

# FATCA (Foreign Account Tax Compliance Act): What American Investors Need to Know Now



## Article Summary

This article examines the new FATCA law (Foreign Account Tax Compliance Act) and explains the significant impact it will have on Americans abroad. It details how the legislation will force foreign financial institutions to directly report to the IRS on assets held by Americans and why this suddenly makes compliance with many old and new reporting requirements much more critical than has 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 new FACTA rules raise the difficulty of compliance and risks of non-compliance.

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.

## What is FATCA?

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.

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Thun Financial Advisors, LLC  
3310 University Ave, Madison, WI 53705

608-237-1318  
Skype: thunfinancial  
[www.thunfinancial.com](http://www.thunfinancial.com)

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 U.S. taxes due on those assets.

The legislation creates new self-reporting requirements and increases 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 ratchets 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 will have to be paid to new self-reporting requirements on foreign financial assets. Equally important, however, is that new attention will have to be paid to many long standing reporting and filing rules that have been widely and safely ignored until now. 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 is all about to change.

### **“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 not to be in compliance with new mandated reporting on financial activity of their U.S. clients. Foreign financial institutions not complying with the rigorous reporting requirements will be 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 we expect almost universal compliance with the June 2013 deadline for foreign financial institutions to enter into a formal agreement with the IRS to comply with FATCA disclosure requirements.

### ***Who, What, When? Details of the Foreign Financial Institutions Reporting Requirements***

#### *Who must report?*

FATCA legislation defines foreign financial institutions extremely broadly and it is being 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-publically 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 will there be 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 will be reported?*

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 will have until June 2013 to agree with the IRS on a program to implement reporting procedures.

### **What Are the New Tax Filer Self-Reporting Requirements?**

Starting with the tax year 2011, 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 resident outside the U.S. the reporting thresholds are raised to \$200,000 and

\$300,000, respectively. Form 8938 will be 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 now 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 has been extended to 6 years (previously 3 years).

### **New Penalties for Non-Compliance**

Where non-compliance is “non-wilful,” 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 “wilful” may result additionally in criminal prosecution.

While FATCA does not change the existing penalties resulting from failure to properly report such as the FBAR and Form 8621 (PFIC report), FATCA will result 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 for Americans Abroad**

The most common mistake likely to be made by Americans abroad with regard to FATCA is

that many will assume that since they have been hiding nothing, the extent of the implications for them is that they will now simply need to file the one new FATCA mandated reporting form (Form 8938). Indeed, for many Americans abroad, this will be 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 exist that until now have very rarely been enforced. In the absence of any real threat of enforcement, individuals and even tax professionals have been woefully ignorant of rules such as FBAR or PFIC. FATCA ends this easy accommodation. Old rules, never before seriously enforced, are now likely to be easily and commonly enforced as FATCA becomes widely implemented.

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

Here are the steps that all Americans abroad should be taking now to prepare for the impact of FATCA:

- 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.
- 2) Inventory all of your non-U.S. assets and identify which ones will be 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 *Primer on Investment Management and Financial Planning for Americans Abroad*, available for free at: [www.thunfinancial.com](http://www.thunfinancial.com))
- 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.
- 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. These issues are addressed in much great detail in Thun Financial Advisors’ research *Currency*

*Management Basics for Americans Abroad* and *A Primer on Investment Management and Financial Planning for Americans Abroad* both available for free on the Thun Financial Advisors website:  
[www.thunfinancial.com](http://www.thunfinancial.com)

## Conclusions

FATCA will dramatically change 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 will be enforced to a far greater degree than they ever have been before because the IRS for the first time will have easy access to information about these assets. The good news is that these changes will prompt 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.

David Kuenzi, CFP®, Thun Financial Advisors  
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