Chapple Blondet, SRL
Apartado Postal 1513
Avenida Roble
Numeró 525
100 m al sur y 50 m oeste de Apartotel María Alexandra
Trejos Montealegre, San Rafael de Escazú
San José
Costa Rica

Tel: +506 2288 9001
Email: kchapple@chappleblondet.com

Reporting Requirements with Respect to Certain Foreign Financial Assets[1] and Form 8938 Statement of Specified Foreign Financial Assets

(These rules, including the forms, are in a perfect state of uncertainty. Thus, one must frequently check for changes.)

10 February 2012

This is part of the beginning of the implementation of the Foreign Account Tax Compliance Act or "FATCA" which we have all been dreading not the least of which includes our foreign financial institution friends as well as those who represent them. FATCA combined with other issues is one of the reasons many foreign financial institutions will not accept citizens of the USA and a few others

[1] As a general rule, we write in the context of Costa Rica interacting with the United States of America ("USA"). We do this for two primary reasons:

1. We live in Costa Rica. Thus, we have a finer understanding of local law than that in many other jurisdictions. It is necessary for one to have some understanding of local law in order to work with USA taxation in the multinational context. Indeed, this is one of the reasons one likely needs to employ tax specialists in each country in which one has a presence. No one professional can possibly know all of the law.

2. Costa Rica is a "non-treaty" country relative to the USA. Tax treaties typically get to better results for taxpayers than otherwise available in either jurisdiction. Treaties are also law which can trump a statute. However, each and every tax treaty is unique. Thus, writing in the context of a non-treaty country would likely illustrate the worst possible outcome. Further, given the number of tax treaties out there, we would never get done with these memos if we did not limit our discussion. Finally, Costa Rica does have a tax information exchange agreement with the USA but this does not rise to the level of a substantive tax treaty.

The essence of the principles discussed in this memo applies to any "foreign" country unless modified by treaty. In this case, we can think of no treaty which yet alters or trumps the rules discussed below. Thus, the answers and actions required should not materially differ in this circumstance regardless of the "foreign" country interacting with the USA.

as clients or do so with limited exception. The compliance burdens are huge and carry very aggressive penalties for failure.

Many of us have had and continue to have discussions as to the overreach of the USA fiscal authorities' view of extraterritorial jurisdiction to the point of literally challenging nation state sovereignty. These criticisms have merit in our view. The responsibility for reporting taxable income and resulting tax within the bounds of law and ethics belongs with the relevant taxpayer – not with financial institutions or other nation states. That said, it is also incumbent upon banks and others to not actively facilitate what can only be described as fraud in many cases and not necessarily limited to taxation.

But first for our banking colleagues. The burden for filing this Form 8938 is exclusively with the taxpayer; not the bank. On the other hand, on occasion, we may need some of your assistance in administering this mess.

Next, for our non-bank clients. Each and every one of our clients is *buena gente* (good people). Each and every one strives to manage their affairs with excellence; not merely within the bounds of law and ethics. However, it is plain that many others, including some of extraordinary wealth with very large USA financial institutions and others whispering in their ear, are not *buena gente*. This Form 8938 and more to come are the consequence of or response to that bad behavior leaving the rest of us to suffer. **These reporting obligations fall on USA Federal taxpayers regardless of where we live including those who physically reside in the USA.**

Next, for the moment (and we mean that literally "for the moment" as we are writing this), these new rules and forms apply only to real people. It is clear, however, that the USA fiscal authorities intend to greatly expand their application. **It seems reasonably clear that these rules may effectively end up with retroactive application to corporations, partnerships and others both in the USA and outside of the USA**. The Internal Revenue Service ("IRS") is plain in stating these rules first apply to 2011 for most of us but will continue to expand on nearly a daily basis. We will have to continuously monitor the IRS web site. Frankly, that is no way to run a treasury.

Finally, we apologize on behalf of the USA and its fiscal authorities for the length of this memo. The complexity and uncertainty within these rules shamefully require the length of more than 50 pages. We have edited this down to what we think is minimally necessary.

So, on to the substance of the matter at hand.

Commencing with our 2011 tax returns for individuals,[2] corporations, partnerships, trusts and estates, there is yet another form to be filed for some of us who own certain assets known as "specified foreign financial assets" which include, but are not limited to, stocks and bonds where the underlying investment or financial account is located outside of the USA. "Specified foreign financial assets" are not limited to publically traded securities and, indeed, include certain private businesses and even certain contracts where the counterparty is not a US person. Please note it is the location of the specified foreign financial asset which is the first tripping point; not the identity and location of the owner. And please be aware. Filing for persons other than natural persons appears to be in the offering with an uncertain effective date.

Given the complexity and length of this discussion, we thought a brief outline or index of this memo might be helpful. Thus, the following is a list of the subject headings within this memo:

- Who has to file
    - Citizen of the USA
    - Resident alien
    - A non-resident alien who elects to be treated as a resident alien for purposes of filing a joint return
    - A non-resident alien who is a *bona fide* resident of American Samoa or Puerto Rico
    - Others
- Assets to be reported
    - Financial accounts maintained by a foreign financial institution
    - Stock or securities issued by someone that is not a US person
    - Any interest in a foreign legal entity

[2] The actual rule says an individual or corporeal person may defer until 2012 filings for 2011 if their tax year begins after 18 March 2010 and they filed their return before Form 8938 was released. We have no idea where this strange effective date sources. The only circumstance we can conjure where a natural person would have a mid-month commencement of a tax year would be upon birth. Form 8938 was released in November 2011 according to the notation at the top of the draft Form 8938 since withdrawn. There is no specific date. The instructions to the form are dated 15 December 2011. We have no idea what the author means by "release date" given the disparate dates noted above. Conservatism dictates using 1 November 2011 as the "release date".

    - Any financial instrument or contract that has an issuer or counterparty that is not a US person

    - Other specified foreign financial assets

- An Interest in a specified foreign financial asset

- The foreign financial asset must be held for investment

- Thresholds for filing

- Asset valuation

- Exceptions to reporting

    - Financial accounts

    - Foreign grantor trusts

    - Domestic investment trusts

    - Domestic bankruptcy trusts

    - Other exceptions

- Penalties

- Statute of limitations

- Insult to injury

We are always reluctant to be overly critical of the taxing authorities especially with respect to the actual people who have to operate them. Their job is not easy. However, this is a notable exception and we think we are fair and just in our criticism. The authors of the instructions to this Form 8938 strike us as naïve and inexperienced. The use of language in these instructions is imprecise, vague and not infrequently apparently incorrect in the sense it implies or states something which does not appear to be either logical or the authors' true intent. Further, the language folds in upon itself rendering what was initially clear, perfectly unclear.

Next, we are told to monitor www.irs.gov/form8938 [3]as "[i]formation about future developments affecting Form 8938 (such as legislation enacted after we release it) will be posted on that page."[4] One would hope the changes will be highlighted as well as posted.

In any event, we find this to be frankly outrageous. Tax forms and their instructions need to be made fixed and certain with respect to each tax year; not changed willy nilly in the midst of filing season. And what precisely are we to do if these instructions change after returns are filed – please note the discussion at Footnote 2 where the current iteration of this form was effectively applied retroactively to returns which have already been filed.

In fairness to the IRS, the IRS does not and cannot legislate. The US Department of Treasury ("Treasury") is charged with interpreting and applying the relevant statutes. Thus, to the extent there is a statutory change with retroactive application, the fault lies with the US Congress; not Treasury or the IRS. The Congress in recent times deserves considerable criticism in this regard.

Finally, the IRS, especially the international section, is seriously understaffed. Again, a large portion of this responsibility lies with the Congress for failing to adequately fund the agency.

In any event, we will attempt to highlight those areas which we find vague or unclear or incomplete.[5]

We also want to highlight two points here with respect to this new Form 8938:

1. This does **not** replace Form TD F 90-22.1 Report of Foreign Bank and Financial Accounts sometimes referenced as the "FBAR". Indeed, the FBAR may be filed electronically or in paper form[6] with

---

[3] Please use great care when accessing the IRS web site. All USA government web sites end with ".gov" such as www.irs.gov . Last we looked, there is a web site with "www.irs" and ".com". That is **not** the IRS. That site has all of the superficial appearances of a government web site including offering to assist with taxation. We suspect the ".com" web site is not much more than a phishing expedition. We have seen similar issues with other Federal and state agencies. These .com addresses should not be permitted.

[4] Instructions to Form 8938 at p 1.

[5] We are mindful that the IRS is supposed to monitor tax advisors' web sites and welcome that. We hope that some of our commentary may actually lead to clarification and greater efficiency.

[6] On 24 February 2012, a general exemption from mandatory electronic filing of Form TD F 90-20.1 Report of Foreign Bank and Financial Accounts or the FBAR was delayed until 1 July 2013. Given that the due date for the FBAR is 30 June of the year following the calendar year being reported, this results in the ability to file the FBARs for the years ending 31 December 2011 and 2012 in paper form.

Treasury while this Form 8938 is filed electronically or by paper form with the IRS by including it within the relevant annual Federal income tax filing. In any event, both are required where otherwise applicable despite large amounts of duplication of data.

2. This Form 8938 is merely a disclosure of information which, in and of itself, generates no tax and no filing fee. On the other hand, failing to include this form with all relevant information with the relevant income tax return results in substantial penalties. Given this circumstance, we typically take a very conservative approach to preparing these and similar forms which we believe best represents our clients. About the last thing our clients need is a failure in this area which can hang as a hammer over their head with respect to all other tax matters.[7]

[7] Some of the issues with this Form 8938 are very similar to Form TD F 90-20.1 Report of Foreign Bank and Financial Accounts or FBAR and certain other forms which will be referenced later in this discussion. The authors explicitly state what has been our consistent view of the statute of limitations with respect to all of these matters. The essence is the statute never tolls until this specific Form 8938 or any other is filed. The statute of limitations never tolls to the extent of an omission from this and similar forms.

This, combined with the extraordinary penalties, is the primary reason for our “conservative” views.

There is a related issue. This Form 8938, like the FBAR, is not required until certain asset levels are achieved. Further, this Form 8938 is not required where the taxpayer is not otherwise required to file a USA Federal income tax return. One of the more common reasons for one not to be required to file a personal USA Federal income tax return is where taxable income falls below certain thresholds. *E.g.*, a single person under the age of 65 does not have to file an income tax return for 2011 where gross income is less than US$9,500.00. While it may sound illogical that a US person with foreign assets would have an income below that threshold, we can think of several circumstances where that might, in fact, occur. The most common would be a child or even a baby with wealth sourced in gifts from parents and grandparents or retirees living abroad.

The likely problem which could arise is the IRS asserts that a taxpayer should have filed a Form 8938 or FBAR for a prior year when the taxpayer had concluded none was required. The IRS will assert the statute of limitations has not passed and never will pass because the relevant form was not filed. The taxpayer is then left with the burden of proving none was required say, for example, ten years ago. How many people keep the records from ten years ago necessary to prove the filing was **not** required? Is it even possible to make such a proof assuming records are available? We have one issue currently in the practice where the asserted tax sources in 1986 where the deficiency was first asserted by the taxing authority in 2011. So, ten years is not that long in the practical world.

Thus, we and our clients are now considering filing “protective” FBARs. A protective filing is where the return is filed when it might otherwise not be required such as when a person’s asset values do not reach statutory minimums. Mechanically, we can do that with the FBAR together with preserving the evidence of filing. We are not sure whether we can do that with this Form 8938 where we are now required to file returns electronically – we are not sure yet whether the

Who has to file

So, let's start with the first hurdle – who is obligated to file this form?

The words say that "…you must file Form 8938 if you are a specified person"[8]. The instructions go on to indicate that "[a] specified person includes[9] any specified individual[10] or, to the extent provided in future regulations, a specified domestic entity".[11]

The instructions add further ambiguity as to what precisely constitutes a specified person. *E.g.*, under the "when and how to file" discussion one is directed to:[12]

> Attach Form 8938 to your annual return and file by the due date (including extensions) for that return.
>
> An annual return includes[13] the following returns:

IRS electronic systems will "receive" an electronically filed form where it may be plain on the face of the form that it is not technically required.

[8] Instructions to Form 8938 at p. 1.

I am going to be in a lot of trouble with my left leaning friends and colleagues. However, the word "person" as that is typically used in USA law is in no way limited to a natural or corporeal person such as you and me. It explicitly includes corporations, partnerships, counties, estates, trusts and other entities which exist only through legal fictions. *See*, *Black's Law Dictionary* 1299 and 1300 (Revised 4th ed. 1968). In this context, the Citizeens United case should hardly be controversial. It is founded on very ancient law. *Citizens United v. Federal Election Commission*, 558 US 130 (Jan. 2010).

However, for USA Federal tax purposes, one does not need to go down this path. The USA Internal Revenue Code ("IRC") §7701 is explicit concerning this matter of the definition of "person". It defines "person" "…to mean and include an individual, a trust, estate, partnership, association, company or corporation".

[9] Use of the word "includes" implies there may be others not specifically listed. This will become relevant with other inconsistencies within the instructions rather than merely "Clintonian" parsing.

[10] The word "individual" seems to be more precise. *Black's Law Dictionary* defines an individual "[a]s a noun…[which] denotes a single person as distinguished from a group or class, and also, very commonly, a private or natural person as distinguished from a partnership, corporation, or association; but, it is said that this restrictive signification is not necessarily inherent in the word, and that it may, in proper cases, include artificial persons." Thus, even this word is ambiguous as to whether or not it includes non-corporeal persons. *Also see,* IRC §7701(a)(11) where the word "individual" is used within the broader definition of "person" where, in the context, the only reasonable interpretation is "individual" means a corporeal person.

[11] Instructions to Form 8938 at p. 1.

[12] Instructions to Form 8938 at p 1.

- Form 1040 [filed by natural or corporeal persons who are citizens of the USA regardless of residency and those who are not citizens but are residents of the USA].

- Form 1120 [filed by many but not all corporations].

- Form 1065 [filed by partnerships].

- Form 1041 [filed by estates and trusts].

- Form 1120-S [filed by corporations which have made certain elections].

- Form 1040NR [filed by natural or corporeal persons who are not citizens and not resident in the USA].

