The Long Arm of FATCA

US TAX ACT'S COMPLEXITY HAS A GLOBAL IMPACT ON FIRMS AND INVESTORS

By Ed McCarthy

US expats often encounter challenges living overseas, but FATCA—the Foreign Account Tax Compliance Act—is making life even more difficult for some of them. Numerous media reports describe US citizens being "locked out" by foreign financial services institutions that are canceling their accounts and refusing to open new ones. FATCA's filing requirements are also exposing past tax-reporting errors and generating potentially large liabilities and penalties.

KEY POINTS

Some reports suggest that FATCA is disrupting US expats' access to foreign financial services.

As new requirements cause foreign financial institutions to report US citizens' holdings to the IRS, these taxpayers may learn that they face penalties for past failures to comply with old rules.

In some cases, foreign trusts must register with the IRS as foreign financial institutions, with possible mandatory withholdings on transactions.

PAST OMISSIONS

FATCA requires foreign financial institutions to give the IRS information about financial accounts held by US taxpayers or those held by foreign entities in which US taxpayers have a significant ownership interest. In addition, US citizens who own foreign financial assets above specified amounts must file a new annual Form 8938, a "Statement of Specified Foreign Financial Assets," with their tax returns.

FATCA does not create extensive new reporting requirements for US citizens abroad, according to David Kuenzi with Thun Financial Advisors LLC in Madison, Wisconsin. Many US citizens will be exempt from filing Form 8938 because their assets fall below the reporting thresholds. But here's the catch: Taxpayers who previously violated filing and disclosure requirements are about to face the error of their ways.

Consider a long-term expat who participates in a foreign retirement savings plan. She assumes the plan's earnings are tax exempt, as they are in the US, so she does not include its earnings on her tax returns or report the account to the IRS.

That assumption is incorrect, but because the IRS didn't know about the account in the past, it wasn't an immediate problem. Under FATCA, however, the IRS will learn about the account and can inquire about her incomplete past filings. Non-compliance is apparently widespread. More than 7 million US citizens are estimated to live abroad, and millions of others have green cards that make them subject to US tax rules. According to the IRS, however, only 170,000 taxpayers filed Form 8938 in 2011 and 187,000 filed in 2012.

The reality is that many people subject to US tax laws have not been reporting their foreign financial assets properly. "These are not new rules related to FATCA; these are very old rules," says Kuenzi. "But the problem is FATCA means because you have to now assume that your foreign financial institution is going to be reporting on your assets and your holdings to the IRS, you have to start complying with these rules, which were basically ignored by virtually everyone."

DAUNTING COMPLEXITY

Omissions are understandable in light of the filing requirements for some foreign assets. In a July 2014 *Wall Street Journal* op-ed, Kuenzi gave the following example of a US family living in Germany. They own five or six German mutual funds that the IRS treats as passive foreign investment companies (PFICs). The US tax filing requirement for this portfolio is onerous; the IRS estimates it takes over 200 hours annually to prepare and file the required forms. "Furthermore, once the filing is made, the taxpayers will find their investment gains taxed annually and subject to a tax rate no less than 39.6%, and potentially much higher," he writes.

The cost of non-compliance mounts quickly. Charles Kolstad, counsel with law firm Venable LLP in Los Angeles, cites a case in which the client's nominal tax liability on an unreported PFIC was about $2,000. That was just the start, though. "Because of the PFIC rules, [the client] ended up with a tax bill for $57,000," he says. "Then you add in a penalty for not having paid the tax and interest on all of that, and [the client] ended up writing a check for over $100,000, where the nominal tax bill was a couple of thousand bucks. So, it becomes very expensive. … The US system is not designed to handle in an easy fashion US people who really are living outside the US on a long-term basis."

LOCKED OUT

Even when expats avoid filing problems and penalties, there may be a risk that their bank or brokerage firm will cancel their accounts, citing FATCA as the cause. According to a June/July 2014 member survey of Washington, DC–based Democrats Abroad, 16% of the respondents had experienced the closure of an account in a foreign bank or brokerage house since FATCA's passage.

The survey's findings indicate that it's likely a cost–benefit analysis by institutions choosing to drop smaller customers rather than incur the expense of complying with FATCA. More than two-thirds (68.0%) of the checking accounts and 40% of the savings accounts closed had balances below $10,000 at closure. On the investment side, more than half (58.9%) of the investment/brokerage accounts held less than $50,000, as did over two-thirds (69.3%) of the dedicated retirement accounts. Kuenzi is also hearing reports of financial companies, including US institutions, making case-specific decisions on each account. "Generally, if you've got a lot of money, they'll keep you," he says. "If you haven't got a lot of money, they're kicking you out."

