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FATCA Update: Treasury Issues Long-Awaited Rules For Foreign Asset Reporting by Domestic Entities

Action Item: Nearly six years after Congress passed the Foreign Account Tax Compliance Act (FATCA), the Treasury Department has finally issued Final Regulations mandating the reporting of foreign assets by domestic entities. Starting with the 2016 tax year, certain closely-held U.S. corporations, partnerships, and trusts must file Form 8938, “Statement of Specified Foreign Financial Assets,” with their federal income tax returns to report their foreign assets. The consequences of non-compliance with this new reporting obligation can be severe: the Internal Revenue Service may assess significant civil penalties and, in addition, determine that the statute of limitations for the entire tax return remains open indefinitely until the Form 8938 is filed.

The Treasury Department has finally issued [regulations](#) implementing the rules requiring domestic entities to annually disclose their foreign financial assets to the Internal Revenue Service. In 2010, as part of the enactment

of the Foreign Account Tax Compliance Act (FATCA), Congress added section 6038D to the Internal Revenue Code requiring certain taxpayers to annually report information about their “specified foreign financial assets,” if the aggregate value of such assets is greater than \$50,000 on the last day of the year, or \$75,000 at any time during the year. Such reporting is to be made on Form 8938, entitled “Statement of Specified Foreign Financial Assets.” Section 6038D applies to individual taxpayers, as well as any domestic entity “formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets as if such entity were an individual.”

In 2011, the Treasury Department published a proposed regulation setting forth the conditions under which a domestic entity would be required to report specified foreign financial assets. Reporting by domestic entities was deferred, however, due to issuance of Notice 2013-10, which provided that such obligation would not be

effective until issuance of final regulations. After receiving comments, the Treasury Department published the final regulation for domestic entity reporting on February 23, 2016. The new rules are effective for tax years beginning after December 31, 2015.

“Specified Domestic Entity”

Section 6038D provides that a “specified domestic entity” that has any interest in a “specified foreign financial asset” during the taxable year must attach Form 8938 to its tax return. The Final Regulations define “specified domestic entity” as any domestic corporation, a domestic partnership, or a domestic trust “formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets.” The determination as to whether a domestic corporation, a domestic partnership, or a domestic trust is a “specified domestic entity” is to be made on an annual basis.

In the case of corporations and partnerships, such entities are considered to have been “formed or availed of” for purposes of holding specified foreign financial assets if (1) the entity is “closely held” by a specified individual and (2) at least 50 percent of the entity’s gross income for the taxable year is passive income or at least 50 percent of the assets held by the entity for the taxable year are assets that produce or are held for the production of passive income. The Final Regulations provide that the percentage of passive assets held by a corporation or partnership for a taxable year is the weighted average percentage of passive assets (weighted by total assets and measured quarterly), and the value of assets of a corporation or partnership is the fair market value of the assets or the book value of the assets that is reflected on the corporation’s or partnership’s balance sheet (as determined under either a U.S. or an international financial accounting standard).

In the preamble to the Final Regulations, Treasury stated that the “weighted average test” for determining whether at least 50 percent of an entity’s income or assets are passive “provides an administrable way to determine the passive asset percentage.” Corporation or partnerships may be required to substantiate their determination of the passive asset percentage upon request by the IRS.

“Closely Held”

The Final Regulations provide that a domestic corporation is deemed to be “closely held” by a specified individual if at least 80 percent of the total combined voting power of all classes of stock of the corporation entitled to vote, or at least 80 percent of the total value of the stock of the corporation, is owned, directly, indirectly, or constructively, by a specified individual on the last day of the corporation’s taxable year.

A domestic partnership is deemed to be “closely held” by a specified individual if at least 80 percent of the capital or profits interest in the partnership is held, directly, indirectly, or constructively, by a specified individual on the last day of the partnership’s taxable year. The preamble to the Final Regulations specifies that this 80-percent threshold should exempt most publicly-traded partnerships from being considered “specified domestic entities.”

The Final Regulations provide that the constructive ownership rules of IRC § 267(c) apply in making the determination of whether a corporation or partnership is “closely held” by a specified individual. The Final Regulations further specify that the constructive ownership rules apply as if the family of an individual includes the spouses of the individual’s family members.

“Passive Income and Assets”

The Final Regulations provide that passive income means the portion of gross income that consists of the following items:

- Dividends, including substitute dividends;
- Interest;
- Income equivalent to interest, including substitute interest;
- Rents and royalties, other than rents and royalties derived in the active conduct of a trade or business conducted, at least in part, by employees of the corporation or partnership;
- Annuities;
- Capital gains from the sale or exchange of property giving rise to passive income in the form of dividends, interest, income equivalent to interest, and rents and royalties.
- Capital gains from commodities transactions (including futures, forwards, and similar transactions) subject to certain exceptions;¹
- The excess of foreign currency gains over foreign currency losses attributable to any IRC § 988 transaction; and
- Net income from notional principal contracts.

