KOSTELANETZ & FINK, LLP

Presents

The Pitfalls of Foreign Asset Reporting

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Timed Agenda for CLE:
The Pitfalls of Foreign Asset Reporting – Presented by Usman Mohammad, Esq.
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The Evolution of Foreign Asset Reporting

U.S. taxpayers taxed on worldwide income

In **1970**, FBAR Form created as part of the Bank Secrecy Act of 1970

- designed to discourage and prevent tax evasion
- requires reporting foreign bank accounts

In **2007**, UBS banker Bradley Birkenfeld discloses to U.S. Government that UBS assisted U.S. taxpayers in evading U.S. taxes via undisclosed foreign bank accounts

Beginning in **2008**, IRS scrutinizes UBS and other Swiss banks over secret Swiss accounts held by U.S. taxpayers

Beginning in **2009**, U.S. begins using a carrot & stick response with U.S. taxpayers re issue of undisclosed foreign bank accounts - IRS voluntary disclosure program (Carrot) coupled with criminal prosecutions by DOJ (Stick)

- In **February 2009**, UBS Enters Deferred Prosecution Agreement with DOJ
- In **March 2009**, First Formal IRS Offshore Voluntary Disclosure Program Announced
- Beginning in **Early 2009 Through Present**, Wave of Criminal Indictments Against U.S. Persons with Foreign Bank Accounts

In **2010**, FATCA was enacted

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What Does FATCA Do

- FATCA stands for The Foreign Account Tax Compliance Act
- Passed as part of the HIRE Act in 2010
- **Reporting by Foreign Banks & Financial Institutions**: Generally requires that foreign financial institutions and certain other non-financial foreign entities report on the foreign assets held by their U.S. account holders or be subject to withholding on withholdable payments
- **Information Reporting by U.S. Individuals**: Created new information reporting requirement for U.S. taxpayer's foreign assets
- Information reporting requirement set forth in IRC 6038D (enacted 2010).
- Regs found at 26 C.F.R. § 1.6038D–0 to 1.6038D–8 (final regs in 2014, but updated in 2016)

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FATCA's Information Reporting Requirement Implemented Via New Form 8938

- Form 8938 created mid-2010; filed with tax returns beginning with 2011 tax year
- Form 8938 is different than information reporting found on other forms such as FBARs
  - Form 8938 requires reporting on all types of foreign assets, not just foreign bank accounts
  - Form 8938 is attached to and made a part of your annual Form 1040 income tax return, so much harder for taxpayer (or accountant) to claim ignorance as to requirement to report a foreign asset
- Form 8938 obligation does not replace obligation to file FBAR or to file other information reporting forms such as Form 5471 or Form 3520

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Who Has to File Form 8938?

"**Specified Individuals**" & "**Specified Domestic Entities**" whose "**Specified Foreign Financial Assets**" exceed certain reporting thresholds

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Specified Individuals for Purposes of Form 8938

- **U.S. persons*** who have an "**interest**" in "**Specified Foreign Financial Assets**" that **exceed certain reporting thresholds**
- Reporting thresholds differ depending on status of the taxpayer, as well as whether the threshold determination is made at any time during the tax year, or at the end of the tax year
- **Examples**:
  - **Unmarried U.S. Citizen Residing in the U.S.**
    - Reporting threshold is met if the total value of your specified foreign financial assets is more than: (i) **$50,000** on the last day of the tax year, or (ii) **$75,000** at any time during the tax year.
  - **Married U.S. Citizens Residing Outside the U.S., Who File Jointly Filed Tax Returns**
    - Reporting threshold is met if the total value of your specified foreign financial assets is more than: (i) **$400,000** on the last day of the tax year, or (ii) **$600,000** at any time during the tax year.

