FATCA: What it Is, What it Isn't, and What's Next

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The Foreign Account Tax Compliance Act (FATCA) came into effect in 2010[1]. In addition to the many important changes FATCA brings to the financial and tax landscape, it is also important to understand the many pre-existing US tax obligations and requirements that the US is seeking to enforce through the information it obtains through FATCA. The technical definitions, requirements, and laws of US taxation can be difficult to navigate, even for the most informed tax professionals. Therefore, the primary purpose of this article is not to offer detailed legal analysis or recite the laws but rather to aid in ending some of the misconceptions, review key issues, inform taxpayers of their compliance obligations, and, perhaps most importantly, remove some of the mystique, confusion, and fear surrounding FATCA.

What it Isn't: Pre-FATCA Laws

Worldwide Tax Reporting

The US taxes the income of all US persons worldwide. US persons include citizens, residents (also known as green card holders), and other taxpayers who have spent enough time in the US to meet the Substantial Presence Test prescribed by the Internal Revenue Code.[2] In addition to paying taxes on worldwide income, US persons are required to report their income regardless of where they live or from where they earn the income. For example, if a taxpayer obtains a green card for the convenience of entering the US or for future immigration planning, they would have to report and pay US tax on worldwide income even if they move back to their home country and have no other ties to the US. A US person earning income abroad may have the ability to utilise benefits such as foreign earned income exclusion or foreign tax credits; however, they will always be obligated to file a US tax return and report the income.

In summary, US persons have to pay taxes on worldwide income regardless of where they earn their income or where they live. However, this system existed long before FATCA.

International Information Reporting

In addition to income reporting, US persons are also required to report a number of foreign activities and transactions even if no income is earned. The reporting is accomplished by submitting a number of additional forms with their tax returns. Except for the Statement

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of Specified Foreign Financial Assets (Form 8938), which will be discussed later, these international information reporting forms existed before FATCA. For example, one of the most common of these forms is the Information Return of US Persons with Respect to Certain Foreign Corporations (Form 5471), which is generally required when US persons who own at least 10 per cent of the stock of a foreign corporation engage in certain transactions or meet ownership thresholds that give them control.[3]

Although these forms are only informational, they can carry significant penalties for failure to file.[4] Before FATCA, there were a number of reasons why these forms were required. Primarily, the US needs to track these foreign activities for tax considerations such as estate taxes, gift taxes, income taxes, capital gains taxes, and Subpart F income, where foreign deferral of income is disallowed.[5] FATCA did not create these filing requirements, the need for the information, or the potential monetary penalties.

Foreign Bank Account Reports (FBARs)

Foreign bank account reports, also known as FBARs, are now completed electronically by filing FinCEN Form114 through the Financial Crimes Enforcement Network (FinCEN) system. These reports are required when taxpayers have ownership of or signature authority over foreign bank accounts that have a cumulative value of at least 10,000 dollars.[6] It is a common misconception that this reporting was a result of FATCA. In fact, FBAR reporting has been around for decades and was initiated by the Bank Secrecy Act of 1970.[7] FATCA, and the change to the FinCEN system, has not changed the requirement for reporting this information or the related penalties. Although FBAR reporting has become associated with income taxes, it was initially intended to combat financial crimes. FBAR reporting is found under Title 31 of the US Code rather than Title 26, also known as the Internal Revenue Code, which governs income taxes. As a result, the implications arising from FBAR reporting and income tax reporting differ. These differences include who must file, related crimes and punishment, civil penalties, tax treaty benefits, and immigration concerns. It is imperative that taxpayers understand these distinctions and do not run afoul of the reporting requirements as the penalties can be severe.

What it Is: New Laws under FATCA

Intergovernmental Agreements ("IGAs"), 30 Per Cent Tax, and W-8s

Perhaps the best known part of FATCA is government reporting through intergovernmental agreements, which are agreements between the US and a foreign country that require financial institutions within that foreign country to report US account holders either to their own government and then to the US or to the US directly.[8] Although some of these agreements are deemed bilateral, in many cases, this information sharing is one-sided in favour of the US.

