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## Offshore Accounts: Insider's Summary of FATCA and Its Potential Future

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2012]

OFFSHORE ACCOUNTS: INSIDER'S SUMMARY OF FATCA  
AND ITS POTENTIAL FUTURE

J. RICHARD (DICK) HARVEY, JR.\*

INDEX

I.	INTRODUCTION, PURPOSE OF ARTICLE, AND INTENDED AUDIENCES .....	472	R
II.	ORIGINS OF FATCA .....	473	R
	A. <i>Background</i> .....	473	R
	B. <i>Problems with the QI System</i> .....	475	R
	C. <i>LGT and UBS Scandals</i> .....	476	R
	D. <i>2009 Offshore Voluntary Compliance Initiative</i> .....	479	R
	E. <i>FATCA Is Conceived</i> .....	479	R
	F. <i>FATCA Legislation Ultimately Adopted</i> .....	482	R
III.	SELECTED FATCA ISSUES .....	485	R
	A. <i>Customer Due Diligence Procedures for Affiliated FFI's</i> .....	486	R
	B. <i>Passthru Payments</i> .....	486	R
	C. <i>Will FATCA Ultimately Accomplish Its Goals?</i> .....	487	R
IV.	RECOMMENDATIONS .....	489	R
	A. <i>Recommendations Important to the Short-term Success of FATCA</i> .....	489	R
	1. <i>Customer Due Diligence Procedures for Affiliated FFI's</i> ...	489	R
	2. <i>Passthru Payments</i> .....	490	R
	a. <i>Analytical Framework</i> .....	491	R
	b. <i>Passthru Payments Summary</i> .....	493	R
	B. <i>Recommendations Important to the Long-term Success of FATCA</i> .....	494	R
	1. <i>Unilateral vs. Multilateral Action</i> .....	494	R
	2. <i>What Might a Multilateral FATCA System Look Like?</i> ..	496	R
	3. <i>Would Countries Need to Agree to All Aspects of FATCA?</i> .....	496	R
V.	OVERALL CONCLUSION .....	497	R

\* Copyrighted 2011 by J. Richard (Dick) Harvey, Jr., Distinguished Professor of Practice, Villanova University School of Law and Graduate Tax Program. The date of this Article is November 15, 2011. Immediately prior to joining the Villanova faculty in August 2010, Professor Harvey was the Senior Advisor to IRS Commissioner Shulman and was significantly involved in the IRS's efforts to combat offshore tax evasion, including: negotiations with UBS, development of the 2009 voluntary disclosure initiative, and development of FATCA. Professor Harvey joined the IRS upon retiring from PricewaterhouseCoopers, LLP as Managing Tax Partner of PwC's U.S. Banking and Capital Markets Tax Practice. Professor Harvey also served in the U.S. Treasury Department Office of Tax Policy during drafting and implementation of the 1986 Tax Reform Act.

(471)

## I. INTRODUCTION, PURPOSE OF ARTICLE, AND INTENDED AUDIENCES

SINCE its signing by President Obama on March 18, 2010, the Foreign Account Tax Compliance Act (FATCA) has been criticized by many in the financial community.<sup>1</sup> The purpose of this Article is to: (i) describe my perception of the origins of FATCA,<sup>2</sup> (ii) discuss selected issues,<sup>3</sup> and finally (iii) make recommendations that may ultimately be helpful to ensuring FATCA's success in both the short and long-run.<sup>4</sup>

This Article is written for several audiences. The entire Article should be of interest to students and academics. For tax professionals and my former colleagues in government, the recommendations in Part IV should be of most interest. In addition, on the off-chance a foreign tax administrator or policy maker reads the Article, Part IV(B)(2) surrounding the benefits of a multilateral FATCA system to countries other than the United States should be of interest.

Before diving into the origins of FATCA, it is important to note that since 2007 the United States has made significant progress in addressing offshore accounts through a combination of tools, including: whistleblowers, *John Doe* summons, exchanges of information pursuant to tax treaties, two major offshore voluntary compliance initiatives, and the threat of FATCA. Having been involved extensively in many of these efforts, it is my sincere hope this progress continues. Given how quickly money can move around the world, it is very important for the IRS to have adequate transparency into the offshore accounts of U.S. taxpayers.

FATCA was a bold, unilateral action by the United States intended to provide this transparency. However, it will take time to successfully implement FATCA and there will be growing pains. Ultimately, the long-term success of FATCA may depend upon whether the United States can convince other countries to adopt a similar system, or better yet, join with the United States in developing a multilateral FATCA system.<sup>5</sup> Thus, as the IRS and Treasury implement FATCA they need to focus on the long-term. In the short-run, various compromises will need to be made to ease the initial implementation of FATCA. Some of those potential compromises are discussed in this article.<sup>6</sup>

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1. See, e.g., *Foreign Account Tax Compliance Act (FATCA) Comment Letter to IRS and Responses*, DELOITTE, [http://www.deloitte.com/view/en\\_US/us/Services/tax/by-issue/fatca-resource-library/e7d4e74a9f948310VgnVCM3000001c56f00aRCRD.htm](http://www.deloitte.com/view/en_US/us/Services/tax/by-issue/fatca-resource-library/e7d4e74a9f948310VgnVCM3000001c56f00aRCRD.htm) (last visited Mar. 5, 2012) (providing links to many comment letters pertaining to FATCA).

