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An Overview of the Foreign Account Tax Compliance Act

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A. Introduction

1. Background and Purpose

On March 18, 2010, President Obama signed into law H.R. 2847, the Hiring Incentive to Restore Employment ("HIRE") Act. The HIRE Act introduced several new reporting provisions related to certain foreign entities and interests held by U.S. persons in foreign assets. These provisions were originally introduced in Congress on October 27, 2009 by Senator Baucus as the "Foreign Account Tax Compliance Act of 2009" ("FATCA" or "Act").[1] FATCA was intended to give the IRS "powerful tools" to combat the problem of offshore tax evasion. In the words of Senator Baucus, the new provisions would ensure that "the days of sending your money offshore to avoid paying U.S. taxes are over."

According to Senator Baucus, this problem, "like . . . the recent UBS scandal, unfairly shifts the tax burden to honest taxpayers who comply with their tax obligation." Of course, the UBS scandal to which Senator Baucus refers pertains to events which began in late 2007 with the guilty plea of a wealthy Los Angeles area real estate developer, who, in turn, cooperated against his Swiss UBS private banker. The banker, Bradley Birkenfeld, was later arrested, and cooperated with authorities by providing his client list as well as documents reflecting a decade-long set of marketing practices by UBS aimed at encouraging U.S. account holders to commit tax fraud. The paper trail led to a senior UBS bank official, who was indicted on one count of criminal conspiracy. After implicating a senior manager in criminal activity, the Department of Justice had grounds under U.S. principles of corporate criminal liability to prosecute UBS itself. This led to UBS entering into a deferred prosecution agreement whereby UBS paid $756,000,000 and agreed to disclose the names and financial information of U.S. persons holding undisclosed accounts in exchange for resolving all criminal and most civil issues arising from the bank's involvement in facilitating U.S. tax evasion. In advocating for FATCA's passage, Baucus recited an IRS estimate that up to 52,000 individuals hid billions of dollars in offshore accounts through UBS alone.

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[1] *See* Congressional Record 111th Congress, Vol. 155, No. 157, S10785. Mr Baucus introduced the bill on behalf of himself, Mr. Kerry and Mrs. Shaheen.

The legislative history of FATCA provides a helpful catalogue of the various tools available under FATCA for the IRS to "detect, deter and discourage offshore tax evasion." First, the IRS would be authorized to receive information reports from "foreign financial institutions" disclosing the identities of their U.S. account holders and the amounts being held in the accounts. Second, individuals with offshore accounts and other assets would be required to provide details of those assets on their tax returns. Third, tax rules pertaining to foreign trusts would be significantly strengthened to prevent U.S. beneficiaries from hiding behind a nominee owner. Additionally, the IRS would be given more time – up to six years – to find and examine unreported and misreported offshore accounts. Finally, the bill would establish "strong incentives" to encourage individuals to properly report income from assets held in offshore accounts and "robust penalties would be in place for those who still try to skirt the rules."

2. <u>General Overview</u>

These several new reporting and enforcement tools were implemented through a variety of new provisions added to the Internal Revenue Code.[2]

First, pursuant to a new Chapter 4, sections 1471-1474, certain foreign financial institutions must disclose the identities of their U.S. account holders or face a 30 percent withholding on "withholdable payments" (including payments of gross proceeds and other non-taxable amounts). In certain circumstances, this requirement will extend to "non-financial foreign entities" and even to U. S. financial institutions.

Second, under new section 6038D, U.S. persons required to file tax returns must provide information on their annual tax returns pertaining to certain foreign financial assets held during the tax year.

Third, under section 1298(f), U.S. persons holding interests in a passive foreign investment company ("PFIC") are required to file an annual information return, regardless of whether they are required to file a tax return, are considered to have received a PFIC distribution or have made an election regarding their interest in the PFIC.

Fourth, section 643(i) has been amended to treat the use by a U.S. grantor or beneficiary of non-financial property of a foreign trust as a distribution. In addition, several clarifications and a presumption have been added to section 679 to limit the opportunities for tax avoidance.

Most of the new reporting requirements come with some form of "strong incentive" or penalty for failure to meet their requirements. In addition to section specific penalties, FATCA makes the accuracy-related penalty of section 6662 applicable to "undisclosed foreign financial asset understatement."

[2] All section references herein are to provisions of the U.S. Internal Revenue Code of 1986 ("IRC" or "Code"), as amended, or to regulations issued thereunder.

Finally, as promised by Senator Baucus, the limitations period to assess and collect tax under sections 6501(c)(8) and 6501(e) are modified to extend the time the IRS has to find and examine unreported and misreported offshore assets.

