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*FRAUD & NEGLIGENCE*

## **Increased Disclosure, Penalties, and Audit Periods Courtesy of the Foreign Account Tax Compliance Act**

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*Proposed legislation targeting offshore tax abuse that had been in the hopper for awhile was finally enacted as a funding mechanism for a measure designed to stimulate employment. The impact of FATCA may seem a bit spread out due to some staggered effective dates, but even some long lead times may be insufficient to help various foreign entities comply with new disclosure rules concerning U.S. clients and U.S. source income.*

EDITED BY ROBERT S. FINK, LL.M.

Although the name changed from the Stop Tax Haven Abuse Act<sup>1</sup> to the Foreign Account Tax Compliance Act (FATCA), the intent remained the same. Both pieces of legislation were designed to deter the use of tax havens for tax evasion. To accomplish this goal, among other provisions, the Abuse Act and FATCA both (1) enhanced mandatory disclosure, (2) expanded the statute of limitations, (3) increased penalties, and (4) imposed rebuttable presumptions to ease the government's burden in prosecuting tax cases involving offshore noncompliance.

FATCA is being used as a revenue offset for the Hiring Incentives to Restore Employment Act (HIRE; P.L. 111-92, 3/18/10), of which it is a part.<sup>2</sup> FATCA will have an impact on the following areas:

- (1) Information returns—increased disclosure.
- (2) Penalties.
- (3) Statute of limitations.
- (4) Foreign trusts.
- (5) Dividend equivalent payments.
- (6) Foreign targeted obligations.

## **HISTORY**

FATCA was first introduced on 10/27/09 as S. 1934 and H.R. 3933., by Sen. Baucus (D-Mont.), chair of the Senate Finance Committee, Sen. Kerry (D-Mass.), senior member of the committee, Rep. Rangel (D-N.Y.), chair of the House Ways and Means Committee, and Rep. Neal (D-Mass.), chair of the Ways and Means Subcommittee on Select Revenue Measures.

President Obama and Treasury Secretary Geithner, who outlined similar proposals in their 2010 budget blueprint, had endorsed the prior version of FATCA. The President stated: "I look forward to working with Congress to turn these proposals into law so that honest Americans no longer shoulder the burden of the few individuals and businesses that put profit before responsibility."<sup>3</sup>

In December, during his opening remarks before the 22nd Annual Institute on Current Issues in International Taxation at George Washington University Law School, Commissioner Shulman stated: "To meet the broad array of challenges that we face in the international arena, the Administration and the IRS are focused on a multi-year international tax compliance strategy that is tailored for both corporate and individual taxpayers."<sup>4</sup> The Commissioner's statement preceded his discussion on a number of topics, one of which was his support for the "Tax Extenders Act of 2009," which had been passed by the House the day before, and which at the time included FATCA.

Similarly, the White House said that the Tax Extenders Act "would fulfill the Administration's commitment to crack down on overseas tax havens and put a stop to billions of dollars worth of tax abuse and would end the special preferential tax treatment for carried interest income."<sup>5</sup> In spite of strong support, however, the extenders legislation floundered in the Senate.

As enacted in HIRE, the FATCA provisions are almost identical to those that were originally introduced. One provision, however, that was not enacted is worth discussing briefly, as it may very well appear in future legislation. The eliminated provision dealt with "material advisors," and from the practitioner's perspective was perhaps the most troublesome part of FATCA. A new Section 6116 was to have been created, which would have required certain material advisors on a foreign entity transaction to disclose the transaction. In essence, material advisors would have been required to file an information return disclosing their assistance to a U.S. individual in acquiring or forming a foreign entity, if the individual were required to file certain specified information returns with respect to the transaction.<sup>6</sup>

A "material advisor" was defined as any person who provided any material aid, assistance or advice with respect to carrying out one or more foreign entity transactions and who directly or indirectly derived gross income in excess of \$100,000 for providing the aid, assistance, or advice during the calendar year. The \$100,000 threshold included all advice related in any way to the transaction. Thus, for practitioners in a firm, the value included all aid, assistance, and advice provided by colleagues, and not just the individual advisor.

