Unlimited Assessment-Period for Form 8938 Violations: Ruling Shows IRS's Intent to Attack Multiple Tax Returns

By Hale E. Sheppard[*]

Hale E. Sheppard examines the assessment period for the Form 8938 and discusses the fact that it essentially remains open forever, unless and until the taxpayer files Form 8938.

I. Introduction

You do not need to be Nostradamus to make this prediction: Thousands of taxpayers and their advisors will struggle with the complexities of Form 8938, *Statement of Specified Foreign Financial Assets,* while preparing tax returns for 2016. The rules regarding the disclosure of foreign financial assets have been long, dense, and complicated since their inception in 2010, but things got increasingly tricky in 2016, when the IRS expanded the Form 8938 filing duty to both specified individuals (SIs) and specified domestic entities (SDEs). Previous articles contain a comprehensive analysis of Form 8938 reporting rules, so they will not be covered again here at length.[1] This current article focuses on one of the least appreciated aspects of Form 8938, *i.e.*, the fact that the assessment-period essentially remains open forever, unless and until the taxpayer files Form 8938. This gives the IRS boundless opportunities to audit and assert taxes, penalties, and interest, and it forces taxpayers and their advisors to consider different strategies than those of yesteryear for approaching the IRS to resolve international tax noncompliance.

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II. Overview of Foreign Financial Asset Reporting

A. A Little History

Code Sec. 6038D, which mandates the filing of Form 8938, was enacted in March 2010 as part of the Foreign Account Tax Compliance Act (FATCA).[2] The IRS began taking regulatory actions about one-and-a-half years later, in December 2011. At that time, the IRS published temporary regulations introducing rules applicable only to SIs, which took immediate effect.[3] At that same time, the IRS released proposed regulations explaining how SDEs might be affected by Code Sec. 6038D in the future.[4]

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The IRS acted again three years later, in December 2014, when it made certain changes to the temporary SI regulations and published them in final form ("Final SI Regulations").[5] The IRS did not provide updated guidance regarding SDEs at that juncture, though.

In February 2016, nearly six years after Congress first unveiled Code Sec. 6038D, the IRS released the SDE regulations in final form ("Final SDE Regulations").[6] The most significant impact was that the Form 8938 filing duty would apply from 2016 onward to both SIs and SDEs. The Final SDE Regulations impact tax years that start after December 31, 2015; therefore, for calendar-year taxpayers, the first relevant year will be 2016.[7] This expansion of the Form 8938 filing duty to SDEs constitutes a major change, one that will obligate many taxpayers, accountants, return preparers, advisors, *etc.,* to dig into the convoluted guidance for the first time.

B. Breakdown of the Filing Duty

The general rule in Code Sec. 6038D(a) can be divided into the following parts:

- Any specified person (SP), which now includes both SIs and SDEs
- Who/that holds an interest
- In a specified foreign financial asset (SFFA)
- During any portion of a tax year
- Must attach to his/her/its timely tax return
- A complete and accurate Form 8938
- If the aggregate value of all SFFAs
- Exceeds the applicable filing threshold

C. Review of Major Issues Related to Form 8938

As indicated in the introductory paragraph, the author of this article has previously published several pieces featuring an in-depth analysis of all Form 8938 reporting rules, so the details will not be repeated here. For purposes of this article, suffice it to address a few of the major issues unique to Form 8938.

1. Who Must File a Form 8938?

Forms 8938 must now be filed by both SIs and SDEs. This merits a quick review of the relevant terminology.

The following categories of individuals ordinarily are considered SIs: (i) U.S. citizens, (ii) individuals who are U.S. residents for any portion of the relevant year, (iii) nonresident aliens who affirmatively elect under Code Sec. 6013(g) or Code Sec. 6013(h) to be treated as U.S. residents for federal tax purposes, (iv) nonresident aliens who are *bona fide* residents of Puerto Rico, and (v) nonresident aliens who are *bona fide* residents of a so-called Section 931 Possession, which, at this point, means American Samoa.[8]

For its part, the term SDE means (i) a domestic corporation, a domestic partnership, or a domestic trust (ii) that was "formed or availed of" for purposes of holding, either directly or indirectly, (iii) SFFAs.[9] More on this complicated, new definition is provided later in this article.

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

Holding an interest in an asset means different things in different contexts. When it comes to Form 8938, an SP generally holds an interest in an SFFA if any income, gains, losses, deductions, credits, gross proceeds or distributions attributable to the holding or disposition of the SFFA are (or should be) reported, included, or otherwise reflected on the SP's annual tax return.[10] The regulations clarify that an SP has an interest in the SFFA *even if* no income, gains, losses, deductions, credits, gross proceeds, or distributions are attributable to the holding or disposition of the SFFA for the year in question.[11] The regulations also indicate that an SP must file a Form 8938, despite the fact that none of the SFFAs that must be reported affect the U.S. tax liability of the SP for the year.[12]

3. What Types of Assets Constitute SFFAs?

For purposes of Code Sec. 6038D, the term SFFA includes two major categories: (i) foreign financial accounts[13] and (ii) other foreign financial assets, which are held for investment purposes.[14] A brief overview of each category is provided below.

a. Foreign Financial Accounts. The concept of "financial account" for purposes of Form 8938 is complicated for several reasons, one of which is that the definition is not even found in the applicable statute, Code Sec. 6038D, or the corresponding regulations. Instead, it is located in the international tax withholding provision, Code Sec. 1471, and its ultra-dense regulations.[15]

i. Items Considered "Financial Accounts". Depository accounts are considered "financial accounts" for purposes of Form 8938. In this context, the term "depository accounts" generally encompasses (i) commercial accounts; (ii) savings accounts; (iii) time-deposit accounts; (iv) thrift accounts; (v) accounts evidenced by a certificate of deposit, thrift certificate, investment certificate, passbook, certificate of indebtedness or any other instrument for placing money in the custody of an entity engaged in a banking or similar business for which the entity is obligated to give credit, regardless of whether such instrument is interest-bearing or non-interest-bearing; and (vi) any amount held by an insurance company under a guaranteed investment contract or similar agreement to pay or credit interest.[16]

