Specified Domestic Entities Must Now File Form 8938: Code Sec. 6038D, New Regulations in 2016, and Expanded Foreign Financial Asset Reporting

By Hale E. Sheppard

HALE E. SHEPPARD, Esq. (B.S., M.A., J.D., LL.M., LL.M.T.) is a Shareholder in the Tax Controversy Section of Chamberlain Hrdlicka and Co-Chair of the firm's International Tax Group. Hale specializes in tax audits, tax appeals, tax litigation and international tax disputes and compliance. You can reach Hale by phone at (404) 658-5441 or by e-mail at hale.sheppard@chamberlainlaw.com.

I. Introduction

Domestic entities are considered U.S. persons for federal tax purposes. As such, they have historically been obligated to complete various forms, disclosing to the IRS each year details about certain foreign income, entities, activities and accounts. In February 2016, the IRS expanded these reporting duties even more, forcing those identified as specified domestic entities (SDEs) to file an annual Form 8938, *Statement of Specified Foreign Financial Assets*, revealing data about a long list of foreign financial holdings. For the past five years, the duty has pertained only to specified individuals (SIs). This article, which is the latest in a series by this author on the complex and dynamic rules concerning Form 8938, focuses on the new rules applicable to SDEs starting in 2016.[1]

II. Overview of Foreign Financial Asset Reporting

A. General Rule and Scope

The general rule, found in Code Sec. 6038D(a), contains the following mandate, which only applies to certain "individual" taxpayers:

> Any *individual* who, during any taxable year, holds any interest in a specified foreign financial asset shall attach to such person's return of tax imposed

> by subtitle A for such taxable year the information described [Code Sec. 6038D(c)] with respect to each such asset if the aggregate value of all such assets exceeds $50,000 (or such higher dollar amount as the Secretary may prescribe).

Despite the narrow applicability of the preceding general rule, Code Sec. 6038D(f) states that, to the extent provided by the IRS through regulations or some other form of guidance, the duty to file an annual Form 8938 shall apply not only to certain "individuals" but also to "any domestic entity which is formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets." As explained below, it has taken more than half a decade for the IRS to act on the authority that Congress granted it in Code Sec. 6038D(f). This delay, of course, has triggered uncertainty and anxiety in the tax community for years.

B. A Little History

Appreciating where we are today first requires a peek at history. Code Sec. 6038D was enacted more than six years ago, in March 2010, as part of the Foreign Account Tax Compliance Act ("FATCA").[2] The IRS began taking regulatory actions about one-and-a-half years later, in December 2011. At that time, the IRS published temporary regulations addressing issues related only to SIs, which took immediate effect ("Temporary SI Regulations").[3] At that same time, the IRS released proposed regulations explaining how SDEs might be affected by Code Sec. 6038D in the future ("Proposed SDE Regulations").[4] Given that they constituted a mere suggestion from the IRS, the Proposed SDE Regulations had no binding effect when they were introduced in December 2011.

The IRS acted again three years later, when it made certain changes to the Temporary SI Regulations and published them in final form ("Final SI Regulations") in December 2014.[5] The IRS did not provide updated guidance regarding SDEs at that juncture, though. Then, in February 2016, nearly six years after Congress first unveiled Code Sec. 6038D, the IRS released the Proposed SDE Regulations in final form ("Final SDE Regulations").[6] This article focuses on the new obligations and issues for taxpayers and their advisors caused by the Final SDE Regulations.

C. Breakdown of the Filing Duty

The general rule in Code Sec. 6038D(a), as recently expanded to SDEs by Code Sec. 6038D(f) and the Final SDE Regulations, can be divided into the following parts:

- any specified person (SP), which now includes both SIs and SDEs
- who/that holds an interest
- during any portion of a tax year
- in a specified foreign financial asset (SFFA)
- must attach to his/her/its timely tax return
- a complete and accurate Form 8938
- if the aggregate value of all SFFAs
- exceeds the applicable filing threshold

D. Review of Major Issues Related to Form 8938

As explained above, the author of this current article has previously published articles providing a comprehensive (some might say tedious) analysis of all Form 8938 reporting rules, as they apply to SIs.[7] Therefore, such details will not be repeated here. What is included below is an overview of certain rules, which is designed to assist the reader in appreciating the significance of the Final SDE Regulations, and the expansion of duties to SDEs. For more details about all things Form 8938, particularly as they pertain to SIs, readers should consult the earlier, comprehensive analysis, together with this current article.

1. Who Must File a Form 8938?

Code Sec. 6038D(a) states that the duty to file Form 8938 only pertains to SIs, but, thanks to Code Sec. 6038D(f) and the new Final SDE Regulations, the obligation will also apply to certain SDEs for 2016 and future years.

The following categories of individuals ordinarily are considered SIs: (i) U.S. citizens, (ii) individuals who are not U.S. citizens, but who are U.S. residents for any portion of the relevant year, (iii) nonresident aliens who affirmatively elect under Code Sec. 6013(g) or Code Sec. 6013(h) to be treated as U.S. residents for federal tax purposes, (iv) nonresident aliens who are *bona fide* residents of Puerto Rico and (v) nonresident aliens who are *bona fide* residents of a so-called "Section 931 Possession," which, at this point, means American Samoa.[8]

For its part, the term SDE is defined as (i) a domestic corporation, a domestic partnership or a domestic trust (ii) that was "formed or availed of" for purposes of holding, either directly or indirectly, (iii) SFFAs.[9]

2. No Tax Return Requirement Means No Form 8938 Requirement

Generally, an SP who/that is not required to file an annual tax return with the IRS for the relevant year is not required to file a Form 8938 either.[10]

3. Consolidated Corporate Returns

If an SDE is a member of a group of corporations that files a consolidated income tax return, then the Form 8938 for the SDE must be filed with the consolidated return.[11]

4. What Period of Time Does Each Form 8938 Cover?

The general rule is that the reporting period covered by Form 8938 is the tax year of the SP, albeit calendar or fiscal.[12] There is an exception for certain SIs. Individuals are calendar-year taxpayers by default, starting each tax period on January 1 and ending on December 31.[13] Thus, when an individual meets the definition of SI for the entire year, the reporting period generates no uncertainty. Things get more complicated, though, when an individual is considered an SI for only part of a year, which could occur when an individual arrives or departs from the United States, when an individual dies mid-year, *etc*.

The regulations explain that the reporting period covered by Form 8938 is the SI's tax year (*i.e.*, Jan. 1 to Dec. 31), except in cases where the individual is an SI for less than a full year. In such partial-year situations, the reporting period is shortened to the portion of the calendar year that the individual actually meets the definition of SI.[14] The Instructions for Form 8938 contain examples that elucidate these scenarios. One example involves Agnes, a single, calendar-year taxpayer, who was a U.S. citizen and who died on March 6. The Form 8938 reporting period begins January 1 and ends March 6. Another example concerns George, a calendar-year taxpayer, who is not a U.S. citizen. George arrived in the United States on February 1 and became a U.S. resident for tax purposes that year because of his "substantial presence" in the United States. The Form 8938 reporting period begins on George's residency starting date, February 1, and ends December 31.[15]

5. When Does an SP "Hold an Interest" in an SFFA?

Holding an interest in an asset means different things in different contexts. When it comes to Form 8938, an SP generally has an interest in a SFFA if any income, gains, losses, deductions, credits, gross proceeds or distributions attributable to the holding or disposition of the SFFA are (or should be) reported, included or otherwise reflected on the SP's annual tax return.[16] The regulations clarify that an SP has an interest in the SFFA *even if* no income, gains, losses, deductions, credits, gross proceeds or distributions are attributable to the holding or disposition of the SFFA for the year in question.[17] On a related note, the regulations also clarify that an SP must file a Form 8938, despite the fact that none of the SFFAs that must be reported affect the U.S. tax liability of the SP for the year.[18]

6. What Types of Assets Constitute SFFAs?

For purposes of Code Sec. 6038D, the term SFFA includes two major categories: (i) foreign financial accounts maintained at a foreign financial institution[19] and (ii) other foreign financial assets, which are held for investment purposes.[20] A brief overview of each category is provided below.

a. Foreign Financial Accounts. The concept of "financial account" for purposes of Form 8938 is complicated for several reasons, one of which is that the definition is not even found in the applicable statute, Code Sec. 6038D, or the corresponding regulations. Instead, it is located elsewhere in the Code, in an international tax withholding provision, Code Sec. 1471, and its ultra-dense regulations.[21]

i. Items Considered "Financial Accounts."

- Depository accounts are considered "financial accounts" for purposes of Form 8938. In this context, the term "depository accounts" generally encompasses (i) commercial accounts, (ii) savings accounts, (iii) time-deposit accounts, (iv) thrift accounts, (v) accounts evidenced by a certificate of deposit, thrift certificate, investment certificate, passbook, certificate of indebtedness or any other instrument for placing money in the custody of an entity engaged in a banking or similar business for which the entity is obligated to give credit, regardless of whether such instrument is interest-bearing or noninterest-bearing and (vi) any amount held by an insurance company under a guaranteed investment contract or similar agreement to pay or credit interest.[22]
- Custodial accounts are deemed to be "financial accounts" for purposes of Form 8938. Here, the term "custodial accounts" ordinarily means an arrangement for holding for the benefit of another person a financial instrument, contract or investment, such as shares of corporate stock, promissory notes, bonds, debentures, other evidences of debt, currency or commodity transactions, credit default swaps, swaps based on a nonfinancial index, notional principal contracts, insurance policies, annuity contracts and any options or other derivative instruments.[23]
- Equity or debt interests in a foreign financial institution, other than interests regularly traded on established securities markets, generally are categorized as "financial accounts."[24]
- The term "financial account" also includes "cash value insurance contracts" and certain types of annuity

contracts issued or maintained by an insurance company, a holding company for an insurance company or certain foreign financial institutions.[25]

- Tax-favored foreign retirement accounts, foreign pension accounts and foreign nonretirement savings accounts meeting certain criteria are treated as "financial accounts" for purposes of Form 8938.[26] Moreover, even if these items have been excluded from the definition of "financial account" pursuant to an intergovernmental agreement (IGA) between the United States and a foreign country to implement FATCA, they will still be considered "financial accounts" for purposes of Form 8938. In other words, while certain foreign governments and financial institutions are not required to provide data to the IRS pursuant to FATCA about certain retirement-type accounts, SPs holding an interest in such accounts will not benefit from such an accommodation.[27]

ii. Items Not Considered "Financial Accounts."