2. See *infra* Part II.

3. See *infra* Part III.

4. See *infra* Part IV.

5. See *infra* Part IV(B).

6. See *infra* Part IV(A).

## II. ORIGINS OF FATCA

A. *Background*

Although U.S. taxpayers have been hiding income overseas for years,<sup>7</sup> the IRS historically had little success pursuing such income. The primary reason for this failure was that foreign financial institutions (FFIs) did not report any information to the IRS. Occasionally the IRS became aware of an offshore account,<sup>8</sup> but effectively U.S. taxpayers were on the honor system. Given what has transpired since 2007, it would appear many U.S. taxpayers with offshore accounts have not been very honest.<sup>9</sup>

During the period 1999–2003, two events occurred that are worth noting. First, the IRS started to have some success pursuing offshore accounts when it (i) obtained credit card information from *John Doe* summons<sup>10</sup>, and (ii) in 2003 offered its first offshore voluntary compliance initiative (referred to herein as the 2003 OVCI).<sup>11</sup> The 2003 OVCI resulted in approximately 1,300 individuals identifying themselves to the IRS with approximately \$75 million collected through July 2003.<sup>12</sup> The knowledge obtained by the IRS from successfully pursuing various *John Doe* summons<sup>13</sup> and structuring the 2003 OVCI would prove valuable in the IRS's future efforts pursuing offshore accounts in Switzerland starting in 2008.

7. *See, e.g.*, Letter from Henry Morgenthau, Jr., U.S. Sec'y of Treasury, to Franklin D. Roosevelt, President of U.S. (May 29, 1937), *available at* <http://www.presidency.ucsb.edu/ws/index.php?pid=15413#axzz1qRIOpHZ8> (explaining why tax collections are less than anticipated). In this letter, Secretary Morgenthau describes offshore accounts held by U.S. taxpayers as part of the problem. *Id.*

8. For example, the IRS was occasionally made aware by a whistleblower such as a former business partner or former spouse.

9. *See, e.g.*, STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS, REP. ON TAX HAVEN BANKS & U.S. TAX COMPLIANCE 9 (July 17, 2008), *available at* <http://www.hsgac.senate.gov/download/report-psi-staff-report-tax-haven-banks-and-us-tax-compliance-july-17-2008> [hereinafter PSI STAFF REPORT]. The report was prepared for a July 17, 2008 hearing by the U.S. Senate Permanent Subcommittee on Investigations (PSI). *See generally id.* Per the PSI report, UBS had approximately 20,000 U.S. customers of which only 1,000 (i.e., 5%) were “declared” accounts implying that 95% of UBS's U.S. accounts may have been evading U.S. tax. *See id.* at 9. The 20,000 accounts had an aggregate value of approximately \$18 billion. *See id.*

10. *See Offshore Credit Card Program (OCCP)*, INTERNAL REVENUE SERVICE, <http://www.irs.gov/newsroom/article/0,,id=105698,00.html> (last updated Aug. 12, 2003) (providing brief summary of IRS efforts issuing *John Doe* summons surrounding credit cards).

11. *See IRS Unveils Offshore Voluntary Compliance Initiative; Chance for “Credit-Card Abusers” to Clear Up Their Tax Liabilities*, INTERNAL REVENUE SERVICE (Jan. 14, 2003), <http://www.irs.gov/newsroom/article/0,,id=105689,00.html>.

12. *See Offshore Compliance Program Shows Strong Results*, INTERNAL REVENUE SERVICE (July 30, 2003), <http://www.irs.gov/newsroom/article/0,,id=111987,00.html> (providing results of 2003 OVCI). Although the IRS tried to portray the 2003 OVCI as a significant success, it was generally viewed as disappointing within the agency because a relatively small number of U.S. taxpayers participated and the amount of money collected was not that significant.

13. A *John Doe* summons is defined as “any summons where the name of the taxpayer under investigation is unknown and therefore not specifically identified.”

The second event occurred on January 1, 2001 which was the effective date for implementation of the United States' Qualified Intermediary (QI) system.<sup>14</sup> Prior to 2001, FFIs generally did not (i) collect U.S. tax documentation with respect to either U.S. or foreign taxpayers, (ii) withhold U.S. tax, (iii) file information returns with the IRS, or (iv) submit to IRS oversight. As a result, there were two major problems:

- A U.S. taxpayer could invest in U.S. source assets with a FFI, but the FFI was not required to report anything to the IRS.<sup>15</sup>
- U.S. withholding agents (e.g., U.S. banks) were not obtaining adequate documentation from FFIs to document a reduced U.S. withholding tax rate on payments to foreign customers of such FFIs. This result was not surprising given that the FFI had the customer relationship, and the U.S. withholding agent did not. Plus, the FFI was not anxious to share the identity of its clients with a potential competitor (i.e., a U.S. bank).