*Can also apply to nonresident aliens under certain circumstances

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Specified Domestic Entities for Purposes of Form 8938

Specified Domestic Entity is:

(i) **closely held domestic corporations** (with at least 50% of gross income from passive income),

(ii) **closely held partnerships** (with at least 50% of gross income from passive income), or

(iii) **domestic trust** with one or more beneficiaries that are either specified individuals or specified entities

Reporting Threshold for Specified Domestic Entity: is met if the total value of your specified foreign financial assets is more than: (i) **$50,000** on the last day of the tax year, or (ii) **$75,000** at any time during the tax year.

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“Interest in” for Purposes of Form 8938

Definition: 26 C.F.R. § 1.6038D–2(b)(1) defines “interest” for purposes of Form 8938 as follows: “A specified person has an interest in a specified foreign financial asset if any income, gains, losses, deductions, credits, gross proceeds, or distributions attributable to the holding or disposition of the specified foreign financial asset are or would be required to be reported, included, or otherwise reflected by the specified person on an annual return.”

Practical Effect:

Definition means that if you would have to report gains or losses from the sale or disposition of the asset, then you have an interest in the asset for purposes of Form 8938

Applies even if there is no gain, loss, etc. from the specified asset for the taxable year at issue

So interest for purposes of Form 8938 **basically amounts to ownership interest**

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Specified Foreign Financial Assets for Purposes of Form 8938

- IRC § 6038D identifies the items considered "Specified Foreign Financial Assets" for purposes of Form 8938. This includes:
  - (1) "any **financial account** maintained by a **foreign financial institution**"
  - (2) "any of the following assets which are not held in an account maintained by a financial institution"
    - (a) "any **stock or security issued by** a person other than a United States person"
    - (b) "any **financial instrument or contract** held for investment that has an **issuer or counterparty** which is other than a United States person"
    - (c) "any **interest in a foreign entity**"

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Examples of Specified Foreign Financial Assets That Must Be Reported on Form 8938

- Contract with a foreign person to buy or sell assets held for investment (will be one of the pitfalls that we discuss)
- Note, bond, debenture, or other form of indebtedness issued by a foreign person
- Stock issued by a foreign corporation
- Gold certificates issued by a foreign person
- Foreign pensions
- Foreign mutual funds
- Foreign hedge funds and foreign private equity funds
- *See* 26 C.F.R. § 1.6038D–3(d) for more

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Examples of Foreign Assets That Are Not Specified Foreign Financial Assets, & Are Not Reported on Form 8938

- Indirect interests in foreign financial assets through an entity
  - **BUT**, if its a domestic entity, then the domestic entity may have to report the foreign assets on its own Form 8938
  - **BUT**, if its a foreign entity, then you may still have to file a Form 8938 reporting your interests in the foreign entity
  - **BUT**, if it's a disregarded entity, then you have to file Form 8938 & include each of the foreign assets held by that entity
- Foreign bank account in which you only have POA or signature authority, & NO ownership interest
  - **BUT**, you do have to report such an account on an FBAR.
- Financial account held at a foreign branch of a U.S. financial institution (e.g., a London branch of Chase Bank).
  - You don't have to file Form 8938, **BUT** you do have to report such an account on an FBAR.
- Financial account at a U.S. branch of a foreign financial institution (e.g., New York branch of Bank Leumi)
  - You don't have to file Form 8938, & you do NOT have to report such an account on an FBAR.
- Foreign equivalent of social security by a foreign government
- Directly held foreign real estate
- Directly held tangible assets, such as art, antiques, jewelry, cars and other collectibles
- Directly held precious metals, such as gold, held for investment and held in a foreign country
- Directly held foreign currency
- A safe deposit box

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Other Relevant Forms for Foreign Asset Reporting

- **FBAR Form** (reporting **foreign bank accounts**) - around since **1970**
- **Form 3520** (**foreign gifts, trusts, estates, and inheritances**) - IRS website has versions going back to **1996**
- **Form 3520-A** (**foreign trust with a U.S. owner**) - IRS website has versions going back to **1997**
- **Form 5471** (**foreign corporations**) - IRS website has versions going back to **1983**
- **Form 8621** (**PFIC, i.e. foreign mutual fund**) - IRS website has versions going back to **1988**
- **Form 8865** (**foreign partnership**) - IRS website has versions going back to **2000**

