FATCA, FBARs, and Foreign Assets: Reining in Offshore Tax Evasion

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As long as there are taxes, people will try to avoid them . . . .

- 1970 – Bank Secrecy Act authorized the TD F 90-22.1, "Report of Foreign Bank and Financial Accounts" (or "**FBAR**" for short)
  - Resulted from concerns about U.S. people hiding behind foreign bank secrecy laws to evade U.S. tax
- 1992 – Treasury delegated to the IRS the authority to investigate FBAR violations and to identify cases to recommend for criminal prosecution or civil penalties
- 2003 – FinCEN (primary TD Bureau responsible for administering and enforcing the BSA) delegated FBAR enforcement authority to the IRS, with the ability to collect civil penalties, employ summons power, etc.
- Historically low rates of compliance and enforcement—until recently

IRS Offshore Voluntary Disclosure Programs

- 2003 – Offshore Voluntary Compliance Initiative
- 2003 – Last Chance Compliance Initiative
- 2009 – Offshore Voluntary Disclosure Program
- 2011 – Offshore Voluntary Disclosure Initiative
- **2012 – Offshore Voluntary Disclosure Program**
  - 2012 OVDP is open-ended

DOJ Crackdown

- Since the 2009 UBS fiasco, the Department of Justice has been aggressively pursuing information from foreign banks and prosecutions of foreign banks and advisors and U.S. account holders

Foreign Account Tax Compliance Act

- Congress got in on the action in 2010 with the passage of FATCA (which actually had its genesis in a 2007 stand-alone bill entitled the "Stop Tax Haven Abuse Act," S.681, February 17, 2007)

FATCA Overview: What We Aren't Covering

- **Withholding provisions (other than trusts & estates)**
- **PFIC disclosure provisions**
  - Annual reporting, rather than to make certain elections
- **Foreign grantor trust provisions**
  - Codified and expanded presumptions that treat foreign trusts created by U.S. persons as grantor trusts
- **Foreign non-grantor trust provisions**
  - Below-market use of trust property is a distribution that carries out DNI/UNI
- **Foreign trust reporting penalty provisions**
  - $10,000 minimum instead of only a percentage of reportable events
- **Miscellaneous taxation provisions**
  - Removed preferential treatment of certain types of investments held by non-U.S. persons (dividend equivalent payments & foreign-targeted bearer bonds)

FATCA Overview: What We are Covering

- **Withholding Provisions (for trusts and estates)**

- **Specified foreign financial asset disclosure provisions (Form 8938)**

Foreign Bank Accounting Reporting TD F 90-22.1

FBAR Failure-to-File Penalties

- Negligent failure
  - Up to $10,000
- Willful failure
  - The greater of $100,000 or 50% of the highest balance in the account
  - Possible criminal exposure (up to $500,000 and up to 10 years of imprisonment) in addition to civil penalties
- Reasonable cause exception
  - If there is reasonable cause and the balance of the account is "properly reported" (presumably, on a late-file FBAR), no penalty will be imposed

FBAR Rules

- The rules discussed in this presentation are effective beginning with FBARs that were due on June 30, 2011, for accounts held during 2010 and all subsequent years (unless otherwise indicated)

FBAR Due Date

- Must be **received** by June 30
- **No extension** available
- **Mandatory e-filing** beginning with 2013 FBARs (unless postponed again)

FBAR – Disclosure on Income Tax Return

- 2011 Revision of Schedule B, Part III, of Form 1040 asks the taxpayer to state (under penalties of perjury) whether or not they are required to file the FBAR

FBAR – Disclosure on Income Tax Return (cont'd.)

Previous Schedule B (Form 1040):

Part III Foreign Accounts and Trusts (See instructions on back.)		You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.	Yes	No
	7a	At any time during 2010, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See instructions on back for exceptions and filing requirements for Form TD F 90-22.1		
	b	If "Yes," enter the name of the foreign country ▶ _____		
	8	During 2010, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back		

FBAR – Disclosure on Income Tax Return (cont'd.)

Current Schedule B (Form 1040):

			Yes	No
Part III Foreign Accounts and Trusts (See instructions on back.)		You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.		
	7a	At any time during 2012, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions		
		If "Yes," are you required to file Form TD F 90-22.1 to report that financial interest or signature authority? See Form TD F 90-22.1 and its instructions for filing requirements and exceptions to those requirements		
	b	If you are required to file Form TD F 90-22.1, enter the name of the foreign country where the financial account is located ▶ _____.		
	8	During 2012, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back		

Revision not yet made to:

- Form 1041, Page 2, Other Information
- Form 1102 & 1120S, Schedule N
- Form 1065, Schedule B, Line 10
- Form 990, Part V, Line 4

FBAR Filing Requirement

A **U.S. person** with a **financial interest** in, or **signature authority** over, one or more **foreign financial accounts**, if aggregate value of accounts exceeds $10,000 at any time during the calendar year

For example, if a taxpayer has 10 foreign accounts, each with only $1,000, they must be reported.

FBAR Filing Threshold

- Based on "**periodic statements**" (however they are usually received), as long as statements fairly reflect the maximum account value
- Use currency exchange rate on the last day of the **calendar year**, using the U.S. Treasury Department's Financial Management Service rate (www.fms.treas.gov/intn.html)

U.S. Persons Required to File FBAR

- U.S. Citizen
- U.S. Resident
  - Using the definition of "resident alien" under IRC § 7701(b) and the Treasury Regulations
    - Green-card holder
    - Substantially present
    - Elected to be treated as a U.S. resident under certain circumstances
  - Using the definition of "United States" under 31 CFR §1010.100(hhh), not under the Treasury Regulations
    - United States and District of Columbia
    - Indian lands
    - U.S. territories and insular possessions

U.S. Persons Required to File FBAR (cont'd.)

- Entity (corporation, partnership, LLC) or trust formed under the laws of the United States, District of Columbia, U.S. Territories and Insular Possessions, or the Indian Tribes

U.S. Persons Required to File FBAR (cont'd.)