B. Chapter 4 Withholding and Reporting Regime

1. Withholding Requirements with Respect to Certain Payments made to Foreign Financial Institutions and other Foreign Entities

Most attention and critical commentary with regard to FATCA relates to the new Chapter 4, which imposes withholding, documentation, and reporting requirements with respect to certain payments made to foreign financial institutions and other foreign entities. Because of the complexity and potential scope and impact of the new reporting and withholding regime, Congress provided a deferred effective date for sections 1471-1474, which apply generally to payments made after December 31, 2012. These provisions were the principal subject of Notice 2010-60 ("the Notice"),[3] which is, to date, the principal guidance that has been issued pertaining to the new Code provisions introduced by FATCA.

The core idea in Chapter 4 is that "withholdable payments" to foreign financial institutions ("FFI's") and non-financial foreign entities ("NFFEs") will be subject to 30 percent withholding unless certain steps are taken, largely embodied in a contractual relationship between the FFI and the IRS. Payments subject to withholding generally include so called "fixed, determinable, annual, or periodical income" (i.e., "FDAPI") from U.S. sources and also gross proceeds from the sale or other disposition of any property of a type that can produce interest or dividends from U.S. sources.

However, the scope of payments withholdable under Chapter 4 extends beyond the normal U.S. source and FDAPI concepts. For example, "withholdable payments" include interest paid by a foreign branch of a domestic financial institution.[4] Moreover, because the definition indiscriminately includes "any payment of interest," it is reasonable to conclude that even interest on tax-free investments (e.g., municipal bonds) would be subject to 30 percent withholding, if the requisite reporting requirements are not fulfilled.[5]

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[3] 2010-37 I.R.B. 329 (Aug. 27, 2010).

[4] IRC § 1473(1)(C).

[5] See IRC § 1473(1)(A)(i). Additionally, under newly enacted IRC § 871(m), certain "dividend equivalent payments" made with respect to U.S. stocks will be treated as if they are actual dividends payments for withholding tax purposes. This would also apply to withholding under Chapter 4. An ISDA Protocal was released on August 23, 1020 to reflect the changes made to the IRC by FATCA. Income that is "effectively connected" with a United State trade or business, which is taken into account under IRC § 871(b)(1) or IRC § 882(a)(1), will not be subject to withholding under Chapter 4 for that taxable year. IRC § 1473(1)(B).

These legislative requirements anticipate that a FFI will agree with U.S. tax authorities to ascertain whether certain U.S. persons hold financial accounts[6] with the institution and, if they do, to report with respect to those accounts. In the case of an NFFE, the beneficial owner or payee must provide the withholding agent with either a certification that the owner has no "substantial United States owners" or information with respect to any such owners. In both cases, foreign entities must comply with the new provisions or face withholding on amounts having no necessary connection with offshore accounts or investments of U.S. persons.

The 30 percent withholding is refundable upon a showing that a lesser amount of tax is due (e.g., by reason of a bilateral tax treaty), but, as a practical matter, the potential withholding will create substantial competitive imbalances between those foreign institutions that enter into agreements with the IRS, thereby escaping the withholding requirement, and those that do not. Moreover, section 1474(b)(3) precludes the possibility of receiving a credit or refund of any overpayment until the beneficial owner of the payment provides the IRS with the information necessary to determine whether that beneficial owner is a "United States owned foreign entity" and the identity of any "substantial United States owners" of such entity.[7] In other words, no refund will be available unless, and until, the identities of the U.S. beneficiaries are provided to the IRS. Thus, the threatened withholding provides a "strong incentive" for compliance. In practical terms, FFIs must enter into a FATCA agreement with the IRS or simply decide that they will not participate in the U.S. investment market in any material respect.

2. <u>Definition of Financial Institution</u>

Section 1471(d)(5) provides a three-fold definition of what constitutes a "financial institution" for purposes of Chapter 4. First, a financial institution is any entity that accepts deposits in the ordinary course of a banking or similar business. Pursuant to Notice 2010-60, factors that are relevant (but not determinative) include whether the entity is subject to banking and credit laws in the United States or a foreign country or to supervision and examination by agencies having regulatory oversight of banking and similar institutions. Examples of entities meeting this definition include entities that would qualify as banks under section 585(a)(2), savings banks, commercial banks, savings and loan associations, thrifts, credit unions, building societies and other cooperative banking institutions.

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[6] A "financial account" includes a depository account, a custodial account, and any equity or debt interest in a financial institution unless that interest is regularly traded on an established securities market. Depository accounts maintained by natural persons in an amount less than $50,000 may be excluded if a particular institution so elects (which an institution might decline to do in order to reduce its compliance burden).

[7] In the case of a trust, a" substantial United States owner" is any specified United States person treated as an owner of any portion of such trust under the grantor trust rules of IRC §§ 671-679. In addition, any specified United States person considered to own more than 10 percent of a nongrantor trust may be considered to be such a substantial owner under regulations to be issued. The term "specified United States person" generally includes *any* United States person, as defined uner IRC § 7701(a)(30), unless an exception applies. See IRC § 1473(3).

