# Facts regarding The Foreign Account Tax Compliance Act

Updated August 2010.

A key component of the United States Federal Government's push for heightened tax compliance among U.S. taxpayers with foreign accounts and assets is the Foreign Account Tax Compliance Act (FATCA).

Despite its supporting role as a revenue offset for HIRE's employment stimulus incentives and relatively little public discussion of it to date, FATCA's potential effect on U.S. taxpayers with foreign accounts and assets is hard to overstate. U.S. taxpayers and their accountants will quickly realize that, as a result of FATCA, the costs of reporting their foreign activities to the IRS have increased, as there are additional disclosures. In addition, once the various provisions become effective, the penalties associated with foreign noncompliance will increase, and the statute of limitations within which the IRS can audit a taxpayer will double. FATCA is generally effective for tax years beginning after March 18, 2010, the day the HIRE Act was enacted.

## INCREASED DISCLOSURE

***Foreign accounts and assets.*** As if U.S. taxpayers with foreign accounts and assets did not already have enough cause for confusion regarding the filing requirements for Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR), FATCA now imposes a second filing requirement on them. Section 511 of FATCA creates new IRC § 6038D, which requires U.S. taxpayers with foreign accounts and assets with an aggregate value exceeding $50,000 to report them on an informational return. It is unclear whether the $50,000 threshold applies if the balance of foreign accounts and assets exceeds $50,000 at the end of the tax year or at any time during the tax year, as in the case of the FBAR $10,000 requirement. FATCA's provisions of IRC § 6038D apply to assets held during tax years beginning after March 18, 2010. The new reporting requirement is much broader than the FBAR, so individuals who do not have an FBAR filing obligation may be subject to the new reporting requirement. For example, FATCA requires taxpayers with investments in foreign entities, such as foreign hedge funds and private equity funds, to report these investments. The FBAR regulations issued by FinCEN on Feb. 26, 2010, exempt these assets from FBAR reporting.

It is not clear if the IRS will create a new form on which this disclosure will be made or whether it is up to taxpayers to make the disclosure in the way they deem best, or whether a Form 8275, *Disclosure Statement*, should be used. What is clear is that taxpayers are to attach the disclosure to their Form 1040. Consequently, the disclosure should be protected by the same confidentiality rules that govern tax returns. As mentioned earlier, this disclosure would be in addition to the FBAR, which is filed with the Treasury Department under Title 31 and not subject to the same confidentiality protections as tax returns under the IRC.

The FATCA disclosure must include the name and address of the financial institution and account number of the taxpayer's account or, in the case of a stock or security, the name and address of the issuer and the class or issue of the stock or security. Similar identification must be disclosed for other types of assets. The disclosure must include the maximum value of the asset during the tax year.

The FBAR is generally required to be filed by a U.S. person with a financial interest, signature authority or other authority over foreign financial accounts if at any point during the calendar year the aggregate value of all such foreign accounts equaled or exceeded $10,000, even if for one day. The section 6038D disclosure is required to report "specified foreign financial assets" when the aggregate value exceeds $50,000.

Section 6038D(b) defines a "specified foreign financial asset" to include ownership of (1) any financial account maintained by a foreign financial institution, (2) any stock or security issued by a non-U.S. person, (3) any financial interest or contract held for investment that has a non-U.S. issuer or counterparty, and (4) any interest in a foreign entity. Section 6038D(b) defines a foreign entity by reference to section 1473(5): any entity that is not a U.S. person. Consequently, taxpayers who purchase foreign real estate through an entity will have a filing obligation.

While section 6038D requires individuals to file this disclosure, the secretary of the Treasury can require "any domestic entity which is formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets" to file the disclosure as if it were an individual (section 6038D(f)). Similarly, the secretary is to issue regulations exempting nonresident aliens and bona fide residents of any U.S. possession from the disclosure. The secretary also has authority to exempt certain assets from being reported (section 6038D(h)).