- Federal tax treatment of entity or trust is irrelevant
  - U.S. disregarded entity must file, even when U.S. owner files
  - U.S. trustee(s) of wholly owned grantor trust must file, even when U.S. grantor/owner files
    - But beneficiary is not required to file if U.S. trustee is filing
    - If trustee is foreign (and is thus not required to file), beneficiary must file even when the U.S. grantor/owner files
  - U.S. trustee of a foreign trust

Reportable Foreign Financial Accounts

- **Physically located** outside of the U.S.
  - Foreign branch of U.S. bank = foreign
    - Not like § 6038D
  - U.S. branch of foreign bank = not foreign
- Accounts physically located on U.S. military installations abroad are not reportable on the FBAR

Reportable Foreign Financial Accounts (cont'd.)

- "Typical" accounts (savings, checking, brokerage, time deposits, etc.)
- Commodity futures or options accounts

Reportable Foreign Financial Accounts (cont'd.)

- **Insurance policies** with cash value
  - No distinction between 953(d) and non-953(d) carriers
  - FinCEN commentary: policy holder, not beneficiary, is the filer
- **Annuity policies** with cash value
  - No distinction between 953(d) and non-953(d) carriers
  - FinCEN commentary: silent on whether owner or beneficiary is the filer (probably both)

Reportable Foreign Financial Accounts (cont'd.)

- Shares in mutual funds or similar pooled funds
  - Only funds that are **publicly available** with **regular NAV determinations** and **regular redemptions**
- Currently, hedge funds and private equity funds not reportable

Reportable Financial Interests

- U.S. person who is **owner of record** or **holder of legal title** must report as having a "financial interest" interest in the account
  - Whether account is held for the person's own benefit or for the benefit of others
  - Multiple U.S. record owners and legal-title holders must all file

Reportable Financial Interests (cont'd.)

- A U.S. person has a "financial interest" in foreign accounts held by:
  - A nominee/agent on their behalf
  - A corporation (or any other entity) owned >50% by the U.S. person (voting power or value)
  - A partnership owned >50% by the U.S. person (capital or distributive share of income)
  - A trust of which the U.S. person is the "owner" under grantor-trust rules

Reportable Financial Interests (cont'd.)

- A U.S. person has a "financial interest" in foreign accounts held by:
  - A trust in which the U.S. person has a >50% **present beneficial interest** in the trust assets
    - FinCEN commentary says that beneficiaries of a purely discretionary trust are not required to file (what if there is only one beneficiary?)
    - Remainder beneficiaries are not required to file
  - A trust from which the U.S. person receives 50% of the **current income**

Reportable Financial Interests (cont'd.)

- A U.S. person who "**causes**" an entity or trust to be created for purposes of evading the FBAR requirement has a reportable "financial interest" in an account held by the entity or trust
  - Say what?

Absurd Examples

- A **non-U.S.-citizen** who lives full time in Puerto Rico is the sole beneficiary of a Bermuda trust created by his Hong Kong uncle that owns a whole-life policy issued by a non-953(d) insurance carrier
- A **Delaware LLC** wholly owned and managed by a German citizen and resident which owns a Swiss bank account that has no U.S.-source income
- A **U.S. attorney** forms an entity for a client, not knowing that the client is forming the entity for purposes of evading the FBAR filing requirement?
- A foreign account that was funded for **one day** (e.g., a real estate closing or loan)

Reportable Signature Authority

The authority of an **individual** (alone or in conjunction with others) to **control the disposition** of the account's assets by **direct communication** (in writing or otherwise) to the person with whom the account is maintained.

FBAR Exceptions

- Correspondent accounts used solely for bank-to-bank transfers
- Accounts of international financial institution of which the U.S. government is a member
- Accounts of any U.S. governmental entity; "governmental entity" includes:
  - College or university that is an agency or instrumentality of, or owned or operated by, a U.S. governmental entity
  - Governmental employee retirement or welfare benefit plan

FBAR Special Rules

- **Financial interest** in more than 25 foreign accounts
  - Minimum information reported; detailed information upon request
- A U.S. entity that owns (directly or indirectly) >50% interest in one or more other entities that are required to file an FBAR
  - May file a **consolidated FBAR** for itself and the other entities
- Foreign accounts owned by **retirement plans and IRAs** not reportable by the participant/owner
  - Reportable by the trustee
- The FBAR statute of limitations (6 years) runs regardless of whether FBAR is filed

Department of Justice Efforts to Combat Offshore Tax Evasion

The Problem

- The 2008 Senate Report estimated that the use of unreported offshore accounts to evade U.S. taxes cost the Treasury approximately $100 billion annually

Prosecution Efforts: Foreign Banks

- Charge: conspiracy (18 U.S.C. § 371)
- UBS
- Wegelin Bank

Prosecution Efforts: Foreign Bankers and Advisors

- Charge: conspiracy (18 U.S.C. § 371)
- Examples

Prosecution Efforts: U.S. Account Holders

- Charges
  - Tax evasion (IRC § 7201)
  - False tax returns (IRC § 7206(1)
  - Conspiracy (18 U.S.C. § 371)
  - Willful failure to file FBARs (31 U.S.C. § 5322)
- Examples

Efforts to Obtain Information: Treaty Requests

- Bank Julius Baer
- Liechtensteinische Landesbank

Efforts to Obtain Information: John Doe Summons

- UBS
- HSBC
- First Caribbean International Bank

Efforts to Obtain Information: Anticipated Actions

- Credit Suisse
- Julius Baer
- Zurcher Kantonalbank
- Bank Leumi
- HSBC (India)

IRS Offshore Voluntary Disclosure Programs

2012 Offshore Voluntary Disclosure Program "OVDP"

- IRS reports that under the 2009 and 2011 Voluntary Disclosure Programs, each of which was open for a six month period, 35,000 taxpayers have come forward, and Treasury has collected $5 billion
- IRS reopened the program on January 9, 2012
- Similar to the 2011 program, but with a few significant differences:
  - Open for an indefinite period of time until otherwise announced; terms of OVDP could change at any time
  - Requires individuals to pay an FBAR penalty of 27.5% (compared to 25% in the 2011 program and 20% in the 2009 program), may be reduced to 12.5% or 5% in certain circumstances
  - 8 year "rolling" look-back period with exclusion of compliant years