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Interplay Between Form 8938 and Other Asset Reporting Forms

Two categories of forms:

(1) **Excepted Forms (Forms 3520, 5471, 8621, 8865, and 3520-A)**

- Foreign assets that taxpayer already reported on one of the excepted forms – Forms 3520, 5471, 8621, 8865, and 3520-A -- do not get separately reported on Form 8938 if those other forms are filed.
- On your Form 8938: You don't list value of the assets reported on the excepted forms.
- You just check a box on Form 8938 stating you filed one of these excepted forms & identify the number of such forms filed.

(2) **Nonexcepted Forms (FBAR)**

- Even if foreign account is listed on filed FBAR, it is not excepted from reporting on Form 8938.
- You must still list the value of the foreign account on Form 8938 if (i) you have an ownership interest in the foreign account, and (ii) your reporting threshold for Form 8938 is otherwise met.

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Pitfall 1: Interplay Between Form 8938 & the Excepted Forms

(i) **Value of Asset Reported on Excepted Form & Calculating Reporting Threshold for Form 8938**.

- **Example**: $200,000 foreign gift & you have $5,000 in foreign bank accounts. You filed Form 3520 for the foreign gift. Do you still have to file Form 8938?
- **For individuals** – even if foreign asset reported on excepted form, you must still consider the value of that foreign asset when determining whether you meet Form 8938 reporting threshold
- **Different rule for Specified Domestic Entities** – if foreign asset is reported on excepted form, then you DO NOT include its value when determining whether you meet Form 8938 reporting threshold

(ii) **Excepted Assets That Don't Meet Threshold for Excepted Forms**.

- **Example**: $70,000 foreign gift, & you have $5,000 in foreign bank accounts. You don't meet the $100,000 reporting threshold for filing Form 3520 for the foreign gift. You don't meet the $10,000 threshold for filing an FBAR. Do you still have to file Form 8938?
- You must still separately calculate whether you meet reporting threshold for Form 8938, even if you don't meet reporting thresholds for other information reporting forms.

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Pitfall 2: Interplay Between Form 8938 & the FBAR

1. Different Reporting Thresholds:
   - FBAR: Reporting threshold is just $10,000
   - Form 8938: Reporting threshold starts at $50,000 (U.S.-based individuals who file separately), & can be as high as $600,000 (married individuals living abroad & filing jointly)
     - **Example**: You have $200,000 in foreign gifts and file Form 3520. You have3 Swiss accounts of just $2,000 each, so you don't file FBAR. What happens on your Form 8938?
2. Type of Interest in Account
   - FBAR: Ownership, or POA, or Signature Authority
   - Form 8938: Only Ownership
3. Foreign Branch Account of U.S. Financial Institution
   - FBAR: must report financial account held at a foreign branch of a U.S. financial institution (e.g., a Chase Bank account at a branch in London)
   - Form 8938: Do not report financial account held at a foreign branch of a U.S. financial institution
4. Indirectly Held Foreign Account
   - FBAR: Must report foreign account if you own 50% or greater interest in entity that with interest in the foreign account.
   - Form 8938: You do not report indirectly held foreign accounts.
5. Valuation on FBAR and Form 8938 Don't Match

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Pitfall 3: Presumption That The Form 8938 Reporting Threshold Has Been Met

- **Presumption** is **built into statute** that if IRS determines that you had an ownership interest in a foreign asset, then the reporting threshold for Form 8938 was met and you were required to report the asset. 26 U.S.C.A. § 6038D(e).
- Burden is on taxpayer to show that reporting threshold was not met.
- Because of presumption built into § 6038D(e) – as well as harsh penalties that may be applied & statute of limitations issues that may arise if foreign assets omitted from Form 8938 -- over-inclusion of assets on Form 8938 may be a preferable