[Bracketed notations belong to the author of this memo; not the author of the instructions.][14]

For the moment, let's move beyond these ambiguities. The instructions go on to define a "specified individual" as any one of the following:[15]

1. A citizen of the USA.

2. A resident alien of the USA for any part of the tax year.

3. A non-resident alien who elects to be treated as a resident alien for purposes of filing a joint return.

4. A non-resident alien who is a *bona fide* resident of American Samoa or Puerto Rico.

---

[13] Here is that word "include" again which, if used properly, indicates the list which follows is not all inclusive or comprehensive. Indeed, there is a plethora of specialized Forms 1120 which read like an alphabet soup. Another example is qualified charities which are typically organized in the USA as either trusts or corporations. However, a qualified charity typically files a Form 990; not the Form 1120 for a corporation or the Form 1041 for a trust. We can think of several substantial USA charities which might well be viewed as "specified persons" with activities here in Costa Rica.

[14] Instructions to Form 8938 at p. 1.

[15] At the risk of adding to the confusion, we will henceforth collectively refer to this group as "US persons".

In each case in Items 1 through 4 above, the description of a specified person seems limited, for the moment, to a natural or corporeal person.[16]

Citizen of the USA

This should generally not be difficult or ambiguous. There are some issues out there such as children born to a US citizen and a non-US citizen. We will leave that issue to immigration specialists but, from time to time, there can be a question. Another issue is dual citizens. Many still think a natural USA citizen cannot be a dual citizen. That is no longer true. *E.g*., the act of merely accepting citizenship in the *República de Costa Rica* ("Costa Rica") no longer automatically revokes my USA citizenship. The relevant ruling is actually a tax rule; not an immigration rule.

Resident alien

No, this not a reference to outer space. A resident alien is a natural person holding a USA "greencard" (regardless of where their physical residence may be) or one who meets the substantial presence test. The substantial presence test for this purpose is as follows:

1. The natural person is physically present in the USA for at least 31 days in the calendar year

   and

2. The natural person who is not a USA citizen is physically present in the USA for 183 days during the 3 year period which includes the current and two prior calendar years where one counts –

   a. All of the days present in the current calendar year,

      and

   b. One third of the days present in the first prior calendar year,

      and

   c. One sixth of the days present in the second prior calendar year.[17]

[16] The draft of Form 8938 which was on the IRS web site but since removed clearly implies from its face that this Form 8938 is to be filed by "…specified domestic entities, partnerships, corporations, trusts and estates." "Specified domestic entities" were not yet defined at the time.

[17] Publication 519 at p. 4 which can be accessed here http://www.irs.gov/pub/irs-pdf/p519.pdf .

A non-resident alien who elects to be treated as a resident alien for purposes of filing a joint return

A non-US citizen may make an election to be treated as a US person for USA income tax purposes by means of electing to file a joint USA income tax return with their US person spouse.[18] We generally avoid making this election like the plague.

One of the conditions or consequences of this election is all of the non-US person spouse's global income is subjected to USA income tax even where the couple resides outside of the USA. This is the more typical circumstance as the non-US spouse would likely be a "resident alien" if the couple resided in the USA. In this day and age and especially in tax advisory practices of any size or scope, both spouses are often employed and either both or the non-US person spouse may be substantially wealthy. Thus, voluntarily subjecting half or more of the family's non-USA sourced income to USA taxation where it can otherwise be properly avoided typically does not "pencil out".[19]

Please note that Item 2 explicitly makes no reference to immigration status. It is merely a day count. So, it can easily pick up those who are in the USA illegally from immigration law point of view. It could also pick up some students or people with long-term tourist visas who spend a lot of time in the USA even though not employed there. This is not that uncommon. *E.g*., Costa Rican grandparents visiting their children and grandchildren who may reside in the USA. For those who enter lawfully, the day counts are picked up by Homeland Security as passports and visas are logged in and out. Once one meets the definition of US person, one's **global income** is subjected to USA Federal income tax; not merely that earned from sources in the USA.

[18] Of course one must define marriage. Generally, one looks to the origin of the actual marriage. In the case of my ex-wife and I, we were married in Caracas, Venezuela. So long as the USA recognizes Venezuelan family law, we were legally married in the USA. This gets tricky. We were divorced in Boston, Massachusetts. Our lawyers actually raised the question of whether Venezuela would recognize the Massachusetts divorce.

In some non-USA jurisdictions, there are some circumstances which look similar to old "common law" marriages under former USA law. In some cases, these circumstances may be recognized in the USA for income tax purposes.

The more current issue is with same sex couples. USA family law is largely controlled by the individual states. Some states recognize these marriages while some do not. Further, some foreign countries also recognize these relationships. However, the USA Federal or national government does not recognize these marriages as a matter of explicit USA Federal statutory law. Thus, we now have mixed tax filings where the same sex married couple in question is viewed as two single unmarried persons for USA Federal taxation and within some, but not all, states while the couple is simultaneously viewed as married in some, but not all states, for state income tax purposes. This circumstance results in some rather odd USA tax filings.

[19] We are aware of one circumstance where a taxpayer queried a local IRS office in Florida about this issue. We are told that the IRS person indicated that the non-US person spouse joining in a USA income return with her US person spouse did **not** have to include her income. She was not a USA resident alien and she is a lawyer in a foreign country. Please remember that the answers

Further, this process subjects the non-US person spouse to the jurisdiction of the USA taxing authorities plus joint and several liability for any tax sourced in the US person spouse. Further still, the non-US person spouse becomes subject to filing this Form 8938 plus a plethora of other disclosure forms which can properly and lawfully be avoided by failing to agree to file a joint return with the US person spouse.[20]

A non-resident alien who is a bona fide resident of American Samoa or Puerto Rico

This is an oddity of limited application. American Samoa is an unincorporated territory of the USA. Puerto Rico is actually the Commonwealth of Puerto Rico in English or *el Estado Libre Asociado de Puerto Rico* in Spanish which is also an unincorporated territory of the USA. The taxation issues are unique.[21]

Others

This next one is a bit of a bombshell and may shed some light on the ambiguities we highlighted earlier. The instructions reference a "specified domestic entity" as another person required to file Form 8938 where other conditions are met. Here is the actual language of the IRS:

> The IRS **anticipates** issuing regulations that will require a domestic 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. Until the IRS issues such regulation, only individuals must file Form 8938.[22] [Emphasis added.]

We are not quite sure what to make of this. Some observations:

---

the IRS gives taxpayers are **not** binding on the IRS. So, if the IRS person gives bad advice, the taxpayer is still on the hook.

[20] We represent certain foreign diplomatic families where some but not all of the family are US persons but certainly not the foreign diplomat although that fact pattern could actually occur. Foreign diplomats and certain employees of foreign governments who are physically present in the USA may be exempt from USA income tax with respect to all or portions of their income. There is some limited discussion of these issues in Publication 519 at pp. 58 and 59 which can be accessed here http://www.irs.gov/pub/irs-pdf/p519.pdf .

[21] Notably absent from this list is Guam and Northern Mariana Islands. We have no idea why these are absent here but included in an exception discussed below.

[22] Instructions to Form 8938 at p 2.

1. It now appears the authors of these instructions attempted to anticipate future Treasury Regulations? Hence, some of the ambiguities and uncertainties?

2. Precisely when does Treasury expect to issue these anticipated regulations?

3. What precisely do they anticipate the effective date to be? Will the effective date require amending prior year returns? Or will strange transition rules apply like they appear to have applied to non-calendar year natural person taxpayers?[23]

4. It appears **for the moment**, despite the clumsy drafting, the authors intend Form 8938 to be filed only by natural or corporeal persons.[24]

5. When one looks at other existing disclosure requirements serving similar purposes, so-called “domestic [fictional or non-corporeal or legal] entities” are not treated differently than natural or corporeal persons. Nor should they be treated differently from a policy point of view especially if the intent is to prevent abuse. It is, frankly, not that difficult to write the necessary regulatory law especially given the models available within other existing provisions. Thus, we are puzzled at the delay. We are also critical of the delay which does

[23] While it is rare, it is possible for a natural person subjected to the USA income tax regime to elect to file using an annual reporting period that does not end on 31 December. In over 30 years of practice, I am aware of only one such individual with whom I attended law school and who is today a tax partner in a significant firm.

It has become rare to see partnerships, limited liability companies, limited liability partnerships, certain closely held corporations and trusts with tax year ends other than 31 December.

It is not rare to see many corporations with tax years other than 31 December.

[24] Perhaps this is an appropriate time and place to comment. In addition to the bizarre language and process in these instructions, we now receive an average of 5 or so e-mails daily from the IRS alerting us to law and regulatory changes. We applaud the IRS personnel who actually make this happen. They have done a remarkable job. But there is a problem here. This reminds me of when my former firm had to close the Moscow office tax practice for about a year, if I recall correctly, as the old Soviet Union collapsed. The reason was not violence. The reason was the speed of change in law and regulation resulting in a perpetual state of uncertainty. We could not get the memos out before the law changed even where clients had relatively simple questions.

Frankly, it is becoming nearly impossible to keep up with the current pace of change in the USA. We simply cannot spend our entire day reading law changes and be responsive to clients including the compliance work. Further, uncertainty and ambiguity with retroactive application of law is simply not administrable including by the taxing authorities. This is becoming very worrisome.

> nothing but create unnecessary confusion and uncertainty which is not good for either the taxpaying public or the IRS.[25]

Assets to be reported

The next issue is what assets constitute "specified foreign financial assets".[26] The list is as follows:

1. Financial accounts maintained by a foreign financial institution.

2. The following foreign financial assets if they are held for investment and not held in an account maintained by a financial institution [foreign or domestic]:

    a. Stock or securities issued by a someone that is not a US person,

    b. Any interest in a foreign entity,

    and

    c. Any financial instrument or contract that has an issuer or counterparty that is not a US person.[27]

There are exceptions which will be discussed later.

Financial accounts maintained by a foreign financial institution

A foreign financial institution is defined in the instructions as:

> Any financial institution that is not a US entity and satisfies one or more of the following:

[25] One can see our discussion of some these other areas where disclosure with a similar policy purpose is currently in effect here http://www.chappleblondet.com/resources/pdf/Reporting_Requirements_with_Respect_to_Certain_Foreign_Financial_Accounts_Held_Outside_of_the_USA.pdf and here http://www.chappleblondet.com/resources/pdf/Disclosure_of_CFCs.pdf . Please be aware of the publication dates noted at the beginning of each memo. These are the dates where we last updated these analyses. In some cases, there have been changes since the date of publication. At this time, most of the changes relate to escalating levels of penalty.

[26] Instructions to Form 8938 at p 4.

[27] Instructions to Form 8938 at p 4.

- It accepts deposits in the ordinary course of banking or similar business.

- It holds financial assets for the account of others as a substantial part of its business.

- It is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities or any interest (including futures or forward contract[s] or option[s]) in such securities, partnership interests or commodities.

  A foreign financial institution includes investment vehicles such foreign mutual funds, foreign hedge funds and foreign private equity.[28]

Whether the financial institution is foreign or not might be somewhat unclear especially with respect to the multi-national banks and investment banks. Financial institutions may be required to organize separate subsidiaries within each country due to non-tax regulatory matters. In other circumstances, they operate branches in foreign countries relative to the parent which are not separate legal entities. These subsidiaries, foreign to the host country and operating as branches, also may or may not be organized in the USA. Thus, for example, UBS AG (UBS Switzerland")[29] is organized under the laws of Switzerland and, if it otherwise met the definition of a financial institution, would be foreign relative to the USA. However, UBS AG operates in the USA through its subsidiary UBS Financial Services, Inc. ("UBS US") which is organized under the laws of the USA and, while certainly a financial institution, it is not a foreign financial institution. On the other hand, one can sit anywhere in the world and access many financial institutions including one's accounts in multiple country specific accounts. *E.g.,* when one logs into UBS US, one can just as easily access one's accounts in their Swiss bank from the same screen.

It is entirely conceivable one could have an account in both UBS US and UBS Switzerland. The UBS Switzerland account is a foreign financial account while the UBS US account is not.

---

[28] Instructions to Form 8938 at p 4.

[29] The author of this memo is not singling out UBS due to Mitt Romney or other issues. Rather, the author has a 30 plus year client relationship with UBS US. Thus, as we construct illustrative examples, it is easiest done where one has personal familiarity with the facts. This is not an endorsement or a critique of UBS. Similar issues exist elsewhere like with CitiGroup, HSBC and so on.

In the definition of a financial institution, the authors include references to "investment vehicles such as… foreign hedge funds and foreign private equity".[30] In the "retail world" some investments in these are held in a brokerage account where the financial institution acts as custodian. However, we are hard pressed to think of a circumstance where a direct investment in either private equity or a hedge fund would or could be viewed as an "account".[31]

A financial account is defined as "…any depository or custodial account".[32] It includes "…any equity or debt interest in a financial institution".[33] This is confusing. The obvious and most common forms of such accounts would be checking and savings accounts or certificates of deposit. The third would be what most of us call a brokerage account.

There are other arrangements out there from time to time. *E.g.*, when the trust department of a financial institution acts as "custodian" of certain assets but without the use of a trust or similar mechanism. There are often accountings issued which often look like traditional trust accountings. It appears that these would also be viewed as "accounts" for this purpose.

Finally, we do not understand what "any equity or debt interest **in** a financial institution" [emphasis added][34] is intended to reference. These words are not necessary to cover arrangements such as the custodial function attached to a brokerage account.[35] Do the authors intend to mean "issued by" instead of

[30] Instructions to Form 8938 at p 4.

[31] The author of this memo does some private equity investing typically in "side by side" investments with the Inter-American Development Bank ("IDB" or "BID", in its Spanish acronym). We also represent certain private equity management firms and their investments. In most cases, the actual investment is an equity, debt or combination interest in a limited liability company, if organized in the USA, or its corollary, if the investment is organized outside of the USA. Often, these are tiered structures. Often where there are US persons as investors, the "box is checked" with respect to foreign entities resulting in the foreign entities being treated as disregarded entities subjected, in part, to the USA partnership income tax regime. Thus, these would not be viewed as "accounts" but, rather, equity investments, loans or some combination. Logically, these would be picked up in Item 2(a) or (b) of the definition of specified foreign financial interests. The distinction does become relevant due to some "exceptions" discussed below. This distinction will also become relevant where expanded disclosure may be required also discussed below.

[32] Instructions to Form 8938 at p 4.

[33] Instructions to Form 8938 at p 4.

[34] Instructions to Form 8938 at p 4.