2012 OVDP (cont'd.)

- More stringent eligibility requirements
  - U.S. government receipt of taxpayer information from "John Doe" summons, treaty request, or similar action is disqualifying event
  - Taxpayers who appeal foreign tax administrator's decision to release account information must notify U.S. Attorney General or be disqualified
  - IRS may in its discretion designate certain classes of taxpayers ineligible
  - IRS has issued a list of 55 questions and answers (Q&A) regarding the Voluntary Disclosure Program
- Continuation of penalty relief under FAQs 17/18 for taxpayers who have reported all foreign-source income but have not filed FBAR and other information forms the 2012 program provides

How To Make a Voluntary Disclosure Under the 2012 OVDP

- **Step One: Pre-Clearance**
  - Send Letter by fax to Criminal Investigation Division ("CI") in Philadelphia asking whether the taxpayer is cleared to make a Voluntary Disclosure
  - Response time is generally 48 hours
- **Step Two**
  - If the Taxpayer is cleared then the taxpayer needs to submit the Voluntary Disclosure Letter requested and Offshore Asset Form within 45 days of receipt of the pre-clearance notification
  - The taxpayer must agree to fully cooperate with the CI which includes providing all necessary documents, such as bank statements, being available for an interview, disclosing the names of people that assisted in establishing and maintaining the foreign account.

2012 OVDP Offshore Penalty: 27.5 Percent

- Values of foreign accounts and other foreign assets are aggregated for each year and the penalty is calculated based upon highest year‘s aggregate value during the OVDP period
- Composition of penalty base:
  - Applies to all of the taxpayer’s offshore holdings that are related in any way to tax non-compliance, including bank accounts, tangible assets such as real estate or art, and intangible assets such as patents or stock or other interests in a U.S. or foreign business
  - Tax noncompliance includes failure to report income from the assets, as well as failure to pay U.S. tax that was due with respect to the funds used to acquire the asset

2012 OVDP Offshore Penalty: 5 Percent, FAQ 52

- Taxpayer who (a) did not open or cause the account to be opened; (b) has exercised minimal, infrequent contact with the account; (c) has, except for a withdrawal closing the account and transferring the funds to an account in the United States, not withdrawn more than $1,000 from the account in any year for which the taxpayer was non-compliant; and (d) can establish that all applicable U.S. taxes have been paid on funds deposited to the account (only account earnings have escaped U.S. taxation).
- Taxpayer who is a foreign resident and was unaware he or she was a U.S. citizen.
- Taxpayer who (a) resides in a foreign country; (b) has made a good faith showing that he or she has timely complied with all tax reporting and payment requirements in the country of residency; and (c) has $10,000 or less of U.S. source income each year.

2012 OVDP Offshore Penalty: 12.5 Percent

- Taxpayer whose highest aggregate account balance (including the fair market value of assets in undisclosed offshore entities and the fair market value of any foreign assets that were either acquired with improperly untaxed funds or produced improperly untaxed income) in each of the years covered by OVDP is less than $75,000.

2012 OVDP: "Opt Out" Option

- An opt out is an election made by a taxpayer to have his or her case handled under the standard audit process.
- IRS recognizes that in certain cases, the opt out option may reflect a preferred approach. That is, there may be instances in which the results under the voluntary disclosure program appear too severe given the facts of the case.
- Full scope examinations will occur if opt out is initiated.
- If issues are found upon a full scope examination that were not disclosed by the taxpayer, those issues may be the subject of review by IRS Criminal Investigation.

2012 OVDP: "Opt Out" Option (cont'd.)

- Favorable scenarios for opting out:
  - Example 1 - Unreported Income But No Tax Deficiency
  - Example 2 - Unreported Income and Failure to File FBAR
  - Example 3 - Unreported Controlled Foreign Corporation
  - Examples 4/5 - Dual citizen residing abroad with no U.S. income and fully compliant with foreign tax laws

- Unfavorable scenarios for opting out:
  - Example 6 - Large Unreported Gain
  - Example 7 – Civil Fraud Penalty Warranted

Risks of "Quiet Disclosure"

- FAQ 15: "Taxpayers are strongly encouraged to come forward under the OVDP to make timely, accurate, and complete disclosures. Those taxpayers making 'quiet' disclosures should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years."
- FAQ 16: "The IRS is reviewing amended returns and could select any amended return for examination. The IRS has identified, and will continue to identify, amended tax returns reporting increases in income. The IRS will closely review these returns to determine whether enforcement action is appropriate. If a return is selected for examination, the 27.5 percent offshore penalty would not be available. When criminal behavior is evident and the disclosure does not meet the requirements of a voluntary disclosure under IRM 9.5.11.9, the IRS may recommend criminal prosecution to the Department of Justice."

Taxpayers and Dual Citizens Residing Abroad

- "Streamlined Procedure" effective date September 2, 2012
- IRS Commissioner Shulman: "Today we are announcing a series of common-sense steps to help U.S. citizens abroad get current with their tax obligations and resolve pension issues"
- Must file 3 years of tax returns and 6 years of FBARs
- Scrutiny by IRS will depend upon assessment of "compliance risk"
- Penalty relief for "reasonable cause" is available
- Relief for certain foreign pensions and retirement plans (including Canadian RRSPs) is available
- But, no protection from criminal prosecution

FATCA
Specified Foreign
Financial Asset Disclosure

FATCA – Specified Foreign Financial Assets

- New **IRC § 6038D**, "Information with respect to foreign financial assets"
- **Form 8938**, "Statement of Specified Foreign Financial Assets"
- **Temporary and Proposed Regs** issued December 2011

Form 8938
Penalties & Punishments

- $10,000 failure-to-file penalty, up to a maximum of $50,000
  - Exception for reasonable case and not willful neglect
- 40% penalty for any tax underpayment attributable to an "undisclosed foreign financial asset"
  - Includes SFFAs and other assets for which reporting has always been required (such as CFCs, foreign trusts, etc.)
- Statute of limitations is 6 years for returns with omissions of income that exceed $5,000 attributable to SFFAs
  - This applies even if the SFFAs were not reportable because they were below the filing threshold