When implementing the QI system, U.S. tax authorities were attempting to address these two problems. As a result, the QI system generally required QIs to identify their customers. If they were foreign customers, the QI could keep the identity of their customer secret as long as the correct amount of U.S. withholding tax was imposed on any payments of U.S. source income to such customer. For U.S. customers, the QI was required to report to the IRS any U.S. source income. In order to keep the QIs honest, the QI system required an "audit"<sup>16</sup> of the QI by either the IRS or an independent auditor.<sup>17</sup>

It is important to note that the QI system was a major advancement when compared to the pre-2001 world, especially with respect to determining the correct amount of withholding tax to be applied on payments to foreigners. However, as time passed, it became *very apparent* that the QI system was not working well at preventing U.S. taxpayers from using offshore accounts to avoid U.S. tax.

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INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL § 25.5.7.2 (2011), available at [http://www.irs.gov/irm/part25/irm\\_25-005-007.html](http://www.irs.gov/irm/part25/irm_25-005-007.html).

14. Treas. Reg. § 1.1441-1(e)(5) (2001).

15. A U.S. taxpayer could also invest in non-U.S. source assets and avoid reporting, but the failure to report income from U.S. source assets was particularly troubling.

16. This was not a real audit. Rather, it was more analogous to an "agreed upon procedures report."

17. Although there may have been a handful of QIs that requested the IRS to audit them, substantially all QIs hired an independent auditor (e.g., one of the Big 4 accounting firms) because they did not want the names of their foreign customers made available to the IRS. Many QIs were fearful the customer's name could be reported by the IRS to a foreign tax authority through information exchange agreements.

B. *Problems with the QI System*

Although the QI system did include some reporting with respect to U.S. taxpayers, there were several major loopholes that were exploited by U.S. taxpayers and their advisors to avoid reporting income to the IRS. For example:

- *Foreign Source Income Not Reported*—The QI system only required QIs to report to the IRS the U.S. source income of their U.S. customers. Because foreign source income was not reported, many U.S. taxpayers invested in foreign source assets to avoid reporting. When the QI system was first implemented in 2001, many U.S. taxpayers that had previously invested in U.S. source assets through a FFI converted those assets to foreign source assets and continued to avoid reporting to the IRS.
- *No Requirement to Determine the Beneficial Owner*—The QI system did not specifically require that QIs look-through foreign shell entities to determine the underlying beneficial owner. Thus, if a U.S. taxpayer wanted to invest in U.S. source assets, it could establish a foreign shell entity (or entities) and argue under the QI system that the entity was the beneficial owner of the income.<sup>18</sup> In such case, the QI took the position that the foreign entity should be viewed as the beneficial owner under the QI regime and no reporting to the IRS was required. When the QI system was implemented, many U.S. taxpayers that had previously invested in U.S. assets and did not want to convert those assets to foreign source assets contributed their U.S. source assets to a foreign shell entity (or entities) and continued to avoid reporting to the IRS.
- *QI Could Represent Only a Portion of the Worldwide Accounts*—Because the primary emphasis of the QI system was to make sure the proper withholding tax was charged on payments to foreigners, the QI system allowed FFIs to designate those accounts that were part of the QI system. This was done to avoid the QI having to perform detailed due diligence procedures on its entire customer base, especially those that never invested in the United States.<sup>19</sup> The result was that QIs could exclude certain customers from the QI system, especially “undeclared accounts.”<sup>20</sup>
- *QIs Were Primarily Banks*—Because the QI system was primarily aimed at custodial relationships, QIs were almost always banks or trust companies. If a U.S. taxpayer wanted to avoid any possibility of U.S. reporting, they could invest in (i) a foreign mutual fund or

18. Shell entities were also used to further obfuscate the true owner of foreign assets held by U.S. taxpayers.

19. In most FFIs, the percentage of the customer base that invested in U.S. source assets was very small. Although I am not aware of any statistics, it could be less than 1% in many cases.

20. These are accounts where the customer refused to identify themselves.

private equity fund treated as a corporation for U.S. tax purposes, or (ii) any other financial institution that was not a QI.

- *QI Audits*—The QI audit was not really an audit, but rather was a list of procedures that needed to be performed. The procedures did not include any requirement for a QI auditor to look for, or report fraud. More importantly, the focus of the audit was on reviewing customer accounts within the QI system, and not testing to determine whether U.S. taxpayers were avoiding reporting by (i) investing in foreign source assets, (ii) holding U.S. source assets in a foreign shell entity (or entities), or (iii) failing to declare themselves.

As will be described in Part II(E), these loopholes were front and center on the minds of the IRS, Treasury, and congressional staff as they proposed and drafted FATCA in 2009 and 2010. But first, a brief discussion of the LGT and UBS scandals is warranted so the reader can understand the political backdrop under which FATCA was proposed and enacted.

### C. *LGT and UBS Scandals*<sup>21</sup>

In February 2008, it became public that German tax authorities had purchased customer account information from an employee at LGT, a bank in Lichtenstein with close ties to the royal family in Lichtenstein. The German authorities apparently shared the information with countries around the world and the IRS announced on February 26, 2008 that it was initiating enforcement action against over 100 U.S. taxpayers with offshore accounts at LGT.<sup>22</sup>In May 2008, an even bigger scandal erupted when the United States arrested Bradley Birkenfeld, a former UBS private banker who subsequently pleaded guilty one month later to helping U.S. taxpayers evade U.S. tax through the use of offshore accounts. The guilty plea included all sorts of spy-like techniques used by Birkenfeld and his colleagues to avoid U.S. detection. They included encrypted computers, code words, smuggling diamonds in toothpaste tubes, and the list goes on.

