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Tax Update

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New Rules for Tax Return Disclosure of Information With Respect to Foreign Financial Assets Will Take Effect for 2011 Returns

by Ron Kramer, Director of Strategic Tax Planning

In March 2010, President Obama signed the Hiring Incentives to Restore Employment Act (HIRE Act). Seen as a revenue-raiser to pay for the employment incentives in the legislation and based on the belief by some in Congress that lax foreign compliance and enforcement contributes to a "tax gap," the HIRE Act contains several foreign account tax compliance provisions know as the "FATCA provisions." The "FATCA provisions" target offshore tax evasion by broadening required disclosure and reporting by foreign financial institutions and other foreign entities with respect to U.S. account holders, and by requiring U.S. individual taxpayers to furnish information regarding foreign assets and transactions with certain foreign entities.

This article will focus on the new rules that will apply to the required disclosure of foreign assets by individual taxpayers in tax returns filed for taxable years starting with 2011.

Foreign Asset Disclosure by Individuals

The HIRE Act added Section 6038D to the Internal Revenue Code (IRC). Section 6038D requires an individual taxpayer who holds any interest in a specified foreign financial asset to attach certain information with respect to each foreign asset to his or her tax return if the aggregate value of all such assets exceeds $50,000. The new rules for foreign asset disclosure apply to taxable years beginning after March 18, 2010. Thus, the rules will generally first be applicable for the 2011 taxable year, the tax return for which will be required to be filed in 2012.

For purposes of the IRC Section 6038D reporting requirements, a specified foreign financial asset includes any depository, custodial or other financial account maintained by a foreign financial institution. In addition, if the assets are not held in an account maintained by a foreign financial institution, an individual must disclose his or her interest in foreign securities, a financial instrument or contract, and interests in foreign entities. Generally, the information required to be disclosed in the tax return will include:

- The maximum value of the asset during the year.
- The name, address and account number of the financial institution in which the account is maintained.
- The name and address of the issuer of a stock or security and a description of its class or issue.
- The name and address of the issuer and other parties, and any other information necessary to identify a financial instrument, contract or interest in a foreign entity.

The IRS has proposed, in initial draft, a new Form 8938, Statement of Foreign Financial Assets, for the required disclosure. We expect that the IRS will finalize Form 8938 and that they will offer more guidance and clarification on the new disclosure requirements in the coming months.

You may be asking yourself, isn't this information already required to be reported under the provisions of the Bank Secrecy Act on Form TD F 90-22.1, Report of Foreign Bank and Financial Account (FBAR)? Much of it does, but you should note that the foreign asset disclosure is required not in lieu of, but in addition to, any required FBAR filings. The FBAR is generally required to be filed by a U.S. person with a financial interest, signature authority or other authority over a foreign financial account if, at any point during the calendar year, the aggregate value of all such foreign accounts equaled or exceeded $10,000, even if for one day. The Section 6038D disclosure is required to report "specified foreign financial assets" when the aggregate value exceeds $50,000 and focuses on the direct ownership of those foreign assets. Signature or other authority over the accounts, as required by FBAR, is not considered in the new disclosure rules.

While Section 6038D requires only individuals to file this disclosure, the Secretary of the Treasury can require "any domestic entity which is formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets" to file the disclosure as if it were an individual (Section 6038D(f)). Accordingly, the IRS may decide to expand the reporting and disclosure requirements to investment partnerships and other foreign investment entities.

Penalties for Failure to Disclose Foreign Assets

The minimum penalty for failing to submit the required disclosure is $10,000. The penalty increases by $10,000 for each 30-day period following notification from the Treasury Department, with a maximum penalty of $50,000. However, there is a 90-day grace period following notification from the Treasury that the necessary disclosure is required before the additional $10,000 penalties start to accrue. The penalty may be waived if the taxpayer is able to demonstrate that the failure to file the information was due to reasonable cause.

Also, if the U.S. Treasury determines that an individual has an interest in one or more specified foreign financial assets, and the individual does not provide sufficient information to demonstrate the aggregate value of such assets, then the aggregate value of the assets is presumed to have exceeded $50,000 for purposes of assessing the penalties.

Increase in Accuracy-Related Penalty

The accuracy-related penalty under IRC Section 6662 will be increased from 20% to 40% of any underpayment of federal income tax attributable to income on transactions involving foreign financial assets that the taxpayer fails to report on his or her income tax return. This provision is effective for taxable years beginning after March 18, 2010 (i.e., 2011 for individuals).