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Pitfall 4: Penalties That May Apply If You Get It Wrong

- What Are the Penalties?
- (1) **Failure to File 8938**. 26 U.S.C.A. § 6038D(d).
  - $10,000 penalty for failure to timely file Form 8938
  - Continuing failure to file: if the IRS mails notice of the failure to file, then after 90 days there is an additional penalty of $10,000 for each 30-day period during which the Form 8938 is not filed.
  - The maximum continuing failure to file penalty is $50,000
- (2) **Inaccurate Form 8938**
  - If the failure to disclose a specified foreign financial asset results in an underpayment of tax, then there is a 40% accuracy-related penalty on the underpayment. 26 U.S.C § 6662(j); *see also* 26 C.F.R. § 1.6038D–8 (Penalties for failure to disclose).
  - Accuracy-related penalty for domestic assets is just 20%.
- (3) **Civil Fraud Penalty in Connection with Form 8938**. 75% civil penalty.
- (4) **Criminal Penalties**

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Pitfall 5: Statute of Limitations Issues That May Arise If You Get It Wrong

- **If no Form 8938 (or inaccurate Form 8938)**: IRS takes the position that there is **no running statute of limitations if you don't file Form 8938**. In fact, the statute of limitations for the **entire tax return may remain open** if you did not file a required Form 8938. Statute will not start to run until you file the required Form 8938. *See* Instructions to Form 8938.
- **If Form 8938 was filed with a tax return:** then the statute of limitations is much the same as the statute of limitations for the underlying tax return: (i) 3 year statute of limitations that runs from the date of the filing; (ii) 6 year statute of limitations in the case of omission of over $5,000 in foreign income related to an item reportable on Form 8938, or a substantial understatement; or (iii) no statute of limitation if the return is deemed a false or fraudulent return filed with the intent to evade tax.
- **If an amended return is filed**, and the Form 8938 is amended or filed for the first time for that tax year, then the normal rules with respect to statute of limitations for amended returns should apply. The limitations period is not extended by the amended return.
  - But IRS may take the position that the original return was fraudulent, and that the statute of limitations is therefore open.
  - IRS may cite to the amended Form 8938 (or the newly included Form 8938) as evidence that the original return was fraudulent.

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Pitfall 6: Contracts with Foreign Counterparties

- Contracts with foreign counterparties are Specified Foreign Financial Assets for purposes of Form 8938, when the contract is to buy or sell property held for investment (e.g., precious metals)
- The contract itself has to be listed on Form 8938
- Applies even if the property that is the subject of the contract is located in the United States (e.g., if the property at issue is a coin collection held in the United States)
- Applies regardless of whether the taxpayer is the purchaser or seller of the property at issue
- No Form 1099, W-2 etc would be issued for most such transactions
- Client will have to remember to advise accountant that such a transaction occurred
- How will client know to do this? Onus may be on the accountant to educate the client
- Just asking the client if she had any foreign assets won't get the job done because client may not think of this as a foreign asset, especially if it involves domestic property

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Basic Questions and Answers on Form 8938 | Internal Revenue Service - Google Chrome

irs.gov/businesses/corporations/basic-questions-and-answers-on-form-8938

narks

Qualified Intermediary (QI)

Government Entities

jewelry, cars and other collectibles, in a foreign country. Do I need to report these assets on Form 8938?

I directly hold precious metals for investment, such as gold, in a foreign country. Do I need to report these assets on Form 8938?

No. Directly held precious metals, such as gold, are not specified foreign financial assets. Note, however, that gold certificates issued by a foreign person may be a specified foreign financial asset that you would have to report on Form 8938, if the total value of all your specified foreign financial assets is greater than the reporting threshold that applies to you.

This tax year I sold precious metals that I held for investment to a foreign person. Do I have to report the sales contract on Form 8938?

The contract with the foreign person to sell assets held for investment is a specified foreign financial asset investment asset that you have to report on Form 8938, if the total value of all your specified foreign financial assets is greater than the reporting threshold that applies to you.