Form 8938
Reporting Thresholds

- General
  - $50,000 on last day of taxable year
  - $75,000 at any time during the taxable year
- Married individuals filing jointly and living in the U.S.
  - $100,000 on last day
  - $150,000 at any time
- Individuals living abroad
  - Single or married filing separately
    - $200,000 on last day
    - $300,000 at any time
  - Married filing jointly
    - $400,000 on last day
    - $600,000 at any time

Form 8938
Foreign Financial Account

- Foreign financial account maintained by a foreign financial institution (FFI)
  - § 6038D: financial institutions organized in U.S. possessions not "foreign"; **BUT**
  - Regs: financial institutions organized in U.S. possessions are "foreign" (more consistent with FBAR rules)
- Accounts with domestic branches of foreign banks are not "foreign"
  - Like the FBAR rules
- Foreign branches or subsidiaries of a U.S. financial institution are not "foreign"
  - Not like the FBAR rules

Form 8938
Foreign Financial Account

- Foreign hedge funds and foreign private equity funds are reportable
  - Unlike FBAR rules

Form 8938
Other Specified Foreign Financial Assets

- The following, if **held for investment** and **not held in a financial account**
  - Stock issued by a foreign corporation
  - Capital or profits interest in a foreign partnership
  - Note, bond, debenture, or other obligation issued by a foreign person
  - Interest rate swap, currency swap, interest rate cap, interest rate floor, commodity swap, equity swap, or similar agreement with a foreign counterparty
  - Option or other derivative of the above that is entered into with a foreign counterparty
- Foreign hedge funds and private equity funds reportable
  - Unlike FBAR rules

Form 8938
Other SFFAs (cont'd.)

- "Held for Investment"
  - Means **only** that it is not used in the conduct of a trade or business
  - Stock is not considered held for use in a trade or business
- If these "other foreign financial assets" are held in a financial account, don't report

Form 8938
Other SFFAs (cont'd.)

- Interests in foreign trusts and estates
  - Considered an SFFA if the taxpayer knows, or has reason to know, of the interest based on readily accessible information
  - Receipt of a distribution constitutes actual knowledge
  - Value reported is actual distributions plus actuarial interest of right to receive mandatory distributions
    - Thus, interests in discretionary foreign trusts where no distribution is made: value is $0 (which must be reported at $0 if there are other SFFAs that exceed threshold)

Form 8938
Other SFFAs (cont'd.)

- Foreign pension plans and deferred compensation plans
  - Reportable
- Foreign social security, social insurance, or other similar program of a foreign government
  - Not reportable

Form 8938
Indirect Ownership of SFFAs

- **Grantor Trusts** – SFFAs held in trust reportable by owner
- **Disregarded Entities** – SFFAs held in entity reportable by owner
- **Corporations and Partnerships** – SFFAs not reportable by owners
- **Joint Owners**
  - Spouse who is a specified individual
    - Joint return – combine value and report once on a single form
    - Separate returns – each spouse reports entire value
  - Spouse who is not a specified individual
    - U.S. spouse reports entire value
  - Non-spouses
    - Each specified individual reports entire value
- **SFFAs owned by child** if parent reports child's unearned income – SFFAs reportable by parent

Form 8938
Who Must File

- Currently, only "**specified individuals**" are required to file for tax years beginning after March 18, 2010 (i.e., 2011)

- When Proposed Regs are finalized, "**specified domestic entities**" will be required to file (Notice 2013-10)

Form 8938
Specified Individual (2011 *et seq*.)

- U.S. citizen
- U.S. resident
  - Green card
  - Substantial presence
- Nonresident alien electing to be treated as a U.S. resident for purposes of filing a joint income tax return
- Nonresident alien who is a bona fide resident of American Samoa or Puerto Rico

Form 8938
Specified Domestic Entity (Prop. Regs.)

- Corporations and Partnerships
  - Owns a specified foreign financial asset, **AND**
  - Owned 80% by a specified individual (constructive ownership rules apply)

  AND

    - 50% of entity's gross income is passive (or 50% of the assets produce passive income)

      OR

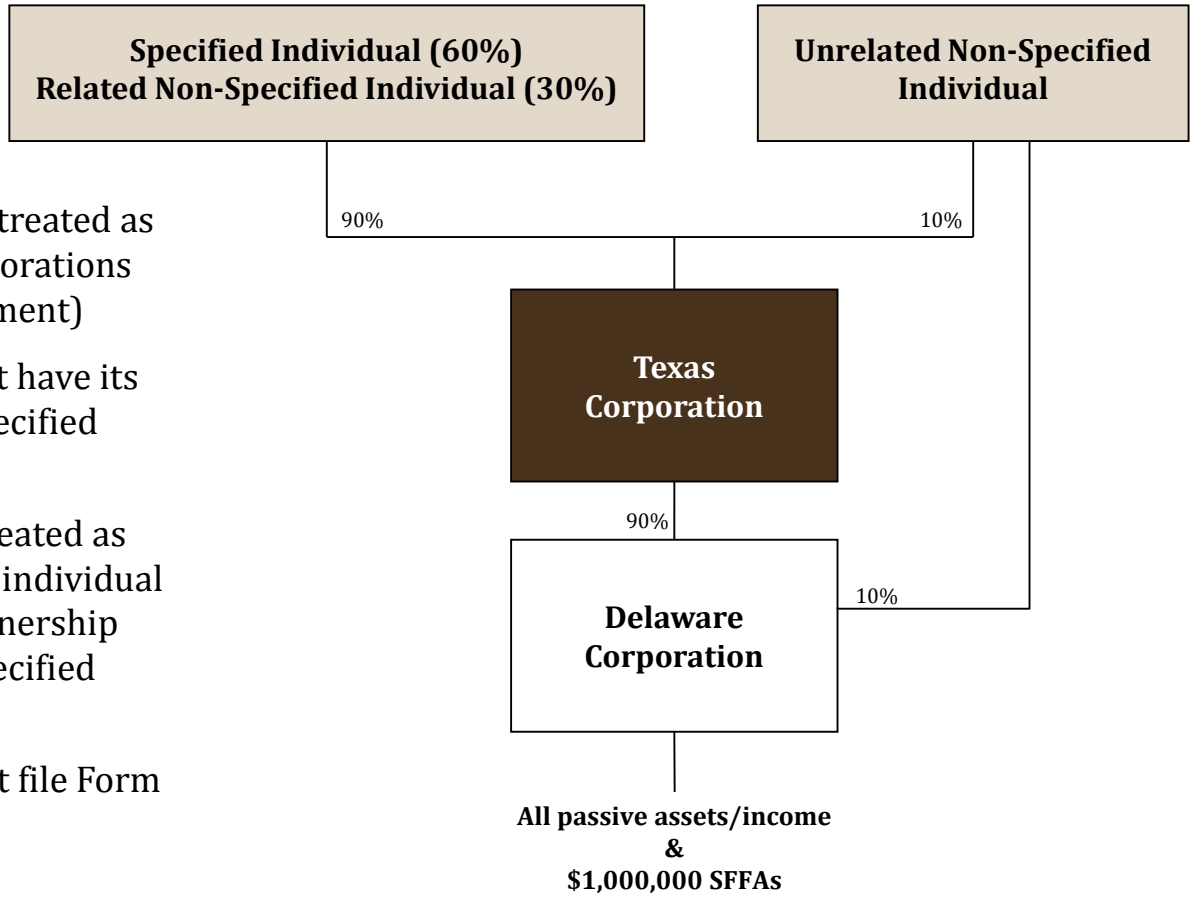
    - 10% of the entity's gross income/assets is passive and the entity is formed or availed of by the specified individual with a principal purpose of avoiding the reporting obligations under § 6038D
      - Facts and circumstances