[35] This gets kind of "murky" outside of the USA. *E.g.,* in the USA, a broker dealer (UBS US, in our case) can and most frequently does also act as custodian of client assets. Indeed, this is one of the very problems in the MF Global or Madoff circumstances. On the other hand, in Costa Rica, a broker dealer or investment bank cannot, as a matter of law, also act as custodian of client assets. The mandated custodian under Costa Rican law is our Central de Valores, SA ("CEVAL")

"in"?[36] This also does not make sense. We are unaware of a circumstance other than privately owned financial institutions where the vast majority of people could own stock **in** an actual financial institution, as defined, other than their holding companies, mutual funds or in the management companies for private equity and hedge fund investments. For example, our stock in Itau Unibanco Holding SA ("Itau") is not equity **in** a financial institution as we think the authors intend to define the term. Itau is a bank holding company and, in that sense, is primarily engaged in investing for its own account in real banks and others. Indeed, our stock in Itau is held by UBS US as custodian and, thereby, included within a financial account held by another financial institution. In the alternative, we could take delivery of the stock certificates in which case our holding would be a foreign financial asset under Item 2(a). Thus, we remain simply confused on this point and this language.

The reference to debt in a financial institution is more believable. Demand deposit accounts (checking accounts), savings accounts and certificates of deposit are debt issued by and in a financial institution. Further, the real financial institutions underneath a bank holding company do issue bonds and similar which some specified persons could easily own. However, these debt instruments are either within the client custodial account of a financial institution or would likely be swept into this reporting under Item 2(a) so the specific reference here is redundant or we do not understand what the authors are attempting to reference.

Some practical examples and our view as to whether the accounts or other foreign financial assets must be included may be helpful:

> Our personal brokerage account at UBS US which includes investments in:
>
> > Siemens AG (a German company)
> > Caterpillar Inc. (a USA company)
>
> Not reportable because the financial or brokerage account is not a foreign financial institution. Siemens AG is not separately reportable as it is held within a financial account.

---

which is a quasi-government entity. However, the Costa Rican statements of individual accounts where Costa Rican private investment banks are involved do not reflect this arrangement – they look no different than others.

[36] We observe specifically that the authors' use the word "in a foreign financial institution" in this context of discussing a financial account while they explicitly use the word "issued" in the context of Item 2(a) when defining when "stock or securities" are foreign. Thus, they seem to be making some kind of distinction between "in" and "issued".

Our individual retirement account at UBS US which includes investments in:

> Switzerland government bond due 11 February 2013 (a foreign sovereign bond)

Not reportable because the financial or brokerage account is not in a foreign financial institution and the pension is a USA pension. But care needs to be exercised. The answer might well differ if this were not a USA pension plan. Further, the pension plan itself might need to report certain assets as the rules are modified over time.[37]

Our personal brokerage account at Aldesa Presto de Bolsa SA ("Aldesa") which includes

> *Gobierno (Ministerio de Hacienda*) bond due 19 March 2014 (a foreign sovereign bond)

The account is reportable because the financial or brokerage account is a foreign financial institution. The assets within it are not separately reportable.

> If our Aldesa brokerage account contained nothing but US Treasury bills, notes and bonds.

The account is reportable because the financial or brokerage account is in a foreign financial institution. The content of the account is not relevant.

The shares we own in Iberdrola SA ADR (a Spanish company) where we took delivery of the shares.

The Iberdrola SA ADR is likely reportable as we hold this stock personally without the benefit of an intervening brokerage account. It certainly would be reportable if these were shares in Iberdrola SA without the ADR overlay. However, due to the uncertainty, we will report the ADR interest.[38]

Our personal checking accounts at BAC San José where one is stated in US dollar and one is stated in colon.

---

[37] Even individual retirement accounts and other pension plans are required to file returns with the IRS. With respect to individual retirement accounts, we just do not typically see these filings or recognize them when we do as they are filed by the trustee of the plan which is typically a US financial institution.

[38] Please *see* discussion below concerning ADRs.

> Both accounts are reportable because the checking accounts are in a foreign financial institution.

As we shall see, the above list is in no way exhaustive. We present it to illustrate the application of these rules with respect to the common or typical accounts most of us have with financial institutions.

Stock or securities issued by someone that is not a US person

This is distressing on so many levels.

Thankfully, the preamble to Item 2 explicitly limits Items 2(a), (b) and (c) to those foreign financial assets **not** held "…in an account maintained by a financial institution [foreign or domestic]". That eliminates a good deal of the more common circumstances not logically relevant in this circumstance.

Next is the use of the word "securities" especially when it is within the phrase "stocks and securities". We have no idea what that word is intended to mean. To our knowledge, there is no comprehensive definition of the word "securities" in the Internal Revenue Code ("IRC"). There are instances where the word is used but in highly specialized areas of the USA tax law.

The word "securities" is typically viewed as comprehensive which would **include** what we commonly refer to as "stocks" as well as bonds and many other instruments. The area of USA law where the definition of "security" is most refined is that within the Securities Acts of 1933 and 1934,[39] the regulatory law thereunder and the case law addressing disputes within this area. The author of this memo is no expert in this area. In this context, the definitional issues of "security" are broad and sweeping. *E.g.,* we distinctly recall a discussion with USA counsel in this area unrelated to taxation. It was his view that our then partnership interest in BDO USA LLP ("BDO US") was likely to be viewed as a "security".[40] That came as a bit of a shock to us.

Oddly enough, upon reflection, it occurs to us that most of the multi-national auditing and tax advisory firms contain many, if not most, of the issues we see within the private equity and hedge fund areas. Further, these firms also reflect many of the issues we see in other closely held multi-national business and investment enterprises, both large and small.

---

[39] 15 USC §77a *et seq.* and 15 USC §78a *et seq.*, respectively.

[40] Like with our references to other specific businesses such as UBS, we do so only because of personal factual familiarity and then only to the extent that the facts are commonly known and in the public domain.

A common structure of many of these firms and institutions can be outlined in general terms. For example, XYZ US is a limited liability partnership organized under the laws of a USA state. It is owned by its partners and former partners. It is a disregarded entity for USA income tax purposes. It is the USA member firm of the multinational auditing and tax advisor commonly known as XYZ International which is not organized under the laws of the USA. XYZ like most of the multinational auditing and tax advisory firms is organized as individual legal entities typically by country. Thus, XYZ Costa Rica SA is organized under the laws of Costa Rica, owned by its "partners" and is not a disregarded entity for USA income tax purposes. XYZ Germany is XYZ AG Wirtshartsprúfungsgesellschaft. It is organized under the laws of the *Bundesrepublik Deutschland* ("Germany"), owned by its "partners" and is not a disregarded entity for USA income tax purposes. The "international firm" really operates by means of an "operating agreement" or "contract" amongst the various country specific firms. One of its primary purposes it to provide for the sharing of common costs amongst its member firms. Thus, a USA partner has no direct or indirect "ownership" interest in the Costa Rican or German firms. There may be some indirect ownership by a USA partner in the XYZ International. Finally, a person who retires or otherwise withdraws from XYZ US has a continuing ownership interest (capital account) in XYZ US often for 20 or more years as the payout of the capital account is not made in a lump sum. Further, a partner who retires from XYZ US has a lifetime promise of a pension-like arrangement whereby XYZ US pays from its current earnings a certain specified retirement benefit if the former partner otherwise meets certain contractual requirements including things like sufficient years of service.

We would like to interject here another requirement in the instructions which is:

> If you are the owner of a disregarded entity, you have an interest in any specified foreign financial assets owned by the disregarded entity.[41] [NB – this is not limited to a USA legal entity which is a disregarded entity.]

This is horribly imprecise. "The owner"? In the context of XYZ US we can assure you that in the large firms, no one partner is "the only owner" as many of these firms have literally hundreds of partners just within the USA.

The USA Federal tax law (statutory and regulatory) is filled with "control" tests including in the area of partnerships. Generally, for partners the test is a scintilla ownership meaning if one owns any quantity of any equity based, broadly defined, interest in a partnership, one looks through the partnership. The partner is deemed to own a proportionate share of the partnership's assets. A foreign legal entity which makes the election to be disregarded for USA income tax

---

[41] Instructions to Form 8938 at p 4.

purposes,[42] such as a multi-owner *sociedad de responsiblilidad limitada* in Costa Rica*, Gesellschaft mit beschränter Haftung & Compagnie Kommanditgesellschaft* in Germany, or similar, is generally viewed as a partnership for USA Federal income tax purposes.

Thus, our first question here is: Do the authors mean that we must own 100% of a partnership for this look through provision to become operative, a scintilla interest or some other measure of control? We specifically note that a single owner disregarded entity is not viewed as a "partnership" within the USA Federal tax law. To our reading in the overall context, "the owner" is perfectly imprecise and unresponsive.

Our second question here is: How does one apply this in the context of tiered structures where some or all of the domestic and foreign legal entities may also be disregarded entities?

Third question: The instructions state that if this look through is operative, one has "…an interest in any specified foreign financial assets owned by the disregarded entity" which must be disclosed by "the partner".[43] If one must do this even if one does not own 100% of the foreign or domestic disregarded entity, does one include the whole value of the foreign financial asset imbedded in the USA based or foreign based "partnership" or the value proportionate to one's ownership interest?

For the moment, let's assume the authors mean to apply the scintilla test and one is required to look all the way through the disregarded entities. Now let's return to the issues embodied in our description of XYZ.

If we were an active partner in XYZ US working and living within the USA bearing in mind we would then be and would remain a specified person in the context of these tax rules:

1. Would we have to file Form 8938 and disclose XYZ US' interest in XYZ International because our XYZ US' interest in XYZ International is a security? If so, what is its value? We do not think the answer is clear. The lack of clarity is due to the "look through" provisions. If those provisions apply where we have a scintilla interest in XYZ US, then the answer appears to be yes, it must be disclosed by each

[42] The opposite is not true. *I.e*., not all disregarded entities are regarded as partnerships under USA Federal tax law such as when there is a single owner.

[43] Instructions to Form 8938 at p 4.

and every current and former partner in XYZ US.[44] If so, what is its value?

Assume we were a "member" of XYZ Costa Rica or XYZ Germany.

1. Would we have to file Form 8938 disclosing our interest in XYZ Costa Rica or XYZ Germany? If an interest in XYZ US is viewed as a "security" for this purpose, an interest in XYZ Costa Rica or XYZ Germany would likely also be a security. The authors do provide examples and this is also easily swept up in the catch all provision. Based on those examples, this would have to be disclosed. If so, what is its value?

2. Would we have to file Form 8938 disclosing XYZ Costa Rica's or XYZ Germany's interest XYZ International? Likely not at this time as XYZ Costa Rica and XYZ Germany are not disregarded entities. Thus, there would be no "look through" based on the silence in these instructions on the point of "look through" where the intervening entity is not a disregarded entity. But, if so, what is its value?

3. Would we have to file Form 8938 disclosing XYZ US' interest in XYZ International? Likely not so long as we did not also have an interest in XYZ US. *But see also* discussion below concerning contractual issues.

Now assume it is today. We have retired or withdrawn. We still have a "capital interest" in XYZ US albeit its amount is fixed and certain resulting in no direct interest in XYZ US' current operating profits or losses. XYZ US is merely obligated to pay out the remaining fixed monetary amount of our remaining capital account.

1. Would we have to file Form 8938 and disclose XYZ US' interest in XYZ International because XYZ International is a security? The answer is likely to be the same as above. We do not think the answer is clear. The lack of clarity is due to the "look through" provisions. If those provisions apply where we have a scintilla interest in XYZ US, then the answer is, yes, it must be disclosed by each and every withdrawn partner in XYZ US until his capital

[44] There are other issues in these multi-national firms and similar which we will not include here. Some of those issues source in their insurance including mal practice in the case of professional firms. Some of these arrangements may not be encompassed here but are possibly picked up in the context of contracts where counterparties are not US persons.

account is zero[45] and each retired partner until his death. If so, what is its value?

The purpose of the above illustration and discussion is to show how these rules can or could apply in areas of our employment, professional and personal lives which we would not typically consider. This is especially germane for our clients and their families who own businesses both within the USA and outside of it. We mentioned we were shocked that our attorney friend suggested our interest in BDO US could be a "security". The reason? We never once thought of our interest in BDO US in the same context as our stock and bond portfolio. Our interest in BDO US is not publically traded. Indeed, its ownership is highly restricted both internally and due to external regulatory issues. It was really the means through which we practiced our craft generating our income not much different than an employee except that, as a partner, we participated in providing the capital necessary to operate the practice. Nonetheless, these kinds of arrangements can be easily swept up in these disclosure rules subject to substantial penalties.

In any event, it appears the more general or intended purpose of this provision is to catch those circumstances where a specified person "takes delivery" of stocks, bonds and similar.[46] In our practice today, we see very little of this. Indeed, the

---

[45] In our case, that will be immediately after our 66th birthday. There is a lesson in here for younger people contemplating accepting partnership in these or similar firms. There is a lesson in here for the firms, as well, in terms of the cost of decades long bookkeeping and tax filings.

[46] Thirty years ago, taking delivery of the certificates evidencing ownership in stocks and bonds was far more common than today. Our maestros were true investors who bought stocks and bonds with a more reasonable vision of time.

That has since changed. Initially, holding stocks and bonds in custodial accounts was touted by the banks as more convenient and more secure. At the time they were correct and, yet today, receiving every dividend and interest check, depositing them and doing the bookkeeping can be annoying. However, whether these custodial accounts remain more secure may prove false in light of such issues as Madoff and MF Global. Thus, we may see a resurgence of true investors actually taking delivery of securities.

The use of mutual funds especially in various pension schemes further removed Americans from investing directly. The banks and others encourage a frequency of trading that bears little resemblance to investing.

Finally, the banks make considerable profit from using client assets even when done within the confines of law and ethics.

There are also circumstances today where one can no longer take delivery. The largest example is US government bills, notes and bonds. With very rare exception which certainly does not include even the wealthy individual, one can no longer obtain the old paper certificates for these securities. They must be held in "notional" accounts either in the investment banks or directly with the various USA Federal Reserve banks.

Thus, we see fewer and fewer stocks and bonds actually directly held by individuals.

norm is for our clients to hold their stocks, bonds and similar in custodial accounts within one or more investment banks or financial institutions both domestic and foreign.

There are two other more common circumstances where this may remain a practical issue.

The first is dividend reinvestment programs where the issuer is not a US legal entity. Again, we see less of this today than in the past. However, it still lurks. Where these are non-USA companies, they must be disclosed by any common sense reading of these rules.

The second is ADRs (American Depository Receipts). ADRs are negotiable securities which trade on the USA bourses representing the underlying securities of a non-US company. The general purpose of these vehicles is to permit shares of a non-USA company to trade indirectly on the USA bourses. The mechanism is the non-USA company deposits its shares in a foreign custodian bank. Then a **USA depository bank** issues the ADRs which subsequently trade on the USA bourses. Arguably, the ADRs should track the value of the foreign stock allowing for currency differences, fees and taxes which may differ and the typical fracturing process.