Denise Hintzke, director of Deloitte's FATCA Initiative in New York City, believes lockouts should diminish as more foreign institutions realize that having US citizens as clients is not what triggers FATCA inclusion. Another factor is that the OECD's Common Reporting Standard starts next year. The easiest way to think of the Standard is "FATCA on steroids," according to Hintzke, and within two years, more than 90 countries will have adopted FATCA-like laws. If a financial institution wants to relieve its compliance burden by dropping customers covered under these regulations, it eventually will have no customers remaining, she notes. "The reporting itself is really not the big issue here: It's identifying and finding the individuals that you need to report that is all the work," she says. "A lot of [institutions] have settled down, and I don't believe that the issue of expats not being able to have bank accounts is really as big as it's been blown up to be by some quarters."

Some lockouts attributed to FATCA can have other causes, as well. Frederic Behrens with Thun Financial Advisors points out that recent decisions by US-registered mutual funds to bar sales to non-residents are the result of seldom-enforced, decades-old rules, not FATCA. Mutual fund distribution agreements typically mandate that fund owners reside domestically in the United States for two main reasons, he reports. First, US fund groups cannot solicit overseas business for their SEC-registered funds, even from US expatriates. Second, mutual funds may make tax treaty claims on their holdings, which require funds to certify that all shareholders reside in the United States.

TRUST ME?

Owners of foreign trusts potentially face additional compliance burdens because the trust might be classified as a foreign financial institution, according to Kolstad. That status requires the trust to obtain a global identification from the IRS "and do a whole bunch of things that, in the context of a family trust, don't make a lot of sense," he adds. Failing to comply means the trust will incur a 30% withholding requirement on specified payments.

Craig Richards, director of tax services at Fiduciary Trust Company International in New York City, shares the example of a foreign trust's portfolio manager selling stock with a $500,000 basis for $1 million, resulting in a $500,000 gain. Fiduciary Trust, acting as the trust's withholding agent, is currently not required to withhold any amounts from the proceeds. But if the trust does not comply with FATCA, the trust company must withhold funds starting in 2017 and each successive trade will deplete the account: "[Assume] a portfolio manager sells the position in a non-compliant FATCA account for a million dollars," he says. "We're going to withhold 30%. So, now you only have $700,000 to reinvest versus in 2014, when you had $1 million to reinvest."

Many advisors aren't aware that clients' trusts can be classified as FFIs (foreign financial institutions), notes Hintzke. That lack of awareness is often based on a misunderstanding of FATCA's applicability, which isn't driven by the presence of a US citizen. "It really doesn't make any difference whether or not there is a US person there," says Hintzke. "It doesn't make any difference whether or not there's US income in the trust. It still needs to be classified and a determination made as to whether it has to register."

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SEEKING SOLUTIONS

One solution attracting headlines is renunciation of US citizenship. It's estimated that about 3,000 persons will do so in 2014; persons considering that option obviously should seek expert counsel. Sources offer several less drastic solutions for expats to manage lockouts. Jonathan Lachowitz of White Lighthouse Investment Management maintains offices in both the US and Switzerland, and he believes the lockout problem is "manageable but it takes hard work." His view is that expats need to do their due diligence and investigate multiple financial institutions to find one in their area willing to work with US citizens. Opening new accounts may require satisfying a bank's compliance department and can include providing tax returns and copies of previously filed foreign asset documentation, among other requirements. Kuenzi notes that US expats in larger foreign cities are more likely to have access to local branches of global banks. Many of these institutions have chosen to continue servicing US banking clients, although that's not necessarily true for investment management.

Behrens sees several possible strategies for avoiding overseas investment account lockout, such as working with a brokerage firm still willing to serve US citizens, investing in exchange-traded funds (which generally can be sold to non-US residents, unlike mutual funds), buying individual stocks and bonds instead of mutual funds, and keeping an address of record in the United States. Rich Checkan with Asset Strategies International in Rockville, Maryland, points out another scenario in which expats with larger investment accounts might hire an independent, SEC-registered investment manager based in the foreign country. Those firms, he explains, continue to welcome US investors.

KEEP GOING

"The End of Bank Secrecy?" *CFA Institute Magazine* (May/June 2013) [www.cfapubs.org]

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