This article revises an earlier version published in October 2011. This version incorporates new IRS rules regarding Form 8938 reporting thresholds that were issued after the earlier publication date. For more information, see the Thun Financial webinar on Effects of FATCA on Investments as an American Living Abroad.

Executive Summary

- Examines the Foreign Account Tax Compliance Act of 2011 and its effects on American cross-border investors.
- Details reporting requirements on foreign financial institutions
- Discusses practical implications of changes to Americans Abroad
- Elaborates plans of action to avoid non-compliance and attendant problems.

Introduction

This article examines the FATCA (Foreign Account Tax Compliance Act) and explains the significant impact it has had on Americans abroad. It details how the legislation has forced foreign financial institutions to directly report to the IRS on assets held by Americans and why this makes compliance with many old and new reporting requirements much more critical than had been the case previously. Practical implications for Americans abroad of these big changes are discussed and recommended actions are suggested to avoid being...
caught unaware as the FACTA rules raised the difficulty of compliance and risks of non-compliance.

**WHAT IS FATCA AND HOW DOES IT AFFECT AMERICANS ABROAD?**

FATCA stand for Foreign Account Tax Compliance Act. The legislation was passed into law in 2010 as part of the unrelated jobs legislation known as the HIRE law. FATCA is a broad, complex set of rules designed to increase tax compliance by Americans with financial assets held outside the United States. The legislation was drawn up primarily as a response to the 2009 UBS off-shore banking scandal which revealed that many Americans were maintaining large financial holdings in secret Swiss bank accounts without reporting or paying the U.S. taxes due on those assets.

The legislation created new self-reporting requirements and increased penalties for failure to comply fully with complex reporting rules. Most importantly, the legislation imposes on all foreign financial institutions a vast new legal mandate to determine who among their clients are “U.S. Persons” and report directly to the IRS information on those clients’ accounts. This mandate is backed up by draconian enforcement mechanisms that ensure that virtually all non-U.S. financial institutions will comply. The legislation also ratcheted up penalties imposed where tax payers fail to fully comply with all the special rules that pertain specifically to non-U.S. financial assets.

For Americans abroad attention must be paid to new self-reporting requirements on foreign financial assets. Equally important, however, is that U.S. Taxpayers must be aware of many long standing reporting and filing rules that have been widely and safely ignored until FATCA’s passage. Failure to comply with these rules has very rarely been an issue because they were virtually unenforceable. With FATCA’s new reporting mandate on foreign financial institution, that changed.

**“SLEDGEHAMMER” ENFORCEMENT OF NEW REPORTING REQUIREMENTS FOR NON-U.S. FINANCIAL INSTITUTIONS**

The most consequential part of the FACTA legislation is the severe penalties that the law imposes on foreign financial institutions that are found to be non-compliant with the mandated reporting on financial activity of their U.S. clients. Foreign financial institutions not complying with the rigorous reporting requirements are subject to a 30% withholding tax on all U.S. sourced payments.

It is important to understand clearly what that implies: any financial institution anywhere in the world not voluntarily complying with FATCA will find that 30% of any U.S. sourced payment (e.g. Microsoft dividend, maturing principal payment from a U.S. corporate or government bond) will be withheld. Because U.S. stocks and bonds are so widely owned globally, virtually all financial institutions everywhere in the world receive substantial U.S. sourced payments, mostly on behalf of clients who have no connection to the U.S. Allowing 30% of these payments to be withheld will not be an acceptable option. That is why there has been almost universal compliance by the July 1, 2014 deadline for foreign financial institutions to enter into a formal agreement with the IRS to comply with FATCA disclosure requirements.

**DETAILS OF THE FOREIGN FINANCIAL INSTITUTIONS REPORTING REQUIREMENTS**

**Who must report?**

FATCA legislation defines foreign financial institutions extremely broadly and it is interpreted to include every conceivable kind of financial institution outside the U.S. This includes banks, brokerage firms, insurance companies, trust companies,
retirement plan administrators, mutual fund companies, etc. No category of institution has yet been exempted (although many are lobbying heavily in Washington to be exempted). Furthermore, non-publicly listed corporations or business entities registered outside the U.S. owned 10% or more by a U.S. Person must report on the details of the stake held by the U.S. person(s) meeting that threshold.

On whom is there reporting?
Reporting is mandated on “U.S. Persons.” This broad category includes U.S. citizens, U.S. residents, green card holders as well as trusts controlled by U.S. Persons. FACTA rules proposed by the IRS include extensive criteria that banks will have to use to screen all of their clients to determine which ones appear to be U.S. Persons.

What is FATCA reporting?
Foreign financial institutions are required to report directly to the IRS the name, address and account number of all clients deemed to be a U.S. persons. They must also report the highest daily account value in U.S. dollars over the course of the year and inflows and outflows to the account.

When?
Foreign financial institutions had until June 2013 to agree with the IRS on a program to implement reporting procedures.