It should be noted that Bradley Birkenfeld reportedly came forward under the IRS's whistleblower program in 2007 and had been disclosing information to the IRS for many months. However, he reportedly failed to disclose information to the IRS and Department of Justice with respect to one of his larger, if not largest, accounts (i.e., Igor Olenicoff). As a result, despite blowing the whistle on UBS, Mr. Birkenfeld was prosecuted and received a forty-month sentence.<sup>23</sup>

21. See PSI STAFF REPORT, *supra* note 9, at 80–110 (providing significantly more detailed description of tax evasion facilitated by LGT and UBS).

22. See *IRS and Tax Treaty Partners Target Liechtenstein Accounts*, INTERNAL REVENUE SERVICE (Feb. 26, 2008), <http://www.irs.gov/newsroom/article/0,,id=179387,00.html>.

23. See *Bradley Birkenfeld: UBS Informant to Begin Prison Sentence Friday*, HUFFINGTON POST (Mar. 18, 2010), <http://www.huffingtonpost.com/2010/01/04/>

2012]

OFFSHORE ACCOUNTS

477

On June 30, 2008, the IRS filed a *John Doe* summons with the U.S. District Court for the Southern District of Florida requesting that UBS disclose to the IRS all its U.S. customers that had potentially been avoiding U.S. tax.<sup>24</sup> One day later, the court approved the serving of the *John Doe* summons. UBS refused to comply with the summons arguing that under Swiss bank secrecy law, they were not allowed to disclose customer information.

On July 17 and 25, 2008, the U.S. Senate Permanent Subcommittee on Investigations (PSI) held highly publicized hearings on offshore accounts.<sup>25</sup> At this hearing, IRS Commissioner Shulman gave testimony on the IRS efforts surrounding offshore accounts and also stated the following with respect to the QI system:

[W]e are working on enhancements to the program to increase the level and quality of information reporting coming through the program. Specifically, we are considering changes to the regulations to require QIs to look through certain foreign entities—such as trusts—to determine whether any U.S. taxpayers are beneficial owners. We are also considering a regulation to have QIs report U.S. taxpayers' worldwide income to the IRS in certain cases—not just U.S. source income.<sup>26</sup>

In addition, the PSI report also made several findings and recommendations surrounding the QI system, including:<sup>27</sup>

- *Abuses by LGT and UBS*—“LGT and UBS have assisted their U.S. clients in structuring their foreign accounts to avoid QI reporting to the IRS, including by allowing U.S. clients who sold their U.S. securities to continue to hold undisclosed accounts and by opening accounts in the name of non-U.S. entities beneficially owned by U.S. clients.”

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bradley-birkenfeld-ubs-in\_n\_410753.html; *Former UBS Banker Sentenced to 40 Months for Aiding Billionaire American Evade Taxes*, U.S. DEPARTMENT JUST. (Aug. 21, 2009), <http://www.justice.gov/opa/pr/2009/August/09-tax-831.html>. Birkenfeld has been fighting his sentence and is also pursuing a large whistleblower settlement pursuant to I.R.C. § 7623(b). Although some have argued the DOJ was too tough on Birkenfeld, no one can dispute that the Birkenfeld case has sent a strong message to future whistleblowers that they should disclose everything they know, especially if their own hands are not 100% clean.

24. See PSI STAFF REPORT, *supra* note 9, at 3 n.10; *Justice Department Asks Court to Serve IRS Summons for UBS Swiss Bank Account Records*, U.S. DEPARTMENT JUST. (June 30, 2008), <http://www.justice.gov/tax/txdv08579.htm>.

25. See generally PSI STAFF REPORT, *supra* note 9.

26. *Tax Haven Banks and U.S. Tax Compliance: Hearing before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. and Governmental Affairs*, 110th Cong. 61 (2008) (statement of I.R.S. Comm'r Doug Shulman) [hereinafter *2008 PSI Hearing*].

27. See PSI STAFF REPORT, *supra* note 9, at 16 (finding abuses by LGT and UBS and recommending (a) requiring reporting of foreign source income and determination of beneficial owner, and (b) strengthening QI audits).



- *Require Reporting of Foreign Source Income and Determination of Beneficial Owner*—“[T]he Administration should strengthen the Qualified Intermediary Agreement by requiring QI participants to file 1099 Forms for: (1) all U.S. persons who are clients (whether or not the client has U.S. securities or receives U.S. source income); and (2) accounts beneficially owned by U.S. persons, even if the accounts are held in the name of a foreign corporation, trust, foundation, or other entity. The IRS should also close the ‘QI-KYC Gap’ by expressly requiring QI participants to apply to their QI reporting obligations all information obtained through their Know-Your-Customer procedures to identify the beneficial owners of accounts.”
- *Strengthen QI Audits*—“The IRS should broaden QI audits to require bank auditors to report evidence of fraudulent or illegal activity.”

