

IVINS, PHILLIPS & BARKER

CHARTERED

February 2012

FATCA Information Reporting Rules for US Individuals Holding Specified Foreign Financial Assets

The Internal Revenue Service (“IRS”) recently released guidance relating to a new requirement for individuals to report their interests in “specified foreign financial assets.” This provision, effective for tax year 2011, is part of the Foreign Account Tax Compliance Act (“FATCA”), enacted as part of the Hiring Incentives to Restore Employment (“HIRE”) Act in 2010. Currently, the new reporting rules only apply to “specified individuals.” Those required to make the disclosures must file a new IRS form, Form 8938, with their 2011 income tax return.

Affected Persons

Currently, the new reporting regulations pertain to “specified individuals” including U.S. citizens, resident aliens, non-resident aliens who have elected to be treated as a U.S. resident under Internal Revenue Code (“Code”) section 6013(g) or (h), and residents of certain U.S. possessions. A specified individual is not required to file Form 8938 for any taxable year for which he is not required to file an annual tax return. Proposed regulations will extend the reporting requirement to “specified domestic entities” including certain closely held domestic corporations, partnerships and certain trusts beginning in tax year 2012. (See *Future Applicability*, below).

Specified Foreign Financial Assets

The scope of assets to be reported is quite broad. Specified foreign financial assets include any financial account maintained by a foreign financial institution (for example, bank or brokerage accounts, interests in foreign hedge funds, mutual funds and private equity funds). Foreign deferred compensation accounts and pension plans (not including government-sponsored social security or social insurance plans) are included in the definition and are reportable. Financial accounts maintained in U.S. branches of foreign financial institutions and foreign branches of U.S. financial institutions are excluded from the definition of specified foreign financial assets and need not be reported.

For assets not held in a foreign financial account, to the extent they are held for investment, foreign stocks or securities issued by foreign entities, debt or contract instruments issued by foreign entities and any interest in a foreign entity generally must be reported. There is no threshold percentage ownership interest below which reporting is not required. Thus, even de

minimis holdings in foreign entities are reportable if the aggregate value of specified foreign financial assets exceeds the applicable reporting threshold. A beneficial interest in a foreign trust or foreign estate may be a specified foreign financial asset if the owner knows or has reason to know of the interest or if the person receives distributions from the trust. A specified individual is not treated as having an interest in any specified foreign financial assets held by a corporation, partnership, trust or estate solely as a result of the person's status as a shareholder, partner or beneficiary. An exception applies to owners of "grantor" trusts who are treated as having an interest in specified foreign financial assets held by the grantor trust.

Reporting Thresholds

A specified individual is required to file Form 8938 only if the aggregate value of his specified foreign financial assets exceeds specified limits. Generally, an individual is required to disclose if the aggregate value of all such assets exceeds \$50,000 on the last day of the taxable year or \$75,000 at any time during the taxable year. Married individuals filing a joint return must report if the aggregate value of all specified foreign financial assets owned by either spouse exceeds \$100,000 on the last day of the taxable year or \$150,000 at any time during the year.

An individual living abroad who is a "qualified individual" under Code section 911(d)(1) (pertaining to the foreign earned income and housing cost income exclusions) must report on Form 8938 if the aggregate value of his specified foreign financial assets exceeds \$200,000 on the last day of the taxable year or \$300,000 at any time during the taxable year. Qualified individuals filing a joint return must disclose if the aggregate value of all of the specified foreign financial assets owned by either spouse exceeds \$400,000 on the last day of the taxable year or \$600,000 at any time during the taxable year.

Reasonable estimates of value are allowed in determining the value of a specific asset. However the IRS will presume that the value of specified foreign financial assets exceeds the reporting threshold if the individual has an interest in one or more such assets and the individual does not provide sufficient information to demonstrate the aggregate value. A specified individual is generally considered to have an interest in a specified foreign financial asset if any income, gains, losses, deductions, credits, gross proceeds, or distributions attributable to the asset would be required to be reported on the individual's annual tax return.

For assets denominated in a foreign currency, the value must be determined first in the foreign currency and then converted to U.S. dollars. The regulations direct taxpayers to use the U.S. Treasury Department's Financial Management Service foreign currency exchange rates, or, if unavailable, another publicly available foreign currency exchange rate. All values are to be converted to dollars using the conversion rate in effect on the last day of the taxable year even if the asset was sold or otherwise disposed of earlier in the year.

Required Disclosures

Persons who are required to file Form 8938 must disclose significant information concerning their specified foreign financial assets. This information includes the account number and the name and address of the foreign financial institution that maintains the account, the name and address of stock or security issuers, the maximum value of the specified foreign financial asset during the portion of the year the asset was owned by the taxpayer, and with respect to financial accounts, whether the account was opened or closed during the taxable year. Taxpayers must also disclose any amounts of gain, loss, deduction or credit recognized in the tax year with respect to specified foreign financial assets.

Penalties for Failure to File Form 8938

The IRS may impose a \$10,000 penalty for failing to file Form 8938. An additional penalty up to a maximum of \$50,000 may apply if the failure continues after notification by IRS. No penalty will apply if the taxpayer can show the failure was due to reasonable cause and not due to willful neglect. A 40 percent penalty is imposed on any understated tax attributable to undisclosed specified foreign financial assets.

A failure to file the Form 8938 extends the statute of limitations for the tax year until the taxpayer provides the required information. Thus a failure to file Form 8938 could result in the limitations period for the taxable year to which the failure pertains to remain open indefinitely. If the failure is due to reasonable cause and not willful neglect, then the statute is extended only with respect to the items relating to the failure. The general limitations period is extended to six years if the taxpayer omits more than \$5,000 from gross income attributable to specified foreign financial assets without regard to the reporting threshold or any reporting exceptions.

Many taxpayers who are required to file Form 8938 must also file Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts ("FBAR"). Nothing in the Form 8938 reporting rules is intended as a substitute for compliance with FBAR reporting requirements. Thus, in many cases, specified individuals will be required to file both the Form 8938 and the FBAR.

Future Applicability

Currently the Form 8938 reporting rules apply only to individuals. Similar reporting rules are expected to apply to "specified domestic entities" with respect to tax years beginning after December 31, 2011. Until final regulations are released, no domestic entity is required to file Form 8938.

As defined in proposed regulations, a specified domestic entity is a domestic corporation, partnership or trust if such entity is formed or availed of for the purpose of holding, directly or indirectly, specified foreign financial assets. A domestic corporation or partnership is formed or

availed of for purposes of holding specified foreign financial assets if (i) the entity has interests in specified foreign financial assets exceeding the reporting thresholds, (ii) the entity is closely held by a specified individual, and (iii) at least 50 percent of the entity's gross income is passive income, or at least 50 percent of the assets held by the entity at any time during the year are assets that produce or are held for the production of passive income. Passive income includes dividends, interest, rents and royalties (other than those derived in the active conduct of a trade or business), capital gains on passive income-producing property and currency gains. A corporation or partnership is closely held by a specified individual if at least 80 percent of the vote or value of the corporation's stock or 80 percent of the partnership's capital or profit interest is owned directly, indirectly or constructively by one specified individual on the last day of the entity's tax year.

Generally, a domestic trust is a specified domestic entity that is formed or availed for purposes of holding specified foreign financial assets if the trust has an aggregate interest in specified foreign financial assets in excess of the reporting threshold and has one or more specified persons as a current beneficiary.

Whether an entity is a specified domestic entity is determined annually. If a specified domestic entity is a member of an affiliated group of corporations that files a consolidated return, the entity's Form 8939 must be filed with the consolidated federal income tax return of the group.