Form 8938
Specified Domestic Entity (Prop. Regs.)

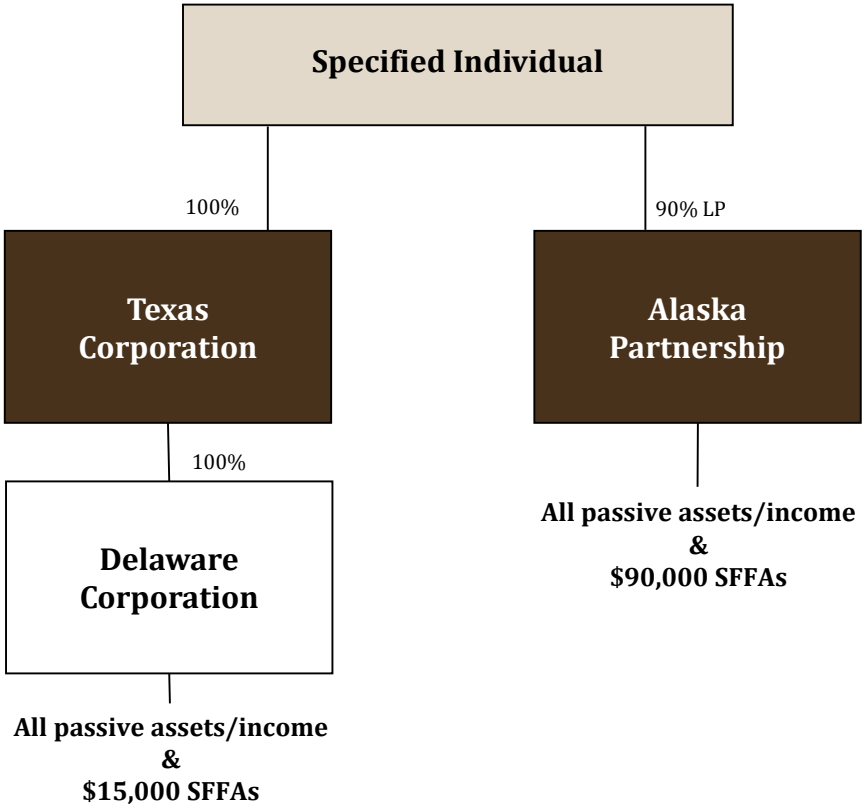
- Related corporations and partnerships
  - Corporations/partnerships owned 80% by the same specified individual **and** that own SFFAs are treated as a single entity for purposes of determining filing threshold

Form 8938
Related Corporations and Partnerships (Prop. Regs.)

- Specified individual is not treated as owning SFFAs held in corporations (for his own filing requirement)
- Texas corporation does not have its own SFFAs, so it's not a specified domestic entity
- Delaware corporation is treated as owned 81% by a specified individual under the constructive ownership rules and is therefore a specified domestic entity
- *Delaware corporation* must file Form 8938



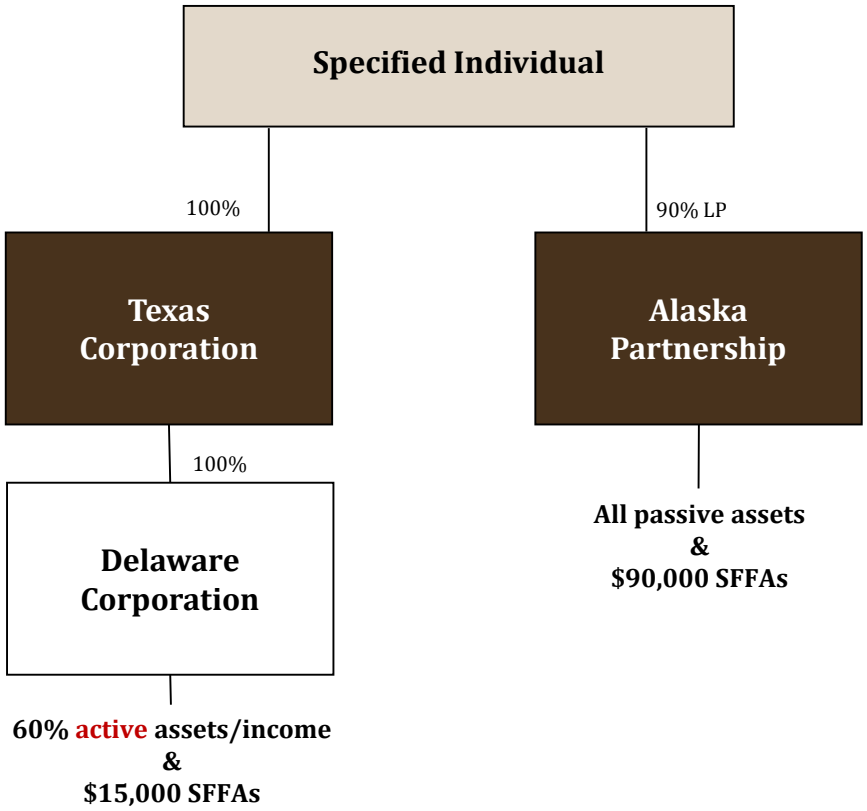
Form 8938
Related Corporations and Partnerships (Prop. Regs.)