Given the evidence obtained from Bradley Birkenfeld and the information uncovered during the PSI investigation, the Department of Justice (DOJ) was pursuing UBS on two fronts. First, DOJ and the IRS were pursuing enforcement of the civil *John Doe* summons, and of potentially much more concern to UBS, they were also pursuing criminal charges for tax evasion and securities violations. Ultimately in February 2009,<sup>28</sup> UBS agreed to: (i) a deferred prosecution agreement (DPA) of the criminal charges, (ii) the payment of a \$780 million fine, and (iii) the disclosure of an unknown number of accounts.<sup>29</sup>

The DPA did not settle the civil issues surrounding the *John Doe* summons. As a result, the day after the DPA was announced, the DOJ filed a motion with the U.S. District Court for the Southern District of Florida to enforce the *John Doe* summons to obtain information on up to 52,000 accounts.<sup>30</sup> UBS continued to refuse to provide the information requested in the summons because it could violate Swiss bank secrecy law.

Instead of allowing the Court to decide the conflict of laws issue between American and Swiss law, the IRS and UBS ultimately settled the *John*

28. See Deferred Prosecution Agreement, *United States v. UBS*, No. 09-60033 (S.D. Fla. 2009), available at <http://www.law.virginia.edu/pdf/faculty/garrett/ubs.pdf> (last visited Mar. 20, 2012); *UBS Enters into Deferred Prosecution Agreement*, U.S. DEPARTMENT JUST. (Feb. 18, 2009), <http://www.justice.gov/tax/txdv09136.htm>.

29. Ultimately, it has been reported that information on approximately 250 U.S. customers was turned over to the U.S. government. See, e.g., David Voreacos, *Credit Suisse May Settle U.S. Probe by Admitting Wrongdoing, Paying Fine*, BLOOMBERG (Aug. 15, 2011), <http://www.bloomberg.com/news/2011-08-15/credit-suisse-likely-to-settle-u-s-probe-than-risk-charges-lawyers-say.html>.

30. See *Tax Haven Banks and U.S. Tax Compliance—Obtaining the Names of U.S. Clients with Swiss Accounts Before the S. Permanent Subcomm. on Investigations, Comm. on Homeland Sec. and Governmental Affairs* 5 (2009) (statement of John DiCicco, Acting Assistant Att’y Gen., Tax Div., U.S. Dep’t of Justice), available at [http://www.justice.gov/tax/DOJ\\_Testimony\\_JDcicco.pdf](http://www.justice.gov/tax/DOJ_Testimony_JDcicco.pdf).

2012]

OFFSHORE ACCOUNTS

479

*Doe* summons in August 2009.<sup>31</sup> The result was that UBS agreed to disclose information on approximately 4,450 U.S. customers.<sup>32</sup> The criteria for determining U.S. customers that would be disclosed were carefully chosen to ensure the United States would get information on the largest and potentially most abusive accounts.

D. *2009 Offshore Voluntary Compliance Initiative (2009 OVCI)*<sup>33</sup>

In March 2009, the IRS announced an offshore voluntary compliance initiative (the “2009 OVCI”). This settlement initiative ultimately ended in October 2009 and resulted in over 14,700 U.S. taxpayers admitting they had previously unreported offshore accounts.<sup>34</sup> Aside from some processing issues, the 2009 OVCI was universally viewed as being successful. Part of the reason for this success was that U.S. customers of UBS were concerned their account information was going to be included in the 4,450 accounts UBS agreed to disclose to the IRS.

For non-UBS customers and non-Swiss bank customers, there was less concern about their account information immediately being turned over to the United States. Nevertheless, many U.S. taxpayers were concerned given (i) the possibility of future whistleblowers at their banks, and (ii) it was anticipated the IRS would obtain a wealth of information from the 2009 OVCI related to non-UBS banks.<sup>35</sup> In addition, U.S. taxpayers were also worried about the long-term implications of certain proposals in President Obama’s fiscal 2010 budget proposal (issued in May 2009).<sup>36</sup>

E. *FATCA Is Conceived*

Given the loopholes and issues surrounding the QI system, there was general agreement among senior IRS officials that something had to be done. The question became: what specific changes should be made to the QI system to make it more effective at preventing U.S. taxpayers from hiding income offshore? The obvious answer was to attempt to address the

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31. See *IRS to Receive Unprecedented Amount of Information in UBS Agreement*, INTERNAL REVENUE SERVICE (Aug. 19, 2009), <http://www.irs.gov/newsroom/article/0,,id=212124,00.html>.

32. UBS’s agreement to disclose customer information supplemented the company’s prior disclosure of approximately 250 customers as part of the deferred prosecution agreement (DPA) in February 2009.

33. The IRS also subsequently had a 2011 OVCI.

34. See Doug Shulman, Comm’r, Internal Revenue Serv., Address to N.Y. State Bar Ass’n Taxation Section Annual Meeting (Jan. 26, 2010), available at <http://www.irs.gov/newsroom/article/0,,id=218705,00.html> (disclosing that over 14,700 taxpayers participated in 2009 OVCI).

35. For example, customers of foreign financial institution *A* were worried that another customer of *A* would participate in the 2009 OVCI and cause the IRS to start aggressively pursuing foreign financial institution *A* in a manner similar to UBS.

