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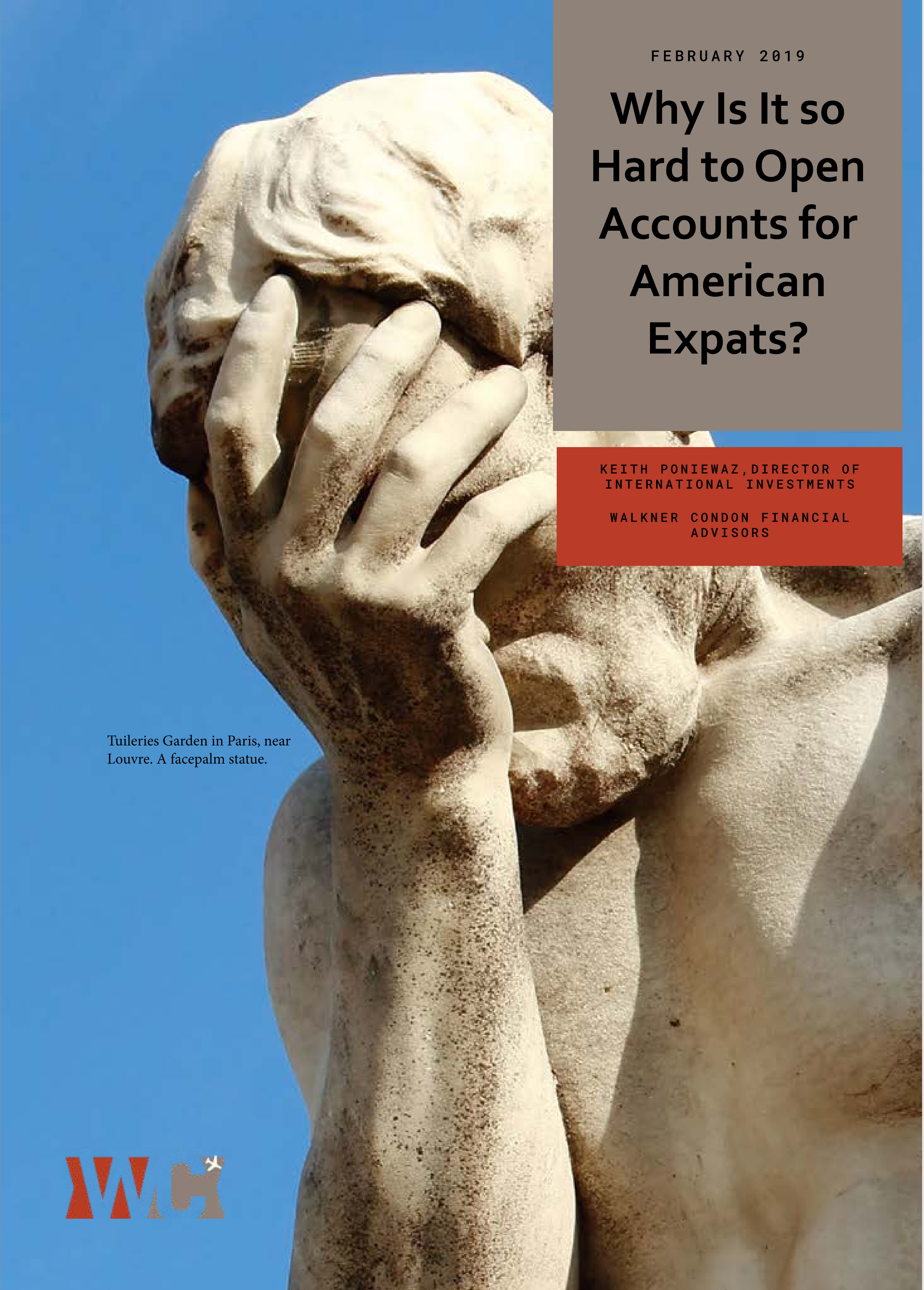
Why Is It so Hard to Open Accounts for American Expats?

KEITH PONIEWAZ, DIRECTOR OF INTERNATIONAL INVESTMENTS

WALKNER CONDON FINANCIAL ADVISORS



Tuileries Garden in Paris, near Louvre. A facepalm statue.

1

WHY IS IT SO HARD TO OPEN ACCOUNTS FOR AMERICAN EXPATS?