- Specified individual is not treated as owning SFFAs held in corporations and partnerships (for his own filing requirement)
- Texas corporation does not have its own SFFAs, so it's not a specified domestic entity
- Alaska partnership and Delaware corporation are each treated as owning the other's SFFAs; therefore, they both meet the filing threshold and are treated as specified domestic entities
- *Alaska partnership* and *Delaware corporation* must each file Form 8938 (to report their own SFFAs)

Form 8938

Related Corporations and Partnerships (Prop. Regs.)



- Specified individual is not treated as owning SFFAs held in corporations and partnerships (for his own filing requirement)
- Assume Texas corporation and Delaware corporation not formed to avoid reporting obligations
- Texas corporation does not have its own SFFAs, so it's not a specified domestic entity
- Alaska partnership and Delaware corporation are each treated as owning the other's SFFAs, but Delaware corporation does not meet passive asset/income test; therefore, Delaware corporation is not a specified domestic entity
- Alaska partnership, on the other hand, is a specified domestic entity
- *Alaska partnership* must file Form 8938

Form 8938

Domestic Trust as Specified Domestic Entity (Prop. Regs.)

- A domestic trust is required to file if:
  - SFFAs exceed $50,000 on the last day of the year or $75,000 any time during the year; **and**
  - One or more specified persons are current beneficiaries (i.e., can receive a distribution)

Form 8938
Duplicate Reporting Exceptions

- Exceptions provided for SFFAs reported on:
  - Form 3520 – foreign trust or estate distribution; foreign gift or inheritance
  - Form 3520-A – foreign trust with a U.S. owner
  - Form 5471 – foreign corporation
  - Form 8621 – passive foreign investment company
  - Form 8865 – foreign partnership
  - Form 8891 –beneficiaries of certain Canadian retirement plans
- For these exceptions, Form 8938 must still be filed, but extensive information need not be provided
- No exception for foreign deposit and custodial accounts reported on FBAR (unless the foreign account is already reported on one of the forms above)

Form 8938
Duplicate Reporting Exceptions

- U.S. Owner of foreign trust that owns SFFAs
  - Excepted only if **both** Form 3520 and Form 3520-A are filed and checked on the Form 8938

Form 8938 – Miscellaneous

- Currency exchange rate to be used is the rate on the last day of the filer's **tax year**, using the U.S. Treasury Department's Financial Management Service rate (www.fms.treas.gov/intn.html)
- Report maximum value during the year
- Assets with negative value are reported at $0
- Form 8938 is not required if no income tax return is required, even if SFFAs exceed threshold

FATCA
Withholding Rules for
Trusts and Estates

Withholding – the basics

- FATCA requires withholding of 30% of "withholdable payments" made to foreign entities (which includes a trust) after June 30, 2014 unless an exemption applies.
- "Withholdable payments" means U.S. source FDAP and, beginning June 30, 2017, gross proceeds from the sale or disposition of assets that produce U.S. source FDAP.
- Exemptions apply to governmental and tax exempt entities, entities engaged in active businesses, retirement plans, and a host of other categories of entities and also to those entities that are FATCA compliant.

Withholding under Chapters 3 and 4 Compared

- The definition of FDAP under Chapter 4 is broader than under Chapter 3:
  - interest on bank deposits
  - portfolio interest
  - treaties
  - gross proceeds
- Effectively connected income (ECI) is not subject to withholding except when realized through a partnership or LLC, but ECI that is exempted from tax under a treaty is subject to Chapter 4 withholding.

Treatment of Trusts under FATCA Withholding Rules

- A foreign trust is considered to be a foreign entity;
- A trust is an "investment entity" if the trust has primarily investment income; and
- Equity interests in an investment entity are "financial accounts."
- A foreign trust will be considered to be a U.S. owned entity if "specified U.S. persons" own or are treated as owning the requisite percentage interest in the trust.

Beneficiaries or Owners of Trusts under the Regulations

- A person is considered to have an equity interest in a trust if she:
  - is treated as the owner of any portion of a trust
  - is entitled to a mandatory distribution from the trust (does this cover future and contingent interests?)
  - is eligible to receive distributions from the trust.

Beneficiaries or Owners of Trusts under the Regulations

- If a **U.S. person** is the owner of 100% of a trust, no other person is treated as having an equity interest. This rule **does not** apply to a foreign grantor. E.g., a U.S. person who receives a distribution from a revocable trust created by a foreign grantor has an equity interest in the trust.

- Different reporting rules apply under the IGAs, discussed below.

Is a Trust a FFI or an NFFE?

- A foreign financial institution ("FFI") has a heavier compliance obligation under FATCA regulations than a nonfinancial foreign entity ("NFFE"). This distinction is less significant under the IGAs. A trust can be either an FFI or an NFFE.

Is a Trust a FFI or an NFFE?

- A trust is an FFI if it has primarily investment income and it is "professionally managed"
- A trust is professionally managed if the trustee is a trust company or the trustee hires a professional investment manager
- It is unclear whether a trust managed by a private trust company or a professional individual trustee will be classified as an FFI
- A trust that is not an FFI will be an NFFE, and most likely a "passive" NFFE unless it is engaged in an active business

Differences in the Treatment of FFIs and NFFEs under Regulations

- Determination of whether a trust has a substantial U.S. owner
- Requirements to avoid withholding
- Ability to obtain a refund of overwithheld tax
- Identification of "payee" for purposes of determining whether withholding is required

Determination of whether a trust has a substantial U.S. owner under the regulations

- If the trust is an FFI, the trust is considered to have a substantial U.S. owner and thus to be a U.S. owned entity if (i) any specified U.S. person is treated as the owner of a portion of the trust under the grantor trust rules or (ii) any specified U.S. persons owns more than a **zero percent** interest in the trust.
- If the trust is an NFFE, only a specified U.S. person who is treated as the owner of a portion of the trust under the grantor trust rules or who owns more than a **ten percent** interest is considered a substantial U.S. owner. However, interests owned by related persons are aggregated.

