

## **Broad Regulations for Foreign Financial Asset Reporting**

*Proposed and temporary Treasury regulations expand upon, and perhaps duplicate, other required information reporting with respect to foreign financial assets held by certain U.S. taxpayers.*

**January 24, 2012**

On December 14, 2011, the U.S. Department of the Treasury (Treasury) issued temporary and proposed regulations relating to information reporting of certain foreign financial assets required under Section 6038D of the Internal Revenue Code of 1986, as amended. These regulations may trigger increased reporting obligations for certain specified persons.

### **Background**

Section 6038D, enacted as part of the Foreign Account Tax Compliance Act (or FATCA) contained within the Hiring Incentives to Restore Employment Act of 2010 (or the HIRE Act, P.L. 111-147), requires individuals holding specified foreign assets in excess of certain thresholds to attach detailed information to their tax returns concerning such assets. For those familiar with Form TDF 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR),<sup>1</sup> the information required by FATCA is separate and distinct from the FBAR and covers a far broader range of foreign assets than the FBAR. To date, Treasury guidance concerning FATCA has focused on the obligations of foreign financial institutions with respect to U.S.-owned accounts maintained by such institutions and how such obligations are to be implemented.<sup>2</sup> The regulations focus on the other major aspect of FATCA, which concerns the reporting obligations of the individuals who own such foreign financial accounts.

### **General Reporting Requirements**

#### *Reporting Triggers and Information Required*

In general, beginning with the 2011 tax year (i.e., for returns due April 15, 2012 or later pursuant to extensions), the temporary regulations provide that a “specified person” (as defined below) residing in the United States must file new Form 8938<sup>3</sup> with his or her tax return if the aggregate fair market value

1. View Form TD F 90-22.1 at <http://www.irs.gov/pub/irs-pdf/f90221.pdf>.

2. See our August 26, 2011 LawFlash, “Recent IRS Notices Provide Supplemental FATCA Guidance and Phased-in Implementation,” which contains a discussion of such guidance under FATCA, available at [http://www.morganlewis.com/pubs/Tax\\_LF\\_FATCAGuidancePhased-inImplementation\\_26aug11.pdf](http://www.morganlewis.com/pubs/Tax_LF_FATCAGuidancePhased-inImplementation_26aug11.pdf).

3. View Form 8938 at <http://www.irs.gov/pub/irs-pdf/f8938.pdf>.

of the “specified foreign financial assets” owned by that person exceeds either \$50,000 on the last day of the taxable year or \$75,000 at any time during the year. With respect to joint filers residing in the United States, these thresholds are increased to \$100,000 and \$150,000, respectively. The temporary regulations provide for significantly higher thresholds of \$200,000 at the end of the year or \$300,000 at any time during the year for certain taxpayers residing outside of the United States (for joint filers living abroad,<sup>4</sup> the applicable thresholds are \$400,000 and \$600,000, respectively). The preamble to the temporary regulations explains the higher thresholds for taxpayers living abroad, noting that such taxpayers “can reasonably be expected” to have a greater amount of specified foreign financial assets for reasons unrelated to the policies underlying Section 6038D (i.e., preventing tax evasion). Where a taxpayer does not provide enough information for the IRS to determine the value of an asset, the taxpayer is presumed to own foreign financial assets with a value in excess of the reporting threshold.

