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U.S. Foreign Account Tax Compliance Act: New Reporting Obligations on Foreign Financial Institutions about U.S. Individuals' Accounts, Investments

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The Foreign Account Tax Compliance Act (FATCA), signed into law on March 18, 2010, was enacted to combat tax evasion by U.S. citizens and residents who have offshore accounts and assets.[1]

Under FATCA, beginning in 2014, the U.S. Internal Revenue Service (IRS) will receive annual reports ("FFI Reports") from certain foreign financial institutions (FFIs)—including foreign banks and foreign investment funds—that disclose information regarding accounts and investments held or owned at the FFI by U.S. citizens and residents, including lawful permanent residents who hold U.S. "green cards" ("U.S. Persons").[2]

Before FATCA, foreign financial institutions were not required to report to IRS information about accounts held directly or indirectly by U.S. Persons, except in limited situations.[3]

For the first time, the United States has instituted a tax reporting regime that imposes a potential penalty on foreign financial institutions that refuse to report information about U.S. Persons who hold accounts or investments with them.

Now, for the first time, the United States has instituted a tax reporting regime that imposes a potential penalty on FFIs that refuse to report information about U.S. Persons who hold accounts or investments with them.

FATCA imposes a 30 percent withholding tax on payments to an FFI of:

- U.S.-source passive income;

- the gross proceeds from the sale of assets that produce U.S.-source income; and
- foreign-source "passthru" payments from other FFIs to the extent attributable to their U.S. assets, unless the FFI enters into an agreement (an "FFI Agreement") with IRS and complies with the terms of the agreement, or the foreign government of the country in which the FFI is located enters into an Intergovernmental Agreement (IGA) with IRS.

This withholding regime is intended to encourage FFIs to enter into FFI Agreements to report accounts and investments by U.S. Persons.

The filing of FFI Reports with IRS will substantially increase the likelihood that U.S. Persons who have failed to file tax returns and required reports with IRS will face severe penalties, including substantial fines, the payment of back taxes, and possible criminal penalties, including potential imprisonment.

Indeed, FFI Reports may, among other things:

- reveal foreign accounts that U.S. Persons failed to report previously to the United States on an annual Report of Foreign Bank and Financial Accounts ("FBAR") or contradict information that U.S. Persons previously submitted to IRS on these or other forms;
- reveal income earned by non-resident U.S. Persons who have little connection to the United States other than their citizenship or green card status and have not paid U.S. income taxes; and/or
- otherwise reveal that U.S. Persons did not comply with their U.S. tax obligations.

IRS has instituted voluntary disclosure programs designed to permit delinquent taxpayers to become compliant. Under these programs, taxpayers generally must pay all back taxes, interest, and at least some percentage of the otherwise applicable civil penalty. In return, however, IRS frequently agrees not to refer the case to the Department of Justice for criminal investigation and prosecution. However, only persons not currently under investigation are eligible for such treatment.

For individuals and entities that hold foreign accounts and may not have complied with all of their federal and state tax liabilities, now may be the ideal (and perhaps last) time to take advantage of IRS voluntary disclosure programs to disclose and address their tax liabilities without criminal punishment.

This article addresses in detail the potential U.S. civil and criminal exposure individuals may face in the wake of FATCA, and potential strategies to assess and address any such exposure.

Pre-FATCA Reporting Requirements Involving Foreign Assets for U.S. Persons

Unlike most other countries, the United States taxes the worldwide income of its citizens and residents. Accordingly, U.S. Persons wherever they reside are generally obligated to file income tax returns and pay U.S. tax on income anywhere in the world.[4]

In light of this regime, many individuals living and working outside the United States are often surprised to learn that they have tax-related obligations to the United States. These include:

- adults born in the United States who have not set foot in the United States since they were very young;
- individuals who are citizens because they are foreign-born children of citizens or because they are foreign-born children adopted by U.S. citizen parents, provided certain conditions are met; and
- lawful permanent residents who acquired green cards many years ago, but who have left the United States without having terminated their green card status.