While IGAs may be the most well-known component of FATCA information sharing, the provision that is catching many off guard is the self-reporting by banks and other financial institutions. To have more timely access to the desired information of US account holders in foreign countries, the US included a clause to motivate financial institutions to self-report.[9] Under the new law, financial institutions that do not register with the US and report US account holders are subject to a 30 per cent withholding tax on payments made from the US.[10] This 30 per cent withholding covers a more expansive list of payments than the usual passive income known as FDAP (fixed, determinable, annual, or periodical).[11] It is also not limited by treaty withholding rates and is imposed even if the financial institution is located in a country that does not have a signed IGA. To avoid this withholding, many financial institutions have already

registered with the US, obtained a tax identification number, and started voluntarily reporting US account holders.[12] Therefore, taxpayers with accounts in countries without an IGA can be surprised when they receive a letter from their bank or financial institution stating that their information will be subject to FATCA reporting.

This reporting brings us to what appears to be the biggest headache for foreign taxpayers – a series of W-8 forms. Whether through self-reporting or IGAs, financial institutions needed a way to determine who a US person is so they could determine who is subject to FACTA reporting. Currently, this is accomplished by requiring the suspected US person to sign either a Request for Taxpayer Identification Number and Certification (Form W-9) to certify that they are a US person or one of the W-8 related forms to certify they are not.[13] The Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Form W-8BEN) existed prior to FATCA, but its variations and the extent of reporting have greatly expanded. The key point for taxpayers to understand is that although these are US forms signed under penalty of perjury and can have consequences with the US, they are firstly an agreement between the taxpayer and the financial institution. If a taxpayer incorrectly completes or fails to file the form, the financial institution will likely refuse to do business with the taxpayer. Although these forms are frustrating and burdensome, it appears they are here to stay. Therefore, anyone who wants to invest in or do business with any financial institution subject to FATCA needs to adjust to this process.

Form 8938

The main form for individuals created by FATCA is the Statement of Specified Foreign Financial Assets, Form 8938.[14] This form is very similar to the FBAR, but it includes some investments and financial instruments that are not required to be reported on a FBAR.[15] The often perceived double reporting between Form 8938 and the FBAR has also frustrated taxpayers. As explained above, the FBAR is not a form required by the Internal Revenue Code and is not submitted to the Internal Revenue Service. Since the FBAR is filed with FinCEN, Form 8938 is a way for the US tax authorities to obtain this same information for their own records and analysis. Again, despite being informational only, Form 8938 can result in severe penalties, and taxpayers must understand their filing requirements. [16]

Extended Statute of Limitations

Although there were no major changes to the civil or criminal penalty structure, FATCA did implement a major change to the statute of limitations.[17] Generally, US tax authorities are given three years to make a tax assessment on a return, which is usually done through a review or audit.[18] The statute of limitations can also be extended for certain circumstances and violations. Additionally, the statute of limitations does not begin to run until a tax return is filed.[19] Prior to FATCA, when a return was filed without the required international information report, the statute of limitations only remained open on the missing international information. FATCA has modified this. Now, regardless of the comparative size of the international report and tax return, the statute of limitations for the entire tax return does not begin to run until all foreign information reports are filed.[20] For example, if a taxpayer has 100 foreign subsidiaries and only files 99, overlooking 1, the statute of limitations on the entire tax return does not begin to run until the final report is filed. This change in the law makes it imperative that taxpayers are vigilant in ensuring that all necessary foreign information reports are timely filed.

What Does This Mean for Taxpayers?

