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Foreign Financial Asset Reporting for Domestic Entities - Expansion of Form 8938

INTERNATIONAL, TAX

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The IRS recently issued final regulations effective February 23, 2016 that provide guidance for certain domestic entities to report specified foreign assets.

The skinny: The IRS has extended its ongoing assault on identifying U.S. entities with foreign financial assets. The final regulations provide the conditions under which a domestic entity will be considered a “specified domestic entity” obligated to satisfy the reporting requirements. These regulations expand the reporting requirements to certain domestic corporations, partnerships, and trusts in addition to the existing rules for individuals.

Background

The IRS enacted Code Section 6038D requiring certain “individuals” to report information about specified foreign financial assets. The final regulations provide that any “specified domestic entity” that is formed or used for purposes of holding (directly or indirectly) specified foreign financial assets in the same manner as if the entity were an individual is required to report those interests.

In order to be treated as a “specified domestic entity,” an entity must have an interest in specified foreign financial assets (excluding excepted assets) that exceed the reporting threshold. A domestic entity that meets the definition of a specified domestic entity applies the reporting threshold (\$50,000 on the last day of the taxable year, or \$75,000 at any time during the taxable year) to determine whether it has a filing obligation.

The Regulations provide that a corporation or partnership is treated as formed or used for purposes of holding (directly or indirectly) specified foreign financial assets if either:

1. the corporation or partnership is closely held by a specified individual; or
2. at least 50% of the corporation or partnership's gross income or assets is passive.

The Treasury Department and the IRS have commented that a 50% passive assets or income threshold appropriately captures situations in which specified individuals may use a domestic corporation or partnership to otherwise circumvent the reporting requirements.

The Regulations provide that whether a domestic partnership is a specified domestic entity is determined annually. A corporation or partnership is closely held if at least 80% 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.

It is apparent that these regulations will not have a significant economic impact on a substantial number of small entities. In the case of domestic corporations and partnerships, these regulations apply only when two separate tests are met. The first requirement is that at least 80% of the entity must be owned, directly, indirectly, or constructively, by a specified individual (a U.S. citizen or resident). The second test compares the entity's business income and assets with its passive income and assets. If more than 50% of the entity's annual gross income for the year is active business income and more than 50% of its assets for the taxable year are assets that produce or are held for the production of active income, then the entity is not subject to the reporting requirements. The two-part test reduces the burden imposed by the final regulations on domestic small business entities because closely held domestic corporations and partnerships that are predominantly engaged in an active business generally will be excluded from reporting.

Furthermore, small not-for-profit organizations that are tax-exempt and small governmental jurisdictions are not subject to these regulations.

For closely held domestic corporations and partnerships that meet both tests, these final regulations limit the reporting burden imposed. First, reporting is required only when the aggregate value of the entity's interests in specified foreign financial assets exceeds the reporting threshold mentioned above. Second, the final regulations exclude the value of specified foreign financial assets reported on other forms from being taken into consideration (such as Forms 3520, 5471, 8621, 8865) in determining whether the small entity satisfies the reporting threshold. Third, small entities that hold specified foreign financial assets generally will be excepted from reporting such assets if the assets are reported on other forms, thereby further limiting the burden imposed by the final regulations on small entities.

Reporting

Unless an exception applies, you must file Form 8938 to report your specified foreign financial assets if the total value of all the specified foreign financial assets in which you have an interest is more than the appropriate reporting threshold. Form 8938 is attached to your annual return and filed by the due date (including extensions) for that return.

Filing Form 8938 does not relieve you of the requirement to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), if you are otherwise required to file the FBAR.

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