A material advisor who failed to make the required disclosure would have been subject to a penalty equal to the greater of \$10,000 or 50% of the fee the advisor earned for providing assistance on the transaction. Thus, the minimum penalty effectively would have been \$50,000 (50% percent of the \$100,000 gross income from the fee).

The troubling aspect of this proposed disclosure requirement was that it appeared to implicate ethical issues as to whether disclosure of client foreign structures to Treasury would compromise the attorney-client privilege and/or work-product doctrine. Another problem with the proposed disclosure was that in some transactions, such as offshore securitization vehicles, advisors may not have the identity of all parties involved and therefore would have been unable to comply with the disclosure requirement.

## **THE NEW LAW**

As noted above, there are six principal areas affected by FATCA—information returns, penalties, statute of limitations, foreign trusts, dividend equivalent payments, and foreign targeted obligations.

## Information Returns—Increased Disclosure

The greatest changes in the way business is done is potentially in the area of the increased disclosure of information from foreign entities.

The default rule is that there will be a 30% withholding tax by the U.S. payor on the payment of certain income earned from U.S. sources to foreign financial institutions and foreign nonfinancial entities. The default rule can be avoided if the foreign entities provide the government with information regarding U.S. taxpayers. It would appear that the foreign entities would then receive a certification or receipt from the IRS to provide to the U.S. payor reflecting that they have complied with the disclosure requirement and are exempt from the withholding obligation.

In addition, taxpayers are required to file disclosures reporting (1) the existence of foreign financial assets when the aggregate value of all such assets exceeds \$50,000, (2) investments in passive foreign investment companies (PFICs), and (3) connections with foreign trusts.

**Financial institution disclosure.** FATCA section 501 adds a withholding system described in new Chapter 4 of the Code, and creates new Sections 1471 and 1472. These provisions are generally applicable to payments made after 2012. 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 to the Service will result in a U.S. payor's being required to withhold a 30% tax on certain U.S. source income.

The withholding will occur on income normally subject to U.S. taxation, such as dividends, as well as to income that is traditionally excluded under Section 871 such as bank interest and capital gains. Failure to comply will subject the U.S. withholding agents to financial penalties.

Both the withholding and disclosure can be eliminated if the foreign institutions simply avoid investing in the U.S. *Query* whether Congress was given estimates as to the potential loss to the economy if investors flee our markets, and compared any such loss to the perceived tax loss from evasion.

In addition, after 3/18/10 Treasury can issue Regulations requiring foreign financial institutions and foreign nonfinancial institutions to file on magnetic media all returns to report taxes withheld. This requirement applies equally to withholding pursuant to Section 1441 or new Section 1474(a). Treasury also can require financial institutions to electronically file returns for taxes they withhold regardless of how many returns the institutions file during the year. Consequently, the IRS may assert a failure-to-file penalty under Section 6721 on financial institutions that fail to comply with these new electronic filing requirements.

**Section 1471.** Foreign financial institutions include, but are not limited to, 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. Such foreign financial institutions have the option of disclosing their U.S. account holders to the IRS. Failure to comply with the disclosure requirement will subject the institution to financial penalties in the form of a 30% withholding tax by U.S. payors on payments of certain U.S. source income.

Foreign financial institutions wishing to comply with the disclosure requirement must agree to the following, as specified in Section 1471(b):

- (1) Obtain information from each holder of an account at the financial institution to determine if any of its accounts is a U.S. taxpayer account.
- (2) Comply with any due diligence procedures required by the Service in relation to a U.S. taxpayer account.
- (3) Provide an annual report to Treasury on any U.S. taxpayer accounts maintained by the institution.
- (4) Deduct and withhold 30% from certain pass-through payments made to recalcitrant U.S. taxpayer account holders or certain other foreign financial institutions.
- (5) Comply with any information requests by the IRS with respect to any U.S. taxpayer account.
- (6) Procure a waiver of any foreign law from each U.S. taxpayer with an account, where such foreign law would prohibit the financial institution from disclosing information.

