

Explanation of Section 6038D Temporary and Proposed Regulations

Foreign Account Tax Compliance Act (FATCA)

December 2011

The Foreign Account Tax Compliance Act, enacted in 2010, created new IRC Section 6038D and requires individuals to file a statement with their income tax returns to report interests in specified foreign financial assets if the aggregate value of those assets exceeds certain thresholds.

Temporary regulations implementing IRC 6038D have been issued. Under the regulations, specified individuals (U.S. citizens, residents and certain non-resident aliens) are required to complete and attach Form 8938, Statement of Specified Foreign Financial Assets, to their income tax returns. This is effective for tax years starting after March 18, 2010, which for most people will be their 2011 tax returns filed during the 2012 filing season.

In developing the regulations IRS considered the potential burden this new self-reporting requirement could have on affected taxpayers. To balance reporting burden and the need for compliance improvement, there are higher asset thresholds for married couples and those residing abroad. There are also exceptions that relieve taxpayers from reporting certain assets, and special rules for valuing assets.

Reporting Thresholds

Reporting thresholds vary based on whether a filer files a joint tax return or resides abroad, and are higher for married couples and taxpayers who qualify for foreign residency.

- Unmarried taxpayers living in the US: The total value of specified foreign financial assets is more than \$50,000 on the last day of the tax year or more than \$75,000 at any time during the tax year
- Married taxpayers filing a joint income tax return and living in the US: The total value of specified foreign financial assets is more than \$100,000 on the last day of the tax year or more than \$150,000 at any time during the tax year
- Married taxpayers filing separate income tax returns and living in the US: The total value of your specified foreign financial assets is more than \$50,000 on the last day of the tax year or more than \$75,000 at any time during the tax year.
- Taxpayers living abroad.

- Status is other than a joint return and the total value of specified foreign assets is more than \$200,000 on the last day of the tax year or more than \$300,000 at any time during the year; or
- Married filing joint return and the value of specified foreign assets is more than \$400,000 on the last day of the tax year or more than \$600,000 at any time during the year. These thresholds apply even if only one spouse resides abroad.

Married individuals who file a joint annual return for the taxable year will file a single Form 8938 that reports all of the specified foreign financial assets in which either spouse has an interest.

Specified Foreign Financial Assets

Specified foreign financial assets include foreign financial accounts, and foreign non-account assets held for investment (as opposed to held for use in a trade or business), such as foreign stock and securities, foreign financial instruments, contracts with non-US persons, and interests in foreign entities. The regulations include a list of examples, such as swaps, options, and derivative contracts.

There are exceptions. Certain assets of a foreign nature are not specified foreign financial assets that require Form 8938 reporting. Additionally, certain specified foreign financial assets reported elsewhere need not be reported on Form 8938. These exceptions are as follows:

- A financial account maintained by a U.S. payor is not a specified foreign financial asset. For example, a specified person is not required to report a financial account maintained by a U.S. branch of a foreign financial institution, or a foreign branch of a U.S. financial institution..
- Exceptions from reporting are made for assets reported on certain other tax forms. These include: Form 3520, Form 3520-A, Form 5471, Form 8621, Form 8865, or Form 8891. The value of specified foreign financial assets reported on these forms are included in determining the total value of assets for Form 8938 purposes, but the assets do not need to be reported on Form 8938. In this situation, the taxpayer identifies on Form 8938 which and how many of these form(s) report the specified foreign financial assets.
- Exceptions from reporting are made for certain trusts, certain assets held by bona fide residents of possessions, and assets or accounts for which mark-to-market elections have been made under Section 475.
- A beneficial interest in a foreign trust or a foreign estate is not a specified foreign financial asset of a specified person unless the specified person knows or has reason to know of the interest.
- An interest in a social security, social insurance, or other similar program of a foreign government is not a specified foreign financial asset.

- A specified individual that is treated as a beneficiary of a domestic bankruptcy trust or a domestic widely held fixed investment trust is not required to file Form 8938 to report any specified foreign financial asset held by the trust.

Certain key definitions of terms in the regulations, such as "financial account" and "financial institution," will be further defined by regulations under FATCA Chapter 4.

Asset Valuation

Taxpayers will need to determine the value of their specified foreign financial assets in order to determine if the aggregate value exceeds the threshold applicable to them. Generally, a reasonable estimate of the highest fair market value of the asset during the tax year is reported, but special rules apply to ease valuation burdens.

- For reporting purposes, a specified individual may rely on a year-end financial account statement or the year-end value of a non-account asset if it reasonably approximates the maximum value of the account or asset during the tax year. Special rules also apply for reporting the maximum value of an interest in a foreign trust, foreign retirement plan, or a foreign estate.
- A specified person may determine the fair market value of a specified foreign financial asset based on information publicly available from reliable financial information sources or from other verifiable sources.
- Even if there is no information from reliable financial information sources regarding the fair market value of a reported asset, the regulations do not require a specified person to obtain an appraisal by a third party in order to reasonably estimate the asset's fair market value.

Non-compliance with Form 8938 Reporting Requirements

Taxpayers required to file Form 8938 who do not are subject to penalties -- a \$10,000 failure to file penalty, an additional penalty of up to \$50,000 for continued failure to file after IRS notification, and a 40 percent penalty on an understatement of tax attributable to non-disclosed assets.

The statute of limitations is extended to six years after a taxpayer's return is filed if the taxpayer omits \$5,000 from gross income attributable to a specified foreign financial asset, without regard to the reporting threshold or any reporting exceptions.