Extended Statute of Limitations

Generally, the IRS has three years from the filing of a return to assess additional tax. This statute of limitations also applies to information required to be reported on certain foreign transfers. Also, the limitation period is

increased to six years if a taxpayer omits 25% or more of gross income. The HIRE Act amended the law to extend the statute of limitations to six years where a taxpayer omits more than $5,000 of income attributable to one or more assets subject to reporting under IRC Section 6038D, regardless of whether the $50,000 threshold for reporting is met. Thus, even if the taxpayer does not have a substantial understatement of income (25% or more), the IRS will have six years in which to investigate and audit the taxpayer in cases where $5,000 or more of foreign income is omitted from his or her returns. Additionally, the three-year and six-year statutes of limitations will be suspended until the foreign information (or information returns) required to be reported under various IRC provisions is provided to the IRS (i.e., IRC Sections 1295(b), 1298(f), 6038, 6038A, 6038B, 6038D, 6046, 6046A and 6048).

The extended statute of limitations is applicable to returns filed after the March 18, 2010, and to returns filed on or before such date if the limitation period has yet to expire. Thus, the extended six-year statute and suspended three-year statute could theoretically apply to tax returns that were filed as early as for 2004 if a six-year statute applies, or for 2007 if the normal three-year statute applies. For instance, a 2006 return filed in 2007, on which the taxpayer failed to report more than $5,000 of income attributable to a foreign financial asset, and which would otherwise be subject to the three-year statute of limitations, will be subject to the six-year statute of limitations, instead.

Reporting of Activities With Respect to Passive Foreign Investment Companies

A foreign corporation is classified as a passive foreign investment company (PFIC) if it meets either of the two tests: (i) income test or (ii) asset test. The income test is satisfied if 75% or more of the foreign corporation's income is passive income, and the asset test is met if 50% or more of the foreign corporation's assets consist of assets that produce, or are held for the production of, passive income.

Prior to March 18, 2010, a U.S. investor who owned directly or indirectly, any stock in a PFIC had to file a Form 8621 (Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund) only if the investor (i) recognized gain on a direct or indirect disposition of PFIC stock; (ii) received certain direct or indirect distributions from a PFIC; or (iii) was making a reportable election on the form.

Effective for taxable years beginning on or after March 18, 2010, each U.S. person who is a PFIC shareholder is required to file an annual information return containing such information as the Secretary may require. The Internal Revenue Service is developing further guidance regarding the reporting obligations under new IRC section 1298(f). For the shareholders of a PFIC who were not otherwise required to file Form 8621 prior to March 18, 2010, they will still not be required to file an annual report as a result of the addition of Section 1298(f) for taxable years beginning before March 18, 2010 (IRS Notice 2010-34).

New IRC Section 1298(f) applies to all U.S. persons, whereas IRC Section 6038D applies only to individuals. Accordingly, a person (generally an individual) meeting the reporting requirements of this provision may also meet the reporting requirements of new Section 6038D requiring disclosure information with respect to foreign financial assets. As such, it is anticipated that the Treasury will issue guidance to avoid duplicate reporting in these cases.

Summary

The full effect of the new rules for tax return disclosure of foreign financial assets will not be felt until 2012 when the first tax returns are required to be filed under the new disclosure rules. Since the HIRE Act broadens the reporting requirements and extends the rules to ownership of foreign assets such as foreign stock or securities and interests in foreign entities such as hedge funds and private equity funds, which are not covered by FBAR reporting, there is sure to be confusion among taxpayers and tax professionals alike as to proper reporting when that time comes. Additional guidance from the IRS in this area will certainly be welcome.

All U.S. persons are reminded that the due date for filing FBARs for the 2010 calendar year is June 30, 2011.

Also, the IRS has just announced a second Offshore Voluntary Disclosure Initiative (OVDI) for taxpayers that might have undisclosed foreign accounts and unreported income from those accounts for 2003 through 2010. Those taxpayers will have until August 31, 2011 to comply with the OVDI program and bring their tax accounts current with reduced penalties and assurance of no criminal prosecution. The program also allows all U.S. persons delinquent in filing FBARs and other foreign information returns for 2003 through 2010, but who have reported all income from the foreign accounts, to file those forms by August 31, 2011 and avoid penalties on those delinquent forms.

If you have any questions regarding the new foreign asset disclosure rules, or on the new IRS OVDI program, please contact your Schneider Downs representative at 412-261-3644.

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