The institutions will be obligated to provide this information annually on all their U.S. account holders. The actual disclosure is specified in Section 1471(c)(1) and includes (1) the identifying number of the U.S. account holder or U.S. owner of a foreign entity holding an account at the institution, (2) the account number, (3) account balances, and (4) the gross deposits and withdrawals from the account.

If a foreign financial institution satisfies the IRS that it does not have any U.S. customers as well as agrees to meet any future procedures that may be issued, it will be exempt from the Section 1471(b) withholding and the Section 1471(c) disclosure provisions. Such institution also may be exempt if Treasury determines that it is one of a class for which the new rules are not necessary.

A foreign financial institution also may agree to the Section 1471 withholding and bypass the Section 1471(c)(1) disclosure if it makes an election under Section 1471(c)(2) to be subject to the same reporting requirements as a U.S. financial institution under Sections 6041, 6042, 6045, and 6049.

FATCA recognizes that where a foreign financial institution is making a U.S. source payment to another foreign financial institution that does not comply with FATCA's disclosure requirements, the payor may not wish to act as a withholding agent for the U.S. source payments. Under new Section 1471(b)(3), such a foreign financial institution may elect to have a U.S. withholding agent (or a foreign financial institution that has entered into an agreement with Treasury) withhold on payments made to the electing foreign financial institution.

If an election under Section 1471(b)(3) is made, the withholding tax will apply with respect to any payment made to the electing foreign financial institution to the extent the payment is allocable to accounts held by foreign financial institutions that do not enter into an agreement with Treasury or to payments made to recalcitrant account holders (i.e. an account holder that refuses to provide required information). A foreign financial institution making the election under Section 1471(b)(3) must notify the withholding agent of the election and must provide information necessary for the withholding agent to determine the appropriate amount of withholding.

To eliminate the duplicate reporting that could occur in tiered arrangements (i.e., a structure in which a foreign financial institution is owned by another foreign financial institution), the FATCA provisions are not applicable if the foreign financial institution where the account is held entered into an agreement with Treasury, or is otherwise subject to information reporting requirements that Treasury determines would make the reporting duplicative.

The Section 1471 rules generally will be effective for payments made after 2012, and will not apply to any obligation or disposition of an obligation made prior to 3/18/12. This will allow Treasury time to draft Regulations concerning the procedures foreign financial institutions will need to adopt to comply with the legislation.

There is no specific guidance regarding the due diligence foreign financial institutions are expected to implement to comply with the legislation's objectives. Presumably, foreign financial institutions will need to obtain documentation from all of their account holders, both U.S. and foreign, to determine which are U.S. account holders. In essence, a foreign financial institution will possibly need to obtain Forms W-8 or W-9 from each of its account holders to ensure it complies with the information reporting requirements of new Section 1471. This would clearly create a burden for foreign financial institutions and their account holders.

In addition, it is questionable as to whether sufficient time exists for the IRS to enter into withholding agreements with the foreign financial institutions.

**Section 1472.** New Section 1472 imposes a 30% withholding tax on any payment made to a nonfinancial foreign entity from a U.S. payor if (1) the beneficial owner of the payment is a nonfinancial foreign entity and (2) all of the following requirements are not met with respect to the beneficial owner:

- (1) The beneficial owner or the payee provides the "withholding agent" with either (a) a certification that the beneficial owner does not have any substantial U.S. owners (i.e., more than a 10% direct or indirect interest), or (b) the name, address, and TIN of each substantial U.S. owner of the beneficial owner;
- (2) The withholding agent does not know, or have reason to know, that any information provided as described above is incorrect; and
- (3) The withholding agent provides the information described above to Treasury in the manner provided for by Treasury.

The rules described above do not apply to any payment beneficially owned by:

- A publicly traded corporation.
- Any corporation that is a member of an expanded affiliated group that includes a publicly traded corporation.
- Any foreign government (or political subdivision, wholly owned agency, or instrumentality).
- Any international organization (or wholly owned agency or instrumentality).
- Any foreign central bank of issue.
- Any other class of persons identified by Treasury.