- Certain term life insurance contracts are not considered "financial accounts."[28]
- Accounts held by an estate of an individual will not be considered "financial accounts," if the documentation for such accounts includes a copy of the deceased's will or death certificate.[29]
- Certain escrow accounts escape the definition of "financial account."[30]
- A noninvestment linked, nontransferable, immediate life annuity contract that monetizes certain types of retirement or pension accounts will not be classified as a "financial account."[31]
- An account or product that is excluded from the definition of "financial account" under an IGA (other than certain tax-favored foreign retirement accounts, foreign pension accounts and foreign nonretirement savings accounts) will not be considered a "financial account."[32]
- Accounts held with "U.S. payors" are not deemed to be "financial accounts."[33] The regulations broadly define the term "U.S. payor" as a "U.S. person," which includes a foreign branch of the U.S. person, a foreign office of the U.S. person and a U.S. branch of certain foreign banks and foreign insurance companies.[34] Examples of financial accounts that are exempt from reporting on Form 8938 because they are held with "U.S. payors" include U.S. mutual funds, U.S. individual retirement accounts, Code Sec. 401(k) retirement accounts, qualified U.S. retirement plans and brokerage/investment accounts maintained by U.S. financial institutions.[35]
- Accounts whose holdings are subject to the mark-to-market rules under Code Sec. 475 are not considered "financial accounts" for purposes of Form 8938.[36]

b. SFFAs Other than Foreign Financial Accounts. In addition to the "financial accounts" described above, SFFAs include those items falling under the catch-all provision, *i.e.*, other foreign financial assets. These are examined below.

i. Items That Are Considered Other SFFAs. The term SFFA also encompasses certain other assets that do not meet the broad definition of "financial account" and that are held for investment purposes. Among these assets are (i) stocks or securities issued by a non-U.S.-person, (ii) financial instruments or contracts held for investment purposes whose issuer or counterparty is a non-U.S.-person and (iii) any interest in a foreign entity.[37] The IRS recognized in the Preamble to the Temporary SI Regulations that creating such expansive categories could lead to redundancies:

> These three categories [of other SFFAs] are broad and overlap in certain cases such that an asset not held in a financial account may be within more than one of the statutory categories … . For example, stock issued by a foreign corporation is stock that is issued by a person other than an U.S. person, and is also an interest in a foreign entity.[38]

The regulations enlarge and clarify the categories, identifying the following items as SFFAs: (i) stock issued by a foreign corporation, (ii) a capital interest or profits interest in a foreign partnership, (iii) a note, bond, debenture or other form of debt issued by a foreign person, (iv) an interest in a foreign trust, (v) an interest swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap or similar agreement with a foreign counterparty and (vi) any option or other derivative instrument with respect to any of the items listed as examples or with respect to any currency or commodity that is entered into with a foreign counterparty or issuer.[39]

ii. Items That Are Not Considered Other SFFAs. The IRS guidance *excludes* two types of foreign assets from classification as SFFAs. First, various sources state that an interest in a social security, social insurance or other similar program of a foreign government is not an SFFA.[40] Second, an interest in a foreign trust or a foreign estate is not an SFFA, unless the SP either knows or has reason to know of the existence of the interest based on readily accessible information.[41] Receipt by the SP of a distribution from the foreign trust or foreign estate constitutes actual knowledge of its existence for purposes of Code Sec. 6038D; that is, an SP who receives cash or other property from a foreign trust or estate during a given year is prohibited from later denying its existence when it comes to reporting it on Form 8938.[42]

III. New Rules from Final SDE Regulations

The changes introduced by the Final SDE Regulations can be divided into the following three parts.

A. Change One of Three

Code Sec. 6038D(a) expressly states that Form 8938 only pertains to "individuals." However, the regulations have indicated from the outset that most rules apply to SPs, a category encompassing both SIs and SDEs.[43] The problem was that the IRS had only defined one of these two key terms, SI. The Final SI Regulations, issued in December 2014, were silent with respect to the meaning of SDEs, indicating that this spot had been "reserved" for later.[44] Now, with the issuance of the Final SDE Regulations in February 2016, this spot has been filled. Instead of addressing the term SDE in the definitional regulation (*i.e.*, Reg. §1.6038D-1), the IRS explains that this tricky concept will be tackled with all other items related to SDEs, in new Reg. §1.6038D-6.[45]

B. Change Two of Three

The second change introduced by the Final SDE Regulations concerns filing thresholds.

Even if an SP holds an interest in SFFAs during a given year, the SP is only required to file a Form 8938 if the aggregate value of the SFFAs surpasses certain filing thresholds. This is easy to say but hard to determine because (i) there are six different thresholds, which, in the case of SIs, depend on whether they lived in the United States or abroad, whether they are single or married, and, if married, whether they file alone or jointly, (ii) the regulations contain unique rules for valuing foreign currency, foreign accounts, foreign trusts, foreign estates, foreign pension plans, foreign deferred compensation plans, foreign assets with negative values and jointly owned assets, (iii) the Final SI Regulations featured special rules for valuing SFFAs that are exempt from reporting on Form 8938, and (iv) now the Final SDE Regulations create additional special rules for exempt SFFAs held by SDEs.[46] To understand the changes effectuated by the Final SDE Regulations, one must first grasp the previous/original rules.

1. General Rule Regarding Filing Thresholds

An SP who/that holds an interest in one or more SFFAs during a year generally must file a Form 8938, if the aggregate value of the SFFAs exceeds (i) $50,000 on the last day of the year, or (ii) $75,000 at any time during year.[47]

2. Certain SFFAs Are Not Required to Be Reported on Form 8938

a. Exemption for SFFAs Reported to the IRS Elsewhere. The Final SI Regulations identified various SFFAs that were *not* required to be reported on Form 8938 because doing so would be duplicative. Specifically, an SP is *not* required to report an SFFA on Form 8938, provided that the SP timely reports such SFFA to the IRS on at least one of the following international information returns:

- Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain 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 of a Qualified Electing Fund*
- Form 8865, *Return of U.S. Persons with Respect to Certain Foreign Partnerships*
- Form 8891, *U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans*
- Any other international information return under the Code that is timely filed with the IRS and identified for this purpose in regulations "or other guidance"[48]

b. Exemption for Certain Foreign Grantor Trusts. An SP who/that is treated as an owner of a foreign trust under the grantor trust rules of Code Sec. 671 to 679 is not required to report any SFFAs held by the foreign trust, provided that three conditions are met: (i) the SP reports the trust on a timely Form 3520, (ii) the foreign trust files a timely Form 3520-A and (iii) the SP checks the proper boxes on Form 8938 to confirm the filing of Form 3520 and Form 3520-A.[49]

c. Exemption for Certain Domestic Grantor Trusts. An SP who is treated as an owner of a domestic trust under the grantor trust rules of Code Sec. 671 to 679 does not need to file a Form 8938 to report any SFFA held by the trust, if the trust is a domestic liquidating trust created pursuant to a court order issued in a Chapter 7 bankruptcy, a confirmed plan in a Chapter 11 bankruptcy or a domestic widely-held fixed investment trust.[50]

d. Exemption for Certain SFFAs in Puerto Rico or American Samoa. As explained at the beginning of this article, various categories of nonresident aliens are considered SIs, namely, those who are *bona fide* residents of Puerto Rico, and those who are *bona fide* residents of a so-called "Section 931 Possession," *i.e.*, American Samoa.[51] These types of SIs must file Forms 1040 with the IRS if they have income from sources outside their respective territories.[52] Cognizant of these realities, the IRS adopted another exemption.

An SI, who is a *bona fide* resident of Puerto Rico or American Samoa, and who is required to file a Form 8938 with the IRS, is *not* required to report the following SFFAs on Form 8938: (i) a financial account maintained by a financial institution organized under the laws of the U.S. possession of which the SI is a *bona fide* resident; (ii) a financial account maintained by a branch of a financial institution not organized under the laws of the U.S. possession of which the SI is a *bona fide* resident, if the branch is subject to the same tax and information reporting requirements applicable to a financial institution organized under the laws of the U.S. possession; (iii) stock or securities issued by an entity organized under the laws of the U.S. possession of which the SI is a *bona fide* resident; (iv) an interest in an entity organized under the laws of the U.S. possession of which the SI is a *bona fide* resident; and (v) a financial instrument or contract held for investment, provided that each issuer or counterparty that is a non-U.S.-person is either an entity organized under the laws of the U.S. possession of which the SI is a *bona fide* resident or a *bona fide* resident of the U.S. possession of which the SI is a *bona fide* resident.[53]

3. Valuation of Exempt SFFAs Under Final SI Regulations

The Final SI Regulations clarified that, just because an SFFA is exempt from reporting on Form 8938 based on the preceding rules, this does not necessarily mean that it can be disregarded when it comes to valuing SFFAs in order to determine whether an SP surpasses the applicable filing threshold. In other words, while SPs may not be required to report certain SFFAs on Form 8938, they might still need to value/count the SFFAs to determine if the SPs even hold sufficient SFFAs to pique the IRS's interest. The Final SI Regulations created two valuation-related rules in this regard.