The minimum penalty for failing to submit the required disclosure is $10,000, and it increases by $10,000 for each 30-day period following notification from the Treasury Department, with a maximum penalty of $50,000. There is, however, a 90-day grace period following notification from the Treasury before the additional $10,000 penalties accrue (section 6038D(d)). This is similar to the penalty for failure to file Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*, and Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*. As with those forms, the penalty may be waived if the taxpayer is able to demonstrate the failure to file was due to reasonable cause. It is important to realize that taxpayers who have this disclosure requirement will likely also have an FBAR filing requirement. While the penalty for failure to file the FBAR is much harsher than the penalty under section 6038D, both of these penalties will be assessed.

Interestingly, there is a presumption that a taxpayer with "specified foreign financial assets" has a filing obligation for purposes of the penalty if the IRS believes the taxpayer has an interest in one or more such assets and the taxpayer does not provide sufficient information to demonstrate the aggregate value is less than $50,000 (section 6038D(e)).

***Foreign companies.*** Generally, a foreign corporation will qualify as a passive foreign investment company (PFIC) if (1) 75% or more of its gross income in the tax year is passive income, or (2) on average during the tax year, at least 50% of the assets held by the corporation produce passive income or are held for the production of passive income (section 1297). Section 521 of FATCA amends section 1298 of the Code to require shareholders in a PFIC to file an annual information return disclosing their ownership of the PFIC (section 1298(f)). Under previous law, such disclosure was required only when taxpayers made a qualifying elective fund election, received certain distributions from the PFIC, or disposed of their interest in the PFIC. The PFIC disclosure was effective March 18, 2010.

***Financial institution disclosure.*** Section 501 of FATCA added a new withholding system described in a new chapter 4 to the Code and created new sections 1471 and 1472. These provisions are generally applicable to payments made after Dec. 31, 2012. Taken together, these sections require foreign financial institutions with U.S. customers and foreign nonfinancial entities with substantial U.S. owners to disclose information regarding the U.S. taxpayers.

Failure to disclose the information will result in the U.S. payor being required to withhold a 30% tax on U.S.-source income. The withholding will occur on income normally subject to U.S. taxation when received by nonresident aliens, such as dividends, as well as to certain types of income that are traditionally excluded from taxation for nonresident aliens under section 871, such as certain bank interest and capital gains not effectively connected to a U.S. trade or business. Failure to comply will subject the U.S. withholding agents to financial penalties. Foreign financial institutions include banks, brokerages and investment funds. Furthermore, non-publicly traded equity and debt interests in foreign financial institutions are deemed to be accounts for purposes of this section. Failure to comply will subject such institutions to financial penalties.

The rules described above do not apply to any payment beneficially owned by (1) any corporation that is a member of an expanded affiliated group that includes a publicly traded corporation; (2) any foreign government (or political subdivision, wholly owned agency or instrumentality); (3) any international organization (or wholly owned agency or instrumentality); (4) any foreign central bank of issue; or (5) any other class of persons identified by the Treasury secretary. Further, under new section 1471(d)(1)(b), a foreign financial institution is not required to disclose account information if the account holder is an individual whose aggregate value of depository accounts held (in whole or in part) and maintained by the same financial institution which maintains such account does not exceed $50,000.

## PENALTIES

Section 6662 permits the IRS to impose a 20% penalty on a substantial understatement of income tax or for negligence or disregard of rules or regulations that is not attributable to fraud (for which a 75% penalty applies). Section 512 of FATCA amended section 6662 to add a penalty of 40% on any portion of an underpayment attributable to a transaction involving an undisclosed financial asset that should have been reported under sections 6038, 6038B, 6046A, 6048 or new section 6038D. The increased penalty structure is effective for tax years beginning after March 18, 2010.