- Custodial accounts are deemed to be "financial accounts" for purposes of Form 8938. Here, the term "custodial accounts" ordinarily means an arrangement for holding for the benefit of another person a financial instrument, contract or investment, such as shares of corporate stock, promissory notes, bonds, debentures, other evidences of debt, currency or commodity transactions, credit default swaps, swaps based on a nonfinancial index, notional principal contracts, insurance policies, annuity contracts and any options or other derivative instruments.[17]
- Equity or debt interests in a foreign financial institution, other than interests regularly traded on established securities markets, generally are categorized as "financial accounts."[18]
- The term "financial account" also includes "cash value insurance contracts" and certain types of annuity contracts issued or maintained by an insurance company, a holding company for an insurance company, or certain foreign financial institutions.[19]
- Tax-favored foreign retirement accounts, foreign pension accounts, and foreign nonretirement savings accounts meeting certain criteria are treated as "financial accounts" for purposes of Form 8938.[20] Notably, even if these items have been excluded from the definition of "financial account" pursuant to an intergovernmental agreement (IGA) between the United States and a foreign country to implement FATCA, they will still be considered "financial accounts" for purposes of Form 8938. In other words, while foreign governments and financial institutions are not required to provide data to the IRS pursuant to FATCA about certain retirement-type accounts, SPs holding an interest in such accounts will not benefit from such an accommodation.[21]

ii. Items Not Considered "Financial Accounts". Certain term life insurance contracts are not considered "financial accounts."[22]

- Accounts held by an estate of an individual will not be considered "financial accounts," if the documentation for such accounts includes a copy of the deceased's will or death certificate.[23]
- Certain escrow accounts escape the definition of "financial account."[24]
- A noninvestment linked, nontransferable, immediate life annuity contract that monetizes certain types of retirement or pension accounts will not be classified as a "financial account."[25]
- An account or product that is excluded from the definition of "financial account" under an IGA (other than certain tax-favored foreign retirement accounts, foreign pension accounts, and foreign nonretirement savings accounts) will not be considered a "financial account."[26]
- Accounts held with "U.S. payors" are not deemed to be "financial accounts."[27] The regulations broadly define the term "U.S. payor" as a "U.S. person," which includes a foreign branch of the U.S. person, a foreign office of the U.S. person, and a U.S. branch of certain foreign banks and foreign insurance companies.[28] Examples of financial accounts that are exempt from reporting on Form 8938 because they are held with "U.S. payors" include U.S. mutual funds, U.S. individual retirement accounts, Code Sec. 401(k) retirement accounts, qualified U.S. retirement plans, and brokerage/investment accounts maintained by U.S. financial institutions.[29]
- Accounts whose holdings are subject to the mark-to-market rules under Code Sec. 475 are not considered "financial accounts" for purposes of Form 8938.[30]

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

i. Items That Are Considered Other SFFAs. The term SFFA also encompasses certain other assets that do not meet the broad definition of "financial account" and that are held for investment purposes. Among these assets are (i) stocks or securities issued by a non-U.S.-person, (ii) financial instruments or contracts held for investment purposes whose issuer or counterparty is a non-U.S.-person and (iii) any interest in a foreign entity.[31] The IRS has recognized that creating such expansive categories leads to redundancies:

> These three categories [of other SFFAs] are broad and overlap in certain cases such that an asset not held in a financial account may be within more than one of the statutory categories … For example, stock issued by a foreign corporation is stock that is issued by a person other than an U.S. person, and is also an interest in a foreign entity.[32]

The regulations enlarge and clarify the categories, identifying the following items as SFFAs: (i) stock issued by a foreign corporation; (ii) a capital interest or profits interest in a foreign partnership; (iii) a note, bond, debenture or other form of debt issued by a foreign person; (iv) an interest in a foreign trust; (v) an interest swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap or similar agreement with a foreign counterparty; and (vi) any option or other derivative instrument with respect to any of the items listed as examples or with respect to any currency or commodity that is entered into with a foreign counterparty or issuer.[33]

ii. Items That Are Not Considered Other SFFAs. The IRS guidance *excludes* two types of foreign assets from classification as SFFAs. First, various sources state that an interest in a social security, social insurance, or other similar program of a foreign government is not an SFFA.[34] Second, an interest in a foreign trust or a foreign estate is not an SFFA, unless the SP either knows or has reason to know of the existence of the interest based on readily accessible information.[35] Receipt by the SP of a distribution from the foreign trust or foreign estate constitutes actual knowledge of its existence for purposes of Code Sec. 6038D; that is, an SP who receives cash or other property from a foreign trust or estate during a given year is prohibited from later denying its existence when it comes to reporting it on Form 8938.[36]

III. New Rules Concerning SDEs in 2016

The biggest change by the Final SDE Regulations issued in 2016 was the introduction of the long-awaited Reg. §1.6038D-6, which contains nearly all rules pertaining to SDEs. Certain aspects of this new guidance are set forth below.