On one hand, the Final SI Regulations stated that the value of any SFFA that is exempt from reporting on Form 8938 because of Reg. §1.6038D-7*(a)* (*i.e.*, SFFAs that the SI already reported to the IRS on international information returns other than the Form 8938, such as Form 3520, 3520-A, 5471, 8621, 8865 or 8891, and certain SFFAs held by a foreign grantor trust properly reported to the IRS) *is included* for purposes of determining the aggregate value.[54] Thus, just because an SI is not required to report on Form 8938 details about ownership in a controlled foreign corporation because the SI already disclosed such data on Form 5471, this does not mean that the value of the SI's interest in the controlled foreign corporation is ignored by the SI when calculating whether the total value of all SFFAs exceeds the applicable filing threshold, such that the SI will be required to file Form 8938.

On the other hand, the Final SI Regulations explained that the value of any SFFA that is exempt from reporting on Form 8938 because of Reg. §1.6038D-7*(b)* or *(c)* (*i.e.*, certain SFFAs located in Puerto Rico and American Samoa, and SFFAs held by certain domestic trusts) *is excluded* when it comes to calculating the aggregate value.[55] For example, if an SI holds an interest in certain domestic grantor trusts, then the SI is not required to include the value of the SFFAs held through the trusts for purposes of measuring the total value of his SFFAs, and the SI is not obligated to report the SFFAs held through the trusts on Form 8938, even if the SI must file Form 8938 because the total value of the SFFAs (not counting those held through the domestic grantor trusts) exceeded the applicable reporting threshold.

The two valuation-related rules described above, which were originally issued in December 2014 as part of the Final SI Regulations, survive the recent introduction of the Final SDE Regulations; they were just renumbered to make room for yet more special rules.[56]

4. Valuation of Exempt SFFAs Under Final SDE Regulations

The Final SDE Regulations contain two new rules, which address valuation of exempt SFFAs held by SDEs.

On the helpful side, the Final SDE Regulations state that the value of any SFFA that is exempt from reporting on Form 8938 because of Reg. §1.6038D-7*(a)* (*i.e.*, SFFAs that the SDE already reported to the IRS on international information returns other than the Form 8938, such as Form 3520, 3520-A, 5471, 8621, 8865 or 8891, and certain SFFAs held by a foreign grantor trust properly reported to the IRS) *is excluded* for purposes of determining the aggregate value.[57] Yes, that is exactly the opposite rule of the one, cited above, relevant to SIs under the Final SI Regulations.

The Final SDE Regulations also state that, for purposes of determining the aggregate value of SFFAs, an SDE that is a domestic corporation or a domestic partnership, and that holds an interest in any SFFA, will be treated as owning *all* the SFFAs (*except* the ones that do not need to be reported on Form 8938 because of the anti-duplication rules in Reg. §1.6038D-7(a)) that are held by *all* domestic corporations and *all* domestic partnerships that are "closely held" by the same SI, as determined under new Reg. §1.6038-6(b)(2).[58]

C. Change Three of Three

The biggest change by the Final SDE Regulations is the introduction of the long-awaited Reg. §1.6038D-6, which

contains nearly all rules pertaining to SDEs. This regulation, like most, is complicated and dense. It is presented in pieces below, with the hopes of making it more manageable.

1. What Is an SDE?

a. General Definition. An SDE is defined in the following manner: (i) a domestic corporation, a domestic partnership or a domestic trust (ii) that was "formed or availed of" for purposes of holding, either directly or indirectly, (iii) SFFAs.[59]

b. What is a "Domestic" Entity? Although not defined in Code Sec. 6038D or the regulations thereunder, and although certain tax professionals might cavalierly overlook this aspect, it is important to start with the basics. The term "domestic," when applied to a corporation or partnership, generally means an entity created or organized in the United States, under the law of the United States or under the law of any state.[60] For its part, a trust is considered "domestic" if a court within the United States is able to exercise primary supervision over the administration of the trust, and one or more U.S. persons have the authority to control all substantial decisions of the trust.[61]

c. What Does "Formed or Availed of" Mean?

i. Rules for Domestic Corporations and Partnerships (But Not Domestic Trusts). The general rule is that a domestic corporation or a domestic partnership was "formed or availed of" for purposes of holding SFFAs if it meets *both* of the following two tests.[62]

- *Test #1*. The domestic corporation or domestic partnership is "closely held" by an SI.[63]
- *Test #2*. At least 50 percent of the gross income of the domestic corporation or the domestic partnership for the relevant year is "passive income" (*i.e.*, the 50-Percent-or-More-Passive-Income Test) *or* at least 50 percent of the assets held by the domestic corporation or the domestic partnership for the relevant year are assets that actually produce or are held for the production of "passive income" (*i.e.*, the 50-Percent-or-More-Passive-Asset Test).[64] For these purposes, the percentage of passive assets held by a corporation or partnership for a particular year is the weighted average percentage of passive assets (weighted by total assets and measured quarterly), and the value of the assets is the fair market value or the book value 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).[65]

ii. Modification of Tests Used by IRS. In issuing the Proposed SDE Regulations back in 2011, the IRS suggested that, in order to be considered "formed or availed of" for purposes of holding SFFAs, a domestic corporation or domestic partnership must meet Test #1, as described above, but a different Test #2. Originally, the IRS indicated that (i) the entity must meet the 50-Percent-or-More-Passive-Income Test or 50-Percent-or-More-Passive-Activity Test *or* (ii) at least 10 percent of the entity's gross income is passive income or at least 10 percent of the entity's assets produce or are held for the production of income, *and* the entity is formed or availed of by an SI "with the principal purpose of avoiding the reporting obligations under Section 6038D," and in making this determination, "all facts and circumstances are taken into account."[66]

The IRS changed course when it issued the Final SDE Regulations, eliminating the "principal purpose" test, along with all the inevitable and protracted tax litigation that would surely have arisen from it. The Preamble to the Final SDE Regulations provides the following explanation for the switch:

> [T]he Treasury Department and the IRS have concluded that taxpayers should be able to determine their reporting requirements under section 6038D *based on objective requirements rather than a subjective principal purpose test*. Therefore, these final regulations eliminate the principal purpose test for determining whether a corporation or partnership is a specified domestic entity. However, the Treasury Department and the IRS 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. If needed, the Treasury Department and the IRS may expand the definition of a specified domestic entity in future guidance.[67]

iii. Test #1—When Is an Entity "Closely Held"? A domestic corporation or domestic partnership will not be considered "formed or availed of" for purposes of holding SFFAs, unless it meets both Test #1 and Test #2.

(a) Test #1—General Rule. Test #1 is satisfied if the domestic corporation or domestic partnership is "closely held" by an SI, as this concept is defined under the Final SDE Regulations. A domestic corporation is "closely held" by an SI if at least 80 percent of the stock (by vote or value) is owned (directly or indirectly or constructively) by an SI on the last day of the corporation's tax year.[68] Similarly, a domestic partnership is "closely held" by an SI if at least 80 percent of the capital or profits interest in the partnership is owned (directly or indirectly or constructively) by an SI on the last day of the partnership's tax year.[69]

(b) Test #1—Custom Rules about Constructive Ownership. As indicated above, the interest in the domestic

corporation or domestic partnership can be held directly, indirectly or constructively by an SI. In this context, Code Sec. 267(c) and Code Sec. 267(e)(3) apply in order to determine whether an SI has a constructive interest, except that Code Sec. 267(c)(4) is applied as if the "family" of an SI also includes the spouses of family members.[70]

Code Sec. 267(c), as modified by the Final SDE Regulations, provides the following rules regarding constructive ownership of stock in a corporation: (i) Stock owned, directly or indirectly, by or for a corporation, partnership, estate or trust shall be considered as being owned proportionately by or for its shareholders, partners or beneficiaries; (ii) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his "family"; (iii) An individual owning (other than by the application of the preceding sentence) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner; (iv) The "family" of an individual shall include his brothers and sisters (whether by the whole-blood or half-blood), spouse, ancestors, lineal descendants and spouses of all the preceding family members; and (v) Stock constructively owned by a person because of the application of (i), above, shall for purposes of applying (i), (ii) and (iii), above, be treated as actually owned by such person, but stock constructively owned by an individual because of application of (ii) or (iii) shall not be treated as owned by him for purposes of again applying either of such paragraphs in order to make another the constructive owner of such stock.

Code Sec. 267(e)(3) states that, for purposes of determining ownership of a capital interest or profits interest of a partnership, the principles described above (in Code Sec. 267(c)) shall apply, except that (iii) shall not apply, and interests owned (directly or indirectly) by or for a C corporation shall be considered as owned by or for any shareholder only if such shareholder owns (directly or indirectly) five percent or more in value of the stock of such corporation.

iv. Test #2—What Are the "Passive" Standards? A domestic corporation or domestic partnership will not be considered "formed or availed of" for purposes of holding SFFAs, unless it meets both Test #1 and Test #2. As explained above, Test #2 is satisfied if a domestic corporation or domestic partnership meets the 50-Percent-or-More-Passive-Income Test (because at least 50 percent of its gross income is "passive income") or meets the 50-Percent-or-More-Passive-Asset Test (because at least 50 percent of the assets held by the entity actually produce or are held for the production of "passive income"). The key to understanding if Test #2 has been met, then, is the definition of "passive income" for purposes of Code Sec. 6038D.