U.S. Persons maintaining significant accounts with foreign banks and other financial institutions are very likely to be reported to IRS under FATCA commencing in 2014 with respect to calendar year 2013 accounts and income.

As discussed further below, these individuals are liable for U.S. tax and may be subject to increased risk of civil and criminal penalties when FFI Reports begin to be filed with IRS.

For those individuals who were unaware of their obligations, or thought they would escape detection, now may be the ideal time for them to address their tax liabilities, because the voluntary disclosure programs may help them avoid criminal penalties. After FATCA goes into effect, this window may close.

Tax Return Filing Obligations, Reporting Requirements Involving Foreign Assets

Generally, a U.S. citizen or resident must file a U.S. income tax return for 2011 if he or she had gross income in excess of $9,500 if single or $19,000 if married and filing jointly ($3,700 if married and filing separately).[5]

In addition to the standard income tax return, U.S. Persons may be required to submit information to IRS regarding foreign trusts, gifts and bequests from foreign persons, and investments in foreign entities. These can include Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts; Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation; Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations; Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation; Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships; Form 8621, Information Return by a U.S. Shareholder of a Passive Foreign Investment Company;

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and Form 8858, Information Return of U.S. Persons With Respect to Foreign Disregarded Entities.

Finally, under the same legislation that adopted FATCA, U.S. Persons who hold an interest in foreign accounts or who own foreign stocks and debt obligations that generally aggregate more than $50,000 at year-end or $75,000 at any time during the year must report such accounts and investment assets to IRS on Form 8938, Statement of Specified Foreign Financial Assets, commencing for calendar year 2011.[6]

FBAR

In addition, U.S. Persons must also annually file an FBAR (Form TD F 90-22.1) with the U.S. Treasury to report their interests in, or signature authority over, financial accounts located outside the United States with foreign financial institutions if the aggregate value of such financial accounts exceeds $10,000 at any time during the calendar year. The obligation to file an FBAR is imposed by the Bank Secrecy Act and not by the Internal Revenue Code of 1986, as amended (the Code).

These financial accounts include many accounts that would be covered by FATCA, including brokerage, demand, savings, checking, commodity futures, or options accounts, insurance policies or annuities with cash values, and shares in certain mutual funds or similar pooled funds.[7] Importantly, a U.S. Person must file an FBAR even if he or she has no current income from any of these accounts and is not required to file a U.S. income tax return.

FATCA Imposes New Requirement for FFIs to Report Information on Foreign Accounts

As described briefly above, FATCA requires FFIs to provide—either directly or through a foreign government intermediary—IRS with certain information about U.S. Persons or entities with substantial U.S. owners that hold debt or equity interests in, or have financial accounts maintained at, such FFIs.[8]

Generally, an FFI will be required to report the following information for each calendar year with respect to any account covered by FATCA[9] :

- name, address, and taxpayer identification number of each account holder;
- the account number;
- the account balance or value;
- payments made on the account during the calendar year; and
- such other information as IRS requires in the FFI Agreement or in other reporting forms and instructions.

Accordingly, U.S. Persons, including dual residents, maintaining significant accounts with foreign banks and other financial institutions are very likely to be reported to IRS under FATCA commencing in 2014 with respect to calendar year 2013 accounts and income.

Potential Civil and Criminal Penalties

U.S. Persons that have not paid their U.S. tax liabilities or filed their required tax returns face severe civil penalties, including substantial fines, the payment of back taxes, and criminal penalties, including possibly imprisonment. FFI Reports will substantially increase the likelihood that these penalties will be asserted.

Civil Penalties

Civil penalties can be significant. For example, if a U.S. Person has failed to file a tax return, that person can be required to pay back taxes and numerous penalties, including a potential penalty equal to 75 percent of the unpaid taxes.[10]

As another example, if an individual has failed to file an FBAR, that individual can be required to pay a fine of at least $10,000 per violation. In the case of willful failure to file an FBAR, the individual will be subject to a civil penalty equal to the greater of 50 percent of the aggregate value of the individual's reportable accounts or $100,000, plus possible criminal prosecution.[11]

U.S. Persons may be required to submit information to IRS regarding foreign trusts, gifts and bequests from foreign persons, and investments in foreign entities.