## EXPANDED STATUTE OF LIMITATIONS

Generally, the IRS has three years from the filing of a return in which to audit a taxpayer and assess additional tax (section 6501(a)). This statute of limitations also applies to information required to be reported on certain foreign transfers, now including those under FATCA. The period is increased to six years if a taxpayer omits 25% or more of gross income (section 6501(e)). Section 513 of FATCA amended section 6501(e) to also extend the statute of limitations to six years where a taxpayer omits more than $5,000 of income attributable to one or more assets required to be reported under section 6038D. Thus, even if the taxpayer does not have a substantial understatement, the IRS will have six years in which to investigate and audit the taxpayer. Additionally, however, the three-year and six-year statutes of limitations will be suspended until the information required to be reported under sections 1295(b), 1298(f), 6038, 6038A, 6038B, 6046, 6046A, 6048 or new section 6038D is provided to the IRS.

The extended statute of limitations is applicable to (1) returns filed after the March 18, 2010, date of enactment and (2) returns filed on or before such date if the limitation period under section 6501 has yet to expire. Thus, the extended six-year statute and suspended three-year statute could theoretically apply to tax returns that were filed as early as 2004 if a six-year statute applies, or 2007 if the normal three-year statute applies.

## FOREIGN TRUSTS

***Penalties.*** The penalty under section 6677 for failure to file a Form 3520 is 35% of the gross reportable amount (generally the amount transferred to or received from the trust). Section 535 of FATCA amended section 6677 so that a failure to file Form 3520 would have a minimum penalty of $10,000. Thus, the penalty is now the greater of $10,000 or 35% of the gross reportable amount. The penalty increases by $10,000 for each 30-day period following notification from the Treasury that the filing is delinquent. There is, however, a 90- day grace period following notification from the Treasury before the additional $10,000 penalties accrue. The penalty is effective for Forms 3520 filed after Dec. 31, 2009.

***Grantor trust status.*** When a U.S. person transfers assets to a foreign trust that has U.S. beneficiaries, IRC § 679 deems the trust to be a grantor trust, and the U.S. transferor is responsible for reporting the trust's income. The regulations under section 679 make the presumption that the trust will have U.S. beneficiaries; thus, it is rare that a U.S. person will fund a foreign trust and it will not be qualified as a grantor trust. Whether taxpayers simply failed to look at the regulations or intended to avoid paying U.S. income tax on the trust's income, the IRS felt that it needed to codify the regulations into the statute. Sections 531 and 532 of FATCA add several new provisions to section 679, including three subparagraphs to section 679(c), which are designed to find a U.S. beneficiary of the foreign trust. The FATCA additions are effective for transfers to a foreign trust after March 18, 2010.

***Taxable distributions.*** Prior to FATCA, section 643(i) provided that a loan of cash or marketable securities from a foreign trust to any U.S. grantor, U.S. beneficiary or any other U.S. person who was related to a U.S. grantor or U.S. beneficiary was generally treated as a distribution by the foreign trust to such grantor or beneficiary.
Section 533 of FATCA provides that any use of trust property after March 18, 2010, by a U.S. grantor, U.S. beneficiary or any U.S. person related to a U.S. grantor or U.S. beneficiary is treated as a distribution. The individual using the trust property will be subject to income equal to the fair market value on the use of the property or loan under section 643(i)(1). This rule does not apply to the extent that the foreign trust is paid fair market value for the use of the property within a reasonable period following the use. FATCA does not define "a reasonable period," but presumably, this will be defined in subsequent Treasury regulations.
It is interesting to note that a subsequent return of the property to the foreign trust is disregarded for tax purposes under section 643(i)(3). Notwithstanding, consistently with section 679, the transferor of the property would qualify as a grantor, and consistently with section 6048, the transfer would be a reportable event that would need to be reported on a Form 3520.

## INCOME FROM FOREIGN SECURITIES

***Dividend equivalent payments.*** The term "dividend equivalent" is defined as any payment made pursuant to a notional principal contract that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. It also includes any other payment determined by the Treasury secretary to be substantially similar to those described above.