Second, a financial institution also includes an entity that holds financial assets for the account of others as a substantial portion of its business. Factors that are relevant again include whether the entity is subject to the banking and credit laws or broker-dealer regulations in the United States or a foreign country or to supervision and examination by agencies having regulatory oversight of banking and similar institutions. Examples of entities meeting this definition, as set out in the Notice, include broker-dealers, clearing organizations, trust companies, custodial banks, and entities acting as custodians with respect to the assets of employee benefit plans.

Finally, an entity is a financial institution if 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 in such securities, partnership interests, or commodities. The Notice specifically differentiates the concept of "trade or business" used in other Code sections from the analysis of a "business" for purposes of Chapter 4. The analysis for the latter purpose must be based upon the relevant facts and circumstances, and isolated transactions that might not give rise to a trade or business for other purposes may, nevertheless, cause an entity to be considered to be engaged primarily in the business of investing, reinvesting, or trading in securities for purposes of Chapter 4; this may depend upon such factors as the magnitude and importance of the transactions in comparison to the entity's other activities. Examples of entities that may be treated as financial institutions under this provision, as stated in the Notice, include mutual funds (or their foreign equivalent), funds of funds, hedge funds, private equity and venture capital funds, other managed funds, commodity pools, and other similar investment vehicles.

a. Certain Financial Institutions treated as Not Financial Entities

Notice 2010-60 sets out a number of circumstances in which a foreign entity that otherwise meets the definition of a financial institution will not be considered an FFI for purposes of Chapter 4. In order to qualify for this exception, the sole reason for the foreign entity meeting the definition of financial institution must be that it is primarily engaged in investing, reinvesting, or trading in securities. Further, the entity must fall within one of the following four classes of foreign entities.

(1) <u>Certain Holding Companies</u>. A foreign entity whose primary purpose is to act as a holding company for subsidiaries engaged in a trade or business other than that of a financial institution is excepted. This does not, however, include foreign entities designed to acquire or fund the start-up of companies and then hold those companies for investment purposes for a limited period of time (e.g., private equity funds, venture capital funds, leveraged buyout funds).

(2) <u>Certain Start-up Companies</u>. A foreign start-up entity that intends to engage in a business other than that of a financial institution and that is not a venture or investment fund that invests in start-up entities is also excepted. However, this exception only exempts a foreign entity for the first 24 months of its organization.

(3) Certain Reorganizations and Liquidations. A foreign entity that is in the process of liquidating its assets or reorganizing and that was a non-financial institution prior to such process and intends to continue or recommence operations as a non-financial institution is also excepted.

(4) Certain Finance Subsidiaries. Finally, a foreign entity that primarily engages in financing and hedging transactions with or for members of its expanded affiliated group of companies that are not FFI's and are primarily engaged in non-financial business is also excepted. Such a foreign entity must not provide such services to non-affiliates.

As explained in Section 4 below, these several categories of foreign entities excepted from the definition of FFI will also be treated as excepted NFFE's and, therefore, exempt from withholding as well as the documentation and reporting requirements under Chapter 4.

b. Insurance Companies

Notice 2010-60 concludes that insurance companies generally will meet the definition of a financial institution for purposes of Chapter 4. However, the Notice provides only limited guidance on the treatment of insurance companies. It states that those insurance companies that solely issue insurance or reinsurance contracts having no cash value (e.g., property and casualty insurance or reinsurance contracts or term life insurance contracts) will be treated as non-financial institutions because they do not give rise to the type of concerns to which Chapter 4 is addressed. However, as an NFFE, such an entity would still be subject to Chapter 4 withholding and reporting, unless it independently satisfies an exception or future guidance creates an exception that applies to it.

c. U.S. Branches of FFI's.

The Notice makes it abundantly clear that U.S. branches of FFI's are not exempt from the Chapter 4 regime. Generally, unless all withholdable payments are exempt from withholding under the effectively connected income exclusion, the branch must execute an FFI Agreement to avoid being subject to the 30 percent withholding requirement. However, the Notice indicates that Treasury may consider permitting such a branch to document account holders under the rules generally applicable to U.S. financial institutions when it receives withholdable payments in its capacity as an intermediary.

3. Requirements imposed on FFI's to avoid 30 percent Withholding

a. Participating FFI's

FFI's may avoid the imposition of 30 percent withholding on "withholdable amounts" paid to them if they comply with certain documentation and reporting requirements. FFI's that agree to undertake these responsibilities are referred as "participating FFI's."

Participating FFI's are required to obtain information that will permit a determination whether "specified United States persons"[8] hold accounts with them. They must comply with verification and due diligence procedures relating to the identification of such accounts and must report information with respect to existing accounts to U.S. authorities. Regarding the verification and due diligence procedures, Notice 2010-60 provides detailed guidance.