The ADR itself attracts fees and even some taxes which would not otherwise be due if one simply bought the stock in the foreign company on the foreign exchange. *E.g.*, ABB Ltd. on either the Swiss or Swedish exchanges or Siemens AG on the German exchange.[47]

---

[47] Back in the day, ADRs served a fine and good purpose including fracturing which allowed smaller sums of money to buy even lots and, thus, mitigating transaction fees. Today not so much. Large USA based brokerage houses or investment banks can buy any security on any major global exchange easily by-passing this ADR overlay. They are loath to do so unless pressed no doubt due to the inherent loss in fees. Recently, one large USA investment bank or brokerage began charging their clients what appears to be an additional 7.44% of every dividend collected when done so through indirect ADR ownership. That 7.44% is currently absent when the dividend is collected on shares directly owned with respect to foreign stocks where the custodial account is within the same USA investment bank. There also appears to be some ill defined fee recently instituted for the mere custody of the ADR which is not yet charged where the client owns the stock directly in the same foreign company. Thus, ADRs both before and now, result in lower investment rates of return specifically because of fees and, in some cases, taxes which attach to the ADR form of ownership.

It is also possible, oddly enough, for a foreign financial institution to be custodian of ADRs on behalf of any client, US person or not. We have no idea why a non-US person would ever invest in these but, nonetheless, it is possible.

Thus, one should use great care when engaging a USA financial institution explicitly directing them **not** to invest in ADRs on behalf of the client. Rather, the financial institution should be directing the client to the actual shares issued by the foreign company.

This used to be the only effective means for most US persons to invest in companies not organized under the laws of the USA. That is no longer true for many of us. Nonetheless, these persist and are promoted by the USA investment banks.

We highlighted some words above. ADRs, of necessity, are issued by a USA depository bank; specifically not a foreign legal entity. Arguably, the issuing vehicle is a “disregarded ·entity”, at least in principle and function if not typical in nature. So, the question is whether the authors intend that an interest in a foreign legal entity via an ADR constitutes a foreign financial asset? We have no idea but would disclose them anyway ignoring the ADR overlay where the ADR is not held in an account in a financial institution.

Any interest in a foreign legal entity

This is the catch-all provision. On its face, it could not be more sweeping. Indeed, in our view, it renders much of Item 2(a) concerning “stocks and securities” redundant. There is no control limit. There is no reference as to publicly traded or not. The plain language excludes only corporeal or natural persons in which, in the modern civilized world, one could not have an “interest”.

We have little to say here other than to suggest the reader now reconsider the discussion above concerning XYZ and similar. Do we even need to ponder the definition of a “security”?

Any financial instrument or contract that has an issuer or counterparty that is not a US person

This is absolutely sweeping. No doubt it is intended to sweep in derivatives and similar which would make greater common sense if (more likely when) these rules are expanded to include non-corporeal persons as specified persons.

Nonetheless, like above, this sweeps directly into our businesses and family circumstances.

Do the authors intend to pick up the loan dad who is a specified person made to his non-US person child or grandchild to buy their first house or start a business? It would seem so.[48]

As one can see from our letterhead, one piece of our practice is conducted through a *sociedad de responsibilidad limitada* organized under the laws of Costa Rica. It is a disregarded entity for USA income tax purposes. The above

[48] There are a plethora of other issues concerning intra-family loans well beyond the scope of this memo.

requires that we disclose all contracts where the counterparty is not a US person.[49] Combine this with the look through provisions applicable to disregarded entities. Oh, we own 100% of the *sociedad de responsibilidad limitada* so there is no debate as to any level of control. The *sociedad de responsibilidad limitada* has engagement letters which are contracts with the clients we serve not all of whom are US persons. Do we have to include those contracts in our Form 8938? If so, what is their value?[50] If so, do the contracts fall under one or both of two "exceptions" we will discuss in a moment where, in the first instance, the *socidad de responsiblidad limitada* data must be included on another disclosure form? The answer, in our case, will prove to be "no". In the second, do these contracts fall under another exception whereby they are used in the conduct of a trade or business? We hope so.

The factual possibilities here are nearly endless in the real world of business, investing and families.

Other specified foreign financial assets

This is rather strangely situated in the instructions. It sits by itself not tagged to any particular category discussed above. We do not necessarily fault its placement as its purpose seems to be to provide some helpful examples of foreign financial assets which are not held in a foreign financial account which could fit within one or more of the categories previously listed under Item 2. Here are the authors' words:

- Stock issued by a foreign corporation.
- A capital or profits interest in a foreign partnership.
- A note, bond, debenture, or other form of indebtedness issued by a foreign person.
- An interest in a foreign trust or foreign estate.

[49] Given the nature of our activity with our clients, we would actually likely know this. However, if our business activity differed, in many or most cases, we would have no idea as to whether any given client was a "US person" or not.

[50] This would actually require a legal analysis (we are a CPA) of the enforceability of these "contracts" under relevant local law. We happen to know that relative to us. Contracts for personal services are effectively unenforceable except to the extent of a resulting account receivable, unbilled but incurred time and any dispute resolution provisions. Thus, the value is easy in our case – it is accounts receivable plus work in process less any reserve for collectability. Other circumstances are not likely to be nearly that easy especially longer-term contracts such as those involved with nation state infra-structure projects and shear volume in larger enterprises.

- An interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap[51] or similar agreement with a foreign counter party.

- An option or other derivative instrument with respect to any currency or commodity that is entered into with a foreign counterparty or issuer.[52]

An interest in a specified foreign financial asset

When one first looks at these rules of disclosure there is a natural presumption that one must "own" a specified foreign financial asset before it must be disclosed. That is neither the plain language nor the standard for a specified foreign financial asset to be disclosed. The language says one must have an "interest" in a specified foreign financial asset.

In this regard, the authors are explicit and helpful:

> You have an interest in a specified foreign financial asset if any income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the asset are or would be required to be reported, included, or otherwise reflected on your [USA] income tax return.[53]

The authors go on to add:

> You have an interest in a specified foreign financial asset even if there are no income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the asset included or reflected on your income tax return for this year.[54]

---

[51] Some of this list reads like the toxic portion of off balance sheet notional entries in banks, broadly defined, plus a few others like hedge funds. As we understand it, even the Bank of International Settlements does not have some of this data and, we suspect, more than a few of the actual institutions may be ill informed as to what they may or may not have. In any event, we do not know of a single natural person who owns credit default swaps. On the other hand, most hedge funds, foreign or domestic, are wholly or partially in the form of disregarded entities. Given the look through provisions, these examples highlight some areas of true concern if only in the context of attempting to marshal the facts.

[52] Instructions to Form 8938 at p 4.

[53] Instructions to Form 8938 at p 4.

[54] Instructions to Form 8938 at p 4.

We think the language is plain.

So, we can return to our example of our interest in XYZ Germany which is a foreign legal entity. Further, assume XYZ Germany is a foreign legal entity which elected to be a disregarded entity. Like the capital interest in XYZ US, the capital interest in XYZ Germany becomes a fixed monetary amount upon withdrawal but is remitted over a period of years. The fixed monetary amount is approximately our allocable share of the net book value of XYZ Germany with no premium or discount. It pays no interest or other premium to compensate for its delayed payment. As a result, there are no “income, gains, losses, deductions, credits, gross proceeds, or distributions” **from a financial reporting point of view** when we actually receive the payments from our capital account valued at our date of withdrawal. However, from a USA Federal income tax point of view, there most certainly are entries of taxable income on our personal USA income tax return. XYZ Germany uses the cash method of reporting its USA Federal taxable income. As a consequence, the accounts receivable net of accounts payable imbedded in our capital account is most assuredly taxable income when received. As a result, according to these rules, we do have an “interest” in XYZ Germany after our withdrawal despite the fact, from an economic point of view, it is more akin to a non-interest bearing loan and our voting rights ceased upon withdrawal.[55] Thus, where XYZ Germany is a foreign legal entity disregarded for USA Federal income tax purposes, we would have to include our interest in it as a specified foreign financial asset while an owner and until our capital account is fully paid.

Again, we use XYZ as an example, but these structures of management and ownership are in no way unique to large law, auditing and tax advisory firms. They are common including in the private equity area and in the context of hedge funds, among others. Similar issues lurk in other business enterprises including industrial.

The foreign financial asset must be held for investment

The foreign financial asset must be “…held for investment”. We think we applaud the authors for this limitation.

In any event, here is the authors’ language with respect to when one holds an asset for investment:

[55] If this were non-interest bearing debt, that debt might also have to be disclosed either on the basis of “gross proceeds” being included in the return or if there is deemed or imputed interest under the USA Federal income tax rules.

> You hold an asset, including a partnership interest, for investment if you do **not** use it in, or hold it for use in, the conduct of any trade or business. [Emphasis added.][56]

They go on:

> Stock is not considered used or held for use in the conduct of a trade or business.[57]

It takes a moment to think through the authors' language. They express the concept in the negative. We think the following is what they intend if one puts their language in the "positive" form of construction:

> Unless you hold a [financial asset] for use in the conduct of any trade or business, you hold that [financial asset] for investment. A partnership interest may be held either for investment or used in the conduct of your trade of business based upon a factual analysis.

As we can now see, this exception is likely to have very limited application in the real world. With respect to "securities", the only enterprise which would likely hold these within its trade or business is a broker/dealer. That broker/dealer world is large and the exemption is meaningful to a broker/dealer. But most of us are not broker/dealers.

Next, we would revisit our discussion above with respect to XYZ. This exception is not particularly helpful or even limiting. The currently active partner in XYZ in disregarded entity form might, arguably, view accounts receivable and operating agreements with foreign counterparties as financial assets used in their trade or business but that becomes a very thin argument with respect to withdrawn or retired partners from the same enterprise.

Further, this explicitly does not exempt US person dad's loan to non-US person child or grandchild to buy their first house or start a business. Parents and grandparents are not in the trade or business of lending money to children and grandchildren regardless of frequency or monetary amount.

Next, the language is very USA centric. This is a very fair and just criticism as the very intent of these rules is to address when one has an interest in a foreign financial asset. "Stock" is a very imprecise word even in American English. In its common usage, it typically references an equity interest in a corporation. Corporations are unique to common law jurisdictions. They do not exist in Costa Rican law, for example, or German law. In Costa Rica, we have *sociedades*

[56] Instructions to Form 8938 at p 4.

[57] Instructions to Form 8938 at p 4.

anómina or *sociedades de responsibilidad limitada* as do many others where the foundation of law sources in civil law. [58] *Sociedad anómina* equity interests are known as *aciones*. *Sociedad de responsibilidad limitada* equity interests are known as *quotas*. Under certain USA tax regulations, a *sociedad anómina* is **viewed** as a corporation **for USA income tax purposes**. Those same USA tax regulations indicate a *sociedad de responsibilidad limitada* is also **viewed** as a corporation unless it and its owners elect to be viewed as a disregarded entity (not a partnership) for **USA income tax purposes**.[59] Those same USA income tax regulations address many other legal entities formed under the laws of other countries well beyond Costa Rica. Yet the instructions explicitly addressing foreign legal entities are phrased using imprecise American English.

That said, it may be that the intent of this language is an imprecise reference to these USA income tax regulations addressing the view of the USA tax law as to the character of a foreign legal entity in an attempt to define when an equity interest in a foreign legal entity is held for investment, including a *per se* rule. If so, using Costa Rica as an example, a *sociedad anómina* and a *sociedad de responsibilidad limitada* which fails to elect to be a disregarded entity are *per se* held for investment. On the other hand, a *sociedad de responsibilidad limitada* which makes the election to be a disregarded entity and has more than one owner (foreign or domestic) is viewed as a partnership[60] which, if used within a trade or business, is not held for investment and, thus, not subject to disclosure. Logic would suggest a similar result where there is one owner.

It is common in Costa Rica for individuals, both citizens of Costa Rica and not, to own houses (including primary residences and vacation homes), cars, cell

---

[58] *Sociedades anómina* are legal entities organized under the laws of Costa Rica. They somewhat resemble corporations under USA law or an *Aktiengesellschaft* ("AG") under German law. They cannot make an election to be disregarded entities under USA Federal tax law. *Sociedades de responsibilidad limitada* are legal entities organized under the laws of Costa Rica. They somewhat resemble limited liability companies under USA law or a *Gesellschaft mit beschränter Hauftung & Compagnie Kommanditgesellschaft* ("GmbH & Co. KG") under German law. They can make an election to be disregarded entities under USA Federal tax law. One can see additional discussion of these at
http://www.chappleblondet.com/resources/pdf/USA_taxation_of_the_owners_of_SAs.pdf .

[59] These USA tax elections to be treated as a disregarded entity must be made by means of first obtaining a USA Federal Identification Number using Form SS-4 Application for Employer Identification Number and then submitting Form 8832 Entity Classification Election to the IRS. Not all foreign legal entities are qualified to make this election. If this election is filed beyond 75 days of the formation of the otherwise qualifying foreign legal entity, there may be serious USA income tax consequences to existing owners who are US persons. Treas. Reg. §301.7701-3. These USA income tax elections have no impact on the foreign legal entity in terms of local tax or governance law.

[60] Under USA tax law, one could never have a "partnership" with one owner. Thus, a foreign entity with one owner electing to be treated as a disregarded entity is viewed as a sole proprietorship or a pure grantor trust.

phones and other personal nonsense in *sociedades anómina* or *sociedades de responsibilidad limitada.*[61] We do not think there is much doubt that cars and cell phones are not held for investment even where they are held indirectly through these Costa Rican legal entities. While we strenuously disagree in economic principle, there are still more than a few who believe our houses or apartments are investments.

Unfortunately, a literal reading of the instructions clearly dictates that these Costa Rican legal entities used for these purposes are required to be included in our Forms 8938 because they are either represented by "stock" or not used in a trade or business or both.

Unfortunately, these legal entities even where there is no "investment" or "profit" motive must still be disclosed by US person owners of these entities once certain US person ownership percentages are met. A distinguishing factor with respect to some of these other mandated disclosure forms is where there is less than 50% US person ownership. In some of these circumstances, the other required disclosures may be event triggered and, thus, may not be required annually.[62]

---

[61] We do not often comment on Costa Rican law. However, using *sociedades* of either form is ill advised and inappropriate in the context of houses, cars, cell phones and similar including in the context of Costa Ricans with no connection to the USA. The promoted purpose of using these legal entities is largely to avoid transfer taxes (capping at 3.5% for real estate) and "privacy" when the house, car, etc. is bought or sold by selling the intangible *aciones* or *quotas* representing the *sociedad* which owns the underlying house, car, etc. (The transfer taxes do not attach to the sales of intangibles and Costa Rica does not look through the transaction as some other jurisdictions do in the context of transfer taxation.) There are endless non-tax reasons which dictate the failure of the Costa Rican transfer tax avoidance angle. There are also Costa Rican income tax issues which trump any alleged savings in transfer taxes. In the context of real estate, even when the *aciones* or *quotas* are bought and sold, the entire maximum 3.5% transfer tax is never avoided. In any event, this continues to persist in Costa Rica. Pending Costa Rican income tax reform may aggravate the Costa Rican income taxes in the context of *sociedades* being used to own our homes.

