# HIRE Act: FATCA Provisions Affect Rules Governing Foreign Trusts and Reporting Requirements

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On March 18, 2010, President Obama signed into law H.R. 2847, the Hiring Incentives to Restore Employment Act (HIRE). HIRE targets job creation by providing tax incentives, such as business credits to companies for newly hired employees. The offset provisions included to raise revenue for such costs include important changes in the rules governing foreign trusts. Subtitle A of Title V of HIRE substantially incorporates the Foreign Account Tax Compliance Act of 2009 (FATCA) as introduced on October 27, 2009 (H.R. 3933, S. 1934). Although the key aspects of FATCA are included in HIRE, the disclosure requirements for tax or investment advisors have been eliminated.

## Title V, Subtitle A of HIRE

The elements of Title V, Subtitle A of HIRE (the FATCA provisions) include the following:

- Considerable changes to U.S. withholding and information reporting requirements for payments by U.S. payors to foreign financial institutions and account holders

- An imposition of penalties up to $50,000 on U.S. taxpayers who own significant assets in offshore accounts but fail to report the same

- The application of a 40 percent penalty on the amount of any understatement of undisclosed foreign assets

- An extension of the statute of limitations to six years for "substantial" omissions of income derived from offshore assets

- Broad requirements that shareholders in passive foreign investment companies (PFICs) file annual returns

- New rules imputing income to U.S. beneficiaries of foreign trusts who use property owned by the trust

- The application of a 30 percent withholding tax on dividend equivalent payments attributable to notional principal contracts paid to foreign corporations

- A lower standard of presumption concerning when foreign trusts are deemed to have U.S. beneficiaries, as well as a lower minimum failure-to-file penalty for certain information returns on foreign trusts

## Foreign Trusts Provisions (Sec. 531 through Sec. 535)

The FATCA provisions claim to clarify and, in fact, expand when, for purposes of Section 679, a foreign trust created by a U.S. donor should be treated as having a U.S. beneficiary. As such, an amount is treated as accumulated for the benefit of a U.S. person even if such U.S. person is a contingent beneficiary and, in the setting of a discretionary trust, the trust shall be treated as having a U.S. beneficiary unless the terms of the trust specifically identify the class of persons to whom such distributions may be made, and none of said persons is a U.S. person during the applicable taxable year.

Additionally, this Subtitle creates a presumption that a foreign trust to which a U.S. person has transferred property will be treated as having a U.S. beneficiary unless the transferor proves, to the satisfaction of the U.S. Treasury Department, that under the trust's terms, no part of the income or principal of the trust may be paid or accumulated during the taxable year to or for the benefit of the U.S. person, and if the trust were terminated during the taxable year, no part of the income or principal could be paid to or for the benefit of a U.S. person.[1] This applies to any transfers of property made after March 18, 2010, the enactment date of HIRE.

The FATCA provisions also expand Section 643(i) such that any uncompensated use of property (wherever located, including in the United States) owned by a foreign trust (*e.g.*, real estate, artwork or personal use property) by a U.S. grantor, U.S. beneficiary, or any U.S. person related to such grantor or beneficiary is treated as a distribution to the grantor or beneficiary equal to the fair market value of the use of such property to the extent of any distributable net income (DNI).[2] Any return of property that is

[1] Sec. 679(d).
[2] Sec. 643(i). This includes real estate, artwork and other tangible personal property; determining the value of such use will be difficult in practice.

deemed distributed is disregarded for tax purposes and is treated as undistributed net income (UNI) in the trust.[3] The use or loan of property will not be treated as a distribution to the extent that the U.S. person repays any loan at market rate or makes a payment equal to the fair market value of the use of the trust property within a reasonable period of time.[4] The provisions do not apply to domestic trusts, and individuals will want either to pay fair value for the use of property owned by a foreign trust, or to consider domesticating the trust. Formerly, the rent-free use of real estate by a trust beneficiary did not constitute a distribution. These provisions apply to loans made, and uses of property allowed, after March 18, 2010.