Participating FFI's must deduct and withhold 30 percent from payments to "recalcitrant account holders"[9] and must comply with requests from the IRS for additional information with respect to U.S. accounts. In this regard, Notice 2010-60 mentions that Treasury and the IRS intend to require a participating FFI to report (i) the number and aggregate value of financial accounts held by both recalcitrant account holders and related or unrelated non-participating FFI's; and (ii) the number and aggregate value of financial accounts held by recalcitrant account holders that have U.S. indicia.

If there is a foreign law that would prevent the reporting of account information, participating FFI's are directed to seek a waiver of that law from holders of accounts or, failing in that effort, must close the accounts.

Note, finally, that all of these requirements are in addition to those that may be imposed on an FFI in its capacity as a Qualified Intermediary.

Treasury or the IRS may publish a list of participating FFI's, presumably for the convenience of withholding agents. In this regard, Notice 2010-60 contemplates the issuance of employer identification numbers ("EIN's") to facilitate the identification of FFI's. Participating FFI's will use these EIN's to identify themselves to withholding agents. Until withholding agents are able to verify the status of FFI's with the IRS, withholding agents (including participating FFI's) will be permitted to rely on certifications provided by FFI's as to their status as participating FFI's, unless the withholding agent knows or has reason to know that a certification is incorrect.

b. Deemed-compliant FFI's

At the discretion of the IRS, there are certain potential exceptions for institutions that do not maintain U.S. accounts and that meet IRS requirements with respect to accounts maintained with them by other FFI's. In addition, the IRS may create exceptions for institutions of a class

[8] The definition of "specified United States person" expressly excludes a corporation whose stock is regularly traded or a member of an affiliated group in which there is a corporation whose stock is regularly traded. The term also excludes an exempt organization, a government or government agency, a bank, a real estate investment trust, a regulated investment company, a common trust fund, and an exempt trust. See IRC § 1473(3).

[9] A "recalcitrant account holder" is any account holder who refuses to comply with requests for information or to provide a waiver of foreign law. IRC § 1471(d)(6).

that, in its view, need not execute an agreement. FFI's that fall under any of these exceptions are referred as "deemed-compliant FFI's."[10]

According to Notice 2010-60, Treasury and the IRS intend to issue guidance under which certain foreign entities that are considered FFI's solely because they are primarily engaged in the business of investing, reinvesting, or trading in securities would be treated as deemed-compliant FFI's, if the withholding agent (1) identifies all the direct and indirect owners of the entity that are individuals, specified United States persons, or exempt NFFE's ("excepted NFFE's," described below), (2) obtains documentation from such persons, and (3) reports to the IRS information regarding any specified U.S. person that is a direct or indirect shareholder in the entity.[11] The effect of this alternative regime is to shift the administrative burden of compliance from the FFI to the relevant withholding agent.

On the other hand, the Notice makes it clear that FFI's that are also Controlled Foreign Corporations ("CFC's") will not be treated as deemed-compliant FFI's and must enter an FFI Agreement in order to avoid withholding. Treasury will coordinate the Chapter 4 reporting of CFCs that are FFI's with other U.S. tax reporting obligations in order to avoid duplicative reporting.

c. Entities described in section 1471(f)

There are also exceptions for certain payments. Under section 1471(f), 30 percent withholding will not apply to any payment to the extent that the beneficial owner of such payment is any foreign government, political subdivision of a foreign government, international organization, foreign central bank of issue, or any other class of persons identified by the Secretary as posing a low risk of tax evasion.

Notice 2010-60 anticipates that foreign retirement plans will be identified as posing a low risk of evasion, provided they (1) qualify as a retirement plan under local law, (2) are sponsored by a non-U.S. employer, and (3) exclude U.S. participants or beneficiaries other than employees who worked in the country where the plan is established during the period the benefits accrued. Payments beneficially owned by qualifying retirement plans will be exempt from withholding.

[10] See IRC § 1471(b)(2).

[11] The Notice does not identify the scope of investment funds that fall under this exemption but it does indicate that the exemption is intended to lower the administrative burden for investment funds and other entities having only a small number of account holders all whom are individuals or non-financial foreign entities that will not be subject to withholding or reporting under Chapter 4. The Notice explains that a small family trust settled and funded by a single person for the sole benefit of his or her children would be among the entities eligible for this exemption.