(a) Test #2—General Rule. Generally, the portion of gross income consisting of the following items constitutes "passive income" in the context of an SDE: (i) dividends, including substitute dividends, (ii) interest, (iii) income equivalent to interest, including substitute interest, (iv) rents and royalties, other than rents and royalties derived in the active conduct of a trade or business that is conducted, at least in part, by employees of the corporation or partnership, (v) annuities, (vi) the excess of gains over losses from the sale or exchange of property that gives rise to any of the types of passive income described previously in this paragraph, (vii) the excess of gains over losses from transactions (including futures, forwards and similar transactions) in any commodity, with certain exceptions, (viii) the excess of foreign currency gains over foreign currency losses (as defined in Code Sec. 988(b)) attributable to any Code Sec. 988 transaction and (ix) net income from notional principal contracts as defined in Reg. §1.446-3(c)(1).[71]

(b) Test #2—Exception for Dealers. Notwithstanding the general rule set forth above, in the case of a domestic corporation or domestic partnership that regularly acts as a "dealer" in certain property, forward contracts, option contracts or similar financial instruments (including notional principal contracts and all instruments referenced to commodities), the term "passive income" does *not* include (i) any item of income or gain (other than 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, and (ii) if such dealer is a dealer in securities (as defined in Code Sec. 475(c)(2)), any income from any transaction entered into in the ordinary course of such trade or business.[72]

(c) Test #2—Special Rules for "Related Entities." For purposes of determining whether Test #2 has been met, all domestic corporations and domestic partnerships which are "closely held" by the same SI, *and* which are connected through stock ownership or partnership-interest ownership with a common parent corporation or partnership, are treated as owning the combined assets of, and receiving the combined income from, *all* members of that group.[73] The Final SDE Regulations expand on this notion, explaining that 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 by vote or value (other than stock in the common parent) or partnership interests representing at least 80 percent of the profits interests or capital interests of such partnership (other than partnership interests in the common parent) is owned by one or more of the other

FIGURE 1

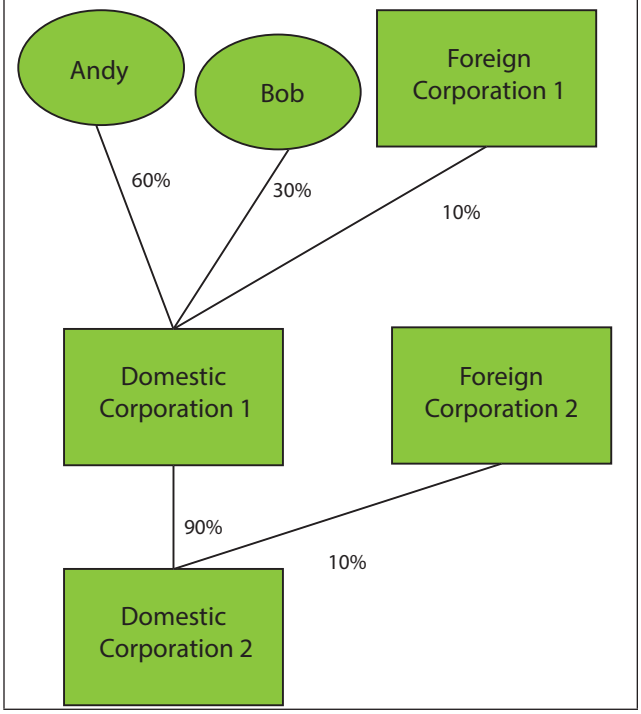
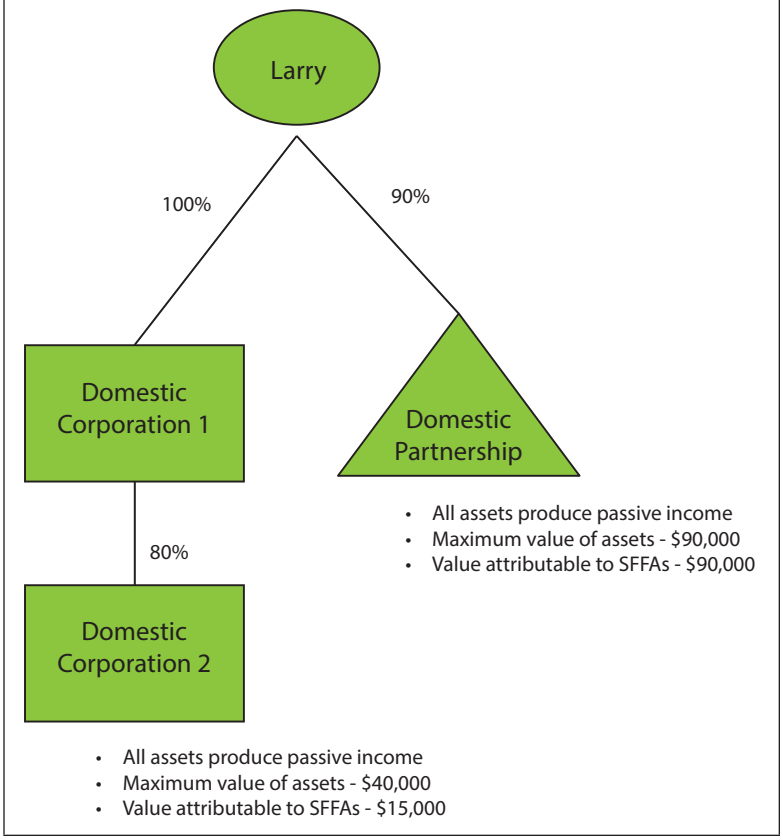


FIGURE 2



connected corporations, connected partnerships or the common parent.[74] For purposes of the preceding rules for "related entities," assets pertaining 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.

d. Examples. The Final SDE Regulations contain three examples, which are set forth below.[75] The author has altered these examples, sometimes significantly, in an effort to make them clearer to the reader. The author also has created charts to visually show the three examples, for the same reasons. Given the convoluted manner in which the IRS presented the material, and given the overall density of the Final SDE Regulations, these efforts at clarification, alas, might be futile.

i. Example 1.

Facts. Domestic Corporation 1 (DC1) is owned 60 percent by Andy (who is an SI), 30 percent by Bob (who is a member of Andy's family under Code Sec. 267(c)(2) but who is not an SI) and 10 percent by Foreign Corporation 1 (FC1). DC1 owns 90 percent of the stock of Domestic Corporation 2 (DC2). Foreign Corporation 2 (FC2) owns the remaining 10 percent of DC2. Andy does not own (directly, indirectly or constructively) any stock in FC1 or FC2. Likewise, Bob does not own (directly, indirectly or constructively) any stock in FC1 or FC2.

Illustration. Below is an illustration (Figure 1), created by the author, of the facts in Example 1.

Analysis. Andy is deemed to own 90 percent of DC1 after applying the Final SDE Regulations, including the customized ownership-attribution rules in Code Sec. 267(c). Andy is also deemed to own 81 percent of DC2 after applying the Final SDE Regulations, including the customized ownership-attribution rules in Code Sec. 267(c). DC1 and DC2 are "closely held" because Andy, who is an SI, is deemed to own more than 80 percent of the total value of each. Therefore, Test #1 has been satisfied.

ii. Example 2.

Facts. Larry is an SI. Larry owns 100 percent of DC1. Larry also owns a 90 percent capital interest in Domestic Partnership (DP). DC1 owns 80 percent of the stock of DC2 but has no other assets. All assets held by DC2 produce passive income, their maximum value during the year was $40,000, and $15,000 of such value was attributable to SFFAs (*i.e.*, 37.5 percent of the total value). All assets held by DP produce passive income, and their maximum value during

the year was $90,000, all of which was attributable to SFFAs (*i.e.*, 100 percent of the total value).

- *Illustration*. Below is an illustration (Figure 2), created by the author, of the facts in Example 2.
- *Analysis—Which Domestic Corporations Are SDEs?*
- DC1 and DC2 are "closely held" by an SI, *i.e.*, Larry, because he owns at least 80 percent of each. Therefore, Test #1 is satisfied.
- DC1 and DC2 are considered "related entities" that are connected through stock ownership with a common parent corporation because DC1 and DC2 are "closely held" by Larry, and DC2 is connected with DC1 through the ownership by DC1 of stock in DC2 representing at least 80 percent of the value/vote of DC2.
- Therefore, for purposes of applying the 50-Percent-or-More-Passive-Income Test and the 50-Percent-or-More-Passive-Asset Test, each of DC1 and DC2 is considered to own the combined assets of, and to receive the combined income from, both DC1 and DC2. However, stock held by DC1 in DC2 is disregarded for this purpose under the "related entity" rules. Therefore, DC1 and DC2 each satisfies the 50-Percent-or-More-Passive-Asset Test because 100 percent of the assets held by each are passive. DC1 and DC2 each meet Test #2.
- DC1 and DC2 are both "domestic corporations," and they both meet Test #1 (because they are "closely held" by Larry, an SI) and they both meet Test #2 (because they satisfy the 50-Percent-or-More-Passive-Asset Test), such that they were "formed or availed of" for purposes of holding SFFAs, directly or indirectly. Consequently, DC1 and DC2 are both SDEs.
- *Analysis—Is DP an SDE?*
- DP is "closely held" by an SI, *i.e.*, Larry, so it meets Test #1.
- DP is not considered a "related entity" with DC1 and DC2 under the "related entity" rules because DC1 and DP are not owned by a common parent corporation or partnership. Consequently, the issue of whether DP meets the 50-Percent-or-More-Passive-Income Test or the 50-Percent-or-More-Passive-Asset Test is determined solely by reference to DP's separately-earned "passive income" and separately held "passive assets." DP holds only passive assets; therefore, it satisfies both the 50-Percent-or-More-Passive-Income Test and the 50-Percent-Or-More-Passive-Asset Test and satisfies Test #2.
- DP is a "domestic partnership," it meets Test #1 (because it is "closely held" by Larry, an SI), and it meets Test #2 (because it satisfied both the 50-Percent-or-More-Passive-Income Test and the 50-Percent-or-More-Passive-Asset Test, such that it was "formed or availed of" for purposes of holding SFFAs, directly or indirectly. Consequently, DP is an SDE.
- *Analysis—Must DC1 File Form 8938?* Under the new rules introduced in the Final SDE Regulations regarding filing thresholds (*see* the discussion of new Reg. §1.6038D-2(a)(6)(ii) in the section of this article, above, called *Change Two of Three*), DC1 is not treated as owning the SFFAs held by DC2 and DP because DC1 does not hold an interest in any SFFAs. DC1 is not required to file Form 8938 because it does not surpass the applicable filing threshold.
- *Analysis—Must DC2 and/or DP File Form 8938?* DC2 and DP each holds an interest in SFFAs. For purposes of calculating the filing threshold, the new rules introduced in the Final SDE Regulations regarding filing thresholds (*see* the discussion of new Reg. §1.6038D-2(a)(6)(ii) in the section of this article, above, called *Change Two of Three*), DC2 is treated as holding its own assets and the assets of DP, while DP is treated as holding its own assets and the assets of DC2. As a result, DC2 and DP each surpasses the filing threshold because the value of the SFFAs is $105,000 in each instance, and the filing threshold is either $50,000 on the last day of the year or $75,000 at any time during a given year. DC2 and DP must each file a Form 8938 reporting the SFFAs and the maximum values, which are $15,000 for DC2 and $90,000 for DP.

iii. Example 3.