Section 541 of FATCA amended IRC § 871(l)(1) to eliminate the disparate tax treatment between dividends on stock of U.S. corporations and dividend equivalent payments by treating dividend equivalent payments as U.S.-source dividend payments. Consequently, any such payments made to a nonresident alien will be subject to a withholding tax applicable to the payment. The effective date of this provision is 180 days after FATCA's date of enactment (that is, on or after Sept. 14, 2010).

***Foreign targeted obligations.*** Prior to FATCA, a deduction was permitted for foreign targeted obligations that were issued in bearer format (that is, not registered), provided certain exceptions were satisfied (that is, they could not be sold to U.S. persons). Section 502 of FATCA repeals the foreign targeted obligation exception. Consequently, for obligations issued in bearer format after March 18, 2012, an interest deduction will be prohibited unless the obligation: (1) is issued by an individual, (2) matures in no more than one year, or (3) is not of a type offered to the public. Therefore, bearer debt obligations with a maturity greater than one year will not be permitted a deduction for interest on the obligation unless the obligations qualify for the FATCA exception.

Similarly, FATCA denies a tax exemption for interest on state and local bonds not issued in a registered form. Thus, for state and local bonds issued after March 18, 2012, the tax-exempt status will be denied unless the obligation matures in no more than one year or is not of a type offered to the public.

## A FUTURE WITH FATCA

Although FATCA's reporting requirements for financial institutions don't kick in until 2013, its individual reporting requirements are already effective. Thus it would appear the only safe course for taxpayers is to begin filing the required disclosures. Otherwise, such failure could be revealed when the financial institution reporting requirement becomes effective, and taxpayers could incur penalties. With the higher penalty amounts and the lengthened IRS statute of limitations described in this article, taxpayer failures to comply with FATCA could prove costly. Therefore, accountants with tax clients holding foreign financial assets should take steps now to make sure they have duly informed those clients of FATCA's wide-ranging new regime and incorporated them into client letters, organizers and return preparation checklists and procedures.

## EXECUTIVE SUMMARY

■ **The Foreign Account Tax Compliance Act (FATCA)** was enacted March 18, 2010, as part of the Hiring Incentives to Restore Employment (HIRE) Act. It carries far-reaching disclosure and reporting requirements for U.S. taxpayers with foreign accounts and assets, as well as foreign financial institutions with accounts owned by U.S. taxpayers.

■ **Some of FATCA's filing requirements are similar to** those of Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR). Although the asset threshold for disclosure is higher ($50,000, rather than FBAR's $10,000), FATCA applies to a wider range of assets, including investments in foreign hedge funds and private equity funds. And while FBAR is filed with the Treasury Department independently of tax returns, FATCA disclosures must be filed as an attachment to an individual income tax return.

■ **The minimum penalty for failure without reasonable cause** to submit the required disclosure is $10,000. Ninety days after notification from the Treasury Department of a failure to submit the required disclosure, the penalty increases by $10,000 for every 30 days of continued failure to submit the disclosure up to a maximum of $50,000. Moreover, FATCA establishes a presumption in favor of the IRS that a taxpayer with "specified foreign financial assets" has an obligation to file the disclosure.

■ **FATCA also added a reporting and withholding system** (effective in 2013) on foreign financial institutions and nonfinancial entities with substantial U.S. owners to disclose information regarding the taxpayers; or payments of U.S.-source income to such institutions and entities will be subject to 30% withholding.

■ **FATCA added to the accuracy-related penalties of IRC § 6662** a 40% penalty for failing to report a transaction involving an undisclosed specified foreign asset and expanded the statute of limitations for IRS examination and assessment. FATCA also amended provisions concerning reporting by foreign trusts, use of trust property and treatment of distributions or interest from certain dividend-related contracts or debt obligations.

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