U.S. persons who buy U.S. securities from a foreign entity are obligated to obtain the certification or else withhold the 30% tax on the purchase. Consequently, it is not just U.S. institutions that are required to withhold. The obligation is imposed on all U.S. withholding agents.

The rules described above do not apply to any class of payments identified by Treasury as posing a low risk of tax evasion.

The requirements under Section 1472 could cause greater disruption than those under Section 1471 because nonfinancial foreign entities, such as hedge funds, may not have procedures in place to conduct the required due diligence that is commonplace for financial institutions. Thus,

Section 1472 could require hedge fund managers and other investment fund managers, who may have never requested due diligence information from investors in the past, to begin doing so.

These managers may be required to become familiar with the ownership attribution rules of Section 318 to accurately determine whether they have U.S. investors. The fund managers also may have to request further documentation from investors, such as Forms W-8 or W-9, to comply with the requirements of new Section 1472. In an economic environment in which there is a great turnover of investors in each vehicle, the legislation would appear to impose an immense burden on these foreign nonfinancial institutions.

**Foreign accounts and assets.** As if taxpayers and tax advisors do not already face enough confusion regarding the filing requirements for the Report of Foreign Bank and Financial Accounts (FBAR), FATCA imposes a second filing requirement on such U.S. taxpayers with foreign accounts and assets. FATCA section 511 creates new Section 6038D, which requires U.S. taxpayers with foreign accounts and assets to report these investments on an information return when the aggregate value of the investments exceeds \$50,000.<sup>7</sup>

Section 6038D applies to assets held during tax years beginning after 3/18/10. The new reporting requirement is much broader than the FBAR, so it is possible that 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 the existence of these investments. The recent FBAR Regulations issued by FinCEN on 2/26/10 exempt these types of assets from FBAR reporting.

It is not clear if the IRS will issue a new form on which this disclosure will be made, or whether it is up to each taxpayer to make the disclosure in the way the taxpayer deems best, or whether Form 8275 (the general disclosure statement) should be used. What is clear is that taxpayers are to attach the information return to their Form 1040. Consequently, the information return should be cloaked with the same confidentiality rules which govern tax returns. As noted above, this disclosure is in addition to the FBAR, which is filed with the Detroit Service Center and is not subject to any degree of confidentiality (as federal officials are able to access the computer database in which FBAR information is entered).

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 only for one day. 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.
- (4) Any interest in a foreign entity.

A "foreign entity" is defined in Section 6038D(b) to include any entity that is not a U.S. person. Consequently, foreign real estate, which is often purchased through an entity, would have to be reported as a specified foreign financial asset.

While Section 6038D requires individuals to file this disclosure, Treasury has the ability to 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.<sup>8</sup> Similarly, Treasury is to issue Regulations exempting nonresident aliens and bona fide residents of any

U.S. possession from the disclosure. It also has authority to exempt certain assets from being reported.

The information to be disclosed under new Section 6038D includes:

- (1) The name and address of the financial institution in which the account is maintained.
- (2) The account number.
- (3) In the case of any stock or security, the name and address of the issuer and other information necessary to determine the ownership.
- (4) In the case of an instrument, the names and addresses of all issuers and counterparties.
- (5) The maximum value of the asset during the tax year.

While this information is quite similar to that required on an FBAR, this disclosure is not required by persons who have signature authority or other authority over a foreign financial account. It is likely, however, that much of the same confusion that surrounds the FBAR filing requirements will affect this informational filing. Nevertheless, since this disclosure is mandated by Section 6038D (i.e., Title 26 (the Code), and not Title 31, as is the FBAR), Treasury may be able to clarify the confusion with Regulations.

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 Treasury, with the maximum penalty being \$50,000. There is, however, a 90-day grace period following notification from the Treasury before the additional \$10,000 penalties accrue. This is similar to the penalty for failure to file Form 5471 and Form 3520. As with those information returns (relating to foreign corporations and foreign trusts or foreign gifts, respectively), the penalty may be waived if the taxpayer is able to demonstrate that the failure to file was due to reasonable cause.