A. What Is an SDE?

1. General Definition

An SDE is defined as (i) a domestic corporation, a domestic partnership or a domestic trust (ii) that was "formed or availed of" for purposes of holding, either directly or indirectly, (iii) SFFAs.[37]

2. What Is a "Domestic" Entity?

Although not defined in Code Sec. 6038D or the regulations thereunder, and although certain tax professionals might cavalierly overlook this aspect, it is important to start with the basics. The term "domestic," when applied to a corporation or partnership, generally means an entity created or organized in the United States, under the law of the United States, or under the law of any state.[38] For its part, a trust is considered "domestic" if a court within the United States is able to exercise primary supervision over the administration of the trust, and one or more U.S. persons have the authority to control all substantial decisions of the trust.[39]

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

a. Rules for Domestic Corporations and Partnerships (But Not for Domestic Trusts). The general rule is that a domestic corporation or a domestic partnership was "formed or availed of" for purposes of holding SFFAs if it meets *both* of the following two tests.[40]

- *Test #1*. The domestic corporation or domestic partnership is "closely held" by an SI.[41]
- *Test #2*. At least 50 percent of the gross income of the domestic corporation or the domestic partnership for the relevant year is "passive income" (*i.e.*, the 50-Percent-Or-More-Passive-Income Test) *or* at least 50 percent of the assets held by the domestic corporation or the domestic partnership for the relevant year are assets that actually produce or are held for the production of "passive income" (*i.e.*, the 50-Percent-Or-More-Passive-Asset Test).[42]

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

Generally, Test #1 is satisfied if the domestic corporation or domestic partnership is "closely held" by an SI, as this concept is defined under the Final SDE Regulations. A domestic corporation is "closely held" by an SI if at least 80 percent of the stock (by vote or value) is owned (directly or indirectly or constructively) by an SI on the last day of the corporation's tax year.[43] Similarly, a domestic partnership is "closely held" by an SI if at least 80 percent of the capital or profits interest in the partnership is owned (directly or indirectly or constructively) by an SI on the last day of the partnership's tax year.[44]

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

Generally, the portion of gross income consisting of the following items constitutes "passive income" in the context of an SDE: (i) dividends, including substitute-dividends; (ii) interest; (iii) income equivalent to interest, including substitute-interest; (iv) rents and royalties, other than rents and royalties derived in the active conduct of a trade or business that is conducted, at least in part, by employees of the corporation or partnership; (v) annuities; (vi) the excess of gains over losses from the sale or exchange of property that gives rise to any of the types of passive income described previously in this paragraph; (vii) the excess of gains over losses from transactions (including futures, forwards and similar transactions) in any commodity, with certain exceptions; (viii) the excess of foreign currency gains over foreign currency losses (as defined in Code Sec. 988(b)) attributable to any Code Sec. 988 transaction; and (ix) net income from notional principal contracts as defined in Reg. §1.446-3(c)(1).[45]

IV. So Many Ways to Go Wrong

If your conclusion after reading the article up to this point is that the Form 8938 rules are extraordinarily complicated and opaque, join the crowd. Also, please keep in mind that the analysis above was merely partial, a look at only a few of the numerous rules, definitions, exceptions, *etc*. A thorough review of *all* the pertinent data would scare and/or bore the heck out of most readers and would confirm that Code Sec. 6038D, the Final SI Regulations, and the Final SDE Regulations contain more than their share of the proverbial "traps for the unwary." For purposes of this article, it is enough to recognize that taxpayers and advisors, even those with the best of intentions and considerable tax acumen, could easily find themselves in problems by not filing Forms 8938, filing late Forms 8938, or filing inaccurate or incomplete Forms 8938. These types of violations necessitate the discussion, below, about the critical, yet unappreciated, consequences of running afoul of the Form 8938 rules.

V. Form 8938—Penalties and Assessment-Period Extensions

Breaches of Form 8938 duties can trigger several bad results for SPs.

A. Penalties Generally

If an SP fails to file the Form 8938 in a timely manner, then the SP "shall" pay a penalty of $10,000.[46] The penalty increases if the SP does not rectify the problem quickly after contact from the IRS. In particular, if the SP has not filed a Form 8938 within 90 days after the day on which the IRS sends a notice about the missing return, then, in addition to the initial penalty of $10,000, the SP "shall" pay another penalty of $10,000 for each 30-day period (or portion thereof) during which the SP fails to file the Form 8938, with a maximum penalty of $50,000.[47]

An SP who unintentionally fails to file a timely, accurate Form 8938 can avoid penalties under Code Sec. 6038D if the SP can demonstrate that the violation was due to reasonable cause and not due to willful neglect.[48] The regulations clarify that the SP bears the burden of making "an affirmative showing of all the facts alleged as reasonable cause."[49] The regulations also emphasize that civil or criminal penalties threatened or imposed by a foreign country against the SP (or any other person) for disclosing the information on the Form 8938 do not constitute reasonable cause.[50]

B. Penalties Doubled for Tax Underpayments Related to Unreported SFFAs

In addition to subjecting violators to the $10,000 per year penalty under Code Sec. 6038D, transgressions also lead to other civil penalties.[51] Code Sec. 6662(a) generally provides that, if there is a tax underpayment on any return, then the IRS may assert a penalty equal to 20 percent of the amount of such underpayment.[52] Code Sec. 6662(b) lists the items that give rise to tax underpayments susceptible to penalties. FATCA expanded this penalty regime by adding Code Sec. 6662(b)(7), which says that any "undisclosed foreign financial asset understatement" can be grounds for an accuracy-related penalty.

To appreciate this new penalty, one must turn to the other provision introduced by FATCA, Code Sec. 6662(j). This statute does several things. For example, it defines an "undisclosed foreign financial asset understatement" as the portion of a tax understatement for a tax year that is attributable to any transaction involving an "undisclosed foreign financial asset."[53] It also describes the term "undisclosed foreign financial asset" as any asset with respect to which information was required to be reported to the IRS under various tax provisions, including Code Sec. 6038D, but was not reported.[54] Finally, Code Sec. 6662(j) doubles the size of the accuracy-related penalty, providing that, in the case of any tax underpayment due to an "undisclosed foreign financial asset" (such as an SFFA not reported on Form 8938), the penalty jumps from 20 percent of the underpayment to 40 percent.[55]

The Instructions to Form 8938 contain information about the application of the enhanced accuracy-related penalty under Code Sec. 6662(j), giving examples of transactions involving undisclosed SFFAs: (i) "You do not report ownership of shares in a foreign corporation on Form 8938 and you received taxable distributions from the company that you did not report on your income tax return"; (ii) "You do not report ownership of shares in a foreign company on Form 8938 and you sold the shares in the company for a gain and did not report the gain on your income tax return"; and (iii) "You do not report a foreign pension on Form 8938 and you received a taxable distribution from the pension plan that you did not report on your income tax return."[56]

