New York Law Journal
WWW.NYLJ.COM
An ALM Publication
VOLUME 245—NO. 91
THURSDAY, MAY 12, 2011

TAX LITIGATION ISSUES

Expert Analysis

FATCA: New Front in the IRS's Battle Against Offshore Accounts

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The "tax gap" measures the difference between estimates of what taxpayers should be paying and what the Internal Revenue Service actually collects. In 2009, Congress attributed $100 billion of the annual $345 billion tax gap to offshore tax abuse.[1] Given the amount of revenues lost to tax havens, the IRS's recent focus on international tax avoidance is unsurprising.[2]

Over the last two years, this column has chronicled the IRS's efforts to encourage non-compliant taxpayers to disclose their offshore bank accounts through its Voluntary Disclosure Practice.[3] These efforts have focused on using the "stick" of increased enforcement and the "carrot" of reduced (and certain) penalties. In the long term, however, the Foreign Account Tax Compliance Act (FATCA), which became law as part of the Hiring Incentives to Restore Employment Act of 2010,[4] may have an even more significant impact on offshore banking.

FATCA attacks the use of offshore accounts as a means of evading income taxes by imposing new reporting requirements on U.S. taxpayers, subjecting taxpayers who fail to report offshore accounts to additional penalties, extending the applicable statutes of limitations, and, perhaps most importantly, by introducing new reporting and withholding requirements on foreign financial institutions.

Individual Requirements

Pursuant to the Bank Secrecy Act of 1970, individual U.S. taxpayers with foreign accounts valued at more than $10,000 are required to file Reports of Foreign Bank and Financial Accounts, or "FBARs," at the IRS Computing Center in Detroit.[5] FATCA imposes an incremental reporting requirement on individual taxpayers with an interest in "specified foreign financial assets" with an aggregate value greater than $50,000.[6] Starting with the 2011 tax year, in addition to filing FBARs, such taxpayers must also provide information regarding their offshore accounts on new Form 8938, which must be filed with their income tax returns.[7]

While the new FATCA reporting requirement is largely redundant to the FBAR requirement, it encompasses some assets that are not otherwise subject to disclosure.[8] The overlapping reporting requirements are best explained by the anomaly that, while the FBAR has been the principal source of information regarding offshore accounts, "it is neither part of the income tax return filed with the IRS nor filed in the same office as that return."[9] Thus, agents examining an income tax return did not have ready access to FBARs filed by the taxpayer, while the confidentiality attributed to tax returns meant that agents tasked with investigating and enforcing FBAR compliance generally did not have access to the taxpayer's returns even though they "may be the best source of information for this purpose."[10] FATCA addresses the first of these information gaps by giving the IRS personnel who examine tax liability immediate access to information regarding the taxpayer's offshore assets.

> The new individual reporting requirements, enhanced penalties and extended statutes of limitations may finally enable the IRS to close the tax gap attributable to offshore accounts.

Penalties for Non-Compliance

The maximum financial penalty for failure to furnish information required under FATCA is $50,000 per year; $10,000 for the initial failure to disclose with additional penalties if the taxpayer fails to remedy his non-compliance within 90 days of receiving notice from the IRS.[11] Taxpayers will be subject to incremental $10,000 penalties for non-compliance for each 30-day period (or fraction thereof) after the 90-day remedy period. These penalties will be waived if the taxpayer can establish that his non-compliance was due to reasonable cause and not willful neglect.[12] Moreover, the taxpayer will bear the burden of rebutting the presumption that the value of any undisclosed foreign assets exceeded the $50,000 reporting threshold.[13] These penalties are in addition to the penalties that can be imposed if the taxpayer also fails to file an FBAR relating to the same assets.[14]

In addition, the 20 percent accuracy-related penalty that applies to underpayments attributable to negligence, disregard of the IRS's rules or regulations, or any substantial understatement of income tax,[15] is doubled in the case of underpayments attributable to income generated by undisclosed foreign financial assets.[16]

