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IRS Issues Draft Form 8938 (Statement of Specified Foreign Financial Assets)

by Edo Pollack

On June 21, 2011, the IRS released their latest draft of Form 8938, Statement of Specified Foreign Financial Assets. The reporting requirements thus far apply only to specified individuals and not partnerships or corporations. The IRS anticipates issuing regulations or other guidance that will require a U.S. entity to file Form 8938 if the entity is formed or availed of to hold specified foreign financial assets and the value of those assets exceeds the appropriate reporting threshold.

Upon completion of a final draft of the form, reporting will need to be done for tax years beginning after March 18, 2010. It is important to note that Form 8938 does not relieve a taxpayer of the requirement to file Form TDF 90-22.1 (Report of Foreign Bank and Financial Accounts).

Per the draft instructions, Form 8938 will be filed along with Form 1040 and Form 1040NR. Should there be no tax filing required for any given tax year, then Form 8938 would also not be required to be filed.

The general filing requirement is on any specified individual — a U.S. citizen, resident alien or nonresident alien who has elected to be treated as a resident alien, who owns specified foreign financial assets during the tax year that exceed the reporting threshold. The reporting threshold can be exceeded in two manners: either by exceeding a year end maximum or by exceeding a slightly inflated maximum at any time during the tax year. The reporting thresholds are as follows:

IRS Issues Draft Form 8938 (Statement of Specified Foreign Financial Assets) *(continued)*

FILING STATUS	RESIDING IN	AT YEAR END	AT ANY TIME DURING THE TAX YEAR
Single	U.S.	>$50k	>$100k
Married filing Joint	U.S.	>$100k	>$200k
Married filing Separate	U.S.	>$50k	>$100k
Single	Foreign country	>$200k	>$400k
Married filing Joint	Foreign country	>$400k	>$600k
Married filing Separate	Foreign country	>$200k	>$400k

A foreign asset's value should be determined in U.S. dollars. If the asset is valued in a foreign currency, the value should be converted at the respective rate using the U.S. Treasury Department's Financial Management Service conversion rate on the last day of the tax year. The reporting period is the same as the taxpayer's tax year.

In situations of joint ownership, the entire value of the asset should be included in the threshold test if the joint ownership is with a spouse filing jointly or anyone other than a spouse. If the filing status is married filing separately, then only one-half the value of the asset would be included in the threshold test.

Specified foreign financial assets include any financial account maintained by a foreign financial institution, as well as assets held for investment not by an institution — stocks or securities of foreign corporations; capital or profit interest in foreign entity (partnership, trust, estate); financial instrument or contract that has an issuer or counterparty that is other than a U.S. person. A foreign financial institution includes investment vehicles such as foreign mutual funds, foreign hedge funds, and foreign private equity funds. If an interest in a foreign financial account is already reported on Form 8938, then there is no need to further report the foreign assets held in that financial account.

An individual that owns foreign assets that are held by a U.S. partnership, corporation, trust or estate would not be considered to own a specified foreign financial asset. If the assets are held by a foreign estate or trust, the individual would only be considered to be an owner if they knew or should have known of the interest (e.g., if they received distributions from the foreign trust or estate). Foreign assets that are held through a grantor trust or disregarded entity would be considered as owned by an individual.

Certain financial accounts are exempt from reporting. If a financial account is maintained by a U.S. payer (including a domestic branch of a foreign bank or insurance company, or a foreign branch of a U.S. bank), there would be no filing requirement. Another exemption from reporting requirements is an account that is maintained by a dealer or trader in securities or commodities and all of the holdings in the account are subject to the mark-to-market accounting rules for dealers in securities or an election under section 475(e) or (f) is made for all of the holdings in the account.

In order to avoid duplicative reporting, any account or asset reported on Form 3520, 5471, 8621, 8865, or 8891 should not be reported again on Form 8938.