“Specified foreign financial assets” generally subject to reporting on Form 8938 include any foreign financial account maintained by a foreign financial institution, and, to the extent not held in an account at a financial institution, (i) any stock or security issued by any non-U.S. person, (ii) any financial instrument or contract held for investment that has a non-U.S. issuer or counterparty, and (iii) any interest in a foreign entity. Unless an exception for a particular asset applies, for each specified foreign financial asset a reporting taxpayer must disclose the maximum value of such asset during the taxable year, as well as other detailed information including the following:

- In the case of a financial account, the name and address of the financial institution maintaining such account and the account number.
- For any stock or security, the name and address of the non-U.S. issuer and information necessary to identify the class or issue of which the stock or security is a part.
- For other instruments, contracts, or interests, the names and addresses of all issuers and counterparties along with information necessary to identify the instruments, contracts, or interests.
- The amount of any income, gain, loss, deduction, or credit recognized for the taxable year with respect to the reported specified foreign financial asset, and the portion of the taxpayer’s tax return where such information is reported.
- The foreign currency exchange rate used to determine the U.S. dollar value of the specified foreign financial asset, as well as the source of such rate if a source other than one specified in the regulations is used.

Although it is not entirely clear, the regulations indicate that a “specified person” (defined below) who is a discretionary beneficiary of a foreign nongrantor trust, and who either knows or has reason to know of the interest in the trust, may be required to disclose information relating to such interest on Form 8938 if the aggregate value of such beneficiary’s specified foreign financial assets (including the value of the interest in the trust) exceeds the applicable thresholds described above. This may be the case even if the value of the interest is deemed to be zero (i.e., because the beneficiary receives no distributions and otherwise has no right to mandatory distributions). For this purpose, a beneficiary will be deemed to know of the interest in the trust if distributions from the trust are made to such person. Although the temporary regulations and other guidance from the IRS are less than clear on this point, a conservative

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4. A taxpayer is considered to live abroad if (1) he or she is a U.S. citizen whose tax home is in a foreign country and he or she is a bona fide resident of a foreign country or countries for an uninterrupted period that includes the entire tax year, or (2) he or she is a U.S. citizen or resident who, during a period of 12 consecutive months ending in the tax year, is physically present in a foreign country or countries for at least 330 days.

reading of the temporary regulations suggests that in order to avoid penalties, a discretionary beneficiary of a foreign nongrantor trust whose interest in the trust is deemed to have a zero value should nonetheless disclose an interest in such trust if such beneficiary's holdings in other specified foreign financial assets trigger a Form 8938 filing obligation.

Note that the definition of "specified foreign financial assets" that are required to be reported by specified persons on Form 8938 encompasses a broader array of foreign assets than those that are subject to reporting by participating foreign financial institutions under FATCA.<sup>5</sup> Currently, participating foreign financial institutions are limited to reporting on "financial accounts." It is unclear whether future FATCA guidance will expand the class of assets that must be reported by participating foreign financial institutions.

Pursuant to the temporary regulations and the instructions to Form 8938, specified foreign financial assets *not* subject to reporting include financial accounts maintained with domestic financial institutions and domestic branches of foreign banks, as well as financial accounts maintained by dealers in securities if the holdings in such accounts are subject to the "mark-to-market" accounting rules. Also excepted from reporting are assets that are subject to reporting on certain other IRS forms (e.g., Form 8621, filed by shareholders of PFICs and Qualified Electing Funds; Form 8865, filed by U.S. persons with respect to foreign partnerships; Form 3520, filed to report transactions with foreign trusts and receipt of certain foreign gifts; and Form 5471, filed by U.S. persons with respect to certain foreign corporations).

Taxpayers may face challenges when valuing the specified foreign financial assets. Generally, the fair market value of an asset is used; however, there are numerous special exceptions (e.g., assets with no positive value, interests in foreign trusts, interests in pension funds and deferred compensation plans). Under the temporary regulations, the value ascribed to a foreign nongrantor trust is the value of distributions made plus the value of the right to receive mandatory distributions from the trust. A foreign nongrantor trust that makes no distributions, and that does not provide for mandatory distributions to discretionary beneficiaries, will have a maximum value of zero, though as discussed above such beneficiaries may decide to disclose information relating to such interest in the trust in order to avoid possible penalties. Further, unlike the FBAR instructions, Form 8938 provides that reliance on periodic account statements to determine maximum value is acceptable unless "you know or have reason to know based on readily accessible information that the statements do not reflect a reasonable estimate of the maximum account value during the tax year." The phrases "reason to know," "readily accessible information," and "reasonable estimate" are likely to be subject to various interpretations by practitioners.