Taxpayers who have a Section 6038D 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 for failure to file under Section 6038D, both of these penalties may be assessed.

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 that the aggregate value is less than \$50,000.

**Foreign companies.** Generally, a foreign corporation will qualify as a 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.<sup>9</sup> FATCA section 521 adds new Section 1298(f) to require persons owning shares in a PFIC to file an annual information return disclosing their ownership of the PFIC.<sup>10</sup> This replaces current law under which disclosure was required only when the taxpayer made a QEF election or disposed of the interest in the PFIC.

The PFIC disclosure requirement became effective as of 3/18/10. Notwithstanding, on 4/6/10 the IRS issued Notice 2010-34, 2010-17 IRB xxx, indicating that forthcoming guidance would clarify the new reporting obligation. As a result, the Notice indicates that taxpayers who were not otherwise required to file Form 8621 prior to the enactment of Section 1298(f) will not have to do so for tax years beginning prior to 3/18/10.

## **PENALTIES**

Section 6662 permits the IRS to impose a 20% penalty on a substantial understatement of income that is not related to fraud. FATCA section 512 adds new Section 6662(j), increasing the standard 20% accuracy related penalty to a 40% penalty on any portion of an underpayment attributable to an undisclosed financial asset that should have been reported under Sections 6038,<sup>11</sup> 6038B,<sup>12</sup> 6046A,<sup>13</sup> or 6048,<sup>14</sup> or new Section 6038D.

Clearly, under FATCA, the penalties associated with failure to file the information returns required by the Code will become progressively more expensive. The increased penalty structure is effective as of the tax year beginning after the date of enactment (i.e., after 2010 for calendar-year taxpayers).

## **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.<sup>15</sup> The assessment period is increased to six years if a taxpayer omits 25% or more of the income that should have been reported in gross income.<sup>16</sup> FATCA section 513 amends Section 6501(e) to extend the six-year period where a taxpayer omitted 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. Furthermore, the three-year and six-year limitations periods will be suspended until the information required to be reported under Section 6038, 6038B, 6046A, or 6048, or new Section 6038D is provided to the IRS.<sup>17</sup>

The extended limitations periods are applicable to (1) returns filed after 3/18/10 (the date of enactment) and (2) returns filed on or before that date if the limitations period under Section 6501 has yet to expire. Thus, the extended six-year statute and suspended three-year statute could apply to tax returns that were filed in 2006-2009.

## **FOREIGN TRUSTS**

As noted above, U.S. persons who transfer assets to a foreign trust<sup>18</sup> or who receive a distribution from a foreign trust are required to file Form 3520. This is simply an informational filing, and has no tax significance. The penalty under Section 6677 is 35% of the gross reportable amount (generally the amount transferred to the trust or received from the trust).

FATCA section 535 amends Section 6677 so that a failure to file Form 3520 will have a minimum penalty of \$10,000. Thus, the penalty will now be 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 Treasury that the filing is delinquent. There is, however, a 90-day grace period following notification from Treasury before the additional \$10,000 penalties accrue. The total penalty assessed for failure to file Form 3520 will not exceed the gross reportable amount.

The increased penalty is effective for Forms 3520 filed after 2009. Therefore, any taxpayers who fail to file a Form 3520 with their 2009 Form 1040 and are otherwise required to do so will face the new penalty structure.

## **Grantor Trust Status**

When a U.S. person transfers assets to a foreign trust that has U.S. beneficiaries, Section 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 create 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 qualify as a grantor trust. Whether because taxpayers simply failed to heed the Regulations, or intended to avoid paying U.S. income tax on the trust's income, the IRS felt it was necessary to have the Regulations codified by having Section 679 amended.

In general, under Section 679 a U.S. taxpayer who transfers property (whether directly or indirectly) to a foreign trust with U.S. beneficiaries is treated as the grantor of the portion of the trust assets transferred to the trust in accordance with the grantor trust rules. Section 679(c) has three subparagraphs, all of which are designed to find a U.S. beneficiary of the foreign trust.

