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IRS Releases Guidance on Foreign Financial Asset Reporting

The Foreign Account Tax Compliance Act, enacted in 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act, requires certain individuals to file a statement with their United States income tax returns to report interests in “specified foreign financial assets” (SFFA) if the aggregate value of those assets exceeds specific thresholds. This reporting requirement is separate from the requirement to file Form TD F 90-22.1 (FBAR).

Temporary regulations implementing this reporting requirement were issued recently. The reporting regime is applicable to U.S. citizens, resident aliens of the United States, non-resident aliens who have elected to be taxed as U.S. residents and certain residents of U.S. possessions (collectively, “specified individuals”). Specified individuals whose SFFA meet certain thresholds, discussed below, are required to complete and attach Form 8938, Statement of Specified Foreign Financial Assets, to their U.S. income tax returns. If a specified individual does not have to file a U.S. income tax return for the tax year, the individual does not have to file Form 8938 even if the value of their SFFA exceeds the reporting threshold. The reporting requirements are effective for tax years starting after March 18, 2010, which for most taxpayers will be their 2011 tax returns that are due to be filed this year.

Reporting Thresholds

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

- Unmarried individuals living in the United States and married taxpayers filing separate returns living in the United States must file Form 8938 if the aggregate fair market value of SFFA exceeds either \$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 and living in the United States must file if the total value of SFFA 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.
- For certain individuals living abroad whose “tax homes” are in a foreign country, the filing threshold is increased and the individual is not required to file until the total value of SFFA is more than \$200,000 on the last day of the tax year or \$300,000 at any time during the tax year. For certain married individuals filing a joint return where one or both spouses reside abroad and have a tax home in a foreign country, the threshold is \$400,000 on the last day of the tax year or more than \$600,000 at any time during the year.

To determine if you are a “specified individual,” please contact your Katten Muchin Rosenman LLP attorney.

If you hold foreign assets and believe you may be affected by the new reporting requirements, please contact any of the following Katten Muchin Rosenman LLP attorneys for assistance.

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Interest in a Specified Foreign Financial Asset

A specified individual generally is considered to have an interest in any SFFA if any tax attributes (i.e., income, gains, losses, deductions, credits, etc.) or distributions from the asset or gross proceeds from the disposition of the asset are or would be required to be reported on the specified individual's U.S. income tax return (even if no tax attributes, gross proceeds or distributions are attributable to the asset for a particular taxable year).

A specified individual who is the owner of a disregarded entity is treated as having an interest in any SFFA held by the disregarded entity. A specified individual that is treated as the owner of a trust for U.S. income tax purposes (i.e., a "grantor trust") is treated as having an interest in any SFFA held by the trust. A specified individual is not treated as having an interest in any SFFA held by a partnership, corporation, non-grantor trust or estate solely as a result of the specified individual's status as a partner, shareholder or beneficiary.

Jointly Owned Assets

A joint interest in any SFFA is subject to reporting by each specified individual that is a joint owner of the asset. In general, each joint owner includes the full value of the jointly owned asset for purposes of determining whether the aggregate value of all SFFA in which the joint owner has an interest exceeds the reporting thresholds.

Married specified individuals who file a joint annual return for the taxable year will file a single Form 8938 that reports all of the SFFA in which either spouse has an interest. If the SFFA are owned jointly by both spouses, the SFFA should be reported once on the form.

Married specified individuals who file separate returns will file a separate Form 8938 that reports all SFFA in which the married specified individual has an interest, including assets jointly owned with the married specified individual's spouse. If the spouse is also a specified individual, each spouse includes only one-half of the value of any SFFA that the married specified individual jointly owns with his or her spouse for purposes of determining whether the aggregate value of all SFFA in which the married specified individual has an interest exceeds the reporting thresholds.

For more information about reporting thresholds, please contact your Katten Muchin Rosenman LLP attorney.

Specified Foreign Financial Assets

SFFA are foreign financial accounts and foreign assets not held in foreign accounts that are held for investment (as opposed to being held for use in a trade or business), such as stock or securities issued by a non-U.S. person, financial instruments issued by a non-U.S. person, contracts with non-U.S. persons and interests in foreign entities (such as foreign trusts, estates or partnerships).

There are certain assets of a foreign nature excepted from reporting on Form 8938. For example:

- A financial account maintained by a U.S. payor. For example, a specified individual 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.
- SFFA reported on other informational forms, such as Form 3520, Form 5471, Form 8621, Form 8865 or Form 8891. Specified individuals must identify on Form 8938 the form(s) on which they report the SFFA and how many of these forms are filed. The value of the SFFA reported on these forms is included in determining the total value of the assets for Form 8938 purposes.
- Exceptions from reporting are made for assets considered owned by a specified individual who is treated as the owner of certain trusts, such as a domestic widely held fixed investment trust or a domestic bankruptcy trust, certain assets held by a specified individual who is a bona fide resident of a U.S. territory, and assets or accounts for which mark-to-market elections have been made.
- Beneficial interests in a foreign trust or a foreign estate are not SFFA of a specified individual unless the specified individual knows or has reason to know of an interest based on readily accessible information. Receipt of a distribution from the foreign trust or foreign estate is deemed for this purpose to be actual knowledge of the interest.
- Interests in a social security, social insurance or other similar program of a foreign government are not SFFA.