C. Extension of Assessment Periods in Two Manners

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

1. Unlimited Assessment Period if Form 8938 Is Not Filed

a. Explanation of Changes. The general rule is that the IRS has three years from the time a taxpayer files a tax return for the IRS to audit and propose adjustments.[57] There are various exceptions to the normal three-year rule. One such exception, found in Code Sec. 6501(c)(8), applies to situations where a taxpayer fails to file an information return with the IRS regarding particular foreign entities, transfers, or assets.[58]

Code Sec. 6501(c)(8), *before* the enactment of FATCA in 2010, stated the following:

> In the case of any information which is required to be reported to the Secretary [under various international tax provisions, *but not Section 6038D*], the time for assessment of any tax imposed by [the Internal Revenue Code] with respect to *any event or period to which such information relates* shall not expire before the date which is 3 years after the date on which the Secretary is furnished the information required to be reported … [59]

Congress changed the preceding provision in two major ways with FATCA. The first way is that Congress specifically identified Code Sec. 6038D as one of the relevant international tax provisions covered by Code Sec. 6501(c)(8). The second way, which was more subtle, is that Congress added the phrase "tax return" to Code Sec. 6501(c)(8) before "event or period," such that the IRS now has additional time to make assessments with respect to any "tax return, event, or period" to which the omitted information relates. Thus, if an SP neglects to file a Form 8938 or files an inaccurate or incomplete Form 8938, then the assessment period essentially stays open indefinitely with respect to the *entire tax return*.

Below is the current version of Code Sec. 6501(c)(8), incorporating the FATCA changes:

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

b. Concept of "Related" Tax Return, Event or Period. Congress and the IRS have adopted from the outset a broad interpretation of a "related" tax return, event or period, though this seems to have gone unnoticed by many taxpayers and tax professionals. For instance, the legislative history indicates that the taxes and tax-related penalties asserted by the IRS during the extended assessment-period under Code Sec. 6501(c)(8) are not limited to items related to the information that should have been reported on an international information return, like Form 8938. Two excerpts from relevant legislative history are set forth below:

> Section 6501(c)(8) provides an exception to the three-year period of limitations due to failures to provide information about cross-border transactions or foreign assets. Under this exception, as amended by the Hiring Incentives to Restore Employment Act, the limitation period for assessment of tax does not expire any earlier than three years after the required information about certain cross-border transactions or foreign assets is actually provided to the Secretary by the person required to file the return. In general, such information reporting is due with the taxpayer's return; thus, the three-year limitation period commences when a timely and complete return (including all information reporting) is filed. Without the inclusion of the information reporting with the return, the limitation period does not commence until such time as the information reports are subsequently provided to the Secretary, even though the return has been filed. *The taxes that may be assessed during this suspended or extended period are not limited to those attributable to adjustments to items related to the information required to be reported by one of the enumerated sections*.[60]

> [T]he limitations period for assessing taxes with respect to a tax return filed on March 31, 2011 ordinarily expires on March 31, 2014. In order to assess tax with respect to any issue on the return after March 31, 2014, the IRS must be able to establish that one of the exceptions applies. If the taxpayer fails to attach to that return one of multiple information returns required [including Form 8938], the limitations period does not begin to run unless and until that missing information return is supplied. Assuming that the missing report is supplied to the IRS on January 1, 2013, the limitations period for the entire return begins, and elapses no earlier than three years later, on January 1, 2016. *All items are subject to adjustment during that time, unless* the taxpayer can prove that reasonable cause for the failure to file existed. If the taxpayer establishes reasonable cause, the only adjustments to tax permitted after March 31, 2014 are those related to the failure to file the information return. *For this purpose, related items include (1) adjustments made to the tax consequences claimed on the return with respect to the transaction that was the subject of the information return, (2) adjustments to any item to the extent the item is affected by the transaction even if it is otherwise unrelated to the transaction, and (3) interest and penalties that are related to the transaction or the adjustments made to the tax consequences*.[61]

As many taxpayers and return-preparers wrangle with the thorny Form 8938 rules for the first time during the 2016 filing season, they should be aware of these realities and seek specialized, international tax assistance, as necessary.

In 2011, the IRS released a Chief Counsel Advisory clarifying points about the extended assessment period.[62] Particularly informative in such IRS guidance is the following example, illustrating how the former version and current version of Code Sec. 6501(c)(8) could apply to a single taxpayer and confirming that the IRS will broadly define the concept of a "related" tax return, event, or period:

> Taxpayer timely filed tax returns for the tax years 2004 through 2009 but failed to properly include a Form 5471 with each return. Under the general limitations period provided in Section 6501(a), *only the assessment periods for the 2008 and 2009 tax years remain open under the general three-year limitations period*.

> For the 2004 and 2005 tax years, it is assumed that the general three-year assessment period for each year had expired before 3/18/2010, the effective date of the recent amendments to Section 6501(c)(8). Accordingly, based on the [IRS's] prior application of 6501(c)(8), *the assessment statute remains open for these tax years only with respect to any item(s) related to the failure to provide the required information*.