FATCA sections 531 and 532 add several new provisions to Section 679, and three new subparagraphs to Section 679(c), all of 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 3/18/10 and include:

- Adding flush language to Section 679(c)(1) to treat amounts accumulated in a foreign trust as being for the benefit of a U.S. person even if the U.S. person's interest in a foreign trust is contingent on a future event.
- Providing in new Section 679(c)(4) that if any person has the discretion to make a distribution from a foreign trust to, or for the benefit of, any person (U.S. or otherwise), the trust will be treated as having a U.S. beneficiary unless the terms of the trust specifically identify the class of persons to whom the distributions may be made and none of those persons can be U.S. persons during the tax year.
- Providing in new Section 679(c)(5) that if any U.S. person who directly or indirectly transfers property to a foreign trust is directly or indirectly involved in any agreement or understanding that may result in the trust's income or corpus being paid or accumulated for the benefit of a U.S. person, the agreement or understanding will be treated as a term of the trust. In essence, any discretion held by a trustee or protector to make a distribution or accumulate income for a U.S. person will be deemed to have been exercised.
- Providing in new Section 679(c)(6) that any loan of cash or marketable securities (or the use of any other trust property) directly or indirectly to or by any U.S. person will be treated as paid or accumulated for the benefit of such U.S. person. This provision would not apply, however, to the extent that the U.S. person repays the loan at a market rate of interest or pays the FMV for the use of the property within a reasonable time.
- Providing in new Section 679(d) that if a U.S. person transfers (directly or indirectly) property to a foreign trust, the trust will be presumed to have a U.S. beneficiary unless the transferor submits information, as requested by Treasury, to demonstrate that no part of the income or trust may be paid or accumulated to or for the benefit of a U.S. person.

## **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. FATCA section 533 amends Section 643(i)(1) to provide that any use of trust property after 3/18/10 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 FMV of the use of the property or loan. This rule does not apply to the extent that the foreign trust is paid FMV for

the use of the property within a reasonable time following the use. FATCA does not define what would be reasonable; presumably this will be clarified in Regulations.

A subsequent return of the property to the foreign trust is disregarded for tax purposes under Section 643(j)(3). Nevertheless, consistent with Section 679 the transferor of the property would qualify as a grantor, and consistent with Section 6048 the transfer would be a reportable event that would need to be included on a Form 3520.

## **DIVIDEND EQUIVALENT PAYMENTS**

"Dividend equivalent" is defined, in part, in new Section 871(l)(2)(B) <sup>19</sup> as any payment made pursuant to a specified notional principal contract that (directly or indirectly) is contingent on, or determined by reference to, the payment of a dividend from sources within the U.S. Under new Section 871(l)(3)(A), a specified notional principal contract is a notional principal contract if:

- (1) In connection with entering into the contract, any long party to the contract transfers the underlying security to any short party to the contract;
- (2) In connection with the termination of the contract, any short party to the contract transfers the underlying security to any long party to the contract;
- (3) The underlying security is not readily tradable on an established securities market;
- (4) In connection with entering into the contract, the underlying security is posted as collateral by any short party to the contract to any long party to the contract; or
- (5) IRS identifies the contract as a specified notional principal contract.

FATCA section 541 is another provision that affects nonfinancial foreign institutions (such as hedge funds) as well as their U.S. investors. It adds new Section 871(l)(1) to eliminate the disparate tax treatment between dividends on stock of U.S. corporations, which are subject to U.S. withholding tax, and dividend equivalent payments, which were not, by treating dividend equivalent payments made after 9/13/10 as U.S.-source dividend payments. Consequently, any such payments made to a nonresident alien would be subject to withholding.