As a matter of USA tax planning, use of a *sociedad anómina* or a *sociedad de responsibilidad limitada* without a timely filed election to be a disregarded entity for USA income tax purposes is typically, but not always, a tax disaster. However, using a *sociedad de responsiblilidad limitada* with a timely election is a USA income tax annoyance typically requiring a greater level of tax compliance time which does nothing but drive annual tax compliance fees.

These new rules are yet another reason to clean up these existing entities through dissolution and liquidation as well as change our behavior going forward in order to minimize the tax compliance labor and risk.

[62] One can see discussion of some of these other disclosure requirements at http://www.chappleblondet.com/resources/pdf/Disclosure_of_CFCs.pdf . This discussion is framed in the context of two foreign legal entities under the laws of Costa Rica. However, the discussion would be identical with respect to legal entities in other countries such as *Aktiengesellschfts* and *Gesellschafts mit beschränkter Haftung & Compagnie Kommanditgesellschaft* under the laws of Germany. There would be differences as to precise consequence where local income and other taxes and rates differ.

Thus, we conclude these foreign legal entities either must be or should be included in our Forms 8938 from a defensive posture.

A final example in this area may be helpful in our collective thinking of our clients' and our circumstance. Grupo de Inversiones Chapple Blondet SRL ("GICB") is a *sociedad de responsibilidad limitada* organized under the laws of Costa Rica. It is a disregarded entity for USA income tax purposes. Its primary business is that of a tax advisory firm. We own 100% thus it is not viewed as a partnership as we understand it, including by implication, the above exceptions. We are certainly a specified person. GICB owns a membership in the Costa Rican Country Club SA (the "Country Club") which is exactly as its name implies and is a *sociedad anónima* organized under the laws of Costa Rica. We assure you that GICB owns less than 10% of the outstanding *aciones* by vote or value. Even if Country Club were silly enough to consider such a thing, Country Club cannot make an election to be a disregarded entity under USA tax law. The membership takes the form of owning *aciones* in the *sociedad anónima*. Here is what we think we have to do:

1. Clearly the income, deductions, gains and losses within GICB must be reported and included as currently taxable income in our USA income tax return. It is largely reported on Schedule C Profit or Loss from Business.[63] This is the form used to report the business income of a sole proprietorship using USA Federal income tax methods of accounting.

2. A Form 8858 Information Return of US Persons With Respect To Foreign Disregarded Entities must be included in our personal USA income tax return reflecting GICB.[64] This form, among other

---

There are other USA reporting requirements not discussed in this memo such as those for foreign trusts.

[63] Items such as interest income on GICB's bank accounts or gains and losses from the disposition of old computers and such are reportable and includable in USA Federal taxable income but simply reported on different forms and lines.

GICB also files an income tax return and pays income tax at the enterprise level to Costa Rica on its income, deductions, gains and losses as defined under Costa Rican tax law. With respect to GICB and many others, the accounting principles required under Costa Rican tax law materially differ from those under USA tax law. Both the accounting principles required under USA and Costa Rican tax law materially differ from financial reporting standards applicable within each country. Further, there are actually three or more USA tax methods of accounting which must be administered each year. The statutorily required tax year end in Costa Rica is 30 September. The statutorily required tax year end for the USA is 31 December. Thus, there are two annual closings of the books. The balance sheets and income statements must be calculated and reported using six differing accounting methodologies. This translates into twelve annual differing calculations of income.

[64] As we write this memo in the last days of February 2012, the actual 2011 Form 8858 does not appear to be available yet. The 2011 instructions to that form do appear to be available on the

> matters, reflects an abbreviated balance sheet and a reasonably detailed income statement both of which must be shown using Generally Accepted Accounting Principles.[65] Inexplicably, the filing of this Form 8858 does not abbreviate the disclosure otherwise required on Form 8938.[66]

IRS web site. The first 2011 returns requiring the inclusion of Form 8858 are due 15 March 2012, just a couple of weeks away. In any event, we do not expect material changes and our general description is consistent with the 2010 version of the form.

We also note this evening that the IRS appears to have withdrawn the actual Form 8938 (the subject of this memo) from their web site leaving only the instructions. Fortunately, we printed a copy of the two page actual Form 8938 a couple of days ago as it then appeared on the IRS web site. This is the draft of Form 8938 upon which our comments and discussion in this memo is based.

[65] The use of Generally Accepted Accounting Principles ("GAAP") today is largely limited to the USA. The rest of the world now uses International Financial Reporting Standards or IFRS. In reality and application, there really are not that many differences between the two systems except in specialized industries. Neither GAAP nor IFRS are used for USA income tax reporting or, for that matter, income tax reporting in all other countries of which we are aware. Thus, imposing the use of GAAP on these forms specifically limited to businesses outside of the USA is a material and unnecessary additional reporting burden.

[66] This is entirely illogical within the confines of these instructions. A foreign legal entity viewed as a corporation for USA income tax reporting purposes must file a Form 5471 Information Return of US Persons With Respect To Certain Foreign Corporations with the frequency of filing dictated by US person "control" combined with certain events. The Instructions to Form 8938 at p 6 dictate that an abbreviated notation or reference on Form 8938 to Form 5471 is sufficient for the disclosure otherwise required on Form 8938 with respect to an interest in that foreign legal entity.

A foreign legal entity which has made a valid election to be disregarded for USA income tax purposes is required to file Form 8858 Information Return of US Person With Respect To Foreign Disregarded Entities [whether the foreign legal entity has more than one owner (partnership rules) or the grantor trust rules apply where the foreign legal entity has a single owner]. Where there is more than one owner, the same foreign legal entity may also be required to file Form 8865 Return of US Persons With Respect to Certain Foreign Partnerships.

As we write this, the IRS has released the 2011 instructions but not the 2011 Form 8858. Based on prior years, the information required on Form 8858 is nearly identical to that required on Form 5471 to the point of distraction. One could easily merge these forms into one form adding a box to check if the reporting foreign legal entity is disregarded.

Thus, it is internally inconsistent within these instructions to permit an abbreviated filing on Form 8839 for a foreign legal entity viewed as a corporation if it is otherwise required to file Form 5471 and not do the same with respect to a foreign legal entity which is disregarded for USA income tax purpose and filing Form 8858.

Form 8865 is required to be filed by certain foreign legal entities viewed as partnerships for USA Federal income tax purposes. Form 8865 is a far more detailed presentation of most, if not all, of the information included in Forms 8858 and 8938 (the subject of this memo). This Form 8865 is not included as an exception to filing detailed data on this new Form 8938. It should be an exception.

3. A Form 8938 Statement of Specified Foreign Financial Assets

    a. We must include GICB as a whole foreign legal entity on Form 8938 because it is a disregarded entity filing Form 8858; not Form 5471.

    b. We must specifically include GICB's two demand deposit accounts (US dollar denominated in one case and colon denominated in the other) in BAC San José on Form 8938 due to the look through provisions applicable to a disregarded entity. It may be possible to argue that these foreign financial assets (checking accounts) are used in a trade or business and, thus, do not have to be separately disclosed on Form 8938.

    c. We must also specifically include GICB's interest in the Country Club because it meets the strict definition of a foreign financial asset (corporate-like form of organization) albeit GICB owns it to facilitate the business' sales and practice development (used in a trade or business) although we certainly do not hold the *aciones* in Country Club with the intent of making a profit as we do with respect to our ownership in Siemens AG.[67]

    d. We might have to include GICB's accounts receivable and work-in-process on Form 8938 to the extent the clients are a non-US persons again due to the look through provisions applicable to a disregarded entity. Our hesitancy as to specific separate inclusion of this asset class is it should be viewed as used in a trade or business and not held for investment.

4. Form TD F 90-22.1 Report of Foreign Bank and Financial Accounts reflecting disclosure of, among other matters, the following sourcing in GICB:

In short, the redundancy is stunning and entirely unnecessary or worse including from the point of view of the IRS.

[67] One has to wonder why Treasury and the IRS really want to know about what is effectively my country club membership. One also has to wonder what their data bases look like today and will look like in the future with so much duplication of asset disclosure including partial data; not just whole. Further, if GICB had more than one US person as an owner, GICB's data would be repeated multiple times within Treasury's and the IRS' data bases. Even with today's data mining technology, the old rule of "garbage in, garbage out" still applies.

a. GICB's two demand deposit accounts in BAC San José are reported a second time with no debate as to "used in a trade or business".

Please do not assume the above list of what and where GICB's activity gets entered on our USA income tax return is complete. There are other forms some of which are in the nature of disclosure that may need to be included from time to time where inclusion is typically event driven.

We hope these examples are helpful. Our intent is to illustrate how broadly and deeply we (taxpayers and tax advisors) must think and review facts some of which might not be facially obvious or logical. Truly traps for the unwary.

Thresholds for filing

The instructions outline certain necessary thresholds of total foreign financial asset value before a specified person, as defined, is actually required to file. The general policy purpose of these kinds of rules is to reduce the burdens of compliance with respect to those of more modest means as well as a first screening of those in which the taxing and regulatory authorities would have no interest or material concern. Information overload can be as problematic as a dearth of information. But, when made unnecessarily complex, much of the original meritorious purposes of these mitigating rules is lost.

These rules turn on fixed monetary amounts. Thus, they may be reasonable today but become less so or nearly meaningless in the future when not adjusted for inflation. For those of us who live in regions of the world which are not part of the US dollar zone, these amounts may become less simple and, sometimes, less meaningful from our point of view. *E.g.*, over the past approximate two years, the Costa Rican colon has appreciated by about 20% relative to the US dollar. 20% even spread over two years is a very meaningful shift in relative currency values. It also results in a shift in relative asset values.

We think the easiest way of presenting these minimum thresholds is in the form of a chart.

A meaningful portion of the complexity sources in the USA tax regime's extreme fetish with marital status.[68] Thus, the chart below is first stratified by marital

[68] The USA Federal and most state income tax regimes with respect to natural or corporeal persons function with four states of marriage or not. We kid you not – four. Further, as we discussed above, it is entirely possible within USA law for a person to be married for purposes of the Commonwealth of Massachusetts income tax, single for US Federal purposes and single for the purpose of the income taxes assessed by the State of Arizona. And, yes, one can easily be required to pay income taxes in more than one USA state. The author of this memo pays income taxes in three USA states despite the fact he resides in Costa Rica and has no property or business interests in the USA. In any event, the state of matrimony or not may well have to be

status. We have relegated the discussion of marital status under USA tax law to a footnote. On the other hand, one's state of matrimony for USA income tax purposes does not necessarily follow common sense.

---

determined multiple times for the same person for USA income tax purposes. So, here are the states of matrimony for USA Federal income tax purposes.

There is "single unmarried". These are people who are not currently in a state of matrimony whether never married (including minors – yes, babies may need to file USA income tax returns including the Form 8939 which is the subject of this memo) and divorced.

Then there is "married filing separately". This is for people who are in a state of matrimony but chose to file their USA income tax returns as separate and distinct persons. This is the default position for those persons who are in a state of matrimony.

The third is "married filing jointly". This is for two people who exist in a state of matrimony to **elect** to file their annual USA income tax returns as if they are a single natural or corporeal person somewhat akin to a consolidation in the world of corporate taxation; perhaps closer to a combination. This is an election with the default being married filing separately. It takes **both spouses** to consent to the joint filing. The author of this memo recalls the time before this filing status existed in the law. However, this has become a near American icon akin to "mom, god, country and apple pie" where filing "separate but married" is viewed as a near act of marital infidelity. In reality, electing to file jointly carries risks with it where, for example, both spouses become liable for each other's income tax even where one spouse may have lied as to their income or, as happens in insolvencies, one spouse has taxable income but no resources with which to pay the resulting liability. In the multi-national arena, making this election can easily double or more the family unit's USA income tax otherwise due within the bounds of law and ethics. As a consequence, today this "joint" filing status of married couples in the author's practice is very much in the minority.

Next is a sometimes married (spouse not living in the same household) and sometimes not married "head of household" with the determining characteristics based on the "dependents" included in the taxpayer's household including their familiar, or lack thereof, relationship with the head of that household.

Finally, there is actually a fifth state of family being more recently inserted into the USA income tax regime. This state of being allows (but does not require) a minor child's, as defined, taxable income to be included in his or her parent's USA Federal income tax return as if parent and child were one person or an effective consolidation; again, perhaps, more akin to a combination. This election can be made with a parent who is unmarried, divorced or divorced and re-married. Throw in a couple of divorces especially with second or even third marriages and it becomes a real mess. We have no idea whatever possessed the USA to put this one in place. It can and does, in fact, create family strife where none would otherwise exist. Further, it "muddies" issues of privilege to a fair thee well. Further still, we have never seen where there is any income tax saved but often see where using this elective state of family being actually increases the income tax on the family unit. Thus, personally the author recalls preparing only one of these returns. As a matter of current firm policy, we generally refuse to prepare a return where this election is made.

This rather lengthy footnote may first appear to be a digression. It is not. The thresholds and the risks and the obligations of filing this Form 8939 turn on which filing statuses are available and which is ultimately elected.

The second factor in these filing thresholds is where the taxpayer "resides". Here again, the authors use an imprecise word namely "resides". We are fortunate, however, as the instructions go on to define "reside". Here is the definition of when one is viewed to "reside abroad":

One resides aboard if one is either:

1. A USA citizen who has been a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year.

   or

2. A USA citizen or [USA] resident who is present in a foreign country or countries at least 330 full days during any period of 12 consecutive months that **ends in** the tax year being reported. [Emphasis added.][69]

Please bear in mind that "specified persons" who may well be required to file this Form 8939 go well beyond mere USA citizens. Yet here the definition of where one resides turns on citizenship in the first instance and US person status in the second. However, for this purpose, one is only attempting to determine the minimum threshold of foreign financial asset value which would require a "specified person" to file Form 8938.

Item 1 above is curious as it seems to omit reference to natural persons who are USA tax residents by means of holding a greencard or certain others who might also well be "*bona fide*" residents of a country other than the USA or "foreign" in the context of these instructions. This is actually quite common in the real world.