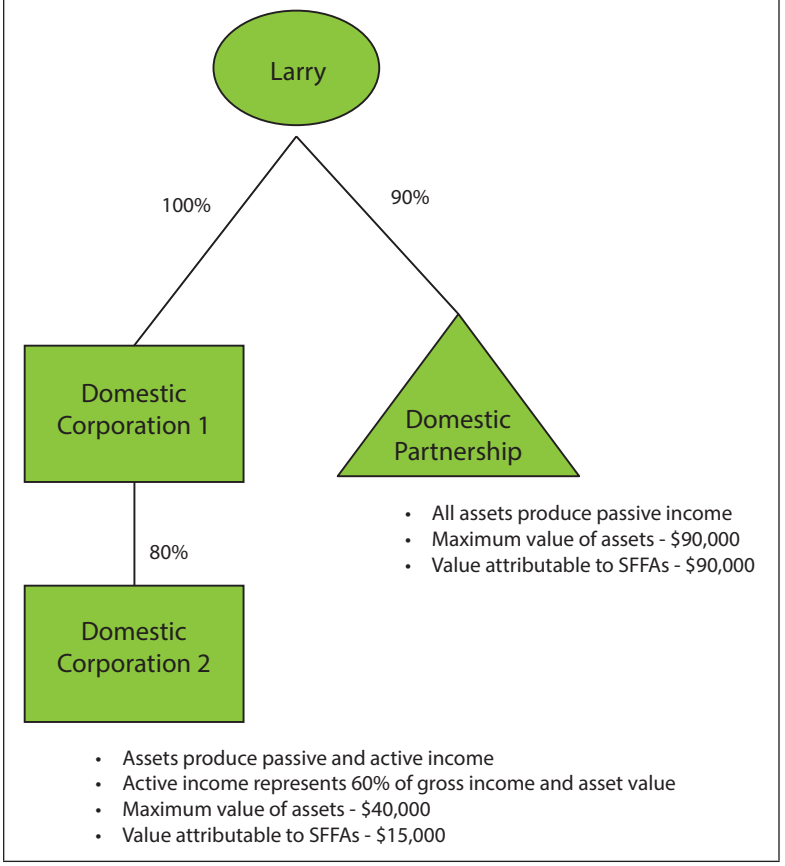
Facts. The facts are the same as those in Example 2, above, except that DC2 also owns an active business. The assets attributable to the active business are not "passive assets" and constitute at least 60 percent of the value of the assets held by DC2 at all times during the year. The income from the active business is not "passive income" and constitutes at least 60 percent of the gross income generated by DC2.

- *Illustration*. Below is an illustration (Figure 3), created by the author, of the facts in Example 3.
- *Analysis—Which Domestic Corporations Are SDEs?*
- DC1 and DC2 are "closely held" by an SI, *i.e.*, Larry, because he owns at least 80 percent of each. Therefore, Test #1 is satisfied.
- DC1 and DC2 are considered "related entities" that are connected through the stock ownership with a common parent corporation because DC1 and DC2 are "closely held" by Larry (an SI), and DC2 is connected with DC1 through the ownership by DC1 of at least 80-percent of the value of the stock of DC2.

Consequently, for purposes of applying the 50-Percent-or-More-Passive-Income Test and the 50-Percent-or-More-Passive-Asset Test, each of DC1 and DC2 is treated as owning the combined assets of, and receiving the combined income from, both DC1 and DC2. However, the stock ownership of DC1 in DC2 is disregarded for this purpose under the "related entity" rules. Therefore, no more than 40 percent of the value of the assets of DC1 and DC2 at all times during the year are "passive assets," and no more than 40 percent of the gross income for DC1 and DC2 is "passive income." Thus, DC1 and DC2 do not trigger the 50-Percent-or-More-Passive-Income Test or the 50-Percent-or-More-Passive-Asset Test, so they do not meet Test #2.

- DC1 and DC2 are not deemed to be "formed or availed of" for purposes of holding SFFAs because they do not meet both Test #1 and Test #2, as required. Therefore, they are not SDEs.
- *Analysis—Is DP an SDE?* For the reasons explained in Example 2, above, DP is an SDE. *Analysis—Must DC1 File Form 8938?* DC1 does not need to file Form 8938 because it is not an SDE.
- *Analysis—Must DC2 File Form 8938?* DC2 does not need to file Form 8938 because it is not an SDE.
- *Analysis—Must DP File Form 8938?* Under the new rules in the Final SDE Regulations regarding filing thresholds (*See* the discussion of new Reg. §1.6038D-2(a)(6)(ii) in the section of this article, above, called *Change Two of Three*), DP is treated as owning its own assets, plus the assets of DC2. Consequently, DP surpasses the filing threshold because the aggregate value of the SFFAs is $105,000, and the filing threshold is $50,000 on the last day of the year or $75,000 at any point during the year. DP must file Form 8938 to report the SFFAs and their maximum value, which was $90,000.

FIGURE 3



e. Public Comments and IRS Responses. The IRS received relatively few comments in response to the Proposed SDE Regulations, but the Tax Section of the Florida Bar took the opportunity to underscore the following issue related to Test #1. The Tax Section of the Florida Bar noted that it is often difficult to determine the precise interest of a partner in a domestic partnership because it may shift depending on the performance of a partnership. Therefore, this group suggested that this should be determined on a year-by-year basis.[76] In issuing the Final SDE Regulations, the IRS emphasized that this figure must be calculated by an SI, once a year, on the last day of the tax year of the domestic partnership. Then, in rejecting the proposal from the Tax Section of the Florida Bar, the IRS provided the following, terse explanation:

> The requirement to determine a partner's capital or profits interest on a particular day is present in other provisions of the Internal Revenue Code, Treasury regulations, and published guidance, and the Treasury Department and the IRS believe it is an appropriate measure of an individual's economic interest in a partnership and, in general, is not overly complex. Accordingly, these final regulations retain the rule in the proposed regulations for determining if a domestic partnership is closely held.[77]

Regarding Test #2, the Proposed SDE Regulations excluded from the definition of "passive income" rents and royalties derived in the active conduct of a trade or business, but only if the trade or business was conducted "by employees" of the corporation or partnership.[78] The Tax Section of the Florida Bar made the following observation

and suggestion: "It is difficult to find a trade or business that is conducted solely by employees of a corporation or partnership. Almost all businesses employ some outside agents to conduct their business. The requirement that the business be conducted by employees should be modified to allow businesses to use agents to some extent."[79] The IRS heeded this comment, agreeing to make a minor change. Specifically, the IRS tweaked the language, such that the Final SDE Regulations indicate that rents and royalties derived in the active conduct of a trade or business will be excluded from the definition of "passive income" for purposes of Test #2, if the trade or business was conducted "at least in part by employees" of the corporation or partnership.[80]

f. Rules for Domestic Trusts (but Not Domestic Corporations or Domestic Partnerships).

i. Explanation of Rules. Generally, a domestic trust is "formed or availed of" for purposes of holding SFFAs if the trust has one or more SPs as a "current beneficiary."[81] The term "current beneficiary" means any person who, at any time during the relevant tax year, is entitled to, or at the discretion of any person may receive, a distribution from the principal or the 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 tax year).[82] The term "current beneficiary" also includes any holder of a general power of appointment, whether or not exercised, that was exercisable at any time during the tax year but does not include any holder of a general power of appointment that is exercisable only on the death of the holder.[83] As a point of clarification, the IRS explains the following in the Preamble to the Final SDE Regulations:

> The Treasury Department and the IRS intend that a specified domestic entity include a trust whereby a specified person has an immediately exercisable general power of appointment, even if such specified person is not technically a beneficiary. Therefore, these final regulations clarify that the term 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.[84]

ii. Public Comments and IRS Responses. The Committee on Estate and Gift Taxation of the New York City Bar Association (NYCBA) complained that the definition of "current beneficiary" could be read broadly to cover situations where a beneficiary's interest may never vest, which might result in the need for a "domestic discretionary trust" to file a Form 8938, even though it never made a distribution.[85] The NYCBA also pointed out that the broad definition might include the situation where a "domestic discretionary trust" with 100 contingent beneficiaries, only one of whom is an SP, and such SP never receives an actual distribution. The NYCBA recommended limiting the Form 8938 reporting requirement to domestic trusts (i) that make actual distributions to an SP in a particular year or (ii) 50 percent or more of whose beneficiaries are SPs. This, posited the NYCBA, would eliminate the Form 8938 filing requirement for domestic discretionary trusts, with only one SP as a contingent beneficiary, which never make an actual distribution.[86]

The IRS rejected this proposal from the NYCBA and seemingly went the other direction, making the definition of "current beneficiary" even broader. In the Preamble to the Final SDE Regulations, the IRS stated that it intended for the definition of SDE to include a trust where an SP has an immediately exercisable general power of appointment, even if such SP is not technically a beneficiary.[87] The IRS went on to explain that the term "current beneficiary" also includes any holder of a general power of appointment that was exercisable at any time during a given year (regardless of whether it was actually exercised) but excludes any holder of a general power of appointment that can only be exercised upon death.[88]

D. Exceptions to the Definition of SDE

The Final SDE Regulations contain three main exceptions to the definition of SDE; that is, they identity certain domestic corporations, partnerships and trusts that will *not* be required to file Forms 8938, regardless of who owns them, why they were formed or the amount of SFFAs they hold.