Tolling

The IRS is required to assess taxes, interest and penalties within three years after a return is filed,[17] unless it can establish either that the taxpayer filed a false or fraudulent return with the intent to evade taxes (in which case there is no statute of limitations)[18] or that the return had a "substantial understatement" of gross income (in which case a six-year limitations period applies).[19]

Recognizing that it is difficult and time-consuming for the IRS to discover unreported income attributable to offshore assets,[20] FATCA extends the limitation periods applicable where the taxpayer has undisclosed offshore assets. First, the three-year clock does not begin to run until the IRS actually receives the information about offshore assets, rather than upon the filing of a return (which may omit such information and therefore be incomplete).[21] This delay in starting the limitations period applies to the entire tax return.[22] Thus, the failure to include Form 8938 with a timely filed return will extend the limitations period relating to any audit adjustments proposed by the IRS, even adjustments that are unrelated to the taxpayer's foreign assets. Second, FATCA applies a six-year statute of limitations where the taxpayer omits more than $5,000 in gross income attributable to foreign financial assets.[23]

The new limitations periods are applicable to all returns filed after March 18, 2010, as well as returns filed on or before that date if the otherwise applicable limitations period has not expired.

Foreign Financial Institutions

While FATCA's individual reporting requirement seeks to enhance the IRS's ability to discover and pursue tax liabilities resulting from undisclosed offshore assets, absent additional enforcement and likelihood of detection, there is little reason to believe that taxpayers who violate the FBAR reporting requirements will disclose offshore assets in response to FATCA. FATCA addresses this problem by putting into place a "new regulatory structure under which foreign financial institutions (and other foreign entities through which money moves from the United States abroad) police the identities of their account holders and assure that U.S. taxpayers pay the appropriate U.S. taxes."[24] These complex and controversial provisions, which will go into effect

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in 2013, are intended to increase the IRS's access to information, and limit the ability of U.S. taxpayers to conceal offshore assets.

Thus, FATCA imposes withholding requirements on any foreign financial institution (FFI) that: (1) accepts deposits in the ordinary course of a banking or similar business; (2) holds financial assets for the accounts of others as a substantial portion of its business; or (3) is engaged in the business of investing, reinvesting or trading securities, partnership interests, commodities, or any similar interest.[25] Under FATCA, such institutions must withhold a 30 percent tax on any payment received from a U.S. source—including interest, dividends, and any gross proceeds from the sale or other disposition of any property of a type that can produce U.S. source interest or dividends.[26] This withholding requirement applies to accounts held by non-U.S. persons as well as those held by U.S. persons.[27]

An FFI can avoid this wide-reaching measure by entering into a qualified intermediary (QI) agreement, committing to obtain information regarding all accounts maintained by the institution in order to (a) identify accounts held by one or more U.S. person or U.S.-owned foreign entity, and (b) provide the IRS with information about those accounts and their owners.[28] Thus, each year, the FFIs will be required to disclose information regarding each account holder identified as a "specified U.S. person" or "U.S. owned foreign entity," as well as information regarding the size of and transactions in the accounts.[29]

FATCA also requires cooperating FFIs operating in jurisdictions that have bank secrecy laws either to obtain waivers of those secrecy laws from account holders or to close any accounts for which waivers are not obtained.[30] Finally, under the QI agreements, even compliant FFIs will be required to withhold the 30 percent tax on any "passthru" payment the institution makes to (a) another FFI that has not entered into a QI agreement or (b) any "recalcitrant account holder" who fails to comply with requests for information or to submit a valid and effective waiver.[31] Under this provision, non-participating FFIs and recalcitrant account holders will generally be subject to withholding on any payment received from a participating FFI, regardless of whether the account holder invests in the U.S. through this account. A participating FFI can only avoid withholding on passthru payments made to non-compliant FFIs or recalcitrant account holders by electing to provide information regarding those accounts to a U.S. withholding agent or other compliant FFI to allow it to determine the appropriate amount of withholding.[32]