If the taxpayer fails to file or properly report an asset on Form 8938, the statute of limitations for the taxable year is extended until the taxpayer provides the required information. If the failure is due to reasonable cause, the statute of limitations is

extended only with regard to the item or items related to such failure and not the entire tax year.

Form 8938 Does Not Relieve Filers of FBAR Filing Requirements

The reporting of foreign financial accounts on Form TD F 90-22.1 ("FBAR") is required under Title 31. Certain foreign financial accounts are reported on both Form 8938 and the FBAR. However, the information required by the forms is not identical in all cases. Different rules, key definitions (for example, "financial account"), and reporting requirements apply to Form 8938 and FBAR reporting. Because of these differences, certain foreign financial accounts may be reported on one but not both forms.

FBAR reporting has other law enforcement purposes in addition to tax administration. As a consequence, different policy considerations apply to Form 8938 and FBAR reporting. These are reflected in the different categories of persons required to file Form 8938 and the FBAR, the different filing thresholds for Form 8938 (i.e., minimum \$50,000 threshold) and FBAR reporting (i.e., \$10,000 reporting threshold), and the different assets (and accompanying information) required to be reported on each form.

These differing purposes and policy considerations were recognized during the passage of the HIRE Act and the enactment of Section 6038D. The intention to retain FBAR reporting notwithstanding the enactment of Section 6038D was specifically noted in the technical explanation of the Joint Committee on Taxation.

For FBAR purposes, a filer must report a financial account if the filer had a financial interest or signature authority in the financial account during the previous calendar year. Financial interest for FBAR purpose is based on whether the person is the owner of record for or holds legal title to the financial account. Signature authority is the authority of a person to dispose of deposits or other assets held in a financial account.

For Section 6038D purpose, an individual has an interest in the financial account if potential tax attributes or transactions related to the account would be reported on the individual's tax return. The concept of signature authority does not apply for Section 6038D purposes.

In certain instances, FBAR reporting is required by persons who do not have a direct financial interest in a foreign financial account. For example, an individual is required to report the foreign financial account of his or her wholly owned domestic or foreign corporation. If a domestic corporation has a direct or indirect financial interest in the foreign account, it will also be required to report the account, as would any individuals, such as employees, that have signature authority over the financial account. For Section 6038D purposes, if a foreign financial account is reported by a specific individual, the foreign account will not also be reported by a specified domestic entity, and vice-versa.

The due date for filing the FBAR is June 30 for financial accounts for which the filer had a financial interest or signature authority during the previous calendar year. The FBAR is filed with the IRS in Detroit. Form 8938 is due with the taxpayer's annual income tax return and filed with the applicable IRS service center.

Specified foreign financial assets held outside of an account with a financial institution are reported on Form 8938, but not reported on the FBAR.

Proposed Regulations with Respect to Form 8938 Filing by Domestic Entities

The proposed regulations relating to specified domestic entities apply to taxable years beginning after December 31, 2011. There is no Form 8938 filing requirement for domestic entities at this time.

The proposed regulations apply to domestic entities formed or availed of for the purposes of holding, directly or indirectly, specified foreign financial assets. Such entities are referred to as specified domestic entities and include certain closely held corporations and partnerships that meet passive income or passive income tests. With exceptions, domestic trusts are included if they have a specified individual(s) as a current beneficiary and exceed the reporting threshold.

"Specified domestic entities" include certain domestic corporations, domestic partnerships and domestic trusts, but not domestic estates.

For a domestic corporation or partnership to be considered a specified domestic entity, three conditions must apply.

- The corporation/partnership must have an interest in specified foreign financial assets with an aggregate value exceeding the \$50,000/\$75,000 reporting threshold.
- It must be closely held (80 percent by vote or value at end of the taxable year) by a specified individual taking into account indirect and constructive ownership rules.
- It must either meet an at least 50 percent passive income/assets test, or meet a 10 percent passive income/assets test and based on the facts and circumstances been formed or availed of with a principal purpose of avoiding reporting under Section 6038D.

Two different aggregation rules apply to determine whether a domestic corporation or domestic partnership is a specified domestic entity.

- First, in determining whether a domestic corporation or domestic partnership meets the reporting thresholds, domestic corporations and domestic partnerships that are closely held by the same specified individual are treated as a single entity.
- Second, for purposes of determining whether a corporation or partnership meets the passive income/asset tests, domestic corporations and domestic partnerships that

are closely held by the same individual and that are connected through stock or partnership interest ownership with a common parent corporation or partnership are treated as a single entity.

A domestic trust is considered a specified domestic entity if it has an interest in specified foreign financial assets (other than assets excepted from reporting) with an aggregate value exceeding the \$50,000/\$75,000 reporting threshold and at least one specified person as a current beneficiary.

A domestic entity is not considered to be a specified domestic entity if it is described in Section 1473(3) and the regulations thereunder as excepted from the definition of the term "specified United States person". This exception does not apply to any trust that is exempt from tax under Section 664(c).

A domestic trust is not considered a specified domestic entity if the trustee or executor is a bank, financial institution, or domestic corporation that is subject to certain examination, oversight or registration requirements, has supervisory authority over or fiduciary obligations with regard to the trust's specified foreign financial assets, and files income tax returns and information returns on behalf of the trust.

A domestic trust or any portion of the trust that is treated as owned by one or more specified persons under Sections 671 through 679 and the regulations issued under those sections is not considered to be a specified domestic entity.