Item 2 explicitly includes USA citizens but also explicitly includes others. On the other hand, it references a day count which is significantly longer than the day count to determine whether the non-USA citizen is a "specified person" required to file this Form 8938. Thus, read literally, a non-USA citizen might well be a "specified person" but that same person could well **not** fit within either of the two definitions of "residing abroad" all the while being very much not physically present in the USA.[70]

---

[69] Instructions to Form 8938 at p 2.

[70] This kind of regulatory "writing" is the worst of all possible worlds. It is as bad for the IRS as it is for "taxpayers" as it sets up a level of unnecessary complexity literally creating potential conflict wasting both the IRS' time and taxpayers' time and money. The definitions should be perfectly identical. The author of this memo notes that the language used here seems to imperfectly reflect that used to ascertain eligibility for the use of the exclusion of certain foreign sourced income. Our discussion of that area of USA Federal taxation can be found here http://www.chappleblondet.com/resources/pdf/USA_foreign_earned_income_exclusion.pdf . Again,please be mindful of the publication date. *E.g.*, the exclusion amount is adjusted for

In any event, when one reads through all of this, the default thresholds of foreign financial asset values necessary to require filing of Form 8938 appear to be those labeled "not living abroad". These thresholds are consistently lower than where the "specified person" "lives abroad", as defined, regardless of the zone of their dominant physical presence.[71]

So, now that we are all thoroughly confused with the definitions, intended or otherwise, following is the relevant chart. The US dollar amount of total asset value necessary to trigger filing of Form 8938 by a specified person must exceed that in the respective columns for each marital category:[72]

---

inflation each year so it generally increases over time. We would frankly applaud the use of consistent definitions despite the disparate nature of the tax issues involved. Definitional consistency renders the application and administration of the various tax regimes more efficient for both the taxing authorities and taxpayers.

[71] This is another general area where the law has become divorced from practical reality. *E.g.*, we have clients who are citizens of far more than merely two countries but where one country certainly is the USA. We have other clients who have business locations in multiple countries, homes in multiple countries and various combinations of citizenship and visas.

[72] It is not clear to us precisely how one determines the second threshold amounts in each category above. The actual language in the instructions is:

> [Y]ou satisfy the reporting threshold only if the total value of your specified foreign financial assets is more than [X] on the last day of the tax year or more than [Y] at **any time during the year**. [Emphasis added] Instructions to Form 8938 at p 2.

Determining the value of all specified assets at the end of the tax year seems clear and not nearly as burdensome in many cases. However, the second test of the total value at any time during the year is unclear. *E.g.,* do we add the maximum value of **each** asset at any time during the year then sum those values or are we supposed to do this in the aggregate for the **asset class** defined as "specified foreign financial assets"? At least for some assets, values vary daily or even more often in the context of high frequency trading. We also note that foreign financial assets sold during the tax year are to be included in that tax year's Form 8938.

In fairness, some of these issues are addressed later.

There was a similar issue with respect to the Form TD F 90-22.1 Report of Foreign Bank and Financial Accounts or FBAR. Some relief was subsequently provided where one is now permitted to look at month-end values within each foreign financial account where one receives a statement from the financial institution holding the account on at least a quarterly basis. If one views the FBAR as instructive here and the authors' intent is consistency, one would look at the maximum value of each asset during the tax year; not the maximum value of the asset class at the end of the year.

Marital status	Living in the USA	Living Abroad
Unmarried	More than US$50,000 on the last day of the tax year or more than US$75,000 at any time during the tax year.	More than US$200,000 on the last day of the tax year or more than US$300,000 during the tax year
Married filing a joint income tax return	More than US$100,000 on the last day of the tax year or more than US$150,000 at any time during the tax year.	More than US$400,000 on the last day of the tax year or more than US$600,000 during the tax year
Married filing separate income tax returns	More than US$50,000 on the last day of the tax year or more than US$75,000 at any time during the tax year.	More than US$200,000 on the last day of the tax year or more than US$300,000 during the tax year

Some observations:

1. Unlike most areas of the USA tax law, married persons filing separate returns are treated no differently than unmarried persons.

2. Many areas of the USA tax law interacting with the ownership of assets located outside of the USA turn on “control tests”. Those control tests require an analysis of the nation state citizenship/visa/residency status of all owners then a determination of “control” typically by all US person owners based on voting rights and value of their interests. While that is typically not difficult where one person owns more than 50% of the enterprise or asset, control tests are more intrusive with respect to others who are not, in fact, US persons. It also means that the reporting person is relying, of necessity, on the representation of others typically with no ability to verify or defend upon inquiry by the fiscal authorities. Thus, these requirements for filing Form 8938 which turn on the value of the asset regardless of enterprise control have merit in limiting intrusive inquiry outside of the jurisdiction of the USA.

There is a secondary issue in determining the threshold level of asset value where there are commonly owned assets. Commonly owned assets frequently arise among married couples but marriage is not required. Thus, one might own the family home with one’s spouse while also owning an undivided interest in the lot next door with a colleague. Further, joint ownership could include more than two common or "joint" owners. The authors use the word "joint" or "joint interests". Again this can be confusing and is imprecise.[73]

As discussed below, one must reference the legal jurisdiction (the states in the case of the USA) in which the relevant asset is located. Similarly, the ownership of an asset located in Costa Rica would be governed under Costa Rican law including for purposes of USA taxation where the USA tax law is otherwise silent as to principles or definitions of ownership.[74]

---

[73] Concepts of joint or common ownership under USA law are controlled by the laws of its various states which can and do vary. While we often think and speak of these in the context of real estate, the concepts are in no way limited to real estate. Where this is relevant for USA taxation, one must first identify the relevant state law applicable to any given asset where the asset is within the USA. The most common forms of joint ownership under USA law are:

1. As "tenants in common" or "tenancy in common" – turning to *Black's Law Dictionary*, tenancy in common is defined as "[w]here property is held by several and distinct titles by unity of possession, neither knowing his own severally, and therefore they all occupy promiscuously." *Black's Law Dictionary* 1635 (Revised 4th ed. 1968). One of the key principles here is each portion of the common ownership can be unilaterally disposed by each common owner.

2. As "joint tenants" – turning to *Black's Law Dictionary*, joint tenancy is defined as [a]n estate in fee simple, fee-tail, for life, for years, or at will, arising by purchase or grant to two or more persons. Joint tenants have one and the same interest, accruing by one and the same conveyance, commencing at one and the same time, and held by one and the same undivided possession. The grand incident of joint tenancy is survivorship, by which the entire tenancy on the decease of any joint tenant remains to the survivors, and at length to the last survivor. *Black's Law Dictionary* 1634 (Revised 4th ed. 1968). Perhaps the key distinguishing factor is any one individual's interest in property held with others as joint tenants passes by operation of law to his fellow owners upon his death, regardless of what his will says even specifically as to the jointly owned property in question. Property interests held as tenants in common pass upon death by the terms of the decedent owner's will or, absent a will, by the relevant laws of intestacy. For those of us living abroad, the relevant laws of intestacy might well be those of a "foreign" country.

3. As "tenancy by the entirety" – once again, turning to *Black's Law Dictionary*, tenancy by the entirety "[i]s created by a conveyance to husband and wife, whereupon each becomes seized and possessed of the entire estate and after death of one the survivor takes the whole. It is essentially a 'joint tenancy,' modified by the common-law theory that husband and wife are one person, and survivorship is the predominant and distinguishing feature of each." *Black's Law Dictionary* 1635 (Revised 4th ed. 1968). This form of common ownership does not exist throughout all USA states. Indeed, it is relatively unusual. One of the distinguishing characteristics not referenced by *Black's Law Dictionary* involves creditors' rights.

[74] Concepts of ownership are deeply and historically imbedded in the law. The majority of the USA law finds its origins in "common law" which traces its origins, especially in the context of property and ownership, back to pre-Arthurian England. Other legal systems differ in their

Thus, especially in the context of these rules whose explicit purpose is to assert an obligation to report certain assets located outside of the USA but owned in whole or part by a US person, one would have to read the word "joint" or "joint interests" in the context of board general principles in no way limited to the technical definition one might find in the law of the several states making up the USA.

The methods of counting the value of joint interests also turn on one's state of matrimony.

As above, following is a chart outlining how one counts joint interests in specified foreign financial assets:

Marital status	Joint Ownership with Spouse Where one's Spouse is a Specified Person	Joint Ownership Where One's Fellow Owners Are Not One's Spouse or Where a Spouse is Not a Specified Person
Unmarried	Not applicable	The whole value of each jointly owned asset
Married filing a joint income tax return[75]	The whole value of each jointly owned asset	The whole value of each jointly owned asset
Married filing separate income tax returns	One half of the whole value of each jointly owned asset[76]	The whole value of each jointly owned asset year or more than

approach to "ownership" such as in "civil law", Germanic law or the Asian concepts including those within socialist systems.

[75] The instructions here explicitly contemplate that the Form 8938 will be filed "jointly" as if the two spouses are one person where the married couple otherwise elects to file a joint return. Of necessity, this would include the relevant assets of a non-US person spouse where that spouse otherwise agreed to join in a joint filing of a USA income tax return.

[76] This contemplates that each spouse is a specified person and that each spouse will be filing a separate USA income tax return. This includes the circumstance where both spouses are USA citizens. But please *also see* the discussion above with respect to persons who are not USA citizens but are still required to file USA income tax returns. Additional discussion of this issue can be found here
http://www.chappleblondet.com/resources/pdf/Residency_for_Tax_Purposes.pdf

Some observations:

1. The joint ownership of property can pull into the disclosure of assets which would not otherwise be required where one spouse is a specified person and the other is not. The solution is simple. Avoid joint ownership.[77]

2. We have never been fond of joint ownership of assets including (sometimes, especially) between spouses and in no way limited to this matter. Joint forms of ownership can have serious and adverse estate planning consequences everywhere. This is aggravated for those of us subjected to the USA tax regime. Indeed, all USA citizens no matter where we live are subjected to USA estate and gift taxation. Joint ownership can complicate or even negate and frustrate proper and thoughtful family and other succession planning.

Asset valuation

The tests above for asset inclusion and, where includable on Form 8938, the actual value to be included turns on a valuation of the foreign financial asset. That may sound circular or even silly. In many cases, sadly, it is not. The standard of asset valuation set forth in the instructions "…is the asset's fair market value" on the dates specified above.[78] Indeed, there are two valuation dates for each asset – the highest value during the tax year ("maximum value") and the value at the end of the tax year.[79] In many cases, the fair market value of an asset may be obvious such as those which trade on the world's public bourses. Many other times such a value is not obvious such as the value of an asset which is closely held or thinly traded. The instructions do provide some guidance with respect to valuing specified foreign financial assets:[80]

---

[77] Great care needs to be exercised in undoing or creating joint ownership especially where a US person is married to a non-US person. *E.g.*, many Americans today assume there is the unlimited right to make transfers of property (including cash) to one's spouse without current USA gift or estate tax. That is explicitly **not** true where the receiving spouse is **not** a US citizen.

[78] Instructions to Form 8938 at p. 2. Please *also see* the discussion at Footnote 71 above.

[79] We have struggled with this dual date requirement. It appears, including from the face of the draft Form 8938, that the relevant value for all purposes is the maximum value. If so, the language referencing an end of tax year value is irrelevant. *I.e.,* if the maximum value happens to coincide with the last day of the tax year, so be it. That is the value to be used. If the maximum value is on a date other than the last day of the tax year, the value on the last day of the tax year has no use. We find this unsettling. Please also see discussion at Footnote 71.

[80] The valuation rules are disjointed in the instructions including some apparent inconsistencies. The rules are stated at pages 2, 4, 5 and 6. We have tried to pull these disparate definitions together here and reconcile, if only by inference, some of the inconsistencies.

1. The instructions specifically state we are to use "fair market value" on the various required dates except where otherwise dictated.[81]

    a. In many cases, there is no readily determinable fair market value reported in publically available sources such as "regularly traded on an established securities market".[82] The instructions are silent on this as to what one is supposed to do except the following:

    > An appraisal by a third party is **not** necessary to **estimate** the maximum fair market value during the year.[83] [Emphasis added.]

    We are perfectly uncertain as to what to do. The fair market value of these assets is critical in determining whether or not disclosure is required. Once it is required, the value is a material part of the disclosure. Both the taxpayer and the paid tax preparer sign a USA tax return under penalties of perjury as follows:

    > Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which the preparer has any knowledge.[84]

    So, how is one to attest to a value of an asset not publically traded if there is no appraisal? Are we supposed to attest to a "guess" as to value? What are the consequences if the

---

[81] Instructions to Form 8938 at p 5.

[82] Instructions to Form 8938 at p 4. Classic examples include closely held business interests. However, markets even for some publicly traded instruments may be thin. *E.g.*, the author of this memo distinctly recalls three differing appraised values of a USA municipal bond portfolio where the appraisals were done by two (not three) different large bond investment banks for the same valuation date. The reason for the differing values on the same date for the same bond was the thin trading of these bonds where the value had to be "inferred" from other trades.

[83] Instructions to Form 8938 at p 5.

[84] Form 1040 at p 2.

guessed value proves to be wrong? The IRS always has hind sight when examining a tax return.[85]

We do these appraisals for many USA tax purposes. Indeed, the body of USA law concerning this process is old and very complete. The problem here is these appraisals are very time consuming and costly.

b. Where there are periodic account statements for the tax year, one may rely on those statements to ascertain the financial account's maximum value unless you know or have reason to know based on readily accessible information[86] that the statements do not reflect a reasonable estimate of the maximum account value during the tax year.[87]

---

[85] There are other issues here. The USA imposes a transfer tax on gifts during life and upon the estate at death. That tax is based on values. The definition of "value" for USA gift and estate tax purposes is "fair market value" on the date of the gift or the date of death. Like the USA Federal income tax, its gift and estate tax applies to all US persons regardless of where we may actually reside. Indeed, it actually applies to non-US persons to the extent assets are located in the USA. Even publically traded corporations such as IBM are viewed as sourcing or located in the USA for USA estate tax purposes. Thus, the value listed on this Form 8938 could be used as an "admission against interest" where it differed materially from that shown on a gift or estate tax return with little or no material factual difference where a proper appraisal might be required even though the value shown on Form 8938 is not more than an "informed guess".

[86] This language "you know or have reason to know based on readily accessible information" is used frequently in these instructions. While we sense the purpose is to mitigate compliance burdens, we think the language is imprecise and uncertain from a practical point of view and easily subject to debate. This, combined with certain references in the penalty area, is in no way helpful including to the IRS. It virtually invites dispute.