### *Reporting Obligations Limited to "Specified Persons"*

The information reporting obligations described above apply to "specified persons," a term that encompasses "specified individuals" and "specified domestic entities." A "specified individual" means a U.S. citizen, a U.S. resident alien, or a nonresident alien who has elected to be taxed as a U.S. resident. The proposed regulations provide that "specified domestic entities" are entities that are formed for the purpose of holding, either directly or indirectly, specified foreign financial assets. The current instructions to Form 8938 provide that, until future regulations are issued, Form 8938 only needs to be filed by "specified individuals."

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5. See the Tax LawFlash "Recent IRS Notices Provide Supplemental FATCA Guidance and Phased-in Implementation," referenced in footnote 2 above.

A specified domestic entity includes either domestic corporations and partnerships that (i) hold specified foreign financial assets valued in excess of the thresholds applicable to U.S. resident individual filers (\$50,000 at year-end or \$75,000 at any time during the year), (ii) are closely held by a specified individual (80% or more owned by such specified individual), and (iii) earn “passive” income such as dividends and interest (or have a combination of passive income and assets that produce passive income) exceeding certain thresholds. A special aggregation rule applies to treat a group of domestic corporations or partnerships as a single entity if they are closely held by the same specified individual. Certain domestic trusts can also be treated as “specified domestic entities” that have an obligation to file Form 8938. Charitable remainder trusts, grantor trusts, and trusts having institutional trustees meeting certain requirements are not specified domestic entities. Entities that are generally exempt from FATCA, such as publicly traded corporations, tax-exempt organizations, REITs, and RICs, are also not treated as “specified domestic entities.” Since the regulations applicable to specified domestic entities are still in a proposed form, no domestic entity is required to file Form 8938 until such regulations are made final by the Treasury.

An otherwise specified person need not file Form 8938 for a particular year if he, she, or it does not have to file a tax return for such year.

### *Penalties for Noncompliance*

Failure to timely comply with the reporting requirements described above may result in a \$10,000 penalty, up to a maximum of \$50,000 for sustained failure to file following receipt of notice from the IRS regarding the failure. This penalty is in addition to other penalties, such as the 40% penalty imposed on a substantial understatement of tax resulting from nondisclosure of assets as well as any penalties and sanctions (both civil and criminal) resulting from a failure to file the existing FBAR form with respect to such foreign assets, discussed briefly below. Further, if no Form 8938 is filed to report a specified foreign financial asset that is reportable, the statute of limitations may remain open for all or part of the return until three years after the date on which the Form 8938 was required to be filed.

### **Potential Duplication of Existing Reporting Obligations**

The disclosure required on Form 8938 may be duplicative of a taxpayer’s disclosure obligations on the FBAR.<sup>6</sup> Unlike Form 8938, the FBAR is not submitted to the IRS with the taxpayer’s return, but is instead subject to a different deadline (June 30 of each year) and must be filed with a separate office of the Treasury. Although each of the FBAR and Form 8938 is subject to different filing triggers, there is a high degree of overlap between the two forms in terms of the disclosure of information required to be