36. See *infra* Part II(E).

problems identified in Part II(B) above. Given the July 2008 PSI report<sup>37</sup> and given the IRS Commissioner's testimony at the July 17, 2008 hearing<sup>38</sup>, it was pretty clear that QIs should be required to:

- Report both U.S. and foreign source income for U.S. taxpayers
- Determine if U.S. taxpayers are the beneficial owners of foreign shell entities
- Review all customer accounts within the affiliated group to identify U.S. taxpayers

Thus, the concept of FATCA was born. However, as the IRS started down this path, several issues arose:

- *Would U.S. Taxpayers Switch Their Investments from QIs to Other Financial Institutions Not Part of the QI System (i.e., NQIs)?*—Because the QI system was a “carrot” primarily utilized by custodial and private banks, the QI system practically did not include many other financial institutions. There was significant concern that if the United States made it difficult for U.S. taxpayers to hide money offshore in bank and trust companies, many U.S. taxpayers would start hiding their money in other offshore vehicles (e.g., various funds) to avoid paying U.S. tax. Thus, any proposal needed to either (i) expand the QI regime to include substantially all foreign financial intermediaries, or (ii) adopt some other approach to reduce the opportunities of U.S. tax cheats<sup>39</sup> to invest with NQIs.
- *Would QIs Abandon the QI system?*—As described in Part II(A), the QI system was designed to encourage FFIs to become QIs so they could avoid disclosing the identity of their customers to potential competitors (e.g., U.S. banks). Given the QI system utilized this carrot approach, there was significant concern that many QIs would abandon the system if they were now required to perform substantial additional burdens, including: (i) report both U.S. and foreign source income for U.S. taxpayers, (ii) determine the true beneficial owner of a shell entity, and (iii) perform customer due diligence on their entire customer base to identify potential U.S. customers.

As a result, it was decided the new and improved QI system needed to have a penalty for failure of a FFI to participate in the QI system. The proposed penalty was to be the imposition of withholding tax on U.S. source payments (both income and gross proceeds) to a NQI.

- *Should the QI System be Changed Administratively or Through Legislation?*—Because the QI system was created through (i) Treasury regulations and (ii) contracts with FFIs, the IRS/Treasury could have changed the QI rules without legislation. However, given the desire

37. See PSI STAFF REPORT, *supra* note 9.

38. See 2008 PSI Hearing, *supra* note 26, at 55–64.

39. The term “tax cheat” is used throughout the Article to refer to U.S. taxpayers that use, or want to use, offshore accounts to evade their U.S. tax obligations.

to impose withholding taxes on payments to NQIs, legislation was needed.

The President's Fiscal 2010 budget released in May 2009 included several provisions to address offshore tax evasion.<sup>40</sup> Given the known problems with the QI system, the proposals to change the QI system were not a surprise. QIs were going to be required to:

- Report both the U.S. and foreign source income for U.S. taxpayers,
- Determine whether U.S. taxpayers are the beneficial owners of foreign shell entities, and
- Potentially review all customer accounts within an affiliated group of companies to identify U.S. taxpayers.<sup>41</sup>

In addition, the Fiscal 2010 Green Book<sup>42</sup> also included various provisions that addressed concerns that (i) QIs would abandon the system, and (ii) U.S. tax cheats might seek out investments with NQIs (e.g., offshore mutual funds). The two major additional provisions were:

- *Withholding Tax*—If a foreign financial intermediary did not become a QI, it would be subject to a withholding tax on both U.S. source income and gross proceeds.<sup>43</sup> This was primarily designed to encourage foreign financial intermediaries to either continue their QI status, or adopt QI status. However, the imposition of a withholding tax on NQIs had the practical effect of extending the impact of the QI regime to a much broader group of foreign financial intermediaries, including offshore funds.<sup>44</sup> In 2008, it was estimated there were approximately 5,600 QIs.<sup>45</sup> The number of financial institutions ultimately impacted by FATCA is likely into the hundreds of thousands.
- *Third Party Reporting of Cross-Border Transfers*—If a U.S. financial intermediary or a QI transferred money or property outside the U.S.

40. See DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 41 (2009), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY-2010.pdf> [hereinafter GENERAL EXPLANATIONS].

41. *Id.* at 42. However, it is important to note the Administration's proposal did not require affiliated entities of a QI to definitely perform due diligence on their entire customer base. Rather, Treasury was given authority to address QI affiliates. This author's intention was that if an affiliated QI adopted certain procedures, signed a management representation that the procedures were functioning, and agreed to potentially be subject to an audit by a third party, then the affiliated QI should be able to avoid performing detailed customer due diligence on its customer base.

42. Because the cover of the Administration's revenue proposals is traditionally green in color, it is often referred to as the "Green Book."

43. GENERAL EXPLANATIONS, *supra* note 40, at 43.

44. This was not crystal clear from the Fiscal 2010 Green Book and may not have been the intention of some that participated in the drafting. Nevertheless, given its general applicability to NQIs and given the Green Book included authority to exempt a diverse group of NQIs, this author thought it applied to offshore funds. However, others involved in the process may not.

