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New Form 8938 for financial asset reporting adds significant complexity to this year's individual income tax return preparation

The IRS recently released temporary and proposed regulations implementing section 6038D, which requires reporting of a specified foreign financial assets (SFFA). If reporting is required, the taxpayer must disclose its SFFA holdings on Form 8938,(Statement of Specified Foreign Financial Assets, with their U.S. federal income tax return. New Form 8938 applies only to individual taxpayers; until further guidance is issued, domestic entities are not required to file form 8938.

The IRS recently released temporary and proposed regulations implementing section 6038D, which requires reporting of a specified foreign financial asset (SFFA). If reporting is required, taxpayers must disclose their SFFA holdings on Form 8938, *Statement of Specified Foreign Financial Assets*, with their U.S. federal income tax returns. New Form 8938 applies only to individual taxpayers; until further guidance is issued, domestic entities are not required to file Form 8938. If applicable, new Form 8938 must be filed with a tax return for tax years beginning after March 18, 2010. In most cases, individuals meeting the thresholds will be required to file Form 8938 with their 2011 tax returns due on April 17, unless an extension is filed.

In simple terms, Form 8938 requires a level of detail that may not be readily accessible to many individual taxpayers. The form requires not only the value of assets to be reported but also that such assets be matched to income, deductions, and credits reported on the individual's tax return. Individuals required to file Form 8938 should expect a significant and material increase in complexity associated with the preparation of Form 1040.

Who should report?

Specified individuals

Specified individuals are subject to reporting requirements if they meet certain reporting thresholds described below. The term "specified individual" includes:

- U.S. citizens,
- U.S. resident aliens for any part of the tax year, and
- Individuals making certain elections to be treated as tax residents as well as bona fide residents of Puerto Rico or American Samoa.

A specified individual is not required to file Form 8938 if he or she is not required to file an annual income tax return with the IRS.

Domestic entities

The final Form 8938 instructions clarify that only individuals must file Form 8938. However, section 6038D contemplates that specified domestic entities -- those formed or availed of for purposes of holding, directly or indirectly, SFFAs -- also are subject to reporting. The IRS is expected to issue additional regulations during 2012 to clarify the treatment of specified domestic entities.

Reporting thresholds

Specified individuals who exceed certain thresholds must report any interest in an SFFA using Form 8938. The threshold amounts depend on the filing status and where the taxpayer is living, as shown below:

File Form 8938 if…	Individual lives in the U.S.	
	Total Value of SFFAs during tax year at any time exceeds:	OR, total value of SFFAs on last day of tax year exceeds:
Single	$75,000	$50,000
MFJ	$150,000	$100,000
MFS	$75,000	$50,000

File Form 8938 if…	Individual lives outside the U.S.	
	Total Value of SFFAs during tax year at any time exceeds:	OR, total value of SFFAs on last day of tax year exceeds:
Single	$300,000	$200,000
MFJ	$600,000	$400,000
MFS	$300,000	$200,000

What are SFFAs?

Financial accounts

SFFAs include any financial account maintained by a foreign financial institution. The financial account -- not the underlying account assets -- should be reported in this case. This category includes any depository or custodial account as well as any equity or debt interest in a foreign financial institution. Examples may include foreign mutual funds, foreign hedge funds, foreign private equity funds, and certain foreign insurance products. However, interests that are regularly traded on an established securities market are exempt.

In addition, a specified individual is not required to report a financial account maintained by a U.S. branch of a foreign financial institution (e.g., the New York branch office of a Swiss-based bank), a domestic branch of a foreign insurance company, or a foreign branch or foreign subsidiary of a U.S. financial institution.

"Other" SFFAs

Certain other assets *not* held in a financial account maintained by a foreign financial institution are considered SFFAs for Form 8938 reporting purposes. These assets include (i) stock or securities issued by a person other than a U.S. person, (ii) a financial instrument or contract issued by a person other than a U.S. person (e.g., certain options, swaps, or derivatives), and (iii) any interest in a foreign entity (e.g., a capital or profits interest in a foreign partnership).

Foreign pensions and deferred compensation plans

The temporary regulations clarify that interests in foreign pension plans and foreign deferred compensation plans typically constitute SFFAs. The underlying assets held by such plans need not be reported separately. Certain questions remain such as whether unvested stock-based compensation awards must be reported.

Foreign trusts and estates

A SFFA generally includes an interest in a foreign trust or estate as long as the person knows or has reason to know about the interest based upon information that is readily accessible. The receipt of distributions constitutes actual knowledge for this purpose.

Who has an "interest"?

The temporary regulations include a core concept that a specified individual is generally considered to have an interest in an SFFA if any income, gains, losses, deductions, credits, gross proceeds, or distributions attributable to the holding or disposition of the SFFA are or would be required to be reported, included, or otherwise reflected on the individual's annual tax return. This rule remains true even if no income, gains, losses, deductions, credits, gross proceeds, or distributions are included or reflected on the individual's income tax return for the year of reporting.