> For the 2006 through 2009 tax years, *the assessment limitations period remains open indefinitely with respect to all items on the tax returns for each of these tax years* … However, if the taxpayer can establish that the

failure to file the required form was due to reasonable and not willful neglect for any of these tax years, then the limitations period is only extended with respect to those items related to the failure to furnish the required information.[63]

c. Limitation Where Reasonable Cause Exists. It is not all bad news for taxpayers. Code Sec. 6501(c)(8)(B), which was added in 2010 by legislation other than FATCA, clarifies that the extended assessment period applies, even if the taxpayer's failure to file Form 8938 was unintentional (*i.e.*, it was "due to reasonable cause and not willful neglect"). However, in such instances, the only open issues are those related to the Form 8938 itself, not the entire Form 1040 or other tax return to which the Form 8938 should have been attached.[64]

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

In addition to modifying the existing rules of Code Sec. 6501(c)(8), FATCA also added new Code Sec. 6501(e)(1)(A) regarding "substantial omissions" of income from returns. The new provision states that if (i) a taxpayer omits from a tax return gross income amounts that should have been included, *and either* (ii) such omitted amounts exceed 25 percent of the gross income actually reported on the tax return, *or* (iii) such omitted amounts exceed $5,000 and are attributable to one or more SFFAs that were required to be reported on Form 8938 under Code Sec. 6038D, then the tax may be assessed within six years of the time the relevant tax return was filed.[65] The consequence of new Code Sec. 6501(e)(1)(A) is that relatively minor instances of income under-reporting can keep the assessment-period open a full six years (instead of the normal three), if the income relates to an SFFA that was not properly disclosed on Form 8938. In today's world, it takes little to reach the new, low trigger of $5,000.

VI. IRS Ruling Shows Use of Form 8938 Violations to Attack Multiple Returns

The IRS issued a document in 2015, Program Manager Technical Advice (PMTA) 2014-018, addressing the extension of assessment-periods under Code Sec. 6501(c)(8) in a situation where the executor of an estate failed to file Forms 8938 for the deceased. Despite its importance, this IRS guidance seems to have received remarkably little treatment from the tax community.[66]

The main facts in PMTA 2014-018 are as follows. The taxpayer, a U.S. person, held an interest in various SFFAs, the value of which exceeded the relevant filing threshold for Form 8938. The taxpayer died in Year 1, leaving behind gross assets large enough to require the filing of a Form 706, *U.S. Estate and Generation-Skipping Transfer Tax Return*. Generally, the executor or administrator of an estate has three main filing duties: (i) File a Form 1040 for the decedent for the short-year, running from January 1 through the date of death; (ii) File a Form 1041, *U.S. Income Tax Return for Estates and Trusts*, for the estate for the short year, running from the date of death until December 31, as well as all subsequent years until the estate is closed; and (iii) File a Form 706 for the estate, if necessary. Here, the executor (i) filed the Form 1040 for the taxpayer but omitted income from the SFFAs and failed to attach Form 8938, (ii) filed Form 1041 for the estate but omitted income from the SFFAs, and (iii) filed Form 706 but omitted the SFFAs from the gross estate. By the time that PMTA 2014-018 was issued, the general three-year assessment-period for Form 1040, Form 1041, and Form 706 had expired.

The IRS's analysis begins with a reminder that Congress has created several "disincentives" to not reporting SFFAs, including the $10,000 per year penalty under Code Sec. 6038D for not filing a Form 8938, the supersized accuracy-related penalty under Code Sec. 6662(j) for not reporting income generated by SFFAs, and the extended assessment-periods under Code Sec. 6501(c)(8). The IRS then focuses on the third "disincentive," emphasizing the "operative language" in the current version of Code Sec. 6501(c)(8): If a taxpayer fails to file a Form 8938 or any of the other international information return specifically listed, then the assessment-period is extended for "any tax imposed by this title with respect to any tax return, event, or period to which [the information on Form 8938] relates." The IRS goes on to emphasize that, from its perspective, *all* aspects of this language should be broadly construed. In particular, the IRS indicates that (i) the phrase "any tax imposed by this title" includes any income tax, estate tax, gift tax or excise tax, along with related penalties and interest; (ii) the phrase "any tax return" encompasses, "at the very least," any return that the IRS requires a taxpayer to file under Chapter 61 of the Code; (iii) the phrase "any event or period" should be construed to include taxes resulting from a particular transaction or event, as well as any taxes arising with respect to a specific taxable period; and (iv) the modifying phrase, "to which such information relates," should be interpreted liberally.

A considerable portion of PMTA 2014-018 focuses on this last aspect, *i.e.*, determining whether information that should have been provided to the IRS on Form 8938 (or any other relevant international information return) "relates" to tax return, event, or period. The IRS states the following in this regard:

Whether information "relates" to a specific "return, event, or period" will generally require a case-specific inquiry. *However, in many cases, the failure of an executor to report a foreign financial asset [on Form 8938], which is required to be reported under Section 6038D (or any of the other listed provisions), will hold open the period of limitations on assessment of any tax required to be shown on the individual's Form 1040 or the estate's Form 1041 or Form 706*, to the extent that the unfurnished information "relates" to such return.

The IRS then applies its interpretation of Code Sec. 6501(c)(8) to the facts in PMTA 2014-018. The executor filed the final Form 1040 for the deceased taxpayer, Form 1041 for the estate, and Form 706 for the estate. The violations consisted of omitting income from the SFFAs on Form 1040 and not attaching Form 8938 to Form 1040, omitting income from the SFFAs on Form 1041, and omitting the SFFAs from the gross estate on Form 706. The IRS provides the following explanation of why the unfiled Form 8938 triggers an indefinite assessment-period for all three tax returns, even though Form 8938 was only required to be filed with one return (*i.e.*, the final Form 1040), and even though there was no discussion, and likely no evidence, that the executor intentionally or willfully did anything wrong:

The information required to be reported under Section 6038D would have helped the [IRS] to identify each of these omitted items. At the very least, the information would have identified a likely source of income, during the relevant time period, and assets held at or near the time of death. *On these facts, it seems clear that the unfurnished information [that should have been reported to the IRS on Form 8938] would relate to each of these three returns because it identified a source of income reportable on the Form 1040 and the Form 1041 and an item which should have been included in the gross estate on the Form 706.*

In case the breadth of the IRS's position on this point somehow escapes a reader, PMTA 2014-018 states it again, in a slightly different manner. The official conclusion is as follows:

In the event of a failure to furnish information required under Section 6038D, Section 6501(c)(8) operates to suspend the period of limitations on assessment of any tax with respect to any return, event, or period, to which the undisclosed information relates. This would suspend the period of limitations for assessment for any tax reportable on an individual's final Form 1040 or an estate's Forms 1041 or 706 *anytime there is a failure to furnish information, required under Section 6038D, which relates to that return*. Whether or not undisclosed information "relates" to a specific return will be a case specific inquiry.