What Are the Tax Filer Self-Reporting Requirements? What Forms do I Need for FATCA?
Since 2011 tax year, the new IRS Form 8938 must be filed by all U.S. persons if total foreign financial assets owned exceeded $50,000 on the last day of the tax year or more than $75,000 at any point during the year. For U.S. persons residing outside the U.S., the reporting thresholds are raised to $200,000 and $300,000, respectively. Form 8938 is in addition to the long-standing Treasury Department FBAR (Foreign Bank and Financial Accounts Report) required for financial assets abroad that exceed $10,000. Form 8621 (Passive Foreign Investment Company – PFIC) must be filed every year for each separate PFIC investment where as previously it was only required to be filed in years that distributions were made from the PFIC investment. The statute of limitation for IRS audits of returns listing foreign sourced income was extended to 6 years (previously 3 years).

New FATCA Penalties for Non-Compliance
Where non-compliance is “non-willful,” failure to file form 8938 results in a minimum $10,000 penalty but may rise to as much as 40% of the value of the asset or account. This is in addition to the tax due and interest due. Non-compliance deemed “willful” may result additionally in criminal prosecution.

While FATCA did not change the existing penalties resulting from failure to properly report such as the FBAR and Form 8621 (PFIC report), FATCA has resulted in a dramatically increased enforcement of these rules and therefore Americans abroad should become familiar with the very significant penalties associated with these and other reporting requirements commonly required of Americans abroad.

Practical Implications of FATCA for Americans Abroad
The most common mistake made by Americans abroad with regard to FATCA is to assume that since they have been hiding nothing, the extent of the implications for them is that they simply need to file the one FATCA mandated reporting form
Indeed, for many Americans abroad, this is more or less correct. However, the risk of reacting this way is that it ignores the implications for enforcement of all the old reporting rules that have commonly never been enforced and therefore widely ignored by subject taxpayers. Many, many Americans who would not dream of not complying with all applicable tax rules have nevertheless been “casually” non-compliant because so many rules existed that until the passage of FATCA had very rarely been enforced. In the absence of any real threat of enforcement, individuals and even tax professionals had been woefully ignorant of rules such as FBAR or PFIC. FATCA ended this easy accommodation. Old rules, never before seriously enforced, are now easily and commonly enforced as FATCA is widely implemented.

**Steps All Americans Abroad Should be Taking Now**

Here are the steps that all Americans abroad should now be taking to ensure FATCA compliance:

**Step 1:** Have a contingency plan in place for when your local banking institution informs you that as an American, you need to close your account. Compliance with complex FATCA reporting requirements will be simplified for foreign financial institutions if they can simply certify that they have no U.S. persons as clients. Americans will increasingly be forced to rely only on the largest global banking institutions for local financial transactions and banking services.

**Step 2:** Inventory all of your non-U.S. assets and identify which ones are subject to FATCA reporting by a foreign institution. Make sure that these assets are not PFICs or improperly reported foreign trusts. (Beware: PFICs are much more common than most realize and may be lurking among your investments and even your bank accounts without you even knowing it. For more help in understanding what a PFIC is, refer to the section on PFICs in *Thun Financial’s Guide Investment Management and Financial Planning for Americans Abroad*).

**Step 3:** Move all of your investment accounts to U.S. financial institutions (and not just overseas branches of U.S. institutions). This will avoid all the difficulties and uncertainties of FATCA compliance for these assets. Furthermore, tax and FATCA compliance aside, there are overwhelmingly good reasons for Americans abroad to invest through U.S. institutions. U.S. securities markets, for all their faults, are still by far the most efficient and individual investor friendly in the world. A thoroughly diversified basket of global assets can be constructed within a plain vanilla U.S. brokerage account far more cost effectively than anywhere else in the world.

**Step 4:** Build a diversified portfolio with optimal exposure to risk and return as well as currency, given your financial situation and your long-term residency plans. Generally, younger investors should be assuming more risk in their investments to maximize long-term returns. The currency denomination of your investments should follow the principal of matching investments and liabilities, to prevent large swings in relative currency values from upending retirement plans or other savings goals (see also *Thun Financial Advisors Research Currency Management Basics for Americans Abroad*).
CONCLUSION

FATCA dramatically changed the financial and tax environment for Americans abroad. These changes cannot be ignored. As a result of FATCA, many old and new rules regarding assets held by Americans outside the United States are enforced to a far great degree than they ever have been before because the IRS for the first time has easy access to information about these assets. The good news is that these changes have prompted many Americans abroad to take steps that they should have taken long ago in any case: learn the reporting requirements and understand that there are many good reasons aside from tax and compliance considerations to maintain investment accounts in the U.S., no matter where abroad you will live or how long you will be there.

For further introduction to the topics discussed here, see: A Primer on Investment Management and Financial Planning for Americans Abroad


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