4. Requirements imposed on NFFE's to Avoid Withholding

a. General Rule

With respect to NFFE's, the statute requires certification from a beneficial owner or payee that the beneficial owner has no "substantial United States owners."[12] If there are any such owners, the beneficial owner must provide their names, addresses, and taxpayer identification numbers. For this purpose, a "substantial United States owner" is any specified U.S. person owning more than 10 percent of the stock of a corporation (by vote or value) or a comparable profits or capital interest of a partnership. In the case of a trust, a "substantial United States owner" includes any specified U.S. person treated as owner of any portion of a grantor trust and any specified U.S. person considered to own more than 10 percent of the beneficial interests in a nongrantor trust, pursuant to regulations or other guidance to be issued by the IRS.

b. Excepted NFFE's

Except as otherwise provided by the IRS, there are exceptions to the general rule applicable to NFFE's for any corporation whose stock is regularly traded on an established securities exchange (or which is a member of an affiliated group in which there is a member whose stock is regularly traded), a possessions entity, a foreign government, political subdivision, agency, or instrumentality, or an international organization, foreign central bank of issue, or any other class of persons identified by the IRS.[13] These entities are referred as "excepted NFFE's."

According to Notice 2010-60, certain financial institutions treated as non-financial entities for purposes of Chapter 4 (see Section II above) will also be treated as excepted NFFEs.

5. Status of Trusts as FFI's or NFFE's

It is possible that a trust could meet the definition of a Foreign Financial Institution under section 1471(d)(5)(B), since, almost by definition,[14] the purpose of a trust is to hold or protect and conserve financial or other assets for the account and benefit of others. Of course, trusts generally are not organized to engage in business, but as indicated above, Notice 2010-60 states that the term "business," as used for purposes of Chapter 4, does not have the same meaning it does for certain other Code purposes. Indeed, it may be that the "business" of a trustee is to acquire and hold financial assets for the benefit of a trust's beneficiaires on a private and non-commercial basis. The Notice appears to indicate that a family trust holding assets for the benefit of its beneficiaries may not be within the scope of entities that the definition of an FFI is

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[12] IRC § 1472(b)(1).

[13] IRC § 1472(c).

[14] See Treas. Reg. § 301.7701-4(a).

intended to target, but but the example is drawn narrowly.[15] It is to be hoped that further helpful guidance will be forthcoming.

Even if a trust is not an FFI, it may still be subject to Chapter 4 withholding as an NFFE. Thus, it would not be required to enter into an FFI Agreement, but it would have to either certify that it has no "substantial United States owners" or provide information in respect of any beneficiaries who are such persons. The difficulty here is that there is, as yet, no guidance on how to measure whether a U.S. beneficiary might be considered to have a greater than 10 percent interest in the trust or its financial accounts and other assets. In the case of a beneficiary with a contingent discretionary interest, there is no certain way in which to measure the value of such an interest.

6. Effective Date and Grandfathered Obligations

As indicated at the outset, because of the complexity and magnitude of the new Chapter 4 provisions, Congress provided a deferred effective date so that Treasury and the IRS would have time to issue necessary guidance and financial institutions and other potential withholding agents would have sufficient opportunity to design and implement appropriate administrative systems. Thus, in general, all of the Chapter 4 rules are generally effective for payments made after December 31, 2012. In addition, there will be an ongoing exception from withholding for payments made after the general effective date on any obligation, or on the proceeds from the disposition of any obligation, that is outstanding on March 18, 2012.

Notice 2010-60 defines the term "obligation" for purposes of this grandfather rule to mean any legal agreement that produces or could produce withholdable payments. However, an obligation will not include any instrument treated as equity or any legal agreement that lacks a definitive expiration or term (e.g., savings deposits, demand deposits, and other similar accounts). Further, a withholdable payment arising from a legal agreement in the nature of brokerage accounts, custodial and similar agreements to hold financial assets for the account of others, and to make and receive payments of income and other amounts with respect to such assets, will not be excepted from 30 percent withholding under this rule.

The Notice explains that obligations subject to a material modification will be deemed "newly issued" as of the date of any such modification. As a result, obligations that have been materially modified after March 18, 2012 will not be excepted from Chapter 4 withholding. If an obligation constitutes indebtedness for U.S. tax purposes, a "material modification" is any significant modification of the debt instrument within the meaning of Treasury Regulation section 1.1001-3. In all other cases, whether a modification of an obligation is material will be determined based on all relevant facts and circumstances.

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[15] This exception appears to only directly apply to small family trusts that are settled and funded by a single person for the sole benefit of his or her children. Under this exception the trust would not be required to enter into an FFI Agreement in order to avoid withholding. The Notice contemplates that the account holders are all individuals or NFFEs that would otherwise not be subject to withholding or reporting. While it is not clear exactly what this means, it could be interpreted to be inapplicable where the account holders are U.S. citizens.

C. Section 6038D Reporting of Foreign Financial Assets

1. In General

New section 6038D requires every individual taxpayer to include with their income tax return information regarding interests held in certain specified foreign financial assets if the aggregate value of such assets exceeds $50,000.[16] The new requirement is applicable for tax years beginning after March 18, 2010, the date of enactment of FATCA. Thus, taxpayers will have to first report this information with their 2011 individual income tax returns. A draft of the form that will be used, Form 8938 ("Statement of Foreign Financial Assets"), was issued without instructions in July 2010.