US Amnesty Programmes

As previously mentioned, many of these requirements have been around for years, but the US is aware

that until recently they were often overlooked or misinterpreted. The main goal of the US is to gain compliance from taxpayers; however, even with this wealth of information from FATCA, there are still undiscovered taxpayers and insufficient resources to locate everyone. For these reasons, the US has a series of programmes for taxpayers to voluntarily become compliant with their taxes and reporting requirements. The problem with these programmes is that they are just programmes; they are not official US law and do not have the same options for appeal or litigation. This can leave taxpayers at the mercy of the government. As a gesture of appeasement, the US has stated that it will not try to excessively punish taxpayers who are making an honest effort to properly report, but exactly what this means is anybody's guess. However, it is clear that the US is going to make an example out of anyone who blatantly evades and/or ignores their obligations.

Offshore Voluntary Disclosure Program (OVDP)

The OVDP has been implemented a few times.[21] The most recent version was introduced in 2012 and updated in 2014.[22] Under the OVDP, taxpayers are able to voluntarily come forward to become compliant with their obligations. To be eligible for the OVDP, taxpayers cannot currently be under audit or criminal investigation.[23] The filing requirements include eight years of amended returns, FBARs, and foreign reports as well as several information reports, letters, and statements.[24] The OVDP allows taxpayers to avoid criminal prosecution and also limits their penalty exposure for noncompliance.[25] In return, taxpayers must pay a heavy penalty. The penalty is determined by looking at all foreign assets that created unreported income during the relevant eight-year period.[26] A penalty of 27.5 per cent is assessed on the highest yearly aggregate value of these assets during the look-back period.[27] While this penalty may sound excessive, the potential penalties and criminal exposure without the OVDP can be much more costly.

Streamlined Filing Compliance Procedures

Until 2014, taxpayers had limited options. They could do nothing, participate in the OVDP, or take their chances with unsanctioned methods such as quiet disclosure. This outraged many taxpayers who felt it was unfair for those who made innocent mistakes or were unaware of their reporting obligations to have to pay the same penalty as potential criminals and tax evaders. In response to this, streamlined filing compliance procedures were implemented.[28] Taxpayers who can certify that their noncompliance was not wilful and meet certain other requirements may take advantage of this programme,[29] which is far more beneficial than the OVDP as only three years of tax returns and information reports along with six years of FBARs are required.[30] Also, most of the OVDP information reports, letters, and other statements are not required. Best of all, the penalty is significantly less. The 27.5 per cent penalty from the OVDP is dropped to a 5 per cent penalty for domestic taxpayers and is imposed on a less expansive list of taxpayer's assets.[31] Moreover, taxpayers who are deemed to be foreign do not have to pay a penalty at all.[32] This illustrates that the US is willing to offer favourable incentives to achieve their main goal of moving taxpayers into compliance.

This programme may seem too good to be true for some people. However, the "non-wilful" standard is not as simple as the taxpayer claiming they had no knowledge of their tax obligations or FBAR reporting.[33] Taxpayers need to be aware that through a series of court cases, the US has created the term "wilful blindness".[34] The importance of this development is that whether the taxpayer actually knew about the requirements may not matter, but whether they should have known does. This makes the decision of whether to enter the streamlined filing compliance procedures a significant one requiring detailed analysis and one that should not be taken lightly.

Delinquent FBAR and International Information Return Submission Procedures

Taxpayers who have in good faith and with reasonable cause committed non-filing violations that have not resulted in unreported income can take advantage of this programme.[35] However, the requirement of "reasonable cause" for the international information returns can make this option difficult as "reasonable cause" is a stricter standard than the "non-wilful" standard in the streamlined procedures. One example where delinquent reporting seems to be most commonly used is when the taxpayer only has signature authority on foreign bank accounts that do not create income but still warrant the filing of an FBAR.

Now What?