Americans face a unique problem that citizens of no other country face: the United States reserves the right to tax its citizens no matter where in the world they live.

Thus, and in contrast to most other expatriots, laws passed in their home country can have huge ramifications on their new lives outside of the United States.

Americans living outside of the United States felt this most recently in the wake of the passage and implementation of FATCA (the Foreign Account Tax Compliance Act which was passed in 2010 and implemented from roughly 2010 to 2017). Americans abroad living abroad at that time faced a period of very trying circumstances in their financial lives. First, they found that the things they were able to do with their accounts were frequently limited or they had to sign a wide variety of new paperwork--either for their U.S. accounts or their international ones. After this initial period of paperwork, things frequently got worse as their U.S. or international accounts frequently sent them information informing them that their accounts would be closed or frozen within thirty days. Such notifications came from major independent custodians (Charles Schwab, TD Ameritrade and others including Vanguard) or large brokerage houses (Morgan Stanley and Merrill Lynch have all recently closed accounts for Americans outside of the United States). While FATCA should assume some of the blame for this change of account status for Americans outside of the United States, it is as much a story about the law of unintended consequences for Americans abroad as FATCA caused many American brokerages to begin to pay attention to laws they had largely ignored, because FATCA suddenly gave the United States the tools to enforce these laws which had been hard to prosecute in the past.

This paper takes FATCA as a starting point of a history to start to address some of the rules and concepts that the unintended consequences of FATCA have made relevant to show why it is now so hard for American expats to open accounts even in the United States.

2

WHAT IS FATCA?

FATCA is, as mentioned above, the "Foreign Account Tax Compliance Act" passed by the United States government in order to eliminate (primarily high net worth) Americans using offshore accounts in order to hide assets from U.S. taxation: especially as the United States taxes all of its citizens on its worldwide income, no matter where in the world they live (see sidebar).

While FATCA has had significant effects on individuals, it is actually a law on financial institutions and doesn't apply to individuals directly. The law requires all financial institutions worldwide to search through their current accounts and report the accounts they have that are owned by Americans. Should they fail to do so, the American government will withhold up to 30% on payments to these Foreign Financial Institutions (FFIs) originating from within the United States. Given the United States situation as hub for a multitude of financial transactions, the harsh (some might say draconian) penalties meant that FFIs went into overtime in an attempt to comply with the law. For smaller banks and institutions, without the resources to ensure compliance, this meant they scoured their records and eliminated Americans who might subject them to FATCA penalties. For larger banks, this generally meant they eliminated smaller accounts, required further paperwork, or restricted the services offered to Americans.

3

KNOW YOUR CLIENT/ CUSTOMER ("KYC") LAWS

While FATCA and its consequences explain why it has been so hard for Americans to open accounts in jurisdictions outside of the United States, they don't explain why Schwab, Merrill Lynch, TD Ameritrade, Vanguard or other companies have made it so hard to open accounts in the United States for Americans who live outside of the United States. **The chief reason is anti-money laundering laws known informally as the "Know Your Client/ Customer" Laws.** The chief amongst these were passed in 2001 as part of the Patriot Act and were refined and clarified before being implemented in the following years though they serve as an updating of 1970's Bank Secrecy Act. The Patriot Act required an "identification" of the client (CID) and "due diligence" (CDD) on the clients' background.

(continued)

KNOW YOUR CLIENT/CUSTOMER ("KYC") LAWS

While the ID portion was rather straightforward, financial institutions struggled with handling the due diligence portion and lacked clarity and guidance. Such guidance came along with the United States' strengthening of the Financial Crimes Enforcement Network (FinCEN) through FATCA and the clarity came in the form of sizeable fines for Financial Institutions in violating due diligence. The generalized attention to violations of the KYC laws were felt industry wide, and according to one FinCEN study, such investigations increased by 35% between 2013 and 2014.

As a result of such enforcement, many large Institutions (Merrill Lynch, Morgan Stanley, Vanguard), etc. began doing a cost benefit analysis of possible fines related to helping clients outside of the United States and realized that such services might not be worth it from a liability perspective. Moreover, many of these firms merged with banks and were subject to additional restrictions because they were now also subject to the 1970s banking secrecy laws. To further limit liability, they frequently housed the remaining clients with specialized International Advisors meaning that those Americans would often lose their long-term financial advisor.