As a general matter, it is important to note that his is not the same requirement that applies to filing Form TD F 90-22.1 (the so-called "FBAR") with the U.S. Treasury Department. A U.S. person having signatory authority over, or a financial interest in, one or more foreign financial accounts having an aggregate value in excess of $10,000 at any point during a calendar year will still be required to file an FBAR on or before June 30 of each year. The section 6038D requirement is in addition to any FBAR requirement, and the required information must be attached to the individual's annual income tax return, on the applicable filing date, if the aggregate value of the specified foreign financial assets exceeds $50,000 in that taxable year.

This requires individuals to first identify all reportable assets and provide sufficient information to demonstrate the aggregate value of such assets. If the Secretary determines that an individual has an interest in specified foreign financial assets and that such individual either failed to report or failed to provide sufficient information regarding their value, then there is a presumption that the value is in excess of $50,000, which will have implications in assessing penalties.[17]

2. Foreign Assets Subject to Reporting Requirement

The "specified foreign financial assets" to be reported include interests in any "financial account" maintained by a "foreign financial institution,"[18] as defined in Chapter 4's section 1471(d), as well as certain other financial assets, including stocks or securities of non-US issuers,[19] financial instruments or contracts having an issuer or counterparty that is not a U.S. person[20] and any interest in a "foreign entity" (i.e., an entity that is not a U.S. person).[21]

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[16] IRC § 6038D(a).

[17] IRC § 6038D(e).

[18] IRC § 6038D(b)(1).

[19] IRC § 6038D(b)(2)(A).

[20] IRC § 6038D(b)(2)(B).

[21] IRC § 6038D(b)(2)(C). The term "foreign entity" is defined in IRC § 1473(5).

Because section 6038D refers to the provisions of new Chapter 4, discussed above, for the meaning of "foreign financial institution" and "foreign entity," it offers no guidance as to whether a financial account held by a trust or a beneficial interest in a trust constitutes a "specified foreign financial asset" that must be reported. Nor is there any guidance on how an individual is to measure the value of a beneficial interest in a trust or its underlying accounts. It is to be hoped that guidance will be issued prior to the due date for 2011 tax returns.

3. Information Required to be Disclosed

Section 6038D(c) requires an individual to disclose the following information regarding any foreign financial asset required to be reported.

a. the name and address for each foreign financial institution, as well as the account number for every account;

b. the name and address of each issuer of every foreign stock or security, as well as information about the class or issue of which the stock or security is a part;

c. the name and address of each issuer or counterparty and the information required to identify every instrument, contract or interest; and

d. the maximum value of *each such asset* during the taxable year.

4. Penalties for Non-compliance

Section 6038D(d) imposes a penalty of $10,000 on any individual who fails to timely file the required information. If a filing delinquency persists for more than 90 days after receipt of notice from the IRS, the penalty increases by $10,000 for each 30-day period of continued non-compliance, up to a maximum value of $50,000.[22] Further, if a taxpayer does not provide sufficient information to demonstrate the value of specified foreign financial assets, the statute creates a presumption that such assets exceed $50,000 for purposes of assessing the penalty.[23] In addition, Treasury is provided broad powers to issue regulations under section 6038D to carry out its purposes, including the ability to apply the section to any domestic entity formed for the purpose of holding specified foreign financial assets as if such entity were an individual.[24] There is a reasonable cause safe harbor that would prevent the application of the penalty if an individual can show that failure to timely file was due to reasonable cause and not to willful neglect.[25] On the other hand, a taxpayer who willfully fails to file the required information or

[22] IRC § 6038D(d).

[23] IRC § 6038D(e).

[24] IRC § 6038D(f).

[25] IRC § 6038D(g). The provision expressly states that the fact that a foreign country would impose civil or criminal penalties on a taxpayer for disclosing required information is not reasonable cause.

who provides false information with regard to foreign assets may be subject to prosecution under the Code's criminal provisions.[26]

Besides this section specific civil penalty, FATCA amends section 6662 to add "undisclosed foreign financial asset understatement" to the list of underpayment items subject to a 40 percent accuracy-related understatement penalty.[27] The statute defines "undisclosed foreign financial asset" to include any omitted item for which information is required to be reported under sections 6038, 6038B, 6038D, 6046A and 6048.

D. New PFIC Reporting Under Section 1298(f)

The Act adds new section 1298(f) to the Code,[28] pursuant to which shareholders of a passive foreign investment company are required to make an *annual* return with respect to their shareholding containing information described in future guidance. The effective date for section 1298(f) is FATCA's date of enactment as part of the HIRE Act, March 18, 2010. However, in Notice 2010-34, [29] the IRS stated that, until further guidance is issued, persons not required to file a PFIC information return before the enactment of IRC § 1298(f) need not make an annual information return. Persons previously required to file Form 8621 should continue to make such a return, if appropriate.[30]

E. Provisions Regarding Foreign Trusts

FATCA makes several changes to the Code's provisions pertaining to foreign trusts, including substantive, reporting and penalty provisions.