[87] We are not clear what the authors intend here. The term "account statements" seems to imply what one would typically reference as a "brokerage statement" which would be unlikely to include an asset that is not publically traded and relatively easily valued. One possibility is where a financial institution acts as custodian of certain assets. In the case of closely held businesses where the evidence of that interest is held by a financial institution (typically the trust department), the closely held assets or businesses will often be listed in the accountings by verbal description often with a token "1" monetary unit value. The very purpose of this kind of notional entry is to maintain a correct inventory of assets but also to clearly indicate the value of one or more assets is unknown.

c. As discussed above, there are two valuation dates – one at the end of the tax year and one at the point in the tax year where any given asset has "maximum value". However, the instructions then go on to state that one may use the end of tax year value unless you know or have reason to know based on readily accessible information that the end of year value does not reflect a reasonable estimate of maximum value during the year. This exception does not apply to a financial account. [88]

For the moment, we are inclined to use "net book value" of a privately held enterprise on the date of its local fiscal year using the relevant local financial reporting standards unless there are obvious special or unusual circumstances.

Then there is the issue of currencies:

2. Where the value of the asset is denominated in a foreign currency, it must be converted to US dollar.[89]

    a. The maximum value of the asset must be determined in the foreign currency converted into US dollar. We are directed to use the US Treasury Management Service foreign currency exchange rate for purchasing US dollar (the "buy" rate). Here is the referenced web site www.fms.treas.gov/intn.html .[90]

---

[88] Instructions to Form 8938 at p 5. The instructions use an odd example here:

> **I have publicly-traded foreign stock not held in a financial account that has a fair market value as of the last day of the tax year of US$100,000, although, based on daily price information that is readily available, the 52-week high trading price for the stock results in a maximum value of the stock during the year of US$150,000.** If you are required to file Form 8938, the maximum value of the foreign stock to be reported is US$150,000, based on readily available information of the stock's maximum value during the tax year. [Emphasis in the original to distinguish the question from the answer.]

Thankfully, the authors limit this to publicly traded stock where the taxpayer has taken delivery of the certificate because we would hate to have to do this for everything including stocks held in a brokerage account. And thankfully, they limit it to the "value as of the last day" as we think that limits it to the daily closing price. With high frequency trading running rampant on some bourses, that could otherwise pose an insurmountable problem.

[89] Instructions to Form 8938 at p 5.

[90] The author of this memo is stunned. Firstly, we were embarrassingly unaware of this Treasury web based data. It is dreadful. For starters, it is done only at each calendar quarter end. Small wonder all conversions are done only with the year end rate. The data quality is interesting. *E.g.*, Banco Central de Costa Rica ("BCCR") which is our central bank says the buy rate for US dollar

b. If the US Treasury Management Service exchange rate does not contain a particular currency, we are directed to use "…another publicly available foreign currency exchange rate for purchasing US dollar" and disclose it on Form 8938.

c. The currency determination date is the **last day of the tax year regardless of the valuation date** including where an asset was sold during the tax year.[91] [Emphasis added.]

---

using colon on 30 September 2011 was 508.36; Treasury says it was 507.7. The source of this Treasury data base is curious and may be limiting as to accuracy. According to their web site the source is:

> This quarterly report reflects exchange rates at which the **U.S. government can acquire** foreign currencies **for official expenditures** as **reported by disbursing officers** for each post on the last business day of **the month prior to the date of the published report.** [Emphasis added.] http://www.fms.treas.gov/intn.html

So, among other matters, the data is reported with a month lag. Further, it is limited to the transactions and rate obtainable by Treasury which, we suspect, may differ a bit from that which we or others can obtain in the market place.

Needless to say, currency exchange rates are seldom, if ever, the same rate at the same time relative to all dealers or for all purposes.

For more than a few years, we have used the University of British Columbia Sauder School of Business web site here http://fx.sauder.ubc.ca/data.html and, for the colon, BCCR's web site here http://www.bccr.fi.cr/flat/bccr_flat.htm . Both of these web sites are far superior to Treasury's web site both in terms of content and format. Among many other features, the data on these web sites is exportable into Excel. We find it rather odd that tiny Costa Rica has better data than Treasury.

[91] So, combining Items 2(b) and (c) above, what do we do with a non-calendar quarter tax year end? We think the authors missed this distinct possibility in the future context of non-corporeal persons being required to file this Form 8938 or upon the death of a corporeal person. We trust we would then look to more complete currency exchange rate data bases than those of Treasury?

3. The value of an interest in a foreign trust[92] is its fair market value.[93] We think the foregoing refers to a traditional analysis of the trust's assets, liabilities and relative beneficial interests. Where this information is not "readily available to the specified person beneficiary obligated to report, the 'maximum value' must be used." The maximum value is the sum of:[94]

    a. The value of cash and other property distributed during the tax year.

    b. The value of the right to receive mandatory distributions as of the last day of the tax year using certain statutory valuation tables.[95]

4. The maximum value of your interest in a foreign estate, foreign pension plan[96] and foreign deferred compensation plan is your

[92] Again, these instructions are distressingly imprecise. We assume the authors, without doing so explicitly, intend to reference the definition of a foreign trust found in USA statutory law specifically outlined by means of the interaction of Internal Revenue Code §§ 7701(a)(30)(E) and 7701(a)(31). These provisions define a "United States Person" when in the form of a trust then define a foreign trust as all others. Based on this definition it is entirely possible to have a trust organized, for example, under the laws of the State of Delaware classified as a "foreign trust" as a matter of statutory law for USA tax purposes.

Not all countries have the legal concept of trusts imbedded in their legal systems. Many have legal entities or arrangements which serve similar societal purposes. The instructions are silent on this point.

[93] Instructions to Form 8938 at p 2.

[94] Instructions to Form 8938 at p 5.

[95] The valuation tables are those referenced in IRC §7520 which are used to value an annuity where the discount rate is approximately equal to 120% of the Federal midterm rate under IRC §1274(d)(1).

We understand the authors' intent with reference to "mandatory distributions". However, many mandatory distribution provisions in trusts and estates are not phrased in fixed monetary terms. *E.g.*, the trustee may be required to distribute all income to a current beneficiary such as a surviving spouse while retaining principal for distribution to children upon the demise of the surviving spouse. Even the trustee may not know what future maximum distributions will be in absolute monetary terms as the "income" of the trust varies over time due to the nature of its investments.

[96] The authors omit explicit reference to what we would call an annuity. With some frequency, these are used as pension-like savings and look a lot like a pension plan. In many cases, they may not be easily valued. In some cases they would be using simple present value calculations albeit the discount rate could vary. It would seem reasonable to include them here.

beneficial interest in the assets of the estate, pension plan or deferred compensation plan determined on the last day of the tax year.[97] If you do not know or have no reason to know based upon readily accessible information, the maximum value is the cash and value of other property received by you during the tax year. Where no distributions are made during the tax year, the value is zero.[98]

5. A specified financial asset with no positive value is listed as zero.[99]

The reference to pension plans here is curious and not necessarily conceptually incorrect. What is curious is there was no explicit reference to foreign pension plans with respect to Form TD F 90-22.1 Report of Foreign Bank and Financial Accounts. We typically include them.

Finally, the very term "pension plan" is not defined. This also may sound silly. But, for example, here in Costa Rica, we have effectively two mandated pension vehicles in our employment law. First, we have a truly public system that could be vaguely analogized to Social Security in the USA. Second, we have a mandated second system where the employer and employee are required to make periodic contributions into a system which somewhat resembles a "401(k)" in the USA. We can value the second based on assets but we do not see how we would value the former.

There is also a mandated system in Costa Rica to address unemployment benefits which is fundamentally different than the USA system. The Costa Rican system includes a point in time where the liability for the contingent unemployment benefit "accrued" on the employers' books reverts to the employee. Arguably, this could be viewed as a foreign financial asset of the employee as the account's ownership (dominion and control) shifts by operation of Costa Rican employment law.

The Instructions to Form 8938 at p 4 do state "[a]n interest in a social security, social insurance, or similar program **of a foreign government** is not a specified foreign financial asset." [Emphasis added.] The word "of" is different than a word such as "mandated by". *E.g.*, Costa Rica's unemployment compensation regime is mandated by Costa Rican law but is administered privately.

There are similar issues in other countries.

[97] Instructions to Form 8938 at p 6. The instructions do not explicitly address liabilities of an estate, trust or similar. It is common for an estate or trust to have liabilities if only accrued trustee and professional fees. Given the overall definition of value (fair market value), one would logically subtract the fair market value of any liabilities in determining the fair market value of an interest in a trust, estate or similar.

[98] There is a notable difference here relative to trusts. With trusts, one is directed to include a present value of future mandatory distributions where one does not have ready access to the actual assets of the trust. The corollary here is notably absent.

[99] Some valuation experts will assert that an asset can never have a negative value. They are flat out wrong. *E.g.,* one can own land which is the functional equivalent of Love Canal (a superfund site deeply and heavily polluted). The liability to clean up these sites imposed on the owner can easily outstrip any "positive" value. The owners of these sites will readily attest to the "negative" value they experienced.

Exceptions to reporting

Other than those implicit in the discussion above, there are a few exceptions to reporting.

Financial accounts[100]

Before we even start with these two exceptions, these are exceptions to **reporting**. The authors are explicit that these accounts must still be **considered in determining the thresholds** for filing Form 8938.[101] Thus, the exceptions for many are effectively moot. For the average specified person, we still have to gather all of the information and make all of the necessary determinations so no time or effort is saved often by those least able to afford the cost.

1. The authors include specific reference to a financial account maintained by a "US payer". They specifically note that a financial account in a domestic branch of a foreign bank or foreign insurance company and the foreign branch or foreign subsidiary of a US financial institution[102] are not required to be reported.

2. The authors also include specific reference to a financial account maintained by a dealer or trader in securities or commodities if the assets within that account are required to be marked to market according to the rules applicable to dealers in securities or there is an election under IRC §475(e) or (f).

The key words in Item 1 above are "US payor" and "branch".

A US payor is defined at Treas. Reg. §1.6049-5(c)(5)(i) as:[103]

---

[100] Instructions to Form 8938 at p 6.

[101] Instructions to From 8938 at p 6.

[102] We do not understand this reference to a "foreign subsidiary of a US financial institution". This also seems to render some discussion above to be moot. However, one can easily picture a multi-national chain of subsidiaries under the US financial institution or even indirect ownership. Indeed, over the years, we have seen such indirect chains in global financial institutions which we have represented.

Thus, we would be seriously reluctant to rely up this exception. Further, it is an exception to reporting but still must be counted for purposes of determining the threshold for filing.

[103] Treas. Reg. §1.6049-5 generally discusses when the payor of interest and original issue discount must independently report the amount of that interest, as defined, or original issue discount to the IRS by means of such forms as Form 1099 in its various iterations. Notably absent is any discussion of when a person must report dividends or the gross proceeds of sales where the financial account is akin to a brokerage account with the financial institution acting as custodian and intermediary.

(A) A person described in section 7701(a)(30) (including a foreign branch or office of such person);[104]

(B) The government of the United States or the government of any State or political subdivision thereof (or any agency or instrumentality of any of the forgoing);

(C) A controlled foreign corporation within the meaning of section 967(a);[105]

(D) A foreign partnership, if at any time of the tax year, one of more of its partners are US persons (as defined in §1.1441-1(c)(2)) who, in the aggregate hold more than 50 percent of the income or capital interest in the partnership or if, at time during its tax year, it is engaged in the conduct or a trade or business in the United States.[106]

(E) A foreign person 50 percent or more of the gross income of which, from all sources for the three-year period ending with the close of its taxable year preceding the collection or payment (or such part of such period as the person has been in existence), was effectively connected with the conduct of trade or business within the United States; or

(F) A U.S. branch of a foreign bank or a foreign insurance company described in §1.1441-1(b)(2)(iv).

A branch is where the foreign entity operates directly within the foreign jurisdiction without forming a local legal entity as a subsidiary. From the account holders' point of view, it is often difficult to ascertain. The letterheads used by the multi-nationals are often intentionally vague. *E.g.,* one will see "CitiGroup" or

---

[104] IRC §7701(a)(30) is the provision within the IRC which defines "person" to include far more than natural or corporeal persons.

[105] A controlled foreign corporation is where a foreign legal entity is viewed as a "corporation" for USA income tax purposes but controlled by US persons. A foreign corporation becomes a controlled foreign corporation when more than 50% of the total combined voting power of all classes of its voting stock is owned or considered to be owned by US shareholders. A US shareholder is a person as defined at IRC §957(c) who owns or is considered to own at least 10% of the total combined voting power of all classes of stock.

[106] Treas. Reg. §1.1441-1(c)(2) defines foreign and US persons for purposes of out bound USA withholding taxes. We would observe here that a single owner disregarded entity whether foreign or domestic is not generally viewed as a "partnership".

"UBS" without more except sometimes in the very fine print. The key appears to be the preface of "a US payor".

Essentially, Item 1 seems to intend to except from reporting on Form 8938 an otherwise foreign financial account held in a foreign "institution" within or outside of the USA which is required to issue a Form 1099 of one sort or another[107] in connection with interest income. We had occasion to ask a member of the management of CitiGroup here in Costa Rica. She assured us that CitiGroup operates in Costa Rica as a "branch" but was unclear as to the actual subsidiary within CitiGroup was operating in Costa Rica.[108] We have clients with accounts at CitiGroup here in Costa Rica and have yet to see a Form 1099 issued in connection with those accounts in the Costa Rican branch.

Further, due to the look through rules, CitiGroup in Costa Rica may well and fairly not know that any given account is subject to USA income tax and disclosure such as where the account is held by a local Costa Rican legal entity. GICB would be a classic example.[109]

On the other hand and in the other direction, it is plain that UBS Financial Services, Inc. is a USA legal entity which is a direct or indirect subsidiary of UBS AG, a Swiss legal entity. UBS US most assuredly does issue Forms 1099.

Observations:

1. USA individual taxpayers and their advisors simply cannot invest the time to determine whether any given "bank" fits within the exception discussed at Item 1 above even assuming this were possible. There is no penalty for disclosing an account not otherwise required to be disclosed. Thus, we generally think the better position is to include all foreign financial accounts even where one might suspect an exception to **reporting** for filing applies or may apply in the threshold determination.

---

[107] The USA tax law requires many to file various Forms 1099 when, for example, a bank pays interest on a demand deposit account or a corporation pays dividends to its owners. In addition to filing these forms with the IRS, the payor is also required to send a copy to the person receiving the funds.