The preamble to the Final Regulations explain that the definition of “passive income” is based upon a similar definition contained with the final FATCA regulations. The definition employed in the Final Regulations is used to “identify entities that have a high risk of being used for tax evasion and to reduce compliance burdens for active entities.”

The Final Regulations eliminate the so-called “principal purpose test” included in the proposed regulations. That test which would have treated any corporation or partnership as “formed or availed of” for purposes of holding specific foreign financial assets if at least 10 percent of the entity’s gross income or assets is passive and the entity was formed or availed of with a principal purpose

of avoiding section 6038D. In the preamble to the Final Regulations, Treasury stated that it believed the 50-percent passive assets or income threshold “appropriately captures situations in which specified individuals may use a domestic corporation or partnership to circumvent the reporting requirements of section 6038D” and that “taxpayers should be able to determine their reporting requirements under section 6038D based on objective requirements rather than a subjective principal purpose test.” In the preamble, Treasury warns that it “will continue to monitor whether domestic corporations and partnerships not required to report under these final regulations are being used inappropriately by specified individuals to avoid reporting under section 6038D” and that Treasury “may expand the definition of a specified domestic entity in future guidance.”

The Final Regulations provide an exception applicable to a corporation or partnership that regularly acts as a dealer in property that gives rise to passive income, forward contracts, option contracts, or similar financial instruments (including notional principal contracts and all instruments referenced to commodities). In the case of such an entity, the term “passive income” does not include (1) any item of income or gain (other than any dividends or interest) from any transaction (including hedging transactions and transactions involving physical settlement) entered into in the ordinary course of such dealer’s trade or business as such a dealer; and (2) if such dealer is a dealer in securities (within the meaning of section 475(c)(2)), any income from any transaction entered into in the ordinary course of such trade or business as a dealer in securities.

The Final Regulations provide a special rule for related entities. All domestic corporations and domestic partnerships that are closely held by the same specified individual and that are connected through stock or partnership interest ownership with a common parent corporation or partnership are treated as owning the combined assets and receiving the combined income of all members of that group. For purposes of this rule, assets

relating to any contract, equity, or debt existing between members of such a group, as well as any items of gross income arising under or from such contract, equity, or debt, are eliminated. A domestic corporation or a domestic partnership is considered connected through stock or partnership interest ownership with a common parent corporation or partnership if stock representing at least 80 percent of the total combined voting power of all classes of stock of the corporation entitled to vote or of the value of such corporation, or partnership interests representing at least 80 percent of the profits interests or capital interests of such partnership, in each case other than stock of or partnership interests in the common parent, is owned by one or more of the other connected corporations, connected partnerships, or the common parent.

EXAMPLES

The Final Regulations provide a series of examples to illustrate these rules.

Example 1. Closely held and constructive ownership.

(i) Facts. DC1 is a domestic corporation the total value of the stock of which is owned 60% by A, a specified individual, 30% by B, a member of A's family for purposes of section 267(c)(2) who is not a specified individual, and 10% by FC1, a foreign corporation. DC1 owns 90% of the total value of the stock of DC2, a domestic corporation. FC2, a foreign corporation, owns 10% of DC2. Neither A nor B owns, directly, indirectly, or constructively, any stock in FC1 or FC2.

(ii) Closely held ownership determination. A is considered to own 90% and 81% of the total value of DC1 and DC2, respectively, by application of the rules of section 267(c) and this section. DC1 and DC2 are closely held by A within the meaning of paragraph (b) (2) of this section because A, a specified individual, is considered to own more than 80% of their total value.

Example 2. Application of aggregation rule and reporting threshold.

(i) Facts. L is a specified individual. In Year X, L wholly owns DC1, a domestic corporation, and also owns a 90% capital interest in DP, a domestic partnership. DC1 owns 80% of the sole class of stock of DC2, a domestic corporation. DC1 has no assets other than its interest in DC2. DC2's only assets are assets that produce passive income, with a maximum value in Year X of \$40,000 on October 12. DC2's assets are comprised in relevant part of specified foreign financial assets with a maximum value in Year X of \$15,000 on October 12. DP's only assets are assets that produce passive income and that are specified foreign financial assets with a maximum value of \$90,000 in Year X on October 12.

(ii) Specified domestic entity status.