1. Provisions Relating to "Outbound" Grantor Trusts

Section 679 was added to the Code by the Tax Reform Act of 1976[31] to treat a U.S. person who transfers property, directly or indirectly, to a foreign trust as "owner" of the trust to the extent of the property transferred if, at any time during a taxable year, the trust has a U.S. beneficiary. One of the principal issues in interpreting and applying section 679 pertains to when a foreign trust is considered to have a U.S. beneficiary. Prior to the changes made by FATCA, the only significant revisions to the section were made by the Small Business Job Protection Act

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[26] *See, e.g.*, IRS §§ 7201, 7203, 7206(1)

[27] HIRE Act § 512(a), amending IRC § 6662(b) and adding new subsection 6662(j).

[28] HIRE Act § 521(a).

[29] 2010-17 I.R.B. 612 (Apr. 6, 2010).

[30] Under prior law, reporting was required to be made only in years that a taxpayer was considered to have received a PFIC distribution, including from a sale of the PFIC shares, or was making one of the several elections available regarding the tax treatment of the PFIC interest.

[31] Pub. L. 94-455, § 1013(a).

of 1996 ("1996 SBJPA"),[32] which, *inter alia*, added section 679(c)(3), which provides that a beneficiary shall not be considered to be a U.S. beneficiary for purposes of section 679's principal operative rule if first becoming a U.S. person more than five years after the date property was transferred to the trust by a U.S. transferor.

Section 679(c)(1) has always provided that a trust is treated as having a U.S. beneficiary unless, (i) under the terms of the trust, no part of the income or capital may be paid or accumulated to or for the benefit of a U.S. person, and (ii) if the trust were terminated no income or capital could be paid for the benefit of such a beneficiary. The Treasury Regulations, at section 1.679-2, adopted following the significant revisions to the treatment of foreign trusts in the 1996 SBJPA aimed at curbing the opportunities for perceived abuses, have sought to interpret these provisions broadly. However, it was believed by Congress that stronger provisions were required, especially given the opportunities for abuse presented by foreign discretionary trusts. Accordingly, FATCA added several "clarifying" provisions to section 679:

> (i) an amount may be considered accumulated for the benefit of a U.S. beneficiary even if such beneficiary's interest in a trust is contingent on a future event;[33]
>
> (ii) if any person (e.g., a trustee or "Protector" has discretion to add a trust beneficiary, the trust will be considered to have a U.S. beneficiary unless the class of persons who may be added are specifically identified and none is a U.S. person during the taxable year;[34] and
>
> (iii) if a U.S. transferor of property to a foreign trust is involved in any agreement or understanding (written or otherwise) that may result in a U.S. person benefitting from the trust (e.g., a letter of wishes, notes for guidance, or an implied understanding with trust fiduciaries), such agreement or understanding will be considered a term of the trust.[35]

To leave nothing to chance, FATCA also added new section 679(d), which provides that the IRS may presume that a foreign trust to which a U.S. person has transferred property has a U.S. beneficiary unless the transferor submits such information as may be requested by the IRS that demonstrates that no income or capital of the trust may be paid, accumulated or, on termination, distributed to or for the benefit of a U.S. person.

2. <u>Expanded Meaning of "Distribution" Under Section 643(i)</u>

Section 643(i) was added to the Code by the 1996 SBJPA to address certain perceived abuses in connection with the tax treatment of foreign trusts having U.S. beneficiaries. Before its recent amendment by the Act, the provision treated only loans of cash or marketable securities to

[32] Pub. L. 104-188, § 1906(c)(1).

[33] Sentence added to flush language following IRC § 679(c)(1).

[34] IRC § 679(c)(4).

[35] IRC § 679(c)(5).

a U.S. grantor or beneficiary of a foreign trust, or to persons considered related to such grantor or beneficiary, as a distribution to the grantor or beneficiary potentially taxable under the rules generally applicable to complex trusts.

Likely as a result of disclosures at 2006 hearings conducted by the Senate Committee on Homeland Security and Governmental Affairs Permanent Sub-Committee on Investigations of the uncompensated use of foreign trust-owned property by U.S. persons,[36] a provision was added to FATCA that amended section 643(i) to also treat the fair market value attributable to use of trust-owned property as a trust distribution. The value of such use is excepted from treatment as a distribution, however, if the trust is paid the fair market value of such use within a reasonable period of time after the use.[37]

Note that section 643(i) only treats the use of trust-owned property as a trust distribution. The provision does not purport to create income to the trust. Thus, the use of trust-owned property will only result in a deemed distribution of taxable income to a grantor or beneficiary if the trust has current or accumulated income from other sources.