1. Description of Three Exceptions to SDE Status

a. First Exception—Non-Specified-United-States-Persons. The Final SDE Regulations provide that any entity that is excluded from the definition of "specified United States person" under Code Sec. 1473(3), and the corresponding regulations will not be considered an SDE for purposes of Code Sec. 6038D.[89] These consist of the following types of entities: (i) any corporation whose stock is regularly traded on an established securities market, (ii) any corporation that is a member of the same expanded affiliated group (as defined in Code Sec. 1471(e)(2) without regard to the last sentence thereof) as a corporation whose stock is regularly traded on an

established securities market, (iii) any tax-exempt organization under Code Sec. 501(a), (iv) an Individual Retirement Plan, (v) the U.S. government or any wholly-owned agency or instrumentality thereof, (vi) any state, the District of Columbia, any U.S. possession, any political subdivision of any of the foregoing or any wholly owned agency or instrumentality of any one or more of the foregoing, (vii) any bank (as defined in Code Sec. 581), (viii) any real estate investment trust (as defined in Code Sec. 856), (ix) any regulated investment company (as defined in Code Sec. 851), (x) any common trust fund (as defined in Code Sec. 584(a)) and (xi) any trust described in Code Sec. 4947(a)(1).[90]

b. Second Exception—Certain Domestic Trusts. The Final SDE Regulations also exclude from the definition of SDE a domestic trust, provided that the trustee of such domestic trust (i) has supervisory authority over or fiduciary obligations with regard to the SFFAs held by the trust, (ii) timely files (including any applicable extensions) annual returns and information returns on behalf of the trust and (iii) falls into one of the following three categories: 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; a financial institution that is registered with and regulated or examined by the Securities and Exchange Commission; or a domestic corporation described in Code Sec. 1473(3)(A) or Code Sec. 1473(3)(B) and the corresponding regulations.[91]

c. Third Exception—Certain Grantor Trusts. Lastly, the Final SDE Regulations remove from the definition of SDE a domestic trust, to the extent that such trust, or any portion thereof, is treated as owned by one or more SPs under Code Secs. 671 through 678 and the corresponding regulations.[92]

2. Public Comments and IRS Responses

The IRS received several public comments in response to the Proposed SDE Regulations with respect to which entities should be exempt and why. Several of these comments are examined below.

The Tax Section of the Florida Bar proposed that the exclusions from SDE status cover publicly traded partnerships because they are similar to publicly traded corporations, which are described in Code Sec. 1473(3) and exempt under the Final SDE Regulations. From the perspective of the Tax Section of the Florida Bar, "[t]here is very low risk of tax avoidance through publicly-traded partnerships because they are subject to strict reporting requirements."[93] The IRS rejected this proposal, explaining that, in order to satisfy Test #1 and be considered "closely held" by an SI, a domestic partnership must own at least 80 percent of the capital or profits interest in the partnership on the last day of the partnership's tax year.[94] This, according to the IRS, constitutes "appropriate general criteria that, as a practical matter, should exempt most publicly traded partnerships from being [SDEs]."[95]

The New York State Society of Certified Public Accountants (NYSSCPA) cited the exclusion of certain domestic trusts from SDE status and explained that this does not take into consideration situations where a trust is not required to file a Form 1041. Referencing the instructions to Form 1041, the NYSSCPA explained that a fiduciary must file Form 1041 for a domestic trust if (i) it has taxable income, (ii) gross income of $600 or more or (iii) a beneficiary who is a nonresident alien. The NYSSCPA suggested that the exception to the definition of SDEs should be expanded to include domestic trusts for which the corporate trustee or bank is not required to file annual Forms 1041 and information returns for the trust.[96] This suggestion was raised by the NYCBA, too.[97] This IRS rejected this idea because, well, this issue has already been addressed elsewhere, in the Final SI Regulations from 2014. As explained earlier in this article, an SP who/that is not required to file an annual return with the IRS for the relevant year generally is not required to file a Form 8938 either.[98] Accordingly, a domestic trust with no obligation to file Forms 1041 also has no obligation to file Forms 8938.[99]

The Organization for International Investment (OFII) acknowledged that certain domestic trusts were excluded from the definition of SDE under the Proposed SDE Regulations and advocated treating "employer trusts" in the same manner, even if they hold SFFAs. To avoid potential abuses, the OFII suggested that the exception only apply to employer trusts held for the benefit of more than a minimum number of employees, say, 50.[100] The IRS declined this suggestion from the OFII, taking the position that the other exemptions under the Final SDE Regulations (particularly those for non-specified-U.S.-persons and certain domestic trusts) are "sufficiently broad to except employer trusts that represent a low risk of tax avoidance from characterization" as an SDE.[101]

IV. Effective Date

The Final SDE Regulations, and thus the potential duty of SDEs to file Form 8938, apply to tax years that start after December 31, 2015.[102] Therefore, for calendar-year taxpayers, the first relevant year will be 2016.

V. Form 8938 Places No Significant Burden on Taxpayers?

After trudging through this long, opaque and technical article, and after surviving the author's articles of similar description on the same topic from 2012 and 2015, readers likely are dreading the thought of being forced to analyze, for each client, for each year, Code Sec.6038D, the Final SI Regulations, the Final SDE Regulations, and the lengthy Instructions to Form 8938, and then, if necessary, completing and filing a timely Form 8938. How much trouble could this be? Little, claims the IRS.

The consequences of a mishap can be serious for tax professionals, too, as their clients undoubtedly would look to them for recompense if bad advice or an absence of advice about thorny Form 8938 issues triggered an audit, civil penalties, extended assessment-periods, etc.

According to the Preamble to the Final SDE Regulations, these new rules "will not have a significant economic impact on a substantial number of small entities."[103] The IRS explains that the two-part test applicable to domestic corporations and domestic partnerships to determine if an entity is an SDE (*e.g.*, Test #1 and Test #2) reduces the burden imposed by the Final SDE Regulations because "closely-held domestic corporations and partnerships that are predominantly engaged in an active business generally will be excluded from reporting."[104] Moreover, continues the IRS, even for those entities that meet Test #1 and Test #2, the burden imposed by the Final SDE Regulations is limited because (i) they only need to file a Form 8938 if the aggregate value of the SFFAs exceeds the filing threshold, (ii) they do not count the value of certain SFFAs when figuring whether the filing threshold has been eclipsed and (iii) thanks to the anti-duplication provisions, they do not need to include all data about SFFAs on Form 8938 if they already reported it on another international information return.[105]

The IRS's Instructions to the Form 8938 for 2015 indicate that, while the amount will vary depending on individual circumstances, the estimated amount of time required for "learning about the law or the form" is a mere 57 minutes.[106] This estimate relates only to SIs because the IRS has not yet released the version of Form 8938 for 2016, *i.e.*, the first year involving SDEs. One would expect the IRS's estimate of how much time it will take taxpayers to understand and apply these expanded rules will increase, but, based on history, expectations are that the IRS will continue to seriously misjudge just how hard international tax compliance is for the masses, particularly those without access to tax professionals with international expertise.

VI. The Importance of Code Sec. 6038D and Form 8938

Understanding the Final SDE Regulations and filing timely, accurate Forms 8938 are critical for the reasons discussed below.

A. Penalties for Violating Code Sec. 6038D

If the taxpayer fails to file the Form 8938 in a timely manner, then he "shall" pay a penalty of $10,000.[107] The penalty increases if the taxpayer does not rectify the problem quickly after contact from the IRS. In particular, if the taxpayer has not filed a Form 8938 within 90 days after the day on which the IRS sends a notice about the missing return, then, in addition to the initial penalty of $10,000, the taxpayer "shall" pay another penalty of $10,000 for each 30-day period (or portion thereof) during which he fails to file the Form 8938, with a maximum penalty of $50,000.[108]

An SP who unintentionally fails to file a timely, accurate Form 8938 can avoid penalties under Code Sec. 6038D if the SP can demonstrate that the violation was due to reasonable cause and not due to willful neglect.[109] The regulations clarify that the SP bears the burden of making "an affirmative showing of all the facts alleged as reasonable cause."[110] The regulations also emphasize that civil or criminal penalties threatened or imposed by a foreign country against the SP (or any other person) for disclosing the information on the Form 8938 does not constitute reasonable cause.[111]

B. Penalties Doubled for Tax Underpayments Related to Unreported SFFAs

Code Sec. 6038D also matters because, in addition to subjecting violators to specialized penalties under Code Sec. 6038D, transgressions could also lead to other civil penalties.[112] Code Sec. 6662(a) generally provides that, if there is a tax underpayment on any return, then the IRS may assert a penalty equal to 20 percent of the amount of such underpayment.[113] Code

Sec. 6662(b) lists the items that give rise to tax underpayments susceptible to penalties. FATCA expanded this penalty regime by adding Code Sec. 6662(b)(7), which says that any "undisclosed foreign financial asset understatement" can be grounds for an accuracy-related penalty.