Frequently, into this breach stepped Registered Investment Advisors. Typically, because their emphasis is on holistic financial planning, meeting and maintaining standards for due diligence was not a problem.

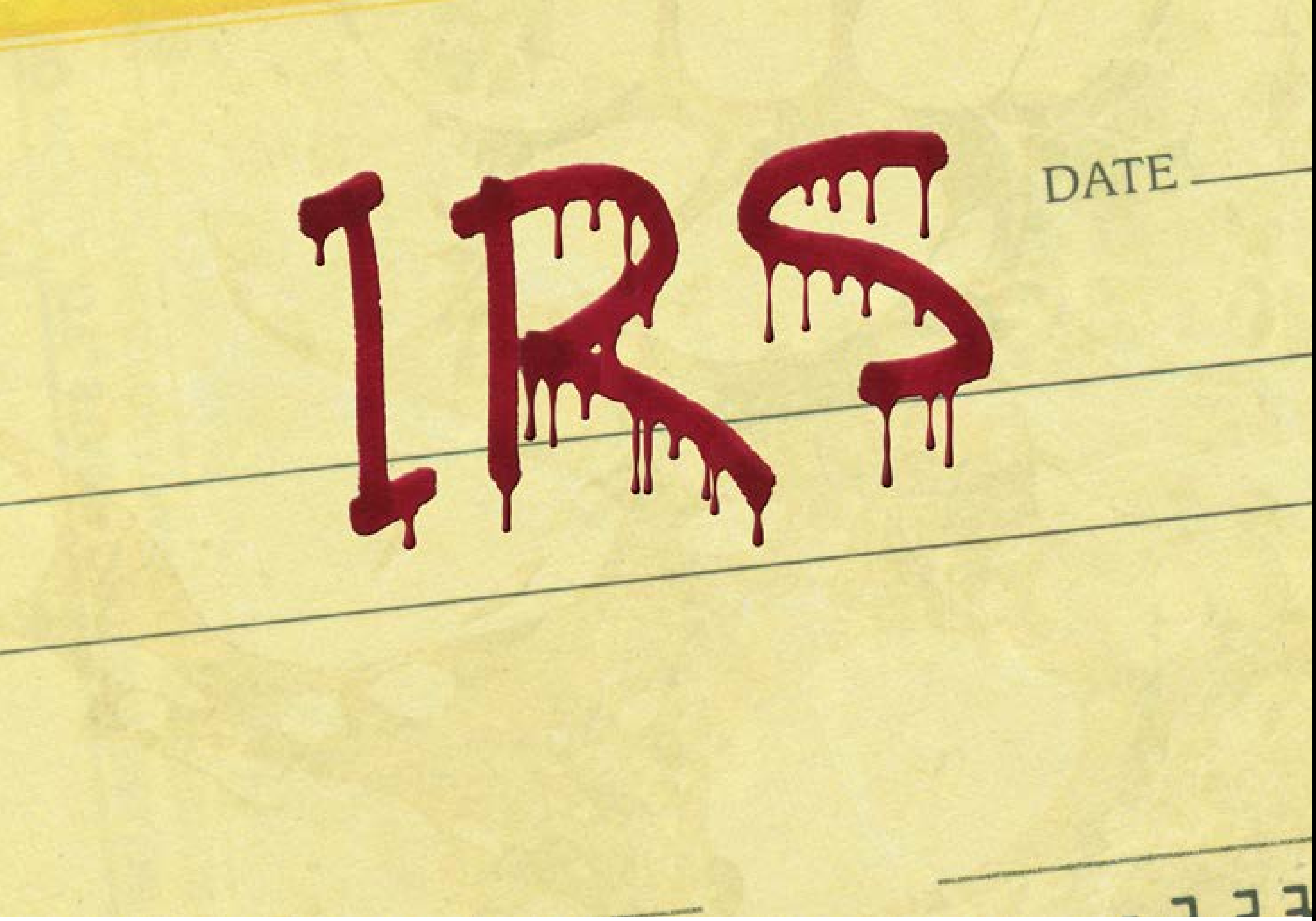
4

PASSIVE FOREIGN INVESTMENT COMPANIES (PFICS)

However, this is not the only consequence of these laws for Americans as in reporting to the United States government, FFIs alerted the government that Americans were frequently holding foreign mutual funds in their foreign accounts. Unfortunately, these revelations exposed Americans abroad to the nightmare of Passive Foreign Investment Companies (PFICs).