(A) DC1 and DC2. DC1 and DC2 are closely held by a specified individual for purposes of paragraph (b) (2) of this section. DC1 and DC2 are considered related entities that are connected through stock ownership with a common parent corporation under paragraph (b)(3)(iii) of this section, because DC1 and DC2 are closely held by L, and DC2 is connected with DC1 through DC1's ownership of stock of DC2 representing at least 80% of the voting power or value of DC2. As a result, for purposes of applying paragraph (b)(1)(ii) of this section, each of DC1 and DC2 is considered as owning the combined assets, and receiving the combined income, of both DC1 and DC2; however, DC1's equity interest in DC2 is disregarded for this purpose under paragraph (b)(3)(iii) of this section. Therefore, DC1 and DC2 each satisfies the passive asset threshold of paragraph (b)(1)(ii) of this section, because 100 percent of each company's assets is passive. DC1 and DC2 are specified domestic entities for Year X.

(B) DP. DP is closely held by a specified individual for purposes of paragraph (b)(2) of this section. DP is not considered a related entity with DC1 and DC2 under paragraph (b)(3)(iii) of this section, because DC1 and DP are not owned by a common parent corporation or partnership. As a result, whether the passive income or passive asset threshold of paragraph (b)(1)(ii) of this section is met with respect to DP is determined solely by reference to DP's separately earned passive income and separately held passive assets. DP holds only passive assets during Year X and therefore satisfies paragraph (b)(1)(ii) of this section. DP is a specified domestic entity for Year X.

(iii) Reporting requirements.

(A) DC1. Under §1.6038D-2(a)(6)(ii), DC1 is not treated as owning the specified foreign financial assets held by DC2 and DP for purposes of applying the reporting threshold of §1.6038D-2(a)(1), because DC1 does not have an interest in any specified foreign financial assets. DC1 is not required to file Form 8938 because DC1 does not satisfy the reporting threshold of §1.6038D-2(a)(1).

(B) DC2 and DP. Under §1.6038D-3, DC2 and DP each has an interest in specified foreign financial assets. For purposes of applying the reporting threshold of §1.6038D-2(a)(1), §1.6038D-2(a)(6)(ii) provides that DC2 is treated as owning in addition to its own assets the assets of DP, and DP is treated as owning in addition to its own assets the assets of DC2. As a result, DC2 and DP each satisfies the reporting threshold of §1.6038D-2(a)

(1), because the value of the specified foreign financial assets each is considered as owning for purposes of § 1.6038D-2(a)(1) is \$105,000 on October 12, Year X, which exceeds DC2's and DP's \$75,000 reporting threshold. DC2 and DP must each file Form 8938 for Year X to report their respective specified foreign financial assets in which they have an interest and disclose their maximum values as provided in § 1.6038D-4 (\$15,000 in the case of DC2 and \$90,000 in the case of DP).

Example 3. Application of aggregation rule and entity with an active trade or business.

(i) Facts. The facts are the same as in Example 2, except that DC2 also owns an active business. The assets attributable to the business are not passive assets and constitute at least 60% of the value of DC2's assets at all times during Year X. The income from the business is not passive income and constitutes at least 60% of the gross income generated by DC2 in Year X.

(ii) Specified domestic entity status.

(A) DC1 and DC2. DC1 and DC2 are considered related entities that are connected through stock ownership with a common parent corporation under paragraph (b)(3)(iii) of this section because DC1 and DC2 are closely held by L, and DC2 is connected with DC1 through DC1's ownership of stock of DC2 representing at least 80% of the voting power or value of DC2. As a result, for purposes of applying paragraph (b)

(1)(ii) of this section, each of DC1 and DC2 is treated as owning the combined assets, and receiving the combined income, of both DC1 and DC2; however, DC1's equity interest in DC2 is disregarded for this purpose under paragraph (b)(3)(iii) of this section. As a result, no more than 40 percent of the value of DC1's and DC2's assets at all times during Year X are passive and no more than 40 percent of DC1's and DC2's gross income for Year X is passive. DC1 and DC2 do not satisfy the passive income or passive asset threshold in paragraph (b)(1)(ii) of this section for Year X. DC1 and DC2 are not specified domestic entities for Year X.

(B) DP. For the reasons described in paragraph (ii)(B) of Example 2, DP is a specified domestic entity for Year X.

(iii) Reporting requirements.

(A) DC1 and DC2. DC1 and DC2 are not specified domestic entities for Year X, and are not required to file Form 8938.

(B) DP. Under §1.6038D-3, DP has an interest in specified foreign financial assets. Under §1.6038D-2(a)(6)(ii), DP is treated as owning in addition to its own assets the assets of DC2. As a result, DP satisfies the reporting threshold of §1.6038D-2(a)(1) because the value of the specified foreign financial assets it is considered to own for purposes of §1.6038D-2(a)(1) is \$105,000 on October 12, Year X, which exceeds DP's \$75,000 reporting threshold. DP must file Form 8938 for Year X to report the specified foreign financial assets in which it has an interest and disclose their maximum values as provided in §1.6038D-4, which is \$90,000.