45. See 2008 PSI Hearing, *supra* note 26, at 60.

reporting regime, there would be a reporting requirement to the IRS.<sup>46</sup> This provision was intended to make it more difficult for U.S. tax cheats to transfer money or property to NQIs that were outside the reporting system.<sup>47</sup>

It should be noted, that as originally conceived in the Fiscal 2010 Budget Proposals, FATCA did not:

- Allow “recalcitrant account holders” (i.e., customers that refused to either identify themselves, or allow reporting of their information to the IRS). Rather, it was assumed that QIs would identify all customers, and U.S. customers would be forced to agree to disclosure of their tax information to the IRS or have their account closed.
- Have “passthru payments” (i.e., I.R.C. § 1471(d)(7)) which can effectively re-source foreign source income to U.S. source income.<sup>48</sup>

Finally, when FATCA was being designed, there was a clear understanding that it would not eliminate all opportunities for a U.S. taxpayer to hide income offshore. For example, a U.S. taxpayer could invest in non-U.S. source assets with an NQI and avoid reporting to the IRS. However, the hope was that substantially all reputable FFIs would become QIs. If this occurred, U.S. tax cheats would be relegated to second or third tier FFIs that could cause the U.S. tax cheat to question whether they really wanted to invest in such institutions.

#### F. FATCA Legislation Ultimately Adopted<sup>49</sup>

Legislation was ultimately introduced in October 2009,<sup>50</sup> modified again in December 2009,<sup>51</sup> and finally adopted in March 2010 as part of the Hire Act.<sup>52</sup> Although there were several changes during drafting, two of particular interest were:

46. GENERAL EXPLANATIONS, *supra* note 40, at 48.

47. However, U.S. tax cheats could still move money offshore the “old fashioned way” (i.e., in suitcases).

48. For additional discussion see *infra* Parts II(f), III(B), IV(A)(2).

49. The President’s proposals referred to participating FFIs as QIs. However, once FATCA was committed to legislative language, the nomenclature changed from QIs to P-FFIs (i.e., participating FFIs) and NP-FFIs (i.e., non-participating FFIs). The remainder of this Article will generally refer to P-FFIs and NP-FFIs.

50. See Foreign Account Tax Compliance Act of 2009, H.R. REP. NO. 111-3933 (2009); see also Foreign Account Tax Compliance Act of 2009, S. REP. NO. 111-1934 (2009); STAFF OF J. COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE FOREIGN ACCOUNT TAX COMPLIANCE ACT OF 2009 (2009).

51. See H.R. REP. NO. 111-4213 (2010); see also STAFF OF J. COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF H.R. 4213, THE “TAX EXTENDERS ACT OF 2009” (2009).

52. See Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, §§ 501–535, 124 Stat. 71 (2010); see also STAFF OF J. COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN SENATE AMENDMENT 3310, THE “HIRING INCENTIVES TO RESTORE EMPLOYMENT ACT” (2010). Although FATCA technically includes sections 501–535, section 501 is the subject of this Article.

- *Recalcitrant Account Holders*—As originally outlined in the Fiscal 2010 Green Book, FATCA would have required FFIs to identify the country of residence of *all* customers—or at least determine whether a customer was a U.S. person or not.<sup>53</sup> The Green Book was silent as to what a qualified foreign financial institution (Q-FFI) should do if a customer refused to provide adequate documentation to demonstrate they were not a U.S. person.

When first drafted by congressional staff, FATCA required that a participating foreign financial institution (P-FFI) would close the account of any customer that would not provide adequate documentation.<sup>54</sup> In addition, if a P-FFI identified a customer as a U.S. person, the FFI would be required to report information to the IRS for such U.S. customer.

It was understood that requiring that (i) a customer's account be closed and (ii) information on U.S. customers be reported to the IRS, could cause issues with local law.<sup>55</sup> However, given the coordinated worldwide effort to address offshore accounts,<sup>56</sup> it was hoped that recalcitrant account holders would ultimately not be tolerated in the worldwide banking system. In addition, if a FFI wanted to be a P-FFI, it was thought that the FFI could choose to not do business with customers that appeared to be U.S. persons (especially new customers) and refused to sign a waiver allowing the P-FFI to disclose the customer's information to the IRS.

As FATCA went through the legislative process, many comments were received surrounding local law restrictions on (i) disclosing customer information to the IRS, and (ii) closing of existing accounts. As a result, the final version of FATCA adopted in March 2010 provided that a P-FFI could have so-called "recalcitrant account holders."<sup>57</sup> It was still hoped that eventually recalcitrant account holders would not be tolerated in the worldwide banking system, but it was understood this could take a number of years to accomplish.

- *Passthru Payments*<sup>58</sup>—As FATCA was being developed, it was understood that in a post-FATCA world a U.S. tax cheat could accomplish

53. See GENERAL EXPLANATIONS, *supra* note 40.

54. See H.R. REP. NO. 111-3933 (presenting initial version of proposed I.R.C. § 1471(b)(1)(E)(ii)); see also S. REP. NO. 111-1934 (same).

55. For example, some customers may not want to identify themselves, local bank secrecy laws may prevent the disclosure of customer information without the customer's consent, and local laws may prevent the closing of an account.

56. See *G20 Summit—Leaders' Statement*, THE GUARDIAN ¶ 15 (Apr. 2, 2009), available at <http://www.guardian.co.uk/world/2009/apr/02/g20-economy>.