Foreign banks and their governments have vehemently objected to FATCA, estimating that a single large bank will have to spend at least $250 million to meet the statutory requirements even though the number of U.S. accounts at banks and securities firms in other countries generally is de minimis.[33] Indeed, many foreign institutions conclude that it is preferable to close accounts with ties to the United States or otherwise avoid U.S. markets and withholdable payments made to U.S. and non-U.S. account holders than to comply with FATCA.[34]

Of course, not all offshore accounts are opened to evade U.S. income taxes, and if FATCA results in foreign financial institutions closing their doors to U.S. taxpayers, it will negatively affect many legitimate U.S. businesses and citizens doing business abroad. Thus, the chairman of the Swiss Private Bankers Association has stated that Americans "risk becoming pariahs of the global banking system through the fault of their own government."[35] Indeed, one U.S. citizen, who has lived in Canada for almost 40 years, notes that while he could live with the "complex and duplicative reporting" requirements imposed by FATCA, he "could not live with…the total denial of banking services in Canada, resulting from the draconian reporting requirements imposed on foreign financial institutions."[36]

> FATCA puts into place a 'new regulatory structure under which foreign financial institutions (and other foreign entities through which money moves from the United States abroad) police the identities of their account holders and assure that U.S. taxpayers pay the appropriate U.S. taxes.'

Conclusion

IRS Commissioner Douglas Shulman has referred to FATCA as "the most important development in international information reporting in a decade." While the Treasury Department has yet to issue final regulations on the implementation of new Chapter 4 of the Code,[37] leaving much about the new requirements unsettled, combined with the reporting requirements imposed on foreign financial institutions, the new individual reporting requirements, enhanced penalties and extended statutes of limitations may finally enable the IRS to close the tax gap attributable to offshore accounts. The issue then will be whether the increased enforcement was worth the costs imposed on legitimate offshore investment activities.

1. Jane G. Gravelle, Congressional Research Service, "Tax Havens: International Tax Avoidance and Evasion" at 2 (July 9, 2009). See also, Treasury Inspector General for Tax Administration, "A Combination of Legislative Actions and Increased IRS Capability and Capacity Are Required to Reduce the Multi-Billion Dollar U.S. International Tax Gap," Reference No. 2009-IE-R001 (Jan. 27, 2009) (estimating the annual tax gap attributable to tax havens ranges between $40 billion to $123 billion).

2. See Office of Management and Budget, "A New Era of Responsibility" at 93-94 ("The 2010 Budget includes funding for a robust portfolio of IRS international tax compliance initiatives, and sustains and improves IRS efforts to narrow the annual tax gap of over $300 billion"); John D. McKinnon, "White House Leans Towards Tighter Enforcement of Taxes," Wall Street Journal (March 26, 2009).

3. Jeremy Temkin, "Voluntary Disclosure of Offshore Accounts: Yet Another 'Last' Chance," New York Law Journal (Feb. 17, 2011); Jeremy Temkin, "Offshore Banking: the End of the World as We Know It?" New York Law Journal (Jan. 14, 2010); Jeremy Temkin, "One Last Chance for Offshore Account Holders," New York Law Journal (May 14, 2009).

4. Pub. L. 111-147 (H.R. 2847).

5. 31 CFR 1010.350.

6. 26 U.S.C. §6038D(a). "Specified foreign financial assets" include any financial account maintained by a foreign financial institution, stocks or securities issued by foreign persons, any other financial instrument or contract held for investment that is issued by or has a counterparty that is not a U.S. person, and any interest in a foreign entity. Id. §6038D(b).

7. Id. §6038D(c).

8. Joint Committee on Taxation, JCX-42-09, "Technical Explanation of the 'Foreign Account Compliance Act of 2009,'" at 34 (Oct. 27, 2009) (giving example of a beneficiary with less than a 50 percent interest in a foreign trust who falls outside the FBAR requirement, but "may nonetheless be required to disclose the interest in the trust with his tax return under this provision if the value threshold is met").

