

# ***“FOREIGN ACCOUNT TAX COMPLIANCE ACT OF 2009”***

**OCTOBER 27, 2009**

**Summary:** Recent events have highlighted the growing use of foreign financial institutions, foreign trusts, and foreign corporations by U.S. individuals to evade U.S. tax. In order to prevent this tax evasion, the *Foreign Account Tax Compliance Act of 2009* would provide the U.S. Treasury Department with significant new tools to find and prosecute U.S. individuals that hide assets overseas from the Internal Revenue Service.

Based on proposals included in President Obama’s 2010 Budget, on legislation proposed by Senator Carl Levin and Representative Lloyd Doggett, and a draft released by Senator Max Baucus, the *Foreign Account Tax Compliance Act* would force foreign financial institutions, foreign trusts, and foreign corporations to provide information about their U.S. accountholders, grantors, and owners, respectively. The nonpartisan Joint Committee on Taxation has estimated the provisions of the *Foreign Account Tax Compliance Act* would prevent U.S. individuals from evading \$8.5 billion in U.S. tax over the next ten years.

The *Foreign Account Tax Compliance Act of 2009* has been developed in close consultation with the U.S. Department of the Treasury, and is the legislative product of numerous hearings conducted in the Senate Permanent Select Committee on Investigations, the Select Revenue Measures Subcommittee of the House Ways and Means Committee, and the Senate Finance Committee.

## **I. INCREASED DISCLOSURE OF BENEFICIAL OWNERS**

*The proposals in this section of the bill have been estimated to raise \$3.1 billion over ten years.*

**Reporting on certain foreign bank accounts.** As a tax enforcement tool, the United States requires U.S. financial institutions to file annual information returns disclosing and reporting on the activities of bank accounts held by U.S. individuals. Many U.S. individuals looking to evade their tax obligations in the United States have sought to hide income and assets from the Internal Revenue Service (“IRS”) by opening secret foreign bank accounts with foreign financial institutions. Some foreign financial institutions have voluntarily agreed to provide information on the U.S. assets of U.S. accountholders as part of the “Qualified Intermediary” program since 2000. However, many of the foreign financial institutions that hold U.S. accounts are outside the reach of U.S. law. As a result, the ability of the United States to require foreign financial institutions to disclose and report on U.S. accountholders is significantly limited. Although these foreign financial institutions are outside the direct reach of U.S. law, many of them have

substantial investments in U.S. financial assets or hold substantial U.S. financial assets for the account of others.

The bill would impose a thirty percent (30%) withholding tax on income from U.S. financial assets held by a foreign financial institution unless the foreign financial institution agrees to disclose the identity of any U.S. individual with an account at the institution (or the institution's affiliates) and to annually report on the account balance, gross receipts and gross withdrawals/payments from such account. Foreign financial institutions would also be required to agree to disclose and report on foreign entities that have substantial U.S. owners. These disclosure and reporting requirements would be in addition to any requirements imposed under the Qualified Intermediary program. It is expected that foreign financial institutions would comply with these disclosure and reporting requirements in order to avoid paying this withholding tax.

**Reporting on owners of foreign corporations and foreign trusts.** Under present law, withholding agents are not required to look-through a foreign corporation to determine whether such corporation is owned by a U.S. individual. This aspect of present law has allowed U.S. individuals to evade their tax obligations in the United States by setting up foreign shell corporations and investing overseas through these shell corporations. The bill would require foreign corporations to provide withholding agents with the name, address and tax identification number of any U.S. individual that is a substantial owner of the foreign corporation (i.e., owns more than ten percent (10%) of the foreign corporation's stock (by vote or value)). Withholding agents would report this information to the U.S. Treasury Department. The bill would exempt publicly-held and certain other foreign corporations from these reporting requirements and would provide the Treasury Department with the regulatory authority to exclude other recipients that pose a low risk of tax evasion. Any withholding agent making a withholdable payment to a foreign corporation that does not comply with these disclosure and reporting requirements would be required to withhold tax at a rate of thirty percent (30%). Similar rules would also apply to foreign trusts.