The IRS, presumably contemplating the need for alternative or back-up arguments in case of challenges to its expansive interpretation of Code Sec. 6501(c)(8) as it concerns Form 8938, tries to diminish the value of "reasonable cause" for taxpayers. As seen below, while the IRS acknowledges the existence of the "reasonable cause" defense, it endeavors to reduce its importance for taxpayers by focusing on the fact that the extended assessment-period still applies to (i) any "item" related to the information that should have been reported to the IRS on Form 8938, (ii) any correlative adjustments triggered by the changes to the relevant "items" and (iii) any penalties related to either the unfiled Form 8938 and/or the understated income. The specific language from PMTA 2014-018 is found here:

It should also be noted that there is a reasonable cause defense under Section 6501(c)(8). If the failure to furnish the required information is due to reasonable cause, and not to willful neglect, then the extension of the period of limitations is restricted to taxes resulting from adjustments to the item(s) to which the information relates (this limits the analysis to any "item" to which the information relates as opposed to any "return, event, or period"). In the case of reasonable cause, adjustments should only be made to unrelated items to the extent necessary to effectuate the adjustments made to related items. Whether the unfurnished information relates to the item(s) at issue is a determination which will need to be made based on the circumstances of each case. Generally, penalties related to or resulting from the unfurnished information or understatements related to the unfurnished information will be a "related" item … [67]

VII. Impact of Code Sec. 6501(c)(8) on "Clean Up" Decisions by Taxpayers

A. Customary Solutions to Mistakes on Original Return

Many taxpayers and tax professionals have traditionally adopted the position, which finds support in case law and other sources of precedent, that "[t]he Internal Revenue Code does not require a taxpayer to file an amended return to correct a mistake discovered after the filing of the original tax return."[68] Following this logic, if an individual taxpayer filed a Form 1040, believing that it was accurate and complete at the time, and later discovered that he had inadvertently omitted certain income, schedules, statements, information returns, *etc.,* he historically would have thought twice before filing a Form 1040X to rectify the oversights. The normal considerations by the taxpayer and his accountant would center on the likelihood of detection by the IRS, the penalties if caught, and how long the taxpayer would potentially be on the hook if he decided not to act (*i.e.*, when would the assessment-period expire with respect to the Form 1040 and all matters related to it). This analysis generally would lead to a decision to take one of three paths: (i) hunker down, do nothing to rectify past problems, and hope for the best; (ii) file a Form 1040X, throwing yourself on the mercy of the IRS with respect to possible penalties, or if the accountant had good knowledge of tax procedure, the taxpayer might file a special brand of Form 1040X called a qualified amended return (QAR) in order to avoid accuracy-related penalties under Code Sec. 6662 and delinquency penalties under Code Sec. 6651[69]; or (iii) if the tax issues and reporting duties involved were recurrent, some taxpayers decided to simply get things right going forward, in future years only.

B. Changes Caused by Code Sec. 6501(c)(8)

Times have changed, and so have the remedies available to taxpayers, particularly when situations involve the filing of an original tax return in good faith, followed by the subsequent realization that foreign-source income or international information returns (such as Form 8938) were omitted.

As a result of the introduction of Code Sec. 6501(c)(8) by Congress and the broad interpretation of this provision by the IRS, the first traditional approach taken by many taxpayers and accountants (described above as "hunker down, do nothing, and hope for the best") has ceased to be prudent. This is primarily because, as explained in detail above, the assessment-period is basically extended indefinitely under Code Sec. 6501(c)(8) for any type of tax (*e.g.*, income, gift, estate or excise) with respect to any tax return, any event or any period to which the information on Form 8938 relates. This is also because, under the new Code Sec. 6501(e)(1)(A), income under-reporting of merely $5,000 maintains the assessment-period open for six years instead of the normal three, if the omitted income relates to an SFFA that was not disclosed on Form 8938. In short, a taxpayer can no longer just keep a low profile and "wait it out," anxiously anticipating the expiration of the general three-year assessment period.

The second traditional method used by many taxpayers and accountants (described above as either filing Form 1040X and hoping for clemency from the IRS, or filing a QAR and demanding nonassertion of penalties) is also unwise these days. This is because the IRS would consider these types of filings "quiet disclosures," behavior that the IRS has repeatedly indicated it plans to sanction harshly.[70] Based on the information derived by the IRS through the "quiet disclosure," the IRS could then initiate an audit and assert additional taxes, penalties and interest.

The third traditional manner utilized by taxpayers and accountants was to simply start full U.S. tax compliance (including the filing of Form 8938) for all future years after the problem was discovered. This approach is disfavored for many reasons, including (i) knowledge of U.S. obligations and the refusal to pro-actively correct past issues might undermine the ability of a taxpayer to take the position, if caught by the IRS, that violations in earlier years were due to "reasonable cause"; (ii) the "variance" between tax returns for consecutive years could trigger an IRS audit; (iii) foreign account data about U.S. clients is being provided to the U.S. government regularly thanks to FATCA, whistleblowers, and participants in various disclosure programs; (iv) the potential penalties for international violations, particularly FBAR infractions, can be enormous; and (v) as highlighted throughout this article, the IRS could audit and assert additional taxes, penalties, and interest, for as far back as 2011, when Code Sec. 6501(c)(8) was modified to add Form 8938 violations as a trigger for extended assessment periods.