[108] It is conceivable that CitiGroup or others operating as branches within Costa Rica may be branches of a non-USA legal entity, as opposed to a USA legal entity which is more directly a subsidiary of the USA bank holding company.

[109] Generally, we must disclose to the bank ownership of the legal entity but that does not guarantee that USA Forms 1099 or similar would get filed even assuming they are otherwise required.

2. These exceptions to reporting are largely inward looking with respect to the issuing institutions. Yet, the reporting burden is imposed upon what is most often likely to be an external account holder. The external account holder upon which the reporting burden is placed likely has little ability to gather the data necessary to administer the exception and prove the exception in the event of fiscal authority inquiry. This is indicia of bad rule making as it unnecessarily sets up a potential point of disagreement which is not good for either taxpayers or the fiscal authorities.

The second exception or Item 2 above is limited to dealers in securities and commodities. It is so limited in scope that we are not going to discuss it further here.

Foreign grantor trusts[110]

A grantor trust generally arises when the person who created the trust retains certain powers over the beneficial interests. The USA Federal income tax consequence is the grantor trust is wholly or partially ignored for USA Federal income tax purposes with its income, gains, deductions and losses included in the grantor's USA Federal income tax return and, consequently, taxable income. This can occur in whole or part with respect to any given trust.

We previously dealt with the definition of a foreign trust.

Again, this really is not an exception. In order to not include the trust in one's Form 8938, one must have:

1. Timely filed Form 3520 annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.

   and

2. The foreign trust has timely filed Form 3520-A Annual Information Return of Foreign Trust With a U.S. Owner.

Reference to the foreign trust is still made directly on Form 8938 and it is still used to assess the threshold but the data in more detailed format is provided on a different form namely Forms 3520 and 3520-A. Thus, this is, at best, a reduction of data redundancy within USA Federal income tax returns.

[110] Instructions to Form 8938 at p 6.

Domestic investment trusts[111]

This is a subset of the grantor trust issue. Please note it is limited to those investment trusts **organized within the USA**. *E.g*., Canada is **not** a state within the USA.[112] This exception applies to “widely-held fixed investment trusts” which are governed by Treas. Reg. §1.671-5. To use common parlance, these are the trusts which are used to facilitate the securitization of certain assets in the USA. Some of these trusts may hold foreign financial assets. Many of the trust units are publicly traded. The sole purpose of this provision is to exempt the owner or beneficiaries of these trusts from having to report on Form 8938 foreign financial assets that may be included in the trusts. These trusts are obligated to provide their owners or beneficiaries with forms advising the beneficiaries of their allocable share of components of the trusts’ income, gains, deductions and losses for USA Federal income tax purposes. Thus, there is little need for additional reporting.

We also observe that the authors indicate one does not have to “report” any foreign financial asset within these trusts. When the word “report” was used previously, one still had to consider the foreign financial assets in determining the threshold levels for filing Form 8938. This exception for domestic investment trusts is below the authors’ explicit distinction with respect to other exceptions. Thus, it is unclear as to whether this is a full exception or merely a reporting exception.[113]

Domestic bankruptcy trusts[114]

The instructions provide that if one is deemed to be one of the owners under the grantor trust rules of any part of a domestic liquidating trust[115] in connection with Bankruptcy Code Chaps. 7 or 11, the **beneficiaries** (creditors in the case of

[111] Instructions to Form 8938 at p 6.

[112] We see from time to time certain publicly traded investment vehicles largely in the mineral and extraction industries which source in Canada. These are foreign financial assets and are not subject to these exceptions. The point of our sarcasm is many fail to consider that Canada is as “foreign” to the USA as Costa Rica. Thus, these rules, unless modified within the USA/Canadian tax treaty apply when Canada is the counterparty.

[113] In many cases, the investor or beneficiary of these investment trusts would be hard pressed to divine the necessary data from the typical reports they receive from the trustees. They would also likely not have sufficient influence over any given trustee to insist upon direct and specific requests for additional information.

[114] Instructions to Form 8938 at p 6.

[115] These are liquidating trusts as defined under Treas. Reg. 301.7701-4(d).

bankruptcy) do not have to report any specified foreign financial asset which is viewed as part of the trust.

Notably absent from this provision is the reporting the trustee or trust itself might otherwise be required to do now or in the future as these rules evolve.

Other exceptions[116]

For those who are *bona fide* residents of US possessions, there are several limited exceptions. Believe it or not, there is a specific definition of "a *bona fide* resident of US possessions" through reference to a series of provisions in the IRC. Firstly, a "US possession" for this purpose includes American Samoa, Guam, the Northern Mariana Islands and Puerto Rico. Special mention is made with respect to the US Virgin Islands.[117] A person is a *bona fide* resident of a US possession if the person is physically present in that possession during the tax year, does not have a tax home elsewhere and does not have a closer connection to the USA or a foreign country during the tax year.[118] For those who are *bona fide* residents of US possessions, here are the exceptions to reporting:[119]

- A financial account maintained by a financial institution organized under the laws of the US possession of which you are a *bona fide* resident.

- A financial account maintained by a branch of a financial institution not organized under the laws of the US possession of which you are a *bona fide* resident, if the branch is subject to the same tax and information reporting requirements that apply to a financial institution organized under the laws of the US possession.[120]

[116] Instructions to Form 8938 at p 6.

[117] Please note the locations relevant to the exception to reporting differ from those defining "specified persons" subject to actually filing this Form 8938.

[118] IRC §§876 and 937 and Treas. Reg. §1.937-1.

[119] Again, the authors use the word "reporting" and again below the section where they address that word. At least in some areas (possibly all), an exception from "reporting" still requires one to consider the value of the otherwise foreign financial assets in determining the threshold value for filing Form 8938. It is entirely unclear what one is supposed to do if the value of one's foreign financial assets exceeds the threshold amount but, based on the reporting exceptions, there would be nothing to actually include in the Form 8938. This is particularly relevant here where a *bona fide* resident of a US possession had their entire wealth invested within that same US possession and their wealth slightly or greatly exceeds the relatively modest threshold levels. *E.g.*, a retiree living in a US possession.

[120] Here again the person responsible for reporting, or not, is charged with peering inside a financial institution's legal structure and the reporting requirements imposed upon it.

- Stock or securities issued by an entity organized under the laws of the US possession of which you are a *bona fide* resident.

- An interest in an entity organized under the laws of the US possession of which you are a *bona fide* resident.

- A financial instrument or contract held for investment, provided each issuer or counterparty that is not a US person is either an entity organized under the laws of the US possession of which you are a bona fide resident or a bona fide resident of the US possession of which you are a bona fide resident.[121]

The overall purpose is plain. The authors intend to redefine "foreign" to exclude the US possession in which a person resides.

Penalties[122]

This required disclosure in no way impacts any USA Federal income tax otherwise due. Further, there is no filing or similar fee. But, the penalties for failure to comply are huge. Here they are:

> If one fails to file a **complete** and **correct** Form 8938 by the due date,[123] one may be subject to a penalty of US$10,000.00 for each tax year of failure. Please note that if the Form 8938 is either incomplete or incorrect, this penalty explicitly applies. It is not limited to a mere and blatant failure to file the form.

---

[121] Incredibly circular and requires, in spades, that the person responsible for reporting is nearly certainly unable to ascertain facts which are internal to a financial institution or other legal entity or entities in a tiered structure.

[122] Instructions to Form 8938 at p 6.

[123] The due date for USA Federal income tax returns for natural or corporeal persons is the 15th day of the fourth month following their tax year end. For the vast majority, that is 15 April of the following year – *i.e.*, 15 April 2012 for tax years ended 31 December 2011. If a request to extend the due date for filing the return is timely filed with **all actual income tax due fully paid at that time**, the due date for filing a USA individual's income tax return where their tax year end is 31 December, can be extended to 15 October of the following year. If the actual tax is not paid in full at the time of the request for extension of time to file, the extension of time to file is likely to be deemed invalid. There are some special provisions for those not in the USA on 15 April of the following year but they are limited and should not be relied upon. These due dates and their extension apply to the Form 8938 as it is included with US persons' USA Federal income tax return.

If one continues to fail to file a complete and correct Form 8938 within 90 days after the IRS mails (delivered or not) a notice,[124] one may be subject to an additional US$10,000.00 penalty for each 30-day period, or part thereof, during which one's failure to file continues. The maximum additional penalty is limited to US$50,000.00 resulting in a total maximum penalty of US$60,000.00 for each tax year of failure.

If you filed a joint USA Federal income tax return with your spouse, the penalties effectively double from those discussed above. As with any tax reflected on the USA Federal income tax return, each spouse is jointly and severally liable for all of the penalties associated with either.[125]

If the IRS determines that one has an interest in any specified foreign financial asset and requests information as to its value and one does not provide "enough" information for the IRS to determine value with respect to the reporting thresholds, one is presumed to meet the relevant reporting threshold. This will likely trip the failure to file penalties.[126]

The penalties will not be imposed where the taxpayer can show failure to file or failure to disclose a particular asset on a filing is due to reasonable cause. However, they explicitly state that reasonable cause does not include the circumstance where a foreign jurisdiction would impose a civil or criminal penalty for disclosure of the information required by the USA.[127]

---

[124] We are seeing an ever increasing level of notices from the IRS where the address on the notice in no way resembles the taxpayer's address as reflected on their income tax returns.

[125] Here is that joint filing again. Remember, this election pulls in all of this disclosure for "foreign financial assets" in which the non-US person may have an interest. So, the compliance risks magnify in multiple directions when a non-US person spouse agrees to file a "joint income tax return" with the US person spouse.

[126] This is rather onerous and flies in the face of the authors' specific statement elsewhere that appraisals are not necessary for closely held or similar businesses and other foreign financail assets. Given the extensive USA Federal tax law concerning the determination of fair market value, the IRS will likely ask for all of the information one would request in connection with a "qualified appraisal", as defined in the IRC and Treasury Regulations, among other sources.

[127] This is in direct response to the UBS cases and similar where foreign financial institutions tried to assert application of the Swiss bank and other nation state secrecy laws. We are not sure how they would apply here to the extent these rules are limited to the US natural or corporeal person owners of these assets. Given the apparent intent of Treasury to expand those who are required to file this Form 8938, one can imagine fact patterns where this issue might arise.

> There is an "accuracy" penalty. If one underpays one's tax (not merely understates the asset value) sourcing in a transaction involving an undisclosed foreign financial asset, one may be assessed a penalty equal to 40% of the underpayment. This is very broad. It is in no way limited to any given tax year. Language such as "sourcing in a transaction" or "involving" leave the field wide open.
>
> If one underpays tax due to fraud, one must pay a penalty of 75% of the underpayment of tax due to the fraud.

Further, criminal penalties may apply if:

- One merely fails to file Form 8938.

- One fails to report an asset on Form 8938.

  or

- There is an underpayment of tax.

On the draft of the Form 8938 which we have, the maximum value designation of "other foreign assets" is a series of ranges of value until the value is more than US$200,000, in which case specificity of value is required. This may mitigate some of the risk of asset valuation disputes for some. It does not minimize the risk with respect to determining the value threshold which trips the filing and reporting.

Given the foregoing, one otherwise required to do so would be well advised to file this form to the very best of their ability resolving all differences of view in favor of Treasury and the IRS. This is not to imply that we agree with the policy or implementation. But, where there is no tax otherwise due and no filing fee combined with very aggressive and broad based penalties, including criminal, disclosure is cheap insurance of restful sleep.

Statute of limitations

Here we applaud the authors. They are explicit and correct:

> If you fail to file Form 8938 or fail to report a specified foreign financial asset that you are required to report, the statute of limitations for the tax year may remain open for all or a part of your income tax return until 3 years **after the date on which you file** [a complete] Form 8938. [Emphasis added.][128]

They go on to say:

> If you do not include in your gross income an amount relating to one or more specified foreign financial assets, and the amount you omit is more than US$5,000, any tax you owe for the tax year can be assessed at any time within 6 years after you filed [sic] your return.[129]

Further, the threshold for filing becomes moot.

This goes to the heart of our consistent advice to clients over the years. Our annual income tax returns and Treasury filings are **permanent records** including proof of filing and proof of payment. Regardless of what one reads in the popular press, these records should **not** be destroyed even four years after filing. This is especially true today as we see an ever rising tide of lost or mangled records at the fiscal authorities. If they lost the filing or think they received less than the whole, they invariably assert the statute of limitations has not run no matter how obvious the error on their side of the house may appear.[130] The burden of proof is always on the taxpayer.

Of course, the usual preparer penalties would also come into the picture where otherwise appropriate.

---

[128] Instructions to Form 8938 at p 7. Please bear in mind that, where a mistake has been made, these forms can and should be amended to correct the error.

[129] Instructions to Form 8938 at p 7.

[130] With electronic filing, we receive a confirmation of receipt of a return from the IRS. We are told with respect to the 2010 filings, all returns containing a particular form related to foreign investments were acknowledged as received. In fact, the particular form was not received through the electronic remittance process. Thus, all of those 2010 returns had to be re-filed. Fortunately, the IRS did send a notice to this effect. However, the problems continue to mount.

Insult to injury

The Treasury and IRS are required as a matter of law to include at the end of the instructions to each form an estimate of the average time needed to complete and file the form in question. With respect to this Form 8938, the IRS informs us that the average time to complete and file it is “1 hour and 5 minutes”.[131]

# # # # #

Many of you who know me know that I am a huge fan of science fiction. One of my favorite authors is Dr. Isaac Asimov. His seminal work, in my view, is *The Foundation Trilogy* first published in 1951. *The Foundation Trilogy* is based upon Dr. Asimov’s view of a failed culture or civilization, the renewal of a dark age and the efforts made to mitigate and shorten that time of human suffering.

In the opening chapters, Dr. Asimov describes the seat of governance or the capital of the 1st Empire which is the planet Trantor. He describes what sounds like an eco disaster where the planet is hollowed out by prior mining, water resources are scarce and the planet requires an artificial shell to retain its atmosphere. There is a description of the last green area in front of the palace – I have never been sure – it is either the Boston Garden or Central Park – Dr. Asimov was a professor of biochemistry at Boston University. Trantor is fully dependent on the outer worlds for all of the necessities of life including energy and food. Politics and governance are fully corrupt.

However, Dr. Asimov describes in one paragraph which many miss the true cause of the failure of the 1st Empire. The true cause of the 1st Empire’s failure was an excessively complex tax regime consuming far too much human talent which could have been used elsewhere to solve humanity’s greater problems.

[131] Instructions to Form 8938 at p 9.