**Extending bearer bond tax sanction to bearer bonds designed for foreign markets.** Bearer bonds (i.e., bonds that do not have an official record of ownership) allow individuals seeking to evade taxes with the ability to invest anonymously. Recognizing the potential for U.S. individuals to take advantage of bearer bonds to avoid U.S. taxes, President Reagan and Congress took a number of steps in 1982 to eliminate bearer bonds in the United States. First, they prevented the United States government from issuing bearer bonds that would be marketed to U.S. investors. Second, they imposed sanctions on issuers of bearer bonds that could be purchased by U.S. investors. Under these sanctions, the issuer of such a bearer bond is not allowed to claim any interest deductions on the bond, the earnings and profits of a corporation are generally not reduced by the amount of any interest on the bond, and interest on the bond will not qualify for any applicable tax exemption (e.g., tax-exempt municipal bonds). Furthermore, certain issuers of such bearer bonds are also subject to an excise tax equal to one percent (1%) of

the principal amount of the bearer bond multiplied by the term of the bond. If the issuer of the bearer bond is not subject to the excise tax, then the holder of the bearer bond would be subject to additional sanctions that apply when the bearer bond is sold, exchanged, lost or becomes worthless: (1) the loss of capital gains treatment and (2) the denial of loss deductions. Because the United States is asking other countries to eliminate opportunities for U.S. investors to purchase bearer bonds issued outside the United States, the bill would extend these sanctions to bearer bonds that are marketed to foreign investors and would prevent the United States government from issuing any bearer bonds.

## **II. FOREIGN FINANCIAL ASSET REPORTING**

*The proposals in this section of the bill have been estimated to raise \$0.9 billion over ten years.*

**Disclosure of information with respect to foreign financial assets.** The bill would require any individual that holds more than \$50,000 (in the aggregate) in (1) a depository or custodial account maintained by a foreign financial institution or (2) any foreign stock, interest in a foreign entity, or financial instrument with a foreign counterparty not held in a custodial account of a financial institution (collectively, “reportable foreign assets”) to report information about these accounts and/or assets to the U.S. Treasury Department with the individual’s annual tax return. Failures to comply with this requirement would be subject to a penalty of \$10,000, and higher penalties (up to \$50,000) could apply if the failure is not remedied within 90 days following notification from the Treasury Department.

**Penalties for underpayments attributable to undisclosed foreign financial assets.** The bill would impose a penalty equal to forty percent (40%) of the amount of any understatement that is attributable to an undisclosed foreign financial asset (i.e., any foreign financial asset that a taxpayer is required to disclose and fails to disclose on an information return).

**Modification of statute of limitations for significant underreporting of income in connection with foreign assets.** Under present law, additional Federal tax liabilities in the form of tax, interest, and penalties must be assessed by the Internal Revenue Service within three years after the date a return is filed. If an assessment is not made within the required time period, the additional liabilities generally cannot be assessed or collected at any future time. This three-year statute of limitations is extended to six years where there is a substantial omission of items from a tax return. This additional time gives the Internal Revenue Service an opportunity to identify the omission and determine the taxpayer’s correct tax liability. In particular, it is often difficult for the Internal Revenue Service to identify omissions that arise in connection with foreign assets. However, the extended six-year statute of limitations only applies where the omission is in excess of twenty-five percent (25%) of the gross income stated on the tax return. The bill would extend the six-year statute of limitations for omissions that exceed \$5,000 and are attributable to one or more reportable foreign assets. The bill would also

clarify that the statute of limitations does not begin to run until the taxpayer files the information return disclosing the taxpayer's reportable foreign assets.

### **III. OTHER DISCLOSURE PROVISIONS**

*The proposals in this section of the bill have been estimated to raise \$1 billion over ten years.*

**Disclosure of assistance in acquiring or forming a foreign entity.** The bill would require any person who derives gross income in excess of \$100,000 for providing any material aid, assistance, or advice to U.S. individuals acquiring certain direct or indirect interests in a foreign entity to file an information return setting forth the identity of the foreign entity and the identity of the U.S. individual. Failures to comply with this requirement would be subject to a penalty equal to the greater of \$10,000 or fifty percent (50%) of the gross income derived by such person with respect to aiding, assisting or advising on such transaction.