To appreciate this new brand of penalty, one must turn to the other provision introduced by FATCA, Code Sec. 6662(j). This statute does several things. For example, it defines an "undisclosed foreign financial asset understatement" as the portion of a tax understatement for a tax year that is attributable to any transaction involving an "undisclosed foreign financial asset."[114] It also describes the term "undisclosed foreign financial asset" as any asset with respect to which information was required to be reported to the IRS under various tax provisions, including Code Sec. 6038D, but was not reported.[115] Finally, this provision doubles the size of the accuracy-related penalty, providing that, in the case of any tax underpayment due to an "undisclosed foreign financial asset" (such as an SFFA not reported on a Form 8938), the penalty jumps from 20 percent of the underpayment to 40 percent.[116] The legislative history clarifies the applicability of these rules in light of the new Form 8938:

> An understatement is attributable to an undisclosed foreign financial asset if it is attributable to any transaction involving such asset. Thus, a U.S. person who fails to comply with various self-reporting requirements for a foreign financial asset and engages in a transaction with respect to that asset incurs a penalty on any resulting underpayment that is double the otherwise applicable penalty for substantial understatements or negligence. For example, if a taxpayer fails to disclose amounts held in a foreign financial account, any underpayment of tax related to the transaction that gave rise to the income would be subject to the penalty provision, as would any underpayment related to interest, dividends, or other returns accrued on such undisclosed amounts.[117]

The Instructions to Form 8938 contain additional information about the application of the strengthened accuracy-related penalty under Code Sec. 6662, providing examples of transactions involving undisclosed SFFAs: (i) "You do not report ownership of shares in a foreign corporation on Form 8938 and you received taxable distributions from the company that you did not report on your income tax return"; (ii) "You do not report ownership of shares in a foreign company on Form 8938 and you sold the shares in the company for a gain and did not report the gain on your income tax return"; and (iii) "You do not report a foreign pension on Form 8938 and you received a taxable distribution from the pension plan that you did not report on your income tax return."[118]

C. Do Not Forget the Criminal Penalties

Code Sec. 6038D is also important because, aside from taking a big bite out of a taxpayer's pocketbook for civil penalties, violations can lead to potential criminal penalties. Lest there be any doubt in this regard, the regulations explain that "[i]n addition to other penalties, failure to comply with the reporting requirements of Section 6038D and the regulations, or any underpayment related to such failure, may result in criminal penalties under Sections 7201, 7203, 7206, et seq., or other provisions of Federal law."[119]

D. Extension of the Assessment Period

The importance of Code Sec. 6038D derives from its impact on assessment periods, too. FATCA modified the assessment period rules under Code Sec. 6501 in two major ways: It modified the existing Code Sec. 6501(c)(8) to insert violations of Code Sec. 6038D, and it added a new Code Sec. 6501(e)(1)(A) concerning "substantial omissions" of income from returns. These two modifications are discussed further below.

1. Unlimited Assessment Period if Form 8938 Is Not Filed

The general rule is that the IRS has three years from the time a taxpayer files his tax return for the IRS to audit him and propose adjustments.[120] There are various exceptions to the normal three-year rule. One such exception applies to situations where a taxpayer fails to file an information return with the IRS regarding particular foreign entities, transfers or assets.[121] Code Sec. 6501(c)(8), *before* the enactment of FATCA, stated the following:

> In the case of any information which is required to be reported to the Secretary [under various international tax provisions, but not Section 6038D], the time for assessment of any tax imposed by [the Internal Revenue Code] with respect to any event or period to which such information relates shall not expire before the date which is 3 years after the date on which the Secretary is furnished the information required to be reported . . . .[122]

Congress changed the preceding exception in two major ways with FATCA. The first way is that Congress specifically identified Code Sec. 6038D as one of the relevant international tax provisions. The second way, which was more subtle, is that Congress added the phrase "tax return" to Code Sec. 6501(c)(8) before "event or period," such that the IRS now has additional time to make assessments with respect to any "tax return, event, or period" to which

the omitted information relates. Thus, if an SP neglects to file a Form 8938 or files an incomplete Form 8938, then the assessment period essentially stays open indefinitely with respect to the *entire tax return*. This expansive notion is supported by legislative history, which contains the following explanation:

> [Code Sec. 6501(c)(8)] also suspends the limitations period for assessment if a taxpayer fails to provide timely information with respect to … the new self-reporting of financial assets. The limitations period will *not* begin to run until the information required … has been furnished to the Secretary. [Code Sec. 6501(c)(8)] also clarifies that the extension is *not* limited to adjustments of income related to the information required to be reported by one of the enumerated sections.[123]

Notably, Code Sec. 6501(c)(8)(B), which was added in 2010 by separate legislation, clarifies that the extended assessment period applies, even if the taxpayer's failure to file Form 8938 was unintentional. However, in such instances, the only open issues are those related to the Form 8938 itself, not the entire Form 1040 to which the Form 8938 should have been attached.[124]

2. Six-Year Assessment Period for Income Omissions from SFFAs

In addition to modifying the existing rules of Code Sec. 6501(c)(8), FATCA also added new Code Sec. 6501(e)(1)(A) about "substantial omissions" of income from returns. The new provision states that if (i) a taxpayer omits from a tax return gross income amounts that should have been included, *and either* (ii) such omitted amounts exceed 25 percent of the gross income actually reported on the tax return *or* (iii) such omitted amounts are attributable to one or more SFFAs that were required to be reported under Code Sec. 6038D and exceeds $5,000, then the tax may be assessed within six years of the time the relevant tax return was filed.[125] The consequence of new Code Sec. 6501(e)(1)(A) is that relatively minor instances of income under-reporting can keep the assessment-period open a full six years (instead of the normal three), if the income relates to an SFFA that was not properly disclosed on Form 8938. In today's world, it takes little to reach the new, low trigger of $5,000.

VII. Conclusion

Summarizing a long article is always difficult, and this is particularly true here, where the guidance found in the new Final SDE Regulations is complicated, the rules derived from the earlier Final SI Regulations were longer and more complex and the penalties for violating the Form 8938 filing duty can be severe for taxpayers. The consequences of a mishap can be serious for tax professionals, too, as their clients undoubtedly would look to them for recompense if bad advice or an absence of advice about thorny Form 8938 issues triggered an audit, civil penalties, extended assessment-periods, *etc*. The IRS has introduced an automated/systematic penalty program that will trigger the immediate assessment of thousands of international information return penalties each year, the IRS has acknowledged that it is now using computers to compare data disclosed by taxpayers on their Forms 8938 and FinCEN Forms 114 ("FBARs"), and the IRS announced in May 2016 that it was in the process of hiring some 700 new enforcement personnel, many of whom will be devoted to international issues. In this environment, taxpayers and tax professionals should make every effort to understand the dense rules, both old and new, regarding Form 8938 in order to get things right. They should also be prepared to seek experienced, specialized help if/when things go wrong.

ENDNOTES

1 Hale E. Sheppard, *The New Duty to Report Foreign Financial Assets on Form 8938: Demystifying the Complex Rules and Severe Consequences of Noncompliance*, 38 Int'l Tax J. 11 (2012); Hale E. Sheppard, *Form 8938 and Foreign Financial Assets: A Comprehensive Analysis of the Reporting Rules after IRS Issues Final Regulations*, 41 Int'l Tax J. 25 (2015).

2 Act Sec. 511 of the Hiring Incentives to Restore Employment Act (P.L. 111-147), March 18, 2010.

3 T.D. 9657, Dec. 19, 2011.

4 REG-130302-10, Dec. 19, 2011.

5 T.D. 9706, Dec. 12, 2014.

6 T.D. 9752, Feb. 22, 2016.

7 Hale E. Sheppard, *The New Duty to Report Foreign Financial Assets on Form 8938: Demystifying the Complex Rules and Severe Consequences of Noncompliance*, 38 Int'l Tax J. 11 (2012); Hale E. Sheppard, *Form 8938 and Foreign Financial Assets: A Comprehensive Analysis of the Reporting Rules after IRS Issues Final Regulations*, 41 Int'l Tax J. 25 (2015).

8 Reg. §1.6038D-1(a)(1) and (2).

9 Reg. §1.6038D-6(a).

10 Reg. §1.6038D-2(a)(7)(i).

11 Reg. §1.6038D-2(a)(7)(ii).

12 Reg. §1.6038D-2(a)(9).

13 Code Sec. 441; Reg. §1.441-1.

14 Reg. §1.6038D-2(a)(9).

15 Instructions for Form 8938 (Dec. 2014), at 5; Instructions for Form 8938 (Oct. 2015), at 5. These examples have been altered by the author to provide additional clarity.

16 Reg. §1.6038D-2(b)(1).

17 Reg. §1.6038D-2(b)(1).

18 Reg. §1.6038D-2(a)(8).

19 Code Sec. 6038D(b)(1); Reg. §1.6038D-3(a)(1).

20 Code Sec. 6038D(b)(2); Reg. §1.6038D-3(b)(1).

21 Reg. §1.6038D-1(a)(7).

22 Reg. §1.1471-5(b)(1)(i); Reg. §1.1471-5(b)(3)(i).

23 Reg. §1.1471-5(b)(1)(ii); Reg. §1.1471-5(b)(3)(ii).

24 Reg. §1.1471-5(b)(1)(iii); Reg. §1.1471-5(b)(3)(iii)(iv).

25 Reg. §1.1471-5(b)(1)(iv); Reg. §1.1471-5(b)(3)(vii); Reg. §1.1471-5(b)(2)(v).

26 Reg. §1.1471-5(b)(2)(i)(A), (B) and (D); *see also* Reg. §1.6038D-3(a)(7).

27 The regulations under Code Sec. 1471, which are specifically cross-referenced by the regulations under Code Sec. 6038D, state that an account that is excluded from the definition of "financial

account" under an IGA will not be considered a "financial account" for purposes of Form 8938. However, the Final Regulations and the Preamble thereto later make it clear that that the IRS intends to disregard the IGA definitions and exceptions when it comes to obligating SPs to file Forms 8938. *See* Reg. §1.1471-5(b)(2)(vi); Reg. §1.6038D-1(a)(7); Preamble to Final SI Regulations, 76 FR 73819-73820 (Dec. 12, 2014); Instructions to Form 8938 (Oct. 2015), at 5.