FATCA has been met with substantial criticism, but it is forging ahead. One reason for this is that the US feels FATCA is accomplishing the intended goals. Following in the US's footsteps, the global community is creating programmes similar to FATCA. This is a good indication that not only is FATCA here to stay but that the future will likely see a move towards an even more transparent tax and financial reporting world. At this point, the US is already obtaining an enormous amount of information, and this amount will only increase. This information will allow the US to find and punish taxpayers who choose to remain non-compliant. Moreover, the position of the Internal Revenue Service and the US government appears to be that taxpayers have been given every opportunity to become compliant through the publicity given to this issue and various amnesty programmes. Therefore, one can only assume that there will be little sympathy for taxpayers who choose to do nothing. Now is the time for taxpayers to understand their international tax reporting and income tax obligations, determine the best way to become compliant, and put procedures into place to stay compliant in the future.

Endnotes

1. Public Law 111-147, Foreign Account Tax Compliance Act.
2. 26 U.S.C. § 7701(a)(30); 26 C.F.R. 301.7701(b)-1(b) and (c).
3. 26 U.S.C. § 6038; 26 C.F.R. 1.6038-2(a).
4. 26 C.F.R. § 1.6038-2(k).
5. 26 U.S.C. § 951-965.
6. 31 C.F.R. 1010.350, Reports of foreign financial accounts.
7. Public Law 91-508.
8. 26 C.F.R. § 1.1471-1(78), (79).
9. 26 U.S.C. § 1471-1490.
10. 26 U.S.C. § 1471(a).
11. 26 U.S.C. § 1471(b)(1)(D); 26 C.F.R. 1.1441-2(b).
12. See https://apps.irs.gov/app/fatcaFfiList/flu.jsf
13. 26 C.F.R. § 1.1471-3.
14. 26 U.S.C. § 6038D; 26 C.F.R. 1.6038D-3.
15. 26 C.F.R. § 1.6038D-3.
16. 26 USC § 6038D(d).
17. 26 USC § 6501(c)(8).
18. 26 USC § 6501(a).
19. 26 USC § 6501(a).
20. 26 USC § 6501(c)(8).

21. Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers (hereinafter "OVDP FAQs"), Q&A 1, available at www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers-2012-Revised.

22. OVDP FAQs, Q&A 1.

23. OVDP FAQs, Q&A 12.

24. OVDP FAQs, Q&A 25.

25. OVDP FAQs, Q&A 4.

26. OVDP FAQs, Q&A 8.

27. OVDP FAQs, Q&A 8. (Penalty can be increased to 50 per cent under certain circumstances; see OVDP FAQs, Q&A 7.2)

28. Streamlined Filing Compliance Procedures Overview (hereinafter "Streamlined Overview"), available at www.irs.gov/Individuals/International-Taxpayers/Streamlined-Filing-Compliance-Procedures.

29. Streamlined Overview.

30. Streamlined Domestic Offshore Procedures for U.S. Taxpayers Residing in the United States (hereinafter "Streamlined Domestic Procedures"), available at www.irs.gov/Individuals/International-Taxpayers/U-S-Taxpayers-Residing-in-the-United-States; Streamlined Foreign Offshore Procedures for U.S. Taxpayers Residing Outside the United States (hereinafter "Streamlined Foreign Procedures"), available at www.irs.gov/Individuals/International-Taxpayers/U-S-Taxpayers-Residing-Outside-the-United-States.'

31. Streamlined Domestic Procedures.

32. Streamlined Foreign Procedures.

33. U.S. v. Williams, 110 AFTR 2d 2012-5298 (4th Cir. 2012).

34. U.S. v. McBride, 908 F. Supp. 2d 1186 (D. Utah 2012); U.S. v. Zwerner, S.D. Fla., No. 1:13-cv-22082, 5 / 28 / 14; Internal Revenue Manuel 4.26.16.6.5.1.

35. Delinquent FBAR Submission Procedures, available at www.irs.gov/Individuals/International-Taxpayers/Delinquent-FBAR-Submission-Procedures; Delinquent International Information Return Submission Procedures, available at www.irs.gov/Individuals/International-Taxpayers/Delinquent-International-Information-Return-Submission-Procedures. T