The penalty for failure to file is $10,000. Continuing failure to file within 90 days of an IRS notice is an additional $10,000 for each 30-day period, up to a maximum of $50,000. Accuracy-related penalties could also be assessed up to 40% of any underpayment of tax related to the foreign assets. Fraud penalties could also be assessed up to 75% of any underpayment as well.

Questions? Please contact Edo Pollack at edo.pollack@eisneramper.com or 212.891.4160 for more information.

To Be (a DFE) Or Not To Be (a DFE) — That Is The Question

by Peter Alwardt

As a result of the financial crisis, many managers of alternative investments have experienced a substantial reduction of inflows or even outflows from their funds. Consequently, many fund managers that did not previously accept investments from ERISA plans (retirement trusts or welfare benefit trusts) are now accepting such investors to help boost assets under management.

BACKGROUND

When a fund manager accepts investments from two or more ERISA plans, it triggers a notification requirement to the ERISA plan sponsor and an optional reporting requirement (filed on IRS Form 5500) for the fund as a Direct Filing Entity ("DFE") with the U.S. Department of Labor ("DOL"). In the past, ERISA plan sponsors would frequently report on their Form 5500 that the fund manager had filed a Form 5500 as a DFE when, in fact, the fund manager had not filed a Form 5500 as a discussed below. The DOL now has a program to match the reporting on the ERISA plan sponsor's Form 5500 with the Form 5500 DFE filing of the fund manager and is issuing notices to ERISA Plan sponsors requesting clarification and, in some cases, additional information. Thus, it is important for fund managers to decide if they will file Form 5500 for their fund and clearly communicate this decision so that the ERISA plan sponsor can correctly report their investment in the fund on the plan's annual Form 5500.

DFE FILING

The DOL created the option for the manager of a pooled separate account, common or collective trust, master trust investment, or 103-12 investment entity (hedge fund, private equity, REIT, etc.) (collectively "fund" or 'funds") to provide information regarding the underlying assets of their funds to the DOL by filing a Form 5500 as a DFE. When the fund manager files as a DFE, each ERISA plan investing in the fund must provide less detail regarding the fund on the balance sheet (Schedule H) of the plan's Form 5500 (see 1 below). Because filing as a DFE simplifies the reporting requirements for the ERISA plan investor, many fund managers file Form 5500 as a DFE as a courtesy to their ERISA investors. The consequences of being a DFE or not being DFE are as follows:

1. ***Fund Manager Files as a DFE*** If the fund manager decides to file as a DFE, it files a separate Form 5500 and applicable schedules for the fund. The fund manager also supplies information about the underlying assets of the fund to DOL by attaching a copy of its audited financial statements (does not apply to pooled separate accounts or common/ collective trusts) to the Form 5500. Each ERISA plan investor must still file its own Form 5500; however, when reporting its investment in the fund, it must only report the fund as a single line item on its balance sheet (Form 5500 Schedule H), rather than separate line items for its proportion of each underlying investment in the fund.

2. ***Fund does not File as a DFE*** If the fund manager does not file as a DFE, each large (100 or more participants) ERISA plan investor in the fund must report its proportional interest in the underlying assets of the fund on its balance sheet for Form 5500. This can result in additional questions being posed to the fund manager from the plan sponsor or from their outside auditor responsible for auditing the ERISA plan's trust financial statements in order to have sufficient detail for reporting the investment on their Form 5500.

To Be (a DFE) Or Not To Be (a DFE) — That Is The Question *(continued)*

NOTIFICATION REQUIREMENT

Whether it files as a DFE or not, the fund manager is required to notify its ERISA plan investors annually regarding whether it intends to file as a DFE. The fund manager must also give ERISA plan sponsors the information needed to complete the Form 5500 for their plan within 120 days after the ERISA plan's year end.

CONCLUSION

As a result of the DOL's new matching program for Form DFE filers and ERISA plan Form 5500 filings, it is imperative that fund managers clearly notify their ERISA investors whether they will be filing with the DOL as a DFE in order to avoid notices being issued to their ERISA plan sponsor.

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