The United States treatment of foreign pooled investment products arose from the comprehensive tax reform bill passed by the United States congress in 1986. Particularly in the very high interest rate period of the early 1980s, investors would frequently establish offshore companies to hold their bonds and collect the interest, thus avoiding the very high domestic tax rates on interest income. As a result, the U.S. tax code created the Passive Foreign Investment Company (PFIC). **A Passive Foreign Investment Company is a company that either has greater than 75% of its income from passive sources (namely: stocks, bonds, or passive real estate investments) or more holds more than 50% of its assets in these passive investments.**

If an asset is classified as a PFIC (according to sections 1291 to 1297 of the United States tax code), a United States taxpayer is required to file IRS form 8621 for each PFIC owned. Form 8621 imposes significant reporting burdens on a United States taxpayer and the IRS states that the form may take somewhere around 15-20 hours per PFIC. Based on these definitions, the average foreign mutual fund or exchange traded fund (ETF) is considered a PFIC. Consequently, an American abroad who built a portfolio from local mutual funds could have hundreds of hours of reporting. In an effort to further discourage investors from using these structures, PFICs are not taxed at capital gains tax rates (15% or 20%), but rather at the highest individual tax rate (37% as of 2019).



PASSIVE FOREIGN INVESTMENT COMPANIES (PFICS)

While it is unlikely that congress wanted to subject “mom and pop” investors (and there is a $25,000 de minimis reporting requirement for PFICs, which mean that aggregate holdings of foreign funds under $25,000 are not subject to reporting) to these requirements, the unfolding interaction of the web of the variety of US laws and citizenship-based taxation (along with the fact that de minimis exemption amount of $25,000 hasn’t increased) have left many US expats facing a tax nightmare.

5

NO US MUTUAL FUNDS, EITHER?

Given the restrictions on foreign mutual funds, one might expect that Americans shouldn't have a problem buying American mutual funds; unfortunately, this isn't the case.

American Mutual Funds are subject to the Investment Companies Act of 1940. Generally known as "40 Act" this governs registration, transparency and reporting requirements for most pooled investment products or funds. There are generally no restrictions on '40 Act funds. However, Mutual funds are also subject to the Securities Act of 1933. In particular, Section 5 of the act restricts the right of American firms to offer open-ended securities outside of the United States. Generally, many investment companies can use Regulation S to create an exception to these rules. However, as an article from Morrison and Forrester notes:"Regulation S is not available for the offer and sale of securities issued by open-end investment companies, unit investment trusts registered or required to be registered under the Investment Company Act of 1940 (the "1940 Act"), or closed-end investment companies required to be registered, but not registered, under the 1940 Act" or, in other words, mutual funds. For a long time, mutual funds ignored these laws, but the new concerns about enforcement have led this interaction and restriction to be recognized once again. As a result many custodians refuse to sell any mutual funds to Americans abroad or simply refuse to work with American expats period.

As we've noted elsewhere [insert link to portfolio], there are solutions to this problem, but it remains another hassle for Americans abroad.

6

CONCLUSION

Based on this history, one can understand the unfolding difficulties of Americans abroad in terms of American tax and compliance. Indeed, this history only scratches the surface for it doesn't account for the recent problems faced by American small-business owners who live outside of the United States who may now face the [“repatriation” or “transition” tax as part of the 2017 Tax Cut and Jobs Act]. Moreover, it hasn't even begun to address the foreign tax compliance difficulties that American expats face along with new regulations on investment products in the European Union (for instance, General Data Protection Regulation (GDPR) or Key Investor Information Documents (KIIDs)) and the separate history of these rules. Finally, there is the question of how local tax laws interact with the United States' tax laws via tax treaty.

There are many pitfalls that Americans abroad face and many organizations including [Americans Citizens Abroad] or the [Association of Americans Resident Overseas] have been working [across partisan lines] to make this burden less costly and time consuming for the average American. However, in the interim, Americans abroad need to manage their investments effectively around this complex interaction of laws, treaties and acronyms. The complexity of which this history has only introduced.