Payments that may be treated as U.S. source dividends include any gross amounts used in computing any net amounts transferred to or from the taxpayer (the "gross amount rule") under Section 871(l)(5). As a result, a counterparty to a total return equity swap may be obligated to withhold and remit tax on the gross amount of a dividend equivalent payment even though it is not required to make an actual payment to the foreign investor. There is no grandfathering provision. Dividend equivalent payments on outstanding notional principal contracts 180 days after the date of enactment (i.e., on or after 9/14/10), therefore, are subject to withholding. This provision is specifically targeted towards the variety of notional principal contracts and equity swaps that have been traditionally excluded from dividends under Sections 871 and 1441. <sup>20</sup>

## **Foreign Targeted Obligations**

Prior to FATCA, a deduction was permitted for foreign targeted obligations that were issued in bearer form (i.e., not registered), provided certain exceptions were satisfied (i.e., they could not be sold to U.S. persons). FATCA section 502 repeals the foreign targeted obligation exception.

Consequently, for obligations issued in bearer form after 3/18/12, an interest deduction will be prohibited unless the obligation (1) is issued by a natural person, (2) matures in no more than one year, or (3) is not of a type offered to the public. Therefore, issuers of 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.

Related thereto, state and local bonds comprise a substantial portion of foreign investment in the U.S. Taxpayers and their advisors should be aware that FATCA would therefore require that these obligations also be in registered form in order to qualify for the portfolio interest exemption.

Finally, Section 871(h)(2) is amended to make portfolio interest paid to a nonresident alien after 3/18/12 subject to a 30% withholding tax unless the bond is issued in a registered form or satisfies the FATCA requirements. Currently, under Section 871(h)(1) portfolio interest is exempt from the 30% withholding tax that applies to other U.S. source interest income received by nonresident aliens. IRS Publication 519 defines portfolio interest (including OID) as including interest that is paid on the following:

- Obligations not in registered form (bearer obligations) that are sold only to foreign investors, and the interest on which is payable only outside the U.S. and its possessions, and that have on their face a statement that any U.S. person holding the obligation will be subject to limitations under the U.S. income tax laws.
- Obligations in registered form that are targeted to foreign markets and the interest on which is paid through financial institutions outside the U.S.
- Obligations in registered form that are not targeted to foreign markets, if the taxpayer furnished the payer of the interest (or the withholding agent) with a Form W-8BEN or similar document indicating that the taxpayer is not a U.S. person.

Portfolio interest also will be defined after 3/18/12 as any interest including OID that (1) would be subject to the withholding tax but for this exemption, and (2) is paid on an obligation that is in registered form, and with respect to which (1) the U.S. person who otherwise would be required to deduct and withhold tax from the interest under Section 1441 receives a statement that the beneficial owner of the obligation is not a U.S. person (i.e. usually Form W-8BEN), or (2) IRS has determined that the statement described above is not needed to carry out the purposes of the portfolio interest exemption (i.e., poses a low risk of U.S. tax base erosion).

## CONCLUSION

It is clear that FATCA, the latest congressional effort to stanch tax evasion, will prove to be burdensome. How U.S. taxpayers, foreign entities and financial organizations deal with the burdens remain to be seen. The *Wall Street Journal*, shortly after FATCA's introduction, published an article discussing the fact that U.S. taxpayers are expatriating in an effort to cease dealing with the IRS.<sup>21</sup> The due diligence requirements imposed on foreign financial institutions and nonfinancial foreign entities, however, may very well lead these institutions to stop investing in the U.S. and cease accepting U.S. customers for their investment accounts.<sup>22</sup> U.S. taxpayers will come to quickly realize that as a result of FATCA the costs involved with reporting their foreign activities to the IRS have increased because there are additional disclosures.

The cost of complying with the new FATCA-mandated disclosures is not the only consequence, however. Once the various provisions are effective, the penalties associated with foreign noncompliance will increase and the time in which the IRS can audit a taxpayer will double. Certainly the doubling of the penalties and statute of limitations for foreign noncompliance may cause certain taxpayers to rethink investing abroad. Nevertheless, it may very well be the "accidental" Americans (individuals who become U.S. residents by virtue of the substantial presence test) and resident aliens who bear the greatest burden, as they often do not know of their U.S. Form 1040 obligations, much less about FATCA.

