfer stock or securities to foreign corporations. However, because most hedge funds require investments of cash, this exception is more likely to apply where an organization invests in a joint venture or operating subsidiary using securities as consideration.

**Form 5471 — Information Return of U.S. Persons With Respect To Certain Foreign Corporations**

This form is required to report an organization’s ownership interest in a foreign corporation. There are four filer categories; virtually all nonprofits will qualify as either Category 3, 4, or 5.

Category 3 filers include organizations that owned 10 percent or more of the total value or voting power of the foreign corporation at any point during the tax year, or disposed of sufficient stock in the corporation to reduce their interest to less than 10 percent during the tax year. Category 4 and 5 filers include organizations that controlled more than 50 percent ownership interest in the foreign corporation for an uninterrupted period of 30 days or more during any tax year, with Category 5 filers owning the stock on the last day of the tax year.

**Form 8865 — Return of U.S. Persons With Respect to Certain Foreign Partnerships**

This form is required to report an organization’s transfers of cash or property to, or ownership interest in, a foreign partnership. There are four categories of filers, the most common of which are Category 1, 3, and 4.

Category 1 filers include organizations that control more than 50 percent ownership interest in the foreign partnership at any time during any tax year. Category 3 filers include organizations that directly or indirectly owned at least a 10 percent interest in the foreign partnership immediately after the contribution, or the value of property contributed by the organization during the 12-month period ending on the date of transfer is more than $100,000. Category 4 filers include organizations that acquired or disposed of sufficient interest in the foreign partnership to either move their ownership interest above or below 10 percent, or that changed their ownership interest by 10 percentage points — for example, from 15 percent to 25 percent.

**Form 8858 — Information Return of U.S. Persons With Respect To Foreign Disregarded Entities**

This form is required to report interests in foreign disregarded entities. It is less common than the other forms noted above, but may be required in cases where an organization establishes a foreign affiliate that qualifies as a disregarded entity, or where an organization controls a foreign entity that has one or more of its own disregarded entities.
FinCEN 114 — Report of Foreign Bank and Financial Accounts (FBAR)

This form, also known as FBAR, is required to report a financial interest in or signature authority over a foreign financial account if the aggregate value of all such accounts exceeds $10,000 at any time during the calendar year. A foreign financial account is any financial account that is located outside of the United States, including but not limited to securities, brokerage, deposit, or other accounts maintained with financial institutions, commodity futures or options accounts, insurance and annuity policies with cash value, and shares in a mutual fund or similar pooled fund that is available to the general public with a regular net asset value determination and regular redemptions.

Private investment funds whose shares are not readily available to the general public, or which do not have regular redemptions, have generally been exempt from FBAR reporting.

It should be noted that, due to the definition of mutual and pooled funds above, private investment funds whose shares are not readily available to the general public, or which do not have regular redemptions, have generally been exempt from FBAR reporting. However, private investment funds are more likely to generate the other foreign reporting requirements noted above (see the section above on Alternative Investments).

Foreign Account Tax Compliance Act (FATCA)

FATCA seeks to obtain information about U.S. account holders or U.S. owners from certain foreign entities, particularly foreign financial institutions (FFIs), and compels these foreign entities to disclose information by imposing a 30 percent penalty withholding tax for noncompliance. It is intended to prevent tax evasion by U.S. persons through foreign bank or financial accounts and shell entities.

While generally more relevant to financial institutions than nonprofits, there are some requirements that nonprofits need to be aware of, in particular the need to obtain the proper Form W-8 from any foreign persons who receive U.S. source fixed or determinable, annual or periodic (FDAP) income, which includes payments such as compensation for personal services, scholarships, grants, prizes, and awards. Failure to properly withhold taxes on U.S. source FDAP income can result in the nonprofit having to pay a 30 percent tax on the gross amount of the payment.

Steps to help minimize compliance risk

Nonprofits with alternative investments, international operations, or payments to non-U.S. taxpayers can take the following steps to minimize compliance risk.

- Before entering into a limited partnership or hedge fund investment, perform due diligence to get as much information about the investment as possible, including the tax and other compliance requirements facing U.S. investors, and whether the fund itself is willing and able to meet some of the reporting requirements on behalf of its investors.
- Maintain a detailed listing of all your organization’s alternative investments, including your legal domicile, legal structure, total transfers into each fund during the tax year, total ownership percentage of each fund at the beginning and end of each tax year, and whether each investment is required to provide a Schedule K-1 to its investors. This should allow you to determine which investments are domiciled in foreign countries and whether your transfers to these funds and ownership interest in the funds meet any of the reporting requirements.
- Obtain a Schedules K-1 for all partnership investments that are required to issue them, including details on the partnerships’ transfers to foreign domiciled entities.
- Determine the legal structure of your affiliates operating outside of the United States, including whether they are branches of a U.S.-domiciled parent or separately incorporated foreign entities.
- Determine whether you hold any bank, securities, or financial accounts outside of the United States, and whether there are any U.S. persons who have signature authority over those accounts; those individuals will also have an FBAR filing.
- For payments to U.S. persons, obtain a Form W-9 from all payees to confirm U.S. taxpayer status.
- For payments to non-U.S. persons, determine and document whether the payment is fixed or determinable, annual or periodic (FDAP). If the payment is FDAP, complete Form W-8BEN, submit it to the payee, and determine if withholding requirements apply.
Our commitment to your success is without boundary or border. Working closely with your team in the United States and abroad, we will help you develop tax solutions that align with your goals.

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