"Bright Line" Test for Determination of the Ownership Threshold

- A person has a 10 percent interest if she (together with related persons):
  - Receives a distribution in a calendar year that exceeds either 10% of the total distributions in the year or 10% of the value of the trust (unclear how value is determined);
  - The value of her mandatory distribution rights (unclear if this includes future or contingent interests) exceeds 10% of the value of the trust; or
  - the sum of the distributions received and the mandatory distribution rights exceeds either 10% of the value of the distributions or 10% of the value of the trust.
- In the case of a trust classified as an FFI, the same bright line test applies except that the threshold is more than zero percent rather than more than 10%
  - Provided that, under a *de minimis* rule, a person will not be considered a substantial U.S. owner of an NFFE if she received $5,000 or less during the year and the value of the mandatory distribution rights, if any, is $50,000 or less.

Indirectly Owned Interests

- A U.S. beneficiary is treated as indirectly owning interests in other entities—other trusts, partnerships and corporations—that the trust owns or has an option to acquire
- The same bright line test applies for measuring indirect ownership of a trust as applies to direct ownership of a trust
- A facts-and-circumstances test applies for measuring indirect ownership by beneficiaries of corporations and partnerships owned by a trust

Indirectly Owned Interests (cont'd.)

- The indirect ownership rules could result in a U.S. person being treated as a substantial U.S. owner of an indirectly held interest in an entity even though she was not a substantial owner of the trust she directly owned.
  - For example, if she had a less than 10% interest in a trust classified as an NFFE and a more than zero% interest in a foreign corporation owned by the trust (assuming that the corporation is classified as an FFI), the corporation would have a substantial U.S. owner even though the trust did not.
- The indirect ownership rules do not apply to a trust that is a participating FFI or a deemed-compliant FFI other than an owner-documented FFI. The indirect ownership rules do apply to owner-documented FFIs.

Indirectly Owned Interests (cont'd.)

- Identification of individual beneficial owners of stock held indirectly through an owner-documented FFI that is a discretionary non-grantor trust will be a problem.
- The regulations do not adequately address this issue except to say that, if indirect ownership cannot be determined, one can presume that the entity has a substantial U.S. owner—but then what do you do? How to report ownership and will there be bad consequences under the CFC and PFIC rules?

Requirements to avoid withholding

- A trust that is an NFFE avoids withholding by certifying that it has no substantial U.S. owners or by identifying the substantial U.S. owners
- NFFEs that are engaged in an active trade or business or whose equity interests are publicly traded are exempt from withholding
- Unless the trust is an exempt person, a trust that is an FFI can avoid withholding only by becoming a participating FFI or a deemed-compliant FFI

Ability to obtain a refund of overwithheld tax

- A trust that is a non-participating FFI may not obtain a refund of tax on income it beneficially owns unless a treaty requires it and even then the refund is paid without interest. The beneficial owner of the income (e.g. the grantor of a grantor trust or a beneficiary who received a distribution that carried out income to the beneficiary) may obtain a refund.
- An NFFE can obtain a refund by providing appropriate documentation
- Ability to obtain a refund is important because U.S. source gross proceeds are not normally taxable to a foreign non-grantor trust

Ability to obtain a refund of overwithheld tax (cont'd.)

- This rule puts an added burden on trustees to make distributions to allow beneficial owners to obtain a refund
- However, because income is deemed distributed based on aggregate distributions and not using a tracing principle, unless all trust distributable net income is distributed, some of the gains will be beneficially owned by the trust
- In addition, unless the trust can assign the right to the refund to the beneficiary and carry out the beneficial ownership of the withheld tax, the only way the trust can cease to own any of the income would be to distribute other assets

Identification of "payee"

- Payments of U.S. source FDAP to a trust that is a not a participating FFI a deemed compliant FFI or an exempt person are subject to withholding even if the trust is not the beneficial owner. Treas. Reg. §1.1471-3(a)(3)(ii).
  - This rule overrides the general rule that the payee is the account holder, who may be the beneficial owner of the account rather than the entity that has title to the account.
- For example, if the trust is a grantor trust, the grantor is the beneficial owner and the deemed "account holder."
  - However, a grantor trust is classified as a "flow-through entity" and the regulations provide that the payee is the flow-through entity (the trust) and not the beneficial owner (the grantor) if the trust is a nonparticipating FFI (other than one owned by exempt persons) and the income is U.S. source FDAP.

Identification of "payee" (cont'd.)

- This rule is not applicable to trusts classified as NFFEs
- This rule is not applicable to payments that are not U.S. source FDAP (such as gross proceeds from the sale of assets that produce U.S. source FDAP)
- This rule is not applicable to FFIs that are owned by exempt persons

Estates

- Payments to accounts owned by estates are not subject to FATCA withholding if the estate provides appropriate documentation
- However, it is not clear whether a U.S. estate will be considered a substantial U.S. owner of trusts and other entities in which the estate holds an interest

How a trust classified as an FFI can avoid withholding

- Become a participating FFI
- Be an exempt person or be beneficially owned by exempt persons
- Become a registered deemed-compliant FFI (this includes an FFI in a Model 1 FATCA partner jurisdiction)
- A trust is a registered deemed-compliant FFI if it is a "sponsored FFI". A trust will be sponsored if the trustee is a participating FFI and agrees to sponsor the trust, which simply means that the trustee undertakes all reporting responsibilities as if the trust were a participating FFI
- Become a certified deemed-compliant FFI
  - Owner-documented
  - Sponsored closely-held investment vehicle

Owner-documented FFI

- An owner-documented FFI must file "owner reports" with its "designated withholding agent" to disclose all its owners (beneficiaries) both U.S. and foreign
  - Only U.S. owners are reported by the withholding agent to the IRS
  - Owner reports are required every three years
- Alternatively, rather than filing owner reports, the FFI can obtain an auditor's letter from an auditor or attorney licensed in the U.S. signed no more than 4 years prior to the date of payment that certifies that the trust is eligible to be an owner-documented FFI and provide an owner reporting statement and Form W-9 for each U.S. beneficiary who is an owner
- Importantly, a discretionary beneficiary who receives nothing is not an "owner." A discretionary trust may have no owners!