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Foreign stocks or securities

I acquired or inherited foreign stock or securities, such as bonds. Do I need to report these on Form 8938?

I directly hold shares of a U.S. mutual fund that owns foreign stocks and securities. Do I need to report the shares of the U.S. mutual fund or the stocks and securities held by the mutual fund on Form 8938?

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Pitfall 7: Indirect Interest Rule

- **Interest in a domestic entity does not mean you have an interest in foreign assets held by that entity for purposes of Form 8938**. *See* 26 C.F.R. § 1.6038D–2(b)(4)("Except as provided in this paragraph (b)(4), a specified person 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 specified person's status as a shareholder, partner, or beneficiary of such entity").
- **Exceptions**:
  - (1) Specified foreign financial assets held by **domestic trusts** must be reported by the taxpayer on Form 8938. See 26 C.F.R. § 1.6038D–2(b)(4)(ii)("A specified person that is treated as the owner of a trust" is "treated as having an interest in any specified foreign financial assets held by the trust or the portion of the trust.").
    - BUT this exception does not apply to:
      - (i) a domestic liquidating trust;
      - (ii) trust created pursuant to bankruptcy court order; or
      - (iii) domestic widely held fixed investment trust
  - (2) Specified foreign financial assets held by a **disregarded entity** must be reported by the taxpayer on Form 8938. See 26 C.F.R. § 1.6038D–2(b)(4)(iii).
  - (3) Interest in a **foreign trust or foreign estate** must be reported by the taxpayer on Form 8938.
    - BUT, an interest in a foreign trust or a foreign estate is not a specified foreign financial asset unless the **person knows, or has reason to know** based on readily accessible information, **of the interest**.
    - **Receipt of a distribution** from the foreign trust or foreign estate constitutes actual knowledge for this purpose. See 26 C.F.R. § 1.6038D–2(b)(4)(iii) and § 1.6038D–3(c).

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Pitfall 8: Jointly Held Foreign Assets

1. Joint Owners Who Are Spouses:
    - In the case of joint owners who are married to each other and file separate returns, each joint owner uses one-half of the jointly owned asset in order to determine if they meet the reporting threshold for Form 8938.
    - But if Form 8938 must be filed, then each joint owner reports the full value of the jointly owned asset on their separately filed Form 8938.

2. Joint Owners Who Are NOT Spouses:
    - Each joint owner uses the full value of the asset in determining whether they meet the Form 8938 reporting threshold &
    - Each joint owner also reports the full value of the asset on their Form 8938.

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Pitfall 9: Foreign Assets Held By Children

1. If Form 8938 reporting thresholds are met, then parents can either:
   - (i) file a Form 1040 on behalf of the child to report unearned income & include a Form 8938 with the child's tax return to report the foreign financial assets owned by the child.
   - (ii) file Form 8814 -- Parents' Election To Report Child's Interest and Dividends -- with the parents' income tax return to elect to include in their gross income certain unearned income of their child ("kiddie tax" election), then the parents must report on the parents' Form 8938 any specified foreign financial asset that the child owns. See Instructions to Form 8938, p. 7.

2. If the child does not have to file an income tax return for the tax year (e.g., not enough unearned income), then there is no obligation to file Form 8938, even if the value of the child's specified foreign financial assets is more than the reporting Threshold for Form 8938. See Instructions to Form 8938, p. 1.

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Takeaways

- Do an analysis for Form 8938 that is separate from any analysis that you do for other asset reporting forms (e.g., FBAR, Form 3520, etc.)
- For Form 8938, do an analysis for whether Form 8938 reporting threshold is met, &, if reporting threshold is met, then do a separate analysis of the values that get reported on Form 8938 (esp. important if there are jointly held assets)
- Value of assets listed on Form 8938 and FBAR should match
- Educate your clients (e.g., contracts with foreign counterparties generate Form 8938 reporting obligations)
- When in doubt, report it

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Thank you

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