If an individual has failed to file a Form 8938, that individual will be required to pay the IRS $10,000 for each failure, plus $10,000 per month for each month such failure continues after the taxpayer is notified of the delinquency, up to $50,000.[12]

Many of these civil penalties may be reduced or eliminated if the taxpayer can show "reasonable cause" for such failure.[13] Reasonable cause, at a minimum, generally requires a taxpayer to have exercised ordinary business care and prudence in determining his or her tax obligations. The burden of proof is on the taxpayer to make an affirmative showing of reasonable cause and generally provide supporting information and certifications under penalties of perjury.

Criminal Penalties

Criminal penalties might also be imposed in some circumstances, resulting in substantial fines and possibly imprisonment. Generally, criminal felony liability may exist where the U.S. Person acted willfully to avoid tax or filing obligations. Such willful intent generally will exist only where the relevant U.S. Person knew of his or her obligation, but took deliberate steps to avoid satisfying that obligation.

The following are just a few of the most potentially relevant federal statutes:

- **26 U.S.C. Section 7201:** This statute makes it a federal crime for any person to willfully seek "in any manner to evade or defeat" any U.S. tax payment. A person found guilty of violating this statute may be fined up to $100,000, imprisoned for up to five years per violation, and will be liable for the costs of prosecution.

- **26 U.S.C. Section 7206:** This statute makes it unlawful for any person to willfully file a false U.S. tax return, Form 8938, or other required IRS filings discussed above. A person found guilty of violating this statute may be fined up to $100,000, imprisoned for up to three years per violation, and will be liable for the costs of prosecution.

- **26 U.S.C. Section 7203:** This statute, a federal misdemeanor, may have particular application in matters involving FATCA. It makes it a crime for any person to willfully fail to file tax returns, Form 8938, or other IRS required filings discussed above. A person found guilty of violating this statute may be fined up to $25,000, imprisoned for up to one year per violation, and will be liable for the costs of prosecution.

- **31 U.S.C. Section 5322(a):** This statute makes it unlawful for any person to willfully fail to file an FBAR. A person found guilty of violating this statute may be fined up to $250,000 and imprisoned for up to five years.

- **18 U.S.C. Section 1001:** This statute makes it unlawful for any person to knowingly make any false or misleading statement to the federal government. According to available IRS guidance regarding this statute, this charge is only "normally invoked in connection with false documents or statements submitted to an Internal Revenue agent during the course of an audit or investigation."[14] A person found guilty of violating this statute may be fined up to $250,000 and imprisoned for up to five years.

Strategies to Assess and Address Civil and Criminal Penalty Exposure

Because of the above civil and criminal exposure, and the imminent implementation of FATCA, it is very important that U.S. Persons promptly take steps to satisfy or settle their liabilities and mitigate their potential civil or criminal liability.

If such individuals or entities determine that they owe U.S. taxes or have failed to file their U.S. tax returns and face potential civil or criminal exposure, they can consider a number of options to potentially address this exposure, including the following:

- **Voluntary Disclosure:** Take advantage of IRS programs that encourage the voluntary disclosure to IRS of past failures to file returns or reports and pay taxes. Under these programs, taxpayers generally must pay all back taxes, interest, and at least some percentage of the otherwise applicable civil penalty. In return, however, IRS frequently agrees not to refer the case to the Department of Justice for criminal investigation and prosecution. However, only persons not currently under investigation are eligible for such treatment. Once FFI Reports start being filed, the voluntary disclosure option may no longer be available.