C. Resolution Methods Currently Acceptable to the IRS

Many of the traditional methods are no longer palatable, in no small part because of the extended assessment period under Code Sec. 6501(c)(8) for nonfiling of Form 8938. Thus, taxpayers are seeking more feasible ways of correcting past transgressions in the international arena. As of the writing of this article, there are five main options, which are acceptable to the IRS, for resolving international noncompliance in past years. These consist of (i) participating in the 2014 Streamline Foreign Offshore Procedure (SFOP); (ii) participating in the 2014 Streamline Domestic Offshore Procedure (SDOP); (iii) participating in the 2014 Offshore Voluntary Disclosure Program (OVDP); (iv) filing late

FBARs on a penalty-free basis pursuant to Delinquent FBAR Submission Procedure (DFSP), which is generally limited to taxpayers who previously reported all income and paid all taxes related to foreign accounts but inadvertently failed to file FBARs; or (v) filing late information returns (other than FBARs) on a penalty-free basis according to the Delinquent International Information Return Submission Procedures (DIIRSPs), which is only open to taxpayers who reported all income and paid all taxes related to foreign entities and assets but neglected to file information returns, such as form 8938, Forms 5471 (for foreign corporations), Forms 8865 (for foreign partnerships), Forms 3520 and Forms 5320-A (for foreign trusts), Forms 8621 (for passive foreign investment companies), Forms 926 (for certain transfers to foreign corporations), Forms 8858 (for foreign disregarded entities), *etc*.

Dozens of articles have been written about the intricacies of the preceding five options, and there is no need to get into that level of detail here. It is enough for our purposes to underscore the order in which taxpayers likely would choose to resolve their matters, if they were to meet the relevant eligibility criteria. Most taxpayers would prefer to settle things through the SFOP, DFSP or DIIRSP because each of these options calls for penalty-free treatment.

If these three penalty-free choices are unfeasible, taxpayers logically would attempt to conclude matters through the SDOP because participants are only required to file Forms 1040X for the past three years, the IRS does not assert penalties on the additional tax liabilities shown on the Forms 1040X, and the one-time "offshore" penalty imposed by the IRS to broadly sanction all past international tax violations is set at just five percent of the highest aggregate value of the noncompliant foreign assets during the SDOP period.

The OVDP occupies the lowest rung on the ladder for most taxpayers because it requires the filing of Forms 1040X for eight years (as opposed to three years), the IRS obligates the taxpayer to pay taxes, penalties and interest with respect to the Forms 1040X (instead of just taxes and interest) and the "offshore" penalty is either 27.5 percent or 50 percent of the highest value of the noncompliant foreign assets (instead of five percent).

VIII. Conclusion

Several previous articles by the author about Form 8938 emphasize the obvious, which is that guidance concerning the Form 8938 filing duty is extensive, complex, counterintuitive, disjointed, and applicable to both SIs and SDEs for the first time starting in 2016. This current article centers on something less apparent, but certainly not less important. Congress introduced two new penalties for Form 8938 violations (*i.e.*, the $10,000 per year penalty under Code Sec. 6038D and the doubled accuracy-related penalty under Code Sec. 6662(j)), and it launched two new ways of prolonging the assessment-period in situations involving Form 8938 violations (*i.e.*, the indefinite extension under Code Sec. 6501(c)(8) and the six-year extension under Code Sec. 6501(e)(1)(A)). These changes escaped the notice of many taxpayers and tax professionals, but not the IRS. As demonstrated by PMTA 2014-018, the IRS intends to use these new provisions, buttressed by a broad interpretation of Code Sec. 6501(c)(8), to attack multiple tax returns for otherwise-closed years in cases where a taxpayer fails to file Form 8938. This, of course, could trigger assessments of additional taxes, tax-related penalties, information-return-related penalties, and interest going back to 2011 (*i.e.*, the first year for which Form 8938 was due). As many taxpayers and return-preparers wrangle with the thorny Form 8938 rules for the first time during the 2016 filing season, they should be aware of these realities and seek specialized, international tax assistance, as necessary.

ENDNOTES

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1 Hale E. Sheppard, *The New Duty to Report Foreign Financial Assets on Form 8938: Demystifying the Complex Rules and Severe Consequences of Noncompliance*, Int'l Tax J., May–June 2012, at 13; Hale E. Sheppard, *Form 8938 and Foreign Financial Assets: A Comprehensive Analysis of the Reporting Rules after IRS Issues Final Regulations*, Int'l Tax J., April 2015, at 31; Hale E. Sheppard, *Specified Domestic Entities Must Now File Form 8938: Section 6038D, New Regulations in 2016, and Expanded Foreign Financial Asset Reporting*, Int'l Tax J., May–June 2016, at 5; Hale E. Sheppard, *Children with Foreign Accounts: Unexpected Income, Schedule B, Form 8938, and FBAR Issues*, 124 J. Int'l Taxation 134 (2016) and 124 J. Taxation 134 (2016).

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

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

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

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

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

7 Reg. §1.6038D-6(e).

8 Reg. §1.6038D-1(a)(1) and (2).

9 Reg. §1.6038D-6(a).

10 Reg. §1.6038D-2(b)(1).

11 Reg. §1.6038D-2(b)(1).

12 Reg. §1.6038D-2(a)(8).

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

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

15 Reg. §1.6038D-1(a)(7).

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

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

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

19 Reg. §1.1471-5(b)(1)(iv); Reg. §1.1471-5(b)(3)(vii);

Reg. §1.1471-5(b)(2)(v).

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

[21] The Final SI Regulations and the Preamble thereto later make it clear that that the IRS intends to disregard the IGA definitions and exceptions when it comes to obligating SPs to file Forms 8938. *See* Reg. §1.1471-5(b)(2)(vi); Reg. §1.6038D-1(a)(7); Preamble to Final SI Regulations, 76 FR 73819-73820 (Dec. 12, 2014); Instructions to Form 8938 (October 2015), at 5.

[22] Reg. §1.1471-5(b)(2)(ii).

[23] Reg. §1.1471-5(b)(2)(iii).

[24] Reg. §1.1471-5(b)(2)(iv).

[25] Reg. §1.1471-5(b)(2)(v).

[26] Reg. §1.1471-5(b)(2)(vi).