The amendments to sections 643(i) and 679 are effective with respect to uses of trust-owned property and transfers of property after March 18, 2010, the FATCA enactment date.

F. Statute of Limitation Changes

Finally, FATCA amends section 6501(e) to extend the statute of limitations from three years to six years after a return is filed where a taxpayer omits from gross income on his return an amount in excess of $5,000 that is attributable to one or more assets of a type required to be reported under section 6038D (without regard to whether taxpayer's aggregate foreign financial assets exceed the threshold value required for there to be reporting under such section).

In addition, section 6501(c)(8) is amended to include the failure to report information under sections 1298(f) and 6038D, as events that toll the statute of limitations for the duration of the taxpayer's noncompliance plus three years. Moreover, and most significantly, FATCA amends section 6511(c)(8) to permit examination of a taxpayer's *entire tax return* and not just of items and events that should have been disclosed on the omitted or insufficient information returns. The Act calls this a "clarification" of prior law, but it is directly contrary to the prior announced position of Treasury and the IRS on the interpretation and application of section 6501(c)(8) in the preamble to final regulations under sections 6038 and 6038B, two other information reporting provisions subject to the extended statute of limitations rule, that limits the

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[36] See, e.g., David Cay Johnston, "U.S. blows the whistle on tax cheats: Evasion is rampant among the super-wealthy, report finds", *International Herald Tribune*, August 1, 2006.

[37] Note that a corresponding provision regarding the use of trust-owned property was also added to IRC § 679 to treat such use by any U.S. person as paid or accumulated for the benefit of a U.S. beneficiary in order to trigger application of that section. As with IRC § 643(i), there is no consequence if fair market value is paid for the use of such property within a reasonable period of time. IRC § 679(c)(6).

effect to just the omitted information.[38] This change dramatically increases the scope of IRS review and enforcement with respect to the information returns corresponding to the Code sections enumerated in the provision.[39]

FATCA's changes to the statute of limitations provisions are generally effective for returns filed after March 18, 2010, and for prior returns for which the period for assessment under section 6501 had not expired as of such date (determined without regard to the amendments).

G. Conclusion

In addition to its provisions requiring reporting individual reporting of foreign assets, extending the statute of limtations, and altering the rules on foreign trusts, FATCA most importantly creates a new and complex regulatory regime applicable worldwide. FATCA is at bottom not a statute designed to raise money by withholding taxes – withholding is intended as a club to force FFIs and others to disclose the identities of American taxpayers who bank and conduct other business overseas.

FATCA was scored by the staff of the Joint Committee on Taxation to raise $8.714 billion over 10 years, but true net revenue gains, if any, could nevertheless be minimal or non-existent, given the likely deductible costs of compliance to U.S. businesses and others. Financial institutions are already predicting that their compliance costs will also rise into the billions. Their compliance and tax departments are just beginning to appreciate the potentially extensive steps that must be taken to achieve compliance with FATCA.

Moreover, many commentators have noted that through the passage of FATCA, the U.S. is seeking to enlist, if not compel, the assistance of non-U.S. businesses and persons, at their own expense, in the enforcement of U.S. laws against tax evasion. Some have pondered the question how the U.S. would react if American institutions were subjected to such a regulatory regime imposed by foreign powers. Many have also noted that FATCA will simply create a disincentive for FFI's and others to invest in the United States and to agree to service U.S. citizens living abroad.

[38] T.D. 8850, 2000-2 I.R.B. 265, 268. A broader discussion of the scope of IRC § 6501(c)(8) is set forth in ITA 200024051 (Apr. 20, 2000), which unambiguously states the view of Chief Counsel (International) that the section keeps the assessment period open only for tax imposed with respect to any event or period to which information required to be furnished to the IRS relates and not with respect to the entire tax return. Further, the Technical Advice confirms that this policy should be applied consistently to all the Code provisions listed in IRS § 6501(c)(8).

[39] Note that IRC § 6501(c)(8) was further amended by an apparent technical correction (Pub. L. 111-226, § 218(a)) on August 10, 2010 (with effect from March 18, 2010, FATCA's date of enactment), to provide that, if failure to provide any of the required information returns is due to "reasonable cause," the extended limitations period only applies to items related to such failure and not to the entire tax return. See CCA 201104041 (Dec. 20, 2010)(which also refers to the statutory amendment as a "clarification" of the law).

However, FATCA, which passed Congress with little fanfare and almost no in-depth analysis, is the law of the land and should be fully implemented by 2013. Many questions remain about how the IRS will interpret and enforce FATCA, and these will be fleshed out in coming months. For now, FFI's and others must begin implementation, and tax practitioners should continue to monitor the IRS for forthcoming guidance.