Further, the FATCA provisions broaden the current trust reporting requirements and modify the current trust reporting penalty assessment scheme. A U.S. person who is treated as the owner of any portion of a foreign trust under grantor trust provisions must provide information as required with respect to the trust, in addition to ensuring that the trustee of the trust complies with its reporting obligations. If such reporting obligations are not met, a minimum penalty of $10,000, or 35 percent of the gross reportable amount, may be imposed. The reporting requirements apply to taxable years after 2010, and the penalties described shall apply to notices and returns required to be filed after December 31, 2009. Such a requirement that a U.S. person ensure that a foreign trustee complies with U.S. reporting requirements may, in practice, prove unworkable.

## Modifications to U.S. Withholding and Information Reporting Requirements (Sec. 501 and 502)

The FATCA provisions require foreign financial institutions to disclose customer identity and account information for any U.S. individual or accounts held by a foreign entity with "substantial" U.S. owners.[5] Similarly, any non-financial foreign entities must provide withholding agents with the name, address and tax identification number of any U.S. person who has at least 10 percent ownership in the entity. If these information reporting requirements are not met, such entities will face a 30 percent withholding tax.[6] Foreign financial institutions may elect to have the 30 percent withholding apply rather than to disclose the U.S. persons interested in the account. Additionally, if withholding tax is imposed under these rules, nonresident alien withholding or Foreign Investment Real Property Tax Act (FIRPTA) withholding requirements would not apply.[7] These requirements are effective for payments made after December 31, 2012, with few exceptions for grandfathered agreements.[8]

Additionally, the FATCA provisions repeal current provisions of I.R.C. Section 163(f)(2)(B), which exempt foreign targeted obligations from general Tax Equity and Fiscal Responsibility Act requirements such that any interest paid to a foreign person on a bearer-bond that is not issued in registered form will be subject to a 30 percent U.S. withholding tax. This rate may be adjusted if the withholding agent can show that the beneficial owner of the amount is eligible for another exemption from withholding or a reduced rate of withholding under a relevant income tax treaty. Further, FATCA extends the "portfolio interest exception" under I.R.C. Section 871(h) to certain registered form debt instruments (i.e., dematerialized bonds such as are the norm in Switzerland) for which the beneficial owner has not provided a requisite Form W-8BEN at the Treasury's discretion.[9] These provisions apply to obligations issued after March 18, 2012.

## Penalties for Failure to Report Significant Assets in Offshore Accounts (Sec. 511)

U.S. taxpayers who, at any time in a taxable year, hold "specified foreign financial assets" totaling $50,000 or more (or such higher dollar amount as the Secretary may prescribe) must include a disclosure statement with their annual income tax return. Under the FATCA provisions, "specified foreign assets" include accounts held at a foreign financial institution and assets held outside of a foreign financial institution, which include stock or security issued by a non-U.S. person, a financial instrument or contract (if the contracting party is a non-U.S. person), or any interest in a foreign entity (possibly including holding U.S. publicly traded stock in a foreign corporation). Though the nature of the information requested is similar to that required on a Report of

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[3] Id.
[4] This section applies to loans made, and uses of property, after the date of enactment of HIRE. Sec. 533.
[5] The FATCA provisions define a "substantial" U.S. owner as: (i) such U.S. person with an interest in the entity equal to or greater than 10 percent; (ii) a U.S. person who owns a foreign account with a balance greater than $50,000; (iii) a U.S. person who owns any portion of the entity who is also engaged primarily in the business of investing, reinvesting or trading securities, partnership interests, commodities or any interests in such; or (iv) if the U.S. person is treated as an owner of any portion of a foreign trust.
[6] The grace period for Internal Revenue Service interest on overpayment is increased from 45 to 180 days for excess withholding. Sec. 1474.
[S] Sec. 1441, 1445.
[8] This section shall not require any amount to be deducted or withheld from any payment under obligation which is outstanding two years from March 18, 2010, or from the gross proceeds from any disposition of such an obligation. Sec. 1474.
[9] Sec. 871(h).