## Practice Notes

The burden of the new disclosure regime applicable to foreign financial institutions and nonfinancial entities that receive payments from U.S. sources will require considerable investment in time and applications to ensure compliance. The companies perhaps best suited to deal with these changes may be those with U.S. operations which already may have access to some of the necessary information.

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[1](#)

Originally introduced on 2/17/07 by Sen. Levin (D-Mich.), then chair of the Senate Permanent Subcommittee on Investigations, Sen. Coleman (R-Minn.), then the ranking Republican on the subcommittee, and Sen. Obama (D-Ill.), then a member of the subcommittee.

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[2](#)

HIRE is designed to incentivize the creation of up to 300,000 new jobs this year. Employers who hire previously unemployed workers are entitled to a Social Security and Medicare tax holiday as well as credits if the employees are retained for at least a year. A detailed discussion of HIRE is beyond the scope of this article.

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[3](#)

See "Statement by President Barack Obama on House and Senate Introducing Legislation to Crack Down on Overseas Tax Havens," at [www.financialtaskforce.org/2009/10/27/president-obama-statement-on-foreign-account-tax-compliance-act-of-2009](http://www.financialtaskforce.org/2009/10/27/president-obama-statement-on-foreign-account-tax-compliance-act-of-2009).

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[4](#)

IR-2009-116, 12/10/09.

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[5](#)

Statement of Administration Policy, 12/8/09, found at [www.whitehouse.gov/omb/assets/sap/sap\\_111/saphr4213r\\_20091208.pdf](http://www.whitehouse.gov/omb/assets/sap/sap_111/saphr4213r_20091208.pdf).

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[6](#)

If the taxpayer were required to disclose the transaction pursuant to Sections 6038, 6038B, 6046A, or 6048, then a material advisor similarly would have been required to disclose the assistance provided in the transaction.

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[7](#)

It is unclear if the \$50,000 threshold applies at the end of the tax year or, as it does for the FBAR \$10,000 requirement, at any time during the tax year.

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[8](#)

Section 6038D(f).

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[9](#)

Section 1297.

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[10](#)

Former subsection (f) is redesignated as Section 1298(g).

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[11](#)

Requiring the filing of Form 8865 by every U.S. person who controls a foreign partnership.

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[12](#)

Requiring each U.S. person who (1) transfers property to a foreign corporation in connection with certain exchanges, (2) makes certain transfers of property to a foreign partnership in exchange for a partnership interest under Section 721 or in any other deemed contribution, or

(3) distributes property in complete liquidation to a person who is not a U.S. person, to furnish to IRS information about the exchange.

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[13](#)

Requiring a U.S. person who (1) acquires any interest in a foreign partnership, (2) disposes of any portion of his interest in a foreign partnership, or (3) whose proportional interest in a foreign partnership changes substantially, to file a return.

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[14](#)

Requiring U.S. persons who transfer assets to or receive distributions from a foreign trust to file Form 3520.

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[15](#)

Section 6501(a).

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[16](#)

Section 6501(e).

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[17](#)

Section 6501(c)(8).

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[18](#)

Including Mexican real estate transferred to a fideicomiso, a Mexican bank trust used by non-Mexican nationals to acquire certain real property in Mexico.

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[19](#)

Former Section 871(l), containing various cross references, is redesignated as Section 871(m).

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[20](#)

John Harrell, Senior Counsel in the Treasury Office of International Tax Counsel, was reported to have said on 4/12/10 at a PLI conference that Treasury and the IRS hope to put out guidance "substantially in front of that" (i.e., the 9/14/10 effective date). See "Government Expediting Guidance on Total Return Swaps, Officials Say," BNA Daily Tax Report, 4/13/10, page G-9.

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[21](#)

See Vaughan, "More Americans Sever U.S. Ties as IRS Gets Tougher," Wall St. J., 4/5/10.

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[22](#)

See Ahren, "Israeli Banks Urge America[n] Clients to Close Israeli Accounts," Haaretz, 3/11/10.