If you are a specified individual and would like advice on whether or how to report SFFA, please contact your Katten Muchin Rosenman LLP attorney.

Asset Valuation

Taxpayers will need to determine the value of their SFFA in order to determine if the aggregate value exceeds the threshold applicable to them. Generally, a reasonable estimate of the highest fair market value (the “maximum 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. A specified individual may determine the fair market value of any SFFA based on information publicly available from reliable financial information sources or from other verifiable sources. Even if there is no such information available, the regulations do not require a specified individual to obtain an appraisal by a third party.
- Special rules apply for reporting the maximum value of an interest in a foreign trust or a foreign estate.
 - If a specified individual is a beneficiary of a foreign trust, the maximum value of the specified individual’s interest in the trust is the sum of the fair market value, determined as of the last day of the taxable year, of all of the distributions from the foreign trust during the taxable year to the specified individual, plus the value as of the last day of the taxable year of the specified individual’s right as a beneficiary to receive mandatory distributions from the foreign trust.
 - The maximum value of a specified individual’s interest in a foreign estate is the fair market value, determined as of the last day of the taxable year, of the specified individual’s beneficial interest in the assets of the foreign estate. If the specified individual does not know or have reason to know based on readily accessible information the fair market value of the individual’s interest in a foreign estate during the taxable year, the maximum value is the fair market value, determined as of the last day of the taxable year, of the distributions made during the taxable year to the specified individual as a beneficiary. Similar rules also apply to foreign retirement plans.

For more information on valuing your SFFA, including your interests in foreign trusts, estates and jointly owned assets, please contact your Katten Muchin Rosenman LLP attorney.

Non-compliance with Form 8938 Reporting Requirements

Taxpayers required to file Form 8938 who do not are subject to penalties. There is a \$10,000 initial failure to file penalty and an additional penalty of up to \$50,000 for continued failure to file after IRS notification. In addition, any underpayment of tax related to undisclosed SFFA may be subject to a 40 percent penalty. However, no penalty will be imposed if the failure to file Form 8938 or disclose SFFA is due to reasonable cause and not willful neglect. The fact that a foreign jurisdiction would impose a civil or criminal penalty on a specified individual if he or she discloses the required information is not reasonable cause.

If you fail to file Form 8938 or fail to report any SFFA that you are required to report, the statute of limitations for the tax year may remain open for all or part of your income tax return until three years after the date on which you file Form 8938.

Due to the sizeable penalties involved, specified individuals may wish to consult their Katten Muchin Rosenman LLP attorney before completing Form 8938.

Form 8938 Does Not Relieve Filers of FBAR Filing Requirements

U.S. persons with interests in foreign accounts may also be required to report foreign financial accounts on Form TD F 90-22.1 (FBAR). Certain foreign financial accounts will be reported on both Form 8938 and the FBAR. However, the information required by the forms is not identical in all cases. There are different categories of persons required to file Form 8938 and the FBAR, different filing thresholds for Form 8938 (i.e., minimum \$50,000 threshold) and FBAR reporting (i.e., \$10,000 reporting threshold), and different assets (and accompanying information) required to be reported on each form. There are also different triggers for filing. Because of these differences, certain foreign financial accounts may be reported on one but not both forms.

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, while Form 8938 is due with the taxpayer’s annual income tax return.

Proposed Regulations with Respect to Form 8938 Filing by Domestic Entities

HIRE also requires certain domestic entities to report SFFA in which they hold an interest. The IRS recently issued proposed regulations that set forth which domestic entities will be considered a “specified domestic entity” and subject to the reporting requirements. The proposed regulations relating to specified domestic entities apply to taxable years beginning after December 31, 2011.

Under the proposed regulations, “specified domestic entities” are domestic entities that are formed or used for the purposes of holding, directly or indirectly, SFFA. Specified domestic entities include certain closely held corporations and partnerships that meet passive income or passive asset tests. With exceptions, domestic trusts are included if they have a specified individual as a current beneficiary and exceed the reporting threshold. However, domestic estates are not specified domestic entities.

A domestic entity is not considered to be a specified domestic entity if it is excepted from the definition of the term “specified United States person.” A “specified United States person” does not include publicly traded corporations and members of their affiliated groups, tax-exempt entities (other than charitable remainder trusts), and individual retirement accounts, banks, REITs and RICs.

A domestic trust is considered a specified domestic entity if it has an interest in SFFA (other than assets excepted from reporting) with an aggregate value exceeding the threshold for domestic single filers described above and at least one specified individual as a current beneficiary. A current beneficiary is any individual who, during the taxable year, is entitled to, or at the discretion of any individual may receive, a distribution from the principal or income of the trust (determined without regard to any power of appointment to the extent that such power remains unexercised at the end of the taxable year).

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 SFFA, 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 individuals for U.S. income tax purposes is also not considered to be a specified domestic entity.

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