Domestic Trusts

A domestic trust is considered to "formed or availed of" for purposes of holding specified foreign financial assets only if it has one or more specified persons as a current beneficiary. The term "current beneficiary" means, with respect to the taxable year, any person who at any time during such taxable year is entitled to, or at the discretion of any person 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 "current beneficiary" also includes any holder of a general power of appointment, whether or not exercised, that was exercisable at any time during the taxable year, but does not include any holder of a general power of appointment that is exercisable only on the death of the holder.

Excepted Domestic Entities

The Final Regulations provide that certain domestic entities are excluded from the definition of "specified domestic entity," including all of the following:

- any corporation the stock of which is regularly traded on an established securities market,
- any corporation which is a member of the same "expanded affiliated group" as a corporation the stock of which is regularly traded on an established securities market,
- any organization exempt from taxation under IRC § 501(a) or an individual retirement plan,
- the United States government or any wholly owned agency or instrumentality thereof,
- any State, the District of Columbia, any possession of the United States, any political subdivision of any of the foregoing, or any wholly owned agency or instrumentality of any one or more of the foregoing,
- any bank (as defined in section 581),
- any real estate investment trust (as defined in section 856),
- any regulated investment company (as defined in section 851),

- any common trust fund (as defined in section 584(a)), and
- any trust which is exempt from tax under section 664(c), or is described in section 4947(a)(1).

In addition, the Final Regulations also exempt a domestic trust provided that the trustee:

- has supervisory authority over or fiduciary obligations with regard to the specified foreign financial assets held by the trust;
- timely files (including any applicable extensions) annual returns and information returns on behalf of the trust; and
- is (1) a bank that is examined by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, or the National Credit Union Administration; (2) a financial institution that is registered with and regulated or examined by the Securities and Exchange Commission; or (3) a domestic corporation whose stock is regularly traded on an established securities market or is a member of the same expanded affiliated group as a corporation whose stock is regularly traded on an established securities market.

Finally, the Final Regulations exempt domestic grantor trusts owned by one or more specified persons.

Valuation Determination

The Final Regulations provide a special rule for purposes of determining the aggregate value of specified foreign financial assets held by a specific domestic entity. Under the existing regulations, a taxpayer is not required to report a particular asset on Form 8938 if such asset is reported on any of the following international information returns: Forms 3520, 5471, 8621, 8865, and 8891. The Final Regulations provide that the value of any specified foreign

financial asset which is reported on one of the enumerated information returns is excluded for purposes of determining the domestic entity's aggregate value of specified foreign financial assets.

The Final Regulations further provide that purposes of determining the aggregate value of specified foreign financial assets, a specified domestic entity that is a corporation or partnership and that has an interest in any specified foreign financial asset is treated as owning all the specified foreign financial assets held by all domestic corporations and domestic partnerships that are closely held by the same specified individual.

Effective Date

The Final Regulations apply to taxable years beginning after December 31, 2015.

Penalties for Non-Compliance

Any domestic entity that is required to file Form 8938 and fails to do so will be subject to an initial civil penalty of \$10,000. A continuation penalty of \$10,000 per month may be applied if the non-compliance continues after the IRS mails a notice regarding the failure to file Form 8938, up to a maximum of \$50,000. In addition to civil penalties, the failure to file Form 8938 may also subject the taxpayer to criminal penalties.

If the taxpayer demonstrates that the failure to file Form 8938 was due to reasonable cause and not due to willful neglect, the penalty may be abated. In order to demonstrate reasonable cause, the taxpayer must make an affirmative showing of all the facts alleged as reasonable cause for the failure to disclose. The IRS will make the determination of whether a failure to disclose a specified foreign financial asset on Form 8938 was due to reasonable cause and not due to willful neglect on a case-by-case basis, taking into account all pertinent facts and circumstances.

The Final Regulations provide that the fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the required information is not reasonable cause.

Even more significant than the potential civil penalty exposure, a taxpayer's failure to comply with the Form 8938 filing obligations may cause the statute of limitations to remain open. In particular, for any taxpayer who fails to file Form 8938, or fails to report a specified foreign financial asset that is required to be reported, the statute of limitations for the tax year may remain open for all or a part of the income tax return until three years after the date on which the Form 8938 is filed.— ©2016, BLANK ROME LLP

1. The Final Regulations exclude (1) any commodity hedging transaction described in IRC § 954(c)(5)(A), determined by treating the corporation or partnership as a controlled foreign corporation; or (2) active business gains or losses from the sale of commodities, but only if substantially all the corporation or partnership's commodities are property described in IRC § 1221(a)(1), (2), or (8).



Matthew D. Lee is the author of ***The Foreign Account Tax Compliance Act Answer Book 2015*** (published by the Practising Law Institute), a definitive treatment of the due diligence, withholding, reporting, and compliance obligations imposed by FATCA on foreign financial institutions, non-financial foreign entities, and withholding agents. For more information on this publication, please click [here](#).

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