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6. For further details on the FBAR, please see the following LawFlashes: “Important New Development Regarding Reporting of Foreign Bank and Financial Accounts: What Corporations and Individuals Need to Know” (Jan.27, 2009), available at [http://www.morganlewis.com/pubs/Tax\\_ForeignBank\\_LF\\_27jan09.pdf](http://www.morganlewis.com/pubs/Tax_ForeignBank_LF_27jan09.pdf); “FinCEN and IRS Issue Guidance on FBAR Filing Requirements for Certain U.S. Persons” (Feb. 26, 2010), available at [http://www.morganlewis.com/pubs/TaxLF\\_FinCEN-IRSGuidanceOnFBARFilingReqs\\_26feb10.pdf](http://www.morganlewis.com/pubs/TaxLF_FinCEN-IRSGuidanceOnFBARFilingReqs_26feb10.pdf); “FinCEN Issues Final FBAR Regulations for Certain U.S. Persons Holding Foreign Financial Accounts” (Mar. 11, 2011), available at [http://www.morganlewis.com/pubs/TaxLF\\_FinCENIssuesFinalFBARRegulations\\_11march11.pdf](http://www.morganlewis.com/pubs/TaxLF_FinCENIssuesFinalFBARRegulations_11march11.pdf); “FinCEN Issues Extension for Certain FBAR Filers” (June 3, 2011), available at [http://www.morganlewis.com/pubs/TaxLF\\_FinCENIssuesExtensionFBARFilers\\_03june11.pdf](http://www.morganlewis.com/pubs/TaxLF_FinCENIssuesExtensionFBARFilers_03june11.pdf); and “Two More Extensions: IRS and FinCEN Issue Extensions for Certain FBAR Filers in IRS Notice 2011-54 and FinCEN Notice 2011-2” (June 20, 2011), available at [http://www.morganlewis.com/pubs/TaxLF\\_IRSFinCENIssueExtensionsforFilers\\_20june11.pdf](http://www.morganlewis.com/pubs/TaxLF_IRSFinCENIssueExtensionsforFilers_20june11.pdf).

furnished by the taxpayer with respect to foreign financial assets. Notwithstanding the high likelihood of duplicative reporting of information concerning the same assets by a taxpayer, the IRS states clearly in the preamble that both forms must be filed if the filing obligation for each form is triggered.

The latest action by the IRS to increase information reporting for offshore assets reflects the IRS's continued pursuit of individuals with unreported assets abroad and complements the provisions of FATCA that apply to foreign financial institutions. Given the attention by the IRS to this area, individuals and their professional advisors must be increasingly aware of this complex and counter-intuitive area of tax compliance.

Our Tax Controversy and Consulting attorneys are prepared to help individuals and companies navigate the overlapping issues of FBAR and FATCA compliance, including issues related to voluntary disclosure and the avoidance of potential criminal prosecutions and large monetary penalties.

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following members of the Morgan Lewis Tax Practice:

**Boston**

Brian C. McManus 617.341.7865 [bmcmanus@morganlewis.com](mailto:bmcmanus@morganlewis.com)

**London**

Charles Lubar +44 (0)20 3201 5531 [clubar@morganlewis.com](mailto:clubar@morganlewis.com)  
Joan Ingram +44 (0)20 3201 5533 [jingram@morganlewis.com](mailto:jingram@morganlewis.com)

**New York**

Richard S. Zarin 212.309.6879 [rzarin@morganlewis.com](mailto:rzarin@morganlewis.com)

**Palo Alto**

Barton W.S. Bassett 650.843.7567 [bbassett@morganlewis.com](mailto:bbassett@morganlewis.com)  
William F. Colgin, Jr. 650.843.7270 [wcolgin@morganlewis.com](mailto:wcolgin@morganlewis.com)

**Philadelphia**

William P. Zimmerman 215.963.5023 [wzimmerman@morganlewis.com](mailto:wzimmerman@morganlewis.com)  
Gabriel A. Quihuis 215.963.4796 [gquihuis@morganlewis.com](mailto:gquihuis@morganlewis.com)

**San Francisco**

Gary A. Herrmann 415.442.1380 [gherrmann@morganlewis.com](mailto:gherrmann@morganlewis.com)

**Washington, D.C.**

Mark E. Matthews 202.739.5655 [mark.matthews@morganlewis.com](mailto:mark.matthews@morganlewis.com)  
T. Joshua Wu 202.739.5053 [jwu@morganlewis.com](mailto:jwu@morganlewis.com)

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