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New Offshore Traps

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The U.S. uses a global approach to income and estate tax. Many of the other G-20 countries use a territorial system. The result is that U.S.taxpayers, are now faced with enhanced disclosure and enforcement issues.

Form 8938 is required for U.S. taxpayers as part of Form 1040 whose aggregate "specified foreign financial assets" exceed specified values depending on filing status. The value test is applied against the greater of the highest value in the year or the year end value. Example: individuals who have aggregate value in excess of $75,000 at any point during the year or $50,000 at year end must comply. Form 8938 is required under the HIRE Act as part of IRC section 6038D. It is important to note that the disclosures required under IRC section 6038D include foreign trusts which are treated as "grantor trusts" under IRC section 6048. What does all this mean for taxpayers?

Form 8938 requires the disclosure of the following asset classes. (a) accounts maintained at foreign financial institutions;(b) stock or securities issues by someone other than a U.S. person; (c) any interest in a foreign entity and (d) any financial instrument or contract that has an issuer or counterparty that is other than a U.S. person. The first provision, disclosure of accounts is somewhat like the disclosure required under the Bank Secrecy Act (BSA) which (FBAR's) except that the aggregate account disclosure level for an FBAR is only $10,000. There are important penalty and enforcement differences applicable to failure to file FBAR's and failure to file Form 8938. FBAR enforcement is governed under the BSA and Form 8938 enforcement under the IRC. But the real issue with Form 8938 is what the disclosure is likely to reveal. The disclosure may have income tax and estate and gift tax consequences.

It would be a dubious proposition to state that Form 8938 is designed to interdict money launderers, drug dealers or arms dealers, which are among the listed objectives of the BSA. But there is a consistent theme and that is tax evaders. Tax evasion may be discovered by auditing activity

Law Offices of Sanford I. Millar

Office: 310-556-3007
Fax: 310-556-3094
Address: 1801 Avenue of the Stars, Suite 600
Los Angeles, CA. 90067
Email: smillar@millarlaw.net

www.millarlawoffices.com

following the filing of Form 8938. How the specified foreign financial assets were acquired will likely be a primary inquiry. Were the assets acquired by gift or inheritance? If so, was a Form 3520 required? Was a distribution from a foreign trust involved? Was a Form 3520A required? Is the taxpayer the holder of in interest in a PFIV or CFC and if so were those returns required? These questions pose ethical issues for tax return preparers who are now obligated to ask about foreign holdings. The burden will fall particularly on taxpayers and who are dual nationals or U.S. ex-patriots.

Returns prepares may have to refer clients to tax counsel once the return preparer discovers the existence of unreported foreign holdings, in order to preserve attorney client privileges. The absence of a specific voluntary disclosure program, like the 2009 OVDP and 2011 OVDI means that taxpayers may now have to apply to enter the general voluntary disclosure program or make a decision to file returns and make a reasonable cause argument for penalty abatement. The penalties assessable under the IRC and mitigation remedies are both complex and require careful reasoned approaches. The result is that some practitioners and taxpayers will be on the wrong side of enforcement actions. As we approach the effective date of FATCA 2014 more and more foreign financial institutions will require proof of U.S. income tax compliance, including the filing of FBAR's and reporting of income. Once FATCA kicks in, those foreign financial institutions and who enter into agreements with the IRS will provide account information on U.S. account holders.

The noose is tightening on a U.S. taxpayers with un disclosed foreign assets. Going forward the cost benefit of non-disclosure will increase, but then again so will the need for careful asset planning. Among the points to consider is how future estate planning should be managed. Assets disclosed on Form 8938 may need to be included in estate tax and/or gift tax returns and result in the taxable estate exceeding the then applicable estate and gift tax exemptions. Should U.S. taxpayers who expect to inherit foreign assets speak with counsel, and their relatives to plan, of course. The result of not acting could be a taxable estate without sufficient liquidity to cover the tax.

Form 8938 is just the beginning of a whole new enforcement and compliance campaign which will mandate more diligence by return preparers and more expense by taxpayers.

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