9. JCX-42-09 at 29.

10. JCX-42-09 at 32.

11. 26 U.S.C. §6038D(d).

12. Id. §6038D(g).

13. Id. §6038D(e).

14. 31 U.S.C. §5321(a)(5) (providing for penalties of $10,000 per account for a non-willful violation and the greater of $100,000 or 50 percent of the value of the account(s) in the case of willful violations).

15. 26 U.S.C. §6662(a), (b).

16. 26 U.S.C. §6662(j)(3).

17. 26 U.S.C. §6501(a).

18. Id. §6501(c)(1).

19. Id. §6501(e).

20. Treasury Department, "General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals," at 61 (Feb. 2010) ("The three-year period provided by section 6501(c)(8) does not always allow sufficient time for the IRS to determine a taxpayer's tax liability where the taxpayer has omitted income and failed to disclose foreign assets").

21. 26 U.S.C. §6501(c)(8).

22. JCX-42-09 at 41.

23. 26 U.S.C. §6501(e)(1)(A)(ii).

24. Stafford Smiley, "President Obama's Efforts at International Tax Reform," Corporate Taxation at 28 (January/February 2011). See also, Shawn P. McKenna, "Impact of the HIRE Act on Non-Financial Foreign Entities and the U.S. Entities With Which They Do Business," BNA Inc. Daily Tax Report (Sept. 15, 2010) ("The expectation is not for the new Chapter 4 to generate revenue through the collection of withholding tax on foreign entities, but instead to generate revenue through the proper reporting of income by U.S. persons").

25. 26 U.S.C. §1471(d)(5).

26. Id. §§1471(a) and 1473(1)(A).

27. The 30 percent withholding amount applies regardless of any applicable treaty provisions which may otherwise provide for a reduced rate of tax for a non-U.S. payee. Id. §1474(b)(2)(A) (non-U.S. payees must file a claim for a refund or credit with the IRS where overpayment made).

28. Id. §1471(b)(1).

29. Id. §1471(c)(1). A "specified U.S. person" is any U.S. person other than a publicly traded corporation, their affiliates, tax-exempt organizations, governments, banks, real estate investment trusts, regulated investment companies, and common trust funds. Id. §1473(3). A "U.S. owned foreign entity" is a foreign entity with one or more "substantial U.S. owners," which is defined by the statute as an owner with more than a 10 percent interest. However, in the case of any investment vehicle, the 10 percent threshold is eliminated and the foreign investment vehicle is deemed a "U.S. owned foreign entity" subject to FATCA's reporting requirements if it has any U.S. owner with an interest. Id. §§1471(d)(3) and 1473(2).

30. Id. §1471(b)(1)(F). But see Harry A. Valetk, "U.S. and European Law Set to Clash—Again: New Tax Law Requires Foreign Banks to Share Unprecedented Details About Customers Overseas," BNA Insights, Vol. 5, No. 27 at 950 (Dec. 31, 2010) (noting concerns raised by European Union that compliance with FATCA will violate national data protection laws).

31. Id. §§1471(b)(1)(D)(i).

32. Id. §1471(b)(3).

33. Letter of European Banking Federation to Treasury Department, Re: Comments on Notice 2010-60 Providing Preliminary Guidance on FATCA (Nov. 12, 2010).

34. Robert Schmidt, "Governments Press U.S. to Ease Overseas Tax-Cheat Law," Bloomberg Businessweek (Jan. 13, 2011); The Association of Americans Resident Overseas, "Banking Services Denied to U.S. Citizens Abroad," (found at http://www.aaro.org/position-papers-2010/banking-services-denied-2010).

35. Schmidt, "Governments Press U.S. to Ease Overseas Tax-Cheat Law."

36. Arden Dale, "The Trouble With FATCA," WSJ Blogs—Financial Advisor (Aug. 11, 2010).

37. IRS Notice 2011-34.

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