Owner-documented FFI (cont'd.)

- An owner documented FFI is not exempt from withholding but only avoids withholding on payments made to it by its designated withholding agent
- The designated withholding agent must be a participating FFI, a U.S. institution or a reporting FFI under a Model 1 IGA

Sponsored closely-held investment vehicle

- A corporation owned by a trust may be a sponsored closely-held investment vehicle. The sponsor must be a participating FFI, a reporting Model 1 IGA FFI or a U.S. financial institution who agrees to assume FATCA responsibilities of the sponsored entity. The sponsor must have control of the entity and be authorized to enter contracts on its behalf
- The sponsor, such as a trustee, undertakes to provide all the information that the investment vehicle would have had to provide had it become a participating FFI

Global Intermediary Identification Numbers ("GIINs")

- Eligible entities can obtain a GIIN
  - Eligible entities include participating FFIs, registered deemed-compliant FFIs, sponsored FFIs and FFIs in Model 1 FATCA partner jurisdictions. An owner-documented FFI may not get a GIIN
- An FFI that does not have a GIIN will be subject to withholding unless another exemption applies
- New Forms W-8 BENE-E will require entities to identify their classifications under FATCA.

Obligations of a Participating FFI

- Identify beneficiaries and owners, specify their interests and withhold on withholdable payments and foreign passthru payments to payees who are nonparticipating FFIs or recalcitrant account owners (owners who fail to produce required documentation concerning their status) and close, block or liquidate recalcitrant accounts
- Withholding on foreign passthru payments is deferred until 6 months after the term is defined in regulations or begins June 30, 2017 if later
- Subject to transition rule in effect through 2015, a participating FFI cannot have affiliates who are not participating FFIs
- File Form 8966 "FATCA Report" annually

Alternative Method of Reporting

- A participating FFI can elect not to file FATCA reports and to instead file information returns (Forms 1099) as if it were a U.S. financial institution and all U.S. accounts were held by individuals
  - However, supplemental reporting is required identifying the U.S. account holders and supplying account numbers
- This election should be modified for trusts so that the same information (Schedules K-1) that a U.S. trustee would be required to file could be filed by foreign trustees

Alternative Method of Withholding

- Rather than undertaking to withhold on payments made to nonparticipating FFIs and recalcitrant account holders, a participating FFI can elect to be withheld upon payments it receives that are allocable to such account holders
- This option may not be viable for discretionary trusts since the amount allocable to a recalcitrant account holder (beneficiary) cannot be known until the trustee makes distribution decisions, which typically would occur after, and not before, it receives payments

Model 1 IGA

- An FFI, including a trust, can register with the IRS and obtain a GIIN and is required to report information about account holders and beneficiaries to its home country tax authority, which then shares the information with the IRS
- Withholding is not required at all
- The "no affiliates" rule is modified so that it continues after 2015
- Not required to close recalcitrant accounts
- Definition of U.S.-owned entity is changed. All "controlling persons" (who don't necessarily actually have control) must be reported
  - In the case of a trust, this means the settlor, trustee, beneficiaries, protector, holder of a power of appointment, or any other person who has control without regard to ownership or shares of beneficial interest

Model 1 IGA (cont'd.)

- The classification of a trust under Model 1 IGA as either an FFI or an NFFE is not so important because:
  - There is no withholding
  - There is no ownership threshold—a trust classified as an NFFE is a U.S. owned entity if any controlling person is a specified U.S. person

Model 2 IGA

- Model 2 FFIs must enter into agreements with the IRS to avoid withholding and their obligations are the same as for any other participating FFI except as modified by the Model 2 IGA
- Modifications include:
  - Reporting of "controlling persons"
  - waiver of the obligation to withhold on payments to recalcitrant account holders
  - waiver of the obligation to close accounts of recalcitrant account holders
  - waiver of the "no affiliates" rule
- However, there is no waiver of the obligation to withhold on payments to non-participating FFIs
- Model 2 institutions report to the IRS the aggregate payments to existing accounts of recalcitrant account holders and then the IGA allows the IRS to seek further information from the FATCA partner

Conclusion

- A trust classified as an FFI will have difficulty avoiding withholding unless it becomes a participating or deemed-compliant FFI
- A trust will have difficulty qualifying as an NFFE because most trusts have professional managers—trustees or investment managers
- Avoiding U.S. investments may not work because financial institutions may prefer to do business only with entities that have a GIIN and provide Forms W-8 BENE-E identifying their classification
- Excluding U.S. beneficiaries is not necessary under the Regulations because a beneficiary who gets nothing is not treated as an owner
- Regulations are very complicated because little guidance is geared specifically to trusts

Conclusion – Need for Guidance

- How does a trust that is an FFI report "accounts" of trust beneficiaries?
- Can a trustee elect to file Schedules K-1 instead of Forms 1099 and FATCA reports?
- How to report indirect ownership of entities (e.g., corporations) owned by discretionary non-grantor trusts?
- Valuation rules for account balances and the 10% rule
- The treatment of future and contingent interests
- Whether the *de minimis* rule applies to trusts classified as an FFI
- How to apply the "no affiliates" rule to trusts

Conclusion – Need for Guidance

- Whether a trust managed by an individual professional trustee or a private trust company is an FFI (and whether a private trust company itself is an FFI)
- Explanation of procedures for a foreign person to obtain a refund of overwithheld tax
- Whether a trustee of an FFI can assign the withheld tax as part of a trust distribution to make the beneficiary the beneficial owner of all of the income on which tax was overwithheld
- How entities owned by U.S. estates are classified under FATCA