[28] Reg. §1.1471-5(b)(2)(ii).
[29] Reg. §1.1471-5(b)(2)(iii).
[30] Reg. §1.1471-5(b)(2)(iv).
[31] Reg. §1.1471-5(b)(2)(v).
[32] Reg. §1.1471-5(b)(2)(vi).
[33] Reg. §1.6038D-3(a)(3)(i).
[34] Reg. §1.6038D-3(a)(3)(i); Reg. §1.6049-5(c)(5)(i); T.D. 9657, Preamble to Temporary SI Regulations, 76 FR 78556 (Dec. 19, 2011); Instructions for Form 8938 (Dec. 2014), at 6. The IRS defines "U.S. payor" by directing taxpayers to the regulations under an unrelated tax provision, Code Sec. 6049.
[35] Instructions for Form 8938 (Rev. Dec. 2014), at 6.
[36] Reg. §1.6038D-3(a)(3)(ii); Reg. §1.6038D-3(b)(2).
[37] Code Sec. 6038D(b)(2); Reg. §1.6038D-3(b)(1).
[38] T.D. 9657, Preamble to Temporary Regulations, 76 FR 78556 (Dec. 19, 2011).
[39] Reg. §1.6038D-3(d).
[40] T.D. 9657, Preamble to Temporary SI Regulations, 76 FR 78556 (Dec. 19, 2011); *see also* Instructions for Form 8938 (Dec. 2014), at 4 and Instructions for Form 8938 (Oct. 2015), at 4, which state that "[a]n interest in social security, social insurance, or other similar program of a foreign government is not a specified foreign financial asset."
[41] Reg. §1.6038D-3(c).
[42] Reg. §1.6038D-3(c).
[43] Reg. §1.6038D-2(a)(1); Reg. §1.6038D-1(a)(1).
[44] Reg. §1.6038D-1(a)(12) (as in effect under the Final SI Regulations on Dec. 12, 2014).
[45] Reg. §1.6038D-1(a)(12) (as in effect under the Final SDE Regulations on Feb. 22, 2016).
[46] *See* Reg. §1.6038D-2; Hale E. Sheppard, *The New Duty to Report Foreign Financial Assets on Form 8938: Demystifying the Complex Rules and Severe Consequences of Noncompliance*, 38 Int'l Tax J. 11 (2012); and Hale E. Sheppard, *Form 8938 and Foreign Financial Assets: A Comprehensive Analysis of the Reporting Rules after IRS Issues Final Regulations*, 41 Int'l Tax J. 25 (2015); Reg. §1.6038D-2(a)(6)(i) and (ii) (as in effect after the Final SDE Regulations in Feb. 22, 2016).
[47] Reg. §1.6038D-2(a)(1).
[48] Reg. §1.6038D-7(a)(1)(i).
[49] Reg. §1.6038D-7(a)(2).
[50] Reg. §1.6038D-7(b).
[51] Reg. §1.6038D-1(a)(2).
[52] T.D. 9657, Preamble to Temporary Regulations, 76 FR 78555 (Dec. 19, 2011).
[53] Reg. §1.6038D-7(c).
[54] Reg. §1.6038D-2(a)(6), as in effect under the Final SI Regulations, became Reg. §1.6038D-2(a)(6)(i) under the Final SDE Regulations.
[55] Reg. §1.6038D-2(a)(6), as in effect under the Final SI Regulations, became Reg. §1.6038D-2(a)(6)(i) under the Final SDE Regulations.
[56] Reg. §1.6038D-2(a)(6), as in effect under the Final SI Regulations, became Reg. §1.6038D-2(a)(6)(i) under the Final SDE Regulations.
[57] Reg. §1.6038D-2(a)(6)(ii).
[58] Reg. §1.6038D-2(a)(6)(ii).
[59] Reg. §1.6038D-6(a).
[60] Code Sec. 7701(a)(4).
[61] Code Sec. 7701(a)(30)(E).
[62] Reg. §1.6038D-6(b)(1).
[63] Reg. §1.6038D-6(b)(1)(i).
[64] Reg. §1.6038D-6(b)(1)(ii).
[65] Reg. §1.6038D-6(b)(1)(ii).
[66] Proposed Reg. §1.6038D-6(b)(1)(B).
[67] Preamble, T.D. 9752 (Feb. 23, 2016); 81 FR 35, at 8835–8836.
[68] Reg. §1.6038D-6(b)(2)(i).
[69] Reg. §1.6038D-6(b)(2)(ii).
[70] Reg. §1.6038D-6(b)(2)(iii).
[71] Reg. §1.6038D-6(b)(3)(i).
[72] Reg. §1.6038D-6(b)(3)(ii).
[73] Reg. §1.6038D-6(b)(3)(iii).
[74] Reg. §1.6038D-6(b)(3)(iii).
[75] Reg. §1.6038D-6(b)(4).
[76] Comments by the Tax Section of the Florida Bar to REG-130302-10, as submitted to the IRS, dated February 14, 2012. Available online at *www.regulations.gov*.
[77] T.D. 9752 (Feb. 23, 2016), Preamble.
[78] Proposed Reg. §1.6038D-6(b)(2).
[79] Comments by the Tax Section of the Florida Bar to REG-130302-10, as submitted to the IRS, dated February 14, 2012. Available online at *www.regulations.gov*.
[80] T.D. 9752 (Feb. 23, 2016), Preamble; Reg. §1.6038D-6(b)(3)(i)(D).
[81] Reg. §1.6038D-6(c).
[82] Reg. §1.6038D-6(c).
[83] Reg. §1.6038D-6(c).
[84] Preamble, T.D. 9752 (Feb. 23, 2016); FR Vol. 81, No. 35, at 8837.
[85] Comments by the Committee on Estate and Gift Taxation of the New York City Bar Association, as submitted to the IRS, dated November 1, 2012. Available online at *www.regulations.gov*.
[86] Comments by the Committee on Estate and Gift Taxation of the New York City Bar Association, as submitted to the IRS, dated November 1, 2012. Available online at *www.regulations.gov*.
[87] T.D. 9752 (Feb. 23, 2016), Preamble.
[88] T.D. 9752 (Feb. 23, 2016), Preamble.
[89] Reg. §1.6038D-6(d)(1). This regulation specifically excludes from this exception a tax-exempt trust under Code Sec. 664(c).
[90] Code Sec. 1473(3).
[91] Reg. §1.6038D-6(d)(2).
[92] Reg. §1.6038D-6(d)(3).
[93] Comments by the Tax Section of the Florida Bar to REG-130302-10, as submitted to the IRS, dated February 14, 2012. Available online at *www.regulations.gov*.
[94] Reg. §1.6038D-6(b)(2)(ii).
[95] T.D. 9752 (Feb. 23, 2016), Preamble.
[96] Comments by the New York State Society of Certified Public Accountants to T.D. 9567 and REG-130302-10, as submitted to the IRS, dated March 19, 2012. Available online at *www.regulations.gov*.
[97] Comments by the Committee on Estate and Gift Taxation of the New York City Bar Association, as submitted to the IRS, dated November 1, 2012. Available online at *www.regulations.gov*.
[98] Reg. §1.6038D-2(a)(7)(i).
[99] T.D. 9752 (Feb. 23, 2016), Preamble.
[100] Comments by the Organization for International Investment to proposed and temporary regulations, as submitted to the IRS, dated February 17, 2012. Available online at *www.regulations.gov*.
[101] T.D. 9752 (Feb. 23, 2016), Preamble.
[102] Reg. §1.6038D-6(e).
[103] Preamble, T.D. 9752 (Feb. 23, 2016); 81 FR 35, at 8837–8838.
[104] Preamble, T.D. 9752 (Feb. 23, 2016); 81 FR 35, at 8837–8838.
[105] Preamble, T.D. 9752 (Feb. 23, 2016); 81 FR 35, at 8837–8838.
[106] Instructions for Form 8938 (2015), at 11.
[107] Code Sec. 6038D(d)(1); Reg. §1.6038D-8(a).
[108] Code Sec. 6038D(d)(2); Reg. §1.6038D-8(c).
[109] Code Sec. 6038D(g); Reg. §1.6038D-8(e)(1).
[110] Reg. §1.6038D-8(e)(2).
[111] Code Sec. 6038D(g); Reg. §1.6038D-8(e)(3).
[112] Reg. §1.6038D-8(f)(1).
[113] Code Sec. 6662(a).
[114] Code Sec. 6662(j)(1).
[115] Code Sec. 6662(j)(2).
[116] Code Sec. 6662(j)(3).
[117] U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act." JCX-4-10. February 23, 2010, at 63–64.
[118] Instructions for Form 8938 (Dec. 2014), at 7.
[119] Reg. §1.6038D-8(f)(2).
[120] Code Sec. 6501(a).
[121] Code Sec. 6501(c)(8).
[122] Code Sec. 6501(c)(8)(A) as in effect before P.L. 111-147, which was enacted on March 18, 2010.
[123] U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act." JCX-4-10. February 23, 2010, at 66 (emphasis added).
[124] Code Sec. 6501(c)(8)(B).
[125] Code Sec. 6501(e)(1)(A).