**Passive foreign investment company reporting.** Under present law, a shareholder of a passive foreign investment company (a "PFIC") is not required to file an information return with the Internal Revenue Service unless the shareholder recognizes gain on the sale of PFIC stock, receives a distribution from a PFIC, or the PFIC has filed a qualified electing fund ("QEF") election. The bill would require each person who is a shareholder of a passive foreign investment company to file an annual report containing such information as the Secretary may require.

**E-Filing of Certain Financial Institution Returns.** Under present law, the Treasury Department cannot require any person to file an electronic return unless such person is required to file at least 250 returns during the calendar year. The bill would provide an exception to this rule for financial institutions with respect to returns relating to withholding taxes. Under the bill, the Treasury Department may require financial institutions to file an electronic return even if such person would file fewer than 250 returns during the calendar year.

### **IV. PROVISIONS RELATED TO FOREIGN TRUSTS**

*The proposals in this section of the bill have been estimated to raise \$1.1 billion over ten years.*

**Clarifications with respect to foreign trusts.** Under present law, a U.S. person is treated as the owner of the property transferred to a foreign trust if the trust has a U.S. beneficiary. Under current Treasury regulations, a foreign trust is treated as having a U.S. beneficiary if any current, future or contingent beneficiary of the trust is a U.S. person. Notwithstanding this requirement, some taxpayers have taken positions that are contrary to this regulation. In order to enhance compliance with this regulation, the bill would codify this regulation into the statute. The bill would also clarify that a foreign trust will be treated as having a U.S. beneficiary if (1) any person has discretion to determine the beneficiaries of the trust unless the terms of the trust

specifically identify the class of beneficiaries and none of those beneficiaries are U.S. persons or (2) any written, oral or other agreement could result in a beneficiary of the trust being a U.S. person. As a final clarification, the bill would clarify that the use of any trust property will be treated as a payment from the trust in the amount of the fair market value of such use.

**Presumption with respect to transfers to foreign trusts.** The bill would provide that any U.S. person who directly or indirectly transfers property to a foreign trust (other than a trust established for deferred compensation or a charitable trust) shall be presumed as having a U.S. beneficiary unless such person can demonstrate to the satisfaction of the IRS that such trust has complied with all reporting requirements and has submitted any additional information as the Secretary of the Treasury may require with respect to such transfer.

**Minimum penalty with respect to failure to report on certain foreign trusts.** Under present law, a taxpayer that fails to file an information return with respect to certain transactions involving foreign trusts (e.g., the creation of a foreign trust, the transfer of money or property to a foreign trust, or the death of a U.S. owner of a foreign trust) is subject to a penalty of thirty-five percent (35%) of the amount required to be disclosed on such return. If the IRS uncovers the existence of an undisclosed foreign trust but is unable to determine the amount required to be disclosed on such return, it is unable to impose a penalty under present law. The bill would strengthen this penalty by imposing a minimum penalty of \$10,000 on any such failure to file. Notwithstanding this minimum penalty, in no event would the penalties imposed on taxpayers for failing to file an information return with respect to a foreign trust exceed the amount required to be disclosed on such return.

## **V. DIVIDEND EQUIVALENT PAYMENTS**

*The proposal in this section of the bill has been estimated to raise \$1.6 billion over ten years.*

**Treatment of dividend equivalent payments received by foreign corporations in the same manner as dividends.** Under present law, dividend payments made to foreign investors are subject to withholding tax at a rate of thirty percent (30%) unless otherwise reduced by an applicable tax treaty. In order to avoid this withholding tax, foreign investors have entered into derivative transactions that provide them with dividend equivalent payments that are not subject to withholding. The bill would require withholding on any dividend equivalent payments that are included in notional principal contracts (e.g., total return swap agreements) and would authorize the Treasury Department to develop rules that would require withholding on dividend equivalent payments that are included in other financial arrangements.

## **INTERACTION AMONG PROVISIONS IN THE BILL**

*Interaction among the various proposals in the bill has been estimated to raise an additional \$0.8 billion over ten years.*