- **New Procedure for 'Low Compliance Risk' U.S. Persons Residing Outside United States:** IRS recently announced a special procedure aimed at individual U.S. Persons living outside the United States who may have only recently learned of their filing obligations and generally owe less than $1,500 in taxes due in each delinquent year or otherwise present a low risk of failing to comply with their tax obligations. Under this procedure, individuals will be required to file all delinquent tax returns, including all related information returns for the past three years, and file delinquent FBARs for the past six years. Taxpayers claiming reasonable cause for abatement of penalties must also submit a dated statement under penalties of perjury explaining why there is reasonable cause for previous failures to file.[15]

- **Quiet Disclosure:** Some U.S. Persons have filed amended returns, reports, and other information, and paid all back taxes and interest, but have not entered the voluntary disclosure programs or expressly notified IRS of past failures. IRS strongly discourages this approach, and has warned that this approach may result in increased scrutiny and increased risk of criminal prosecution.[16]

These options and others carry considerable potential risks and rewards. For example, even voluntary disclosure will not guarantee that one will not face criminal prosecution. Whether to engage in any of the above strategies or others will depend entirely upon the unique facts and circumstances surrounding a particular U.S. Person's situation, and the facts and circumstances should be examined carefully.

NOTES

1 FATCA was enacted as part of the Hiring Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147, 124 Stat. 71 (2010) (the "HIRE Act").

2 IRS will primarily receive FFI Reports in one of two ways: 1) from the FFIs themselves, or 2) from foreign governments that will collect FATCA-related information from FFIs on behalf of IRS pursuant to an agreement between the United States and the relevant foreign government (an "Intergovernmental Agreement," or IGA).

3 An exception is the qualified intermediary (QI) program, in which foreign financial institutions that enter into a QI agreement with IRS are required to report, either to IRS or to U.S. withholding agents, the identity of certain U.S. account holders with respect to income paid from U.S. sources.

4 Some minor exceptions exist. For example, in 2012 generally the first $95,100 of earned income of U.S. persons residing outside the United States for more than 330 days of a year is exempt from U.S. tax.

5 The filing thresholds are adjusted for inflation each year.

6 Although the scope of the information required to be filed on Form 8938 is similar to the information required to be disclosed on an FBAR, it is not identical. For example, interests in hedge funds, private equity funds, and other private investment vehicles, as well as interest rate and currency swaps with foreign counterparties, and stock and debt interests in foreign entities that are not currently required to be reported under FBAR, are generally required to be reported on Form 8938. However, unlike the FBAR, Form 8938 is not required to be filed by an individual who is not otherwise required to file an income tax return for such year.

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[7] However, at least currently, there is no requirement to report on FBAR interests in hedge funds and private equity or similar investment funds.

[8] FATCA also requires certain non-publicly traded foreign entities that are not financial institutions (referred to as non-financial foreign entities, or NFFEs) to provide information to their withholding agents (which withholding agents then remit to IRS) about any U.S. person that directly or indirectly owns more than 10 percent of the voting power or value of the NFFE's stock (with similar thresholds for foreign partnerships and trusts), or that "control" the NFFE, or to certify to their withholding agent that they have no such U.S. owners.

[9] An FFI Agreement will also require the FFI to withhold on any pass-thru payments that it makes to "recalcitrant holders" that do not provide the required information and to FFIs that themselves have not entered into FFI Agreements.

[10] See, *e.g.*, Sections 6651, 6662, and 6663 of the Code.

[11] 31 U.S.C. Section 5321(a)(5).

[12] Section 6038D(d) of the Code.

[13] See, *e.g.*, Section 6664(c) of the Code

[14] However, according to such guidance, it is generally not invoked in "the case of a false statement on a return because, assuming the return is signed under penalties of perjury, 26 USC § 7206(1) is considered a more appropriate charge." See Internal Revenue Manual Section 9.1.3.4.9 (available at http://www.irs.gov/irm/part9/irm_09-001-003-cont01.html).

[15] See "New Filing Compliance Procedures for Non-Resident U.S. Taxpayers" in IR-2012-65 and at http://www.irs.gov/Individuals/International-Taxpayers/New-Filing-Compliance-Procedures-for-Non-Resident-U.S.-Taxpayers. Importantly, the new procedure does not provide protection from criminal prosecution.

[16] If a taxpayer has reported and paid all taxes due on all of his or her taxable income for past years, but failed to file an FBAR or information return, the taxpayer can simply file such forms and attach an explanation as to why the forms were filed late. IRS generally imposes a penalty for such late filing. See 2012 "Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers" FAQs 17 and 18 at http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers.

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