An owner of an entity that is disregarded as separate from its owner for U.S. federal tax purposes (so-called "disregarded entities") is treated as having an interest in any SFFA owned by that entity. In addition, a specified individual who is treated as the owner of a trust or any portion of certain trusts (generally relating to grantor trusts), is treated as having an interest in any SFFA held by the trust (or portion thereof), with certain exceptions for bankruptcy trusts. A specified individual is not treated as having an interest in any SFFA held by a partnership, corporation, trust, or estate *solely* as a result of the individual's status as a partner, shareholder, or beneficiary.

Valuation of SFFAs

The value of an SFFA is generally the fair market value, although special rules apply for valuing interests in foreign trusts, estates, pension funds, and deferred compensation plans.

For the value of "other" SFFAs, taxpayers need to disclose the value of these assets only in ranges of $50,000 increments when such assets are valued at less than $200,000.

Periodic account statements

The maximum value of a financial account means a reasonable estimate of the maximum value of the holdings of the financial account at any time during the tax year. The preamble to the temporary regulations indicates that periodic account statements -- "at least annually" -- may be relied upon in determining the maximum value, unless there is reason to know based on readily accessible information that such statements do not reflect a reasonable estimate of the account's maximum value.

Joint ownership

Generally, the joint owners of an SFFA each include the full value of such asset in determining whether the reporting threshold is satisfied. Each joint owner generally reports the entire value of the asset when they must report maximum value. Special rules apply for married individuals; e.g., if they are filing a joint return, they must take into account the value of a jointly owned asset only once.

Conversion to U.S. dollars

Assets denominated in foreign currency must be converted to U.S. dollars according to guidance in the instructions, generally using the U.S. Treasury Department's Financial Management Service foreign currency exchange rates. When calculating the maximum value of a SFFA, the currency determination date is generally the exchange rate on the last day of the tax year, even when an SFFA is disposed of prior to the end of the tax year.

Tracing requirements

In addition to reporting SFFAs and their values, Form 8938 also requires taxpayers to summarize the tax items attributable to SFFAs. Individuals must trace and report tax items such as interest, dividends, gains, credits, or deductions (if any) that correspond to the specific financial account or other SFFA that is being disclosed. In addition, individuals must list the form, schedule, and line on which these tax items are otherwise reported.

Duplicate reporting

Reporting on other IRS forms

A taxpayer meeting the filing threshold need not report an SFFA on Form 8938 if the taxpayer has reported it on certain other forms timely filed for the same tax year. Note that if the reporting threshold is met, an individual still is required to file Form 8938 and must disclose what other report was filed. The following forms would qualify for this "duplicative reporting" exception:

- Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Foreign Gifts*
- Form 3520-A, *Annual Information Return of Foreign Trust with a U.S. Owner*
- Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*
- Form 8621, *Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund*
- Form 8865, *Return of U.S. Persons with respect to Certain Foreign Partnerships*
- Form 8891, *Beneficiaries of Certain Canadian Registered Retirement Plans*

FBAR reporting

SFFAs may have to be reported both on Form 8938 and Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (the so-called "FBAR" form.) Filing Form 8938 does not relieve the requirement to file TD F 90-22.1. Treasury's believes the two forms serve distinct purposes and policy considerations.

Penalties and statute of limitations

Failure to file a Form 8938 subjects the taxpayer to a $10,000 penalty. A failure to comply that lasts more than 90 days after the date of an IRS notice will be subject to an additional penalty not to exceed $50,000. The penalty may be waived if, based on all the facts and circumstances and an affirmative showing of the taxpayer, the failure is due to reasonable cause and not willful neglect. If an underpayment is attributable to an undisclosed SFFA, the accuracy-related penalty may be increased from 20 percent to 40 percent.

In addition, the statute of limitations on assessment potentially will remain open with respect to the *entire* return if there is a failure to comply with section 6038D, unless an exception applies. If that failure is due to reasonable cause and not willful neglect, the statute of limitations on assessment will remain open only with respect to the item that is not properly reported.

For purposes of assessing penalties, the aggregate value of SFFAs will be presumed to be in excess of the applicable reporting threshold if there is insufficient information for the IRS to determine the aggregate value.

How PwC can help

The release of the temporary and proposed regulations under section 6038D represents an extraordinary event and not just a modification of existing law. Taxpayers and tax preparers are faced with a significant and material increase in complexity associated with the preparation of Form 8938. Specifically, Form 8938 is unique in that it requires taxpayers and paid preparers to consider all foreign assets in one place. Thus, the more types of assets an individual may possess, the higher the complexity of the reporting becomes. Even minimal reporting will require considerable time due to the level of detail. Additional complexities may exist when certain income is not reported due to a treaty or domestic law exception.

Due to such complexities, taxpayers may wish to seek PwC's assistance in evaluating their specified foreign financial asset holdings, identify and determine the value of any SFFAs, and analyze whether the individual surpasses the thresholds to file and disclose. PwC can help with the reporting on Form 8938 and also ensure that assets not reported on the form have been reported on the appropriate qualifying form, such as forms 3520, 5471, or 8621.

For more information, please do not hesitate to contact:

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