[27] Reg. §1.6038D-3(a)(3)(i).

[28] Reg. §1.6038D-3(a)(3)(i); Reg. §1.6049-5(c)(5)(i); T.D. 9657; Preamble to 76 FR 78556 (Dec. 19, 2011); Instructions for Form 8938 (December 2014), at 6. The IRS defines "U.S. payor" by directing taxpayers to the regulations under an unrelated tax provision, Code Sec. 6049.

[29] Instructions for Form 8938 (Rev. December 2014), at 6.

[30] Reg. §1.6038D-3(a)(3)(ii); Reg. §1.6038D-3(b)(2).

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

[32] T.D. 9657; Preamble to 76 FR 78556 (Dec. 19, 2011).

[33] Reg. §1.6038D-3(d).

[34] T.D. 9657; Preamble to 76 FR 78556 (Dec. 19, 2011); *see also* Instructions for Form 8938 (December 2014), at 4 and Instructions for Form 8938 (October 2015), at 4, which state that "[a]n interest in social security, social insurance, or other similar program of a foreign government is not a specified foreign financial asset."

[35] Reg. §1.6038D-3(c).

[36] Reg. §1.6038D-3(c).

[37] Reg. §1.6038D-6(a).

[38] Code Sec. 7701(a)(4).

[39] Code Sec. 7701(a)(30)(E).

[40] Reg. §1.6038D-6(b)(1).

[41] Reg. §1.6038D-6(b)(1)(i).

[42] Reg. §1.6038D-6(b)(1)(ii). For these purposes, the percentage of passive assets held by a corporation or partnership for a particular year is the weighted average percentage of passive assets (weighted by total assets and measured quarterly), and the value of the assets is the fair market value or the book value that is reflected on the corporation's or partnership's balance sheet (as determined under either a U.S. or an international financial accounting standard).

[43] Reg. §1.6038D-6(b)(2)(i).

[44] Reg. §1.6038D-6(b)(2)(ii). For custom rules about constructive ownership in the context of SDEs, *see* Reg. §1.6038D-6(b)(2)(iii).

[45] Reg. §1.6038D-6(b)(3)(i). For exceptions for dealers and special rules for "related entities," *see* Reg. §1.6038D-6(b)(3)(ii) and Reg. §1.6038D-6(b)(3)(iii).

[46] Code Sec. 6038D(d)(1); Reg. §1.6038D-8(a).

[47] Code Sec. 6038D(d)(2); Reg. §1.6038D-8(c).

[48] Code Sec. 6038D(g); Reg. §1.6038D-8(e)(1).

[49] Reg. §1.6038D-8(e)(2).

[50] Code Sec. 6038D(g); Reg. §1.6038D-8(e)(3).

[51] Reg. §1.6038D-8(f)(1).

[52] Code Sec. 6662(a).

[53] Code Sec. 6662(j)(1).

[54] Code Sec. 6662(j)(2).

[55] Code Sec. 6662(j)(3).

[56] Instructions for Form 8938 (December 2014), at 7.

[57] Code Sec. 6501(a).

[58] Code Sec. 6501(c)(8).

[59] Code Sec. 6501(c)(8)(A) as in effect before P.L. 111-147, which was enacted on March 18, 2010.

[60] U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions Contained in Senate Amendment to the House Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010. JCX-46-10. Aug. 10, 2010, at 36 (emphasis added); *see also* U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act." JCX-4-10. Feb. 23, 2010, at 66 (emphasis added).

[61] U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions Contained in Senate Amendment to the House Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010. JCX-46-10. Aug. 10, 2010, at 37.

[62] CCA 201147030 (Nov. 25, 2011).

[63] CCA 201147030 (Nov. 25, 2011) (emphasis added).

[64] Code Sec. 6501(c)(8)(B).

[65] Code Sec. 6501(e)(1)(A).

[66] The author located no major tax articles on this IRS guidance, and only a few summary pieces. *See, e.g.*, Executor's Failure to Report Foreign Financial Accounts Triggered Suspend Assessment Period, 61 Federal Taxes Weekly Alert, April 2, 2015, as republished in 40(5) Estate Planners Alert Newsletter, May 5, 2015.

[67] U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions Contained in Senate Amendment to the House Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010. JCX-46-10. Aug. 10, 2010.

[68] T. Keith Fogg, *Amended Returns—Imposing a Duty to Correct Material Mistakes*, 2008 TAX NOTES TODAY 175-43 (Sept. 9, 2008).

[69] For more information about QARs, *see* Hale E. Sheppard, *Qualified Amended Returns: Case of First Impression Examinations Parameters of this Powerful Taxpayer Remedy*, 116 J. TAXATION 96 (2012).

[70] *See, e.g.*, Robert B. Stack & Douglas M. Andres, *Expedited Opt-Out Needed for OVDI Participants Who Owe No Tax*, 2012 TAX NOTES TODAY 21-12 (Jan. 30, 2012) (stating that the taxpayer is "is worried that requesting retroactive treaty relief through the letter ruling process could be deemed a quiet filing, [the taxpayer] decides to enter the OVDI"); Robert Goulder, *Quiet Disclosures Get No Love from IRS*, 2010 TAX NOTES TODAY 90-1 (May 11, 2010); Marie Sapirie, *Charges Against HSBC Bank Bermuda Client Raise Quiet Disclosure Questions*, 201 TAX NOTES TODAY 98-1 (May 20, 2011); U.S. Government Accountability Office. *IRS Has Collected Billions of Dollars, but May Be Missing Continued Evasion*, GAO-13-318 (2013) (explaining that the IRS intends to increase efforts to identify "quiet disclosures" by analyzing taxpayers who have for the first time filed an FBAR, checked "yes" to the foreign-account question on Schedule B to Form 1040, or filed a Form 8938, that the IRS will cross-reference data received from financial institutions received through FATCA, and that the IRS plans to penalize taxpayers attempting to achieve compliance without participating in one of the many voluntary disclosure programs established by the IRS).