Foreign Bank and Financial Accounts (FBAR), this requirement does not eliminate the need for a foreign account holder to file an FBAR. This new requirement is supplementary, and broadens the disclosure requirements by applying to certain persons who may not meet the current levels of ownership to require an FBAR filing. Because the reporting threshold under this rule is value based, there will be instances in which a U.S. person may be required to file both a disclosure statement and an FBAR, and other instances in which a U.S. person's interest may not meet the FBAR reporting threshold but may be great enough so as to require disclosure under the FATCA provisions of HIRE.

If such a disclosure statement is not timely filed, a $10,000 penalty is applied.[10] An additional $10,000 penalty is due for every 30 days the failure to file persists longer than 90 days after the taxpayer is informed of such failure, up to a maximum penalty of $50,000.[11] These provisions went into effect on March 18, 2010.

## Penalties on Understatements Attributable to Undisclosed Foreign Assets (Sec. 512)

Under the enacted FATCA provisions, if a U.S. person understates income that is related to an "undisclosed foreign financial asset," such person will be subject to a 40 percent penalty.[12] An "undisclosed foreign financial asset" is defined as any asset for which information was not properly provided but is required to be disclosed as a "specified foreign asset" or under any other provisions of the Code.[13] Section 512 is effective for taxable years beginning after 2010.

## Extension of Statute of Limitations for "Substantial" Omissions (Sec. 513)

For purposes of the FATCA provisions, any "substantial omission" of income that is derived from "specified foreign assets" in an amount exceeding $5,000 in any taxable year shall be subject to an extended statute of limitations of six years.[14] Under previous law, this exception only applied to a "substantial omission" of an amount equal to 25 percent of the gross income reported. The FATCA provisions significantly lower this requirement for purposes of foreign assets. The failure to report more than $5,000 of income from foreign assets is a complete and separate ground for extending the statute of limitations to six years. Thus, if a U.S. taxpayer has $1 million of income in 2010, which is correctly reported, but the taxpayer mistakenly fails to report income of over $5,000 from an undisclosed foreign account, the statute of limitations applicable to the taxpayer's entire 2010 return is six years.

This section is effective for returns filed after 2010 but is retroactive to those filed on or before if the assessment period for such taxes has not expired as of 2010.

## Shareholders' Annual Return Requirements for Interests in PFICs (Sec. 521)

Generally, a U.S. person who is a shareholder in a PFIC must file a "Return by a Shareholder of a Passive Foreign Investment Company or Qualifying Electing Fund" (Form 8621) for each tax year such person recognizes gain on a direct or indirect disposition of PFIC stock, receives certain direct or indirect distributions from a PFIC, or makes a reportable election.[15] The FATCA provisions expand this requirement so as to require annual filings from any U.S. person who is a PFIC shareholder.[16] This section is effective as of March 18, 2010.

[10] Sec. 6046.
[11] Sec. 6046A.
[12] Sec. 6662A.
[13] Id. This provision is subject to the same defenses otherwise available under Section 6662.
[14] Sec. 6038D.
[15] See Instructions to IRS Form 8621.
[16] Sec. 1291(e).

## Dividend Equivalent Payments Subject to Withholding Tax (Sec. 541)

The FATCA provisions expand the withholding tax to apply to certain income received from a notional principal contract.[17] The provision subjects any dividend equivalent—a substitute dividend made pursuant to a lending or sale-repurchase transaction or a payment made under a notional principal contract—that directly or indirectly is contingent upon, or determined by reference to, the payment of a dividend from U.S. sources to withholding taxes applicable to foreign persons.[18] It is at the Secretary's discretion to apply this provision, and the Secretary may exclude any payments under a contract which he or she determines does not lead to a potential avoidance of U.S.-source dividend taxes.

This provision is applicable to payments made on or after the date that is 180 days after March 18, 2010, the enactment date of the HIRE Act.

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[17] Treas. Reg. sec. 1.863-7(b)(1). A notional principal contract is defined as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. Treas. Reg. sec. 1.446-3(c)(1).
[18] Sec. 871.