57. See I.R.C. § 1471(b)(1)(F), (d)(6) (West 2010).

58. See I.R.C. § 1471(d)(7) (West 2010) (including in definition of "passthru payment" "any withholdable payment or other payment to the extent attributable to a withholdable payment"). Because the first part of § 1471(d)(7)'s definition is relatively non-controversial, for purposes of this Article, the term "passthru pay-

their objective by investing in non-U.S. source assets with a non-participating foreign financial institution (NP-FFI). The hope was that over time, the number of reputable FFIs and countries that a U.S. tax cheat could invest in would gradually be eliminated. In order to accomplish this result, it was understood the United States may need to ultimately convince other countries to adopt FATCA style systems, or alternatively participate in a multilateral P-FFI system.<sup>59</sup>

Although it was understood U.S. tax cheats could invest in non-U.S. source assets through a NP-FFI, the general intention was to prevent U.S. tax cheats from investing in U.S. source assets through a P-FFI. During the legislative process a group of tax professionals met with congressional staff to express concern that (i) U.S. tax cheats could invest in non-U.S. source assets in NP-FFIs, but more importantly, (ii) tax planners could setup a “blocker entity” to effectively allow U.S. tax cheats to indirectly invest in U.S. source assets.<sup>60</sup> The first observation was not a surprise, but the second was to certain staff.

The concern about a “blocker entity” can best be described by an example. Assume Offshore Fund A invests in U.S. source assets and further assume A elects to become a P-FFI. Further assume that a NP-FFI (e.g., another offshore fund X) is an investor in A, and a U.S. tax cheat is an investor in X. Given this scenario, the tax professionals were concerned that payments from A to X would be foreign-to-foreign payments and therefore not subject to withholding under FATCA. Thus, tax planners could avoid FATCA by establishing a P-FFI as a blocker between U.S. investments and NP-FFIs or U.S. tax cheats.

Primarily as a result of this meeting, the passthru payment provision<sup>61</sup> was inserted into FATCA. Thus, in addition to withholding on a withholdable payment, a P-FFI needs to withhold on other payments “to the extent attributable to a withholdable payment.” This provision has the potential to effectively (i) re-source a portion of what would otherwise be a foreign source payment to a NP-FFI or recalcitrant account holder, and (ii) impose a 30% withholding tax on the portion of such payment re-sourced to the United States.

Continuing with the example above, assume a U.S. tax cheat invests \$1 million in non-U.S. source assets with X (a NP-FFI) and further assume X invests the \$1 million in non-U.S. source assets

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ment” is referring to the second part of the definition (i.e., “other payment to the extent attributable to a withholdable payment”). *Id.*

59. For further discussion, see *infra* Part IV(b)(2).

60. See I.R.S. Notice 2011-34, 2011-19 I.R.B. 765, at § II (providing brief description of concern surrounding blocker FFIs); see also I.R.S. Notice 2010-60, 2010-37 I.R.B. 329, at § V.B. (same).

61. See I.R.C. §§ 1471(b)(1)(D), 1471(d)(7) (West 2010).

with A (a P-FFI). Finally, assume A makes a \$100,000 payment to X. Given these facts, the passthru payment rules provide that A must agree to withhold 30% of any “withholdable payment” or “other payment to the extent attributable to a withholdable payment.”<sup>62</sup> Because the \$100,000 payment relates to foreign sources, it is not a “withholdable payment”. However, it may be a payment “attributable to a withholdable payment” to the extent A invested in U.S. assets and received payments from such assets.

As a result, even though a payment from a P-FFI to a NP-FFI appears to entirely relate to foreign source assets, the passthru payment rules could result in the imposition of withholding tax by effectively re-characterizing a portion of the foreign source payment as a U.S. source payment. The intended effect of this provision appears to have been (i) to discourage U.S. tax cheats from investing in non-U.S. assets with NP-FFIs, and (ii) more directly, penalizing NP-FFIs for doing business with a P-FFI.<sup>63</sup> The hope may have been to encourage NP-FFIs to become FFIs.

In addition, the passthru payment rules also apply to a recalcitrant account holder. Thus, if a recalcitrant account holder invests in non-U.S. source assets with a P-FFI, the passthru payment concept could result in a resourcing of foreign source income to U.S. income and result in withholding.

As will be discussed in Parts III(B) and IV(A)(2), the passthru payment rule has been very controversial because (i) it can be administratively complex, and (ii) it re-sources foreign source income to U.S. source income in situations where there may be no tax abuse.

### III. SELECTED FATCA ISSUES

Although there are many issues surrounding FATCA,<sup>64</sup> this Article will discuss three issues. The first two are specific issues surrounding (i) customer due diligence procedures,<sup>65</sup> and (ii) passthru payments.<sup>66</sup> The customer due diligence issue was recognized during the original conceptualization of FATCA, while the passthru payment issue resulted from decisions made during congressional drafting of FATCA. Although these two issues need to be addressed by IRS/Treasury in both the short and the long-run, the passthru payment issue is particularly complicated.

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62. *Id.*

63. As will be discussed in Part IV(A)(2), because of the additional administrative burdens it imposes on the P-FFI, the passthru payment also effectively penalizes the P-FFI for doing business with an NP-FFI.

64. For a discussion of the various issues surrounding FATCA, see *supra* note 1.

65. See *infra* Part III(A).

66. See *infra* Part III(B).



The third issue is a general question: Will FATCA ultimately accomplish its goals?<sup>67</sup>

#### A. *Customer Due Diligence Procedures for Affiliated P-FFIs*

As discussed in Part II of this Article, one of the major problems with the QI system was the ability of a QI to effectively (i) ignore customer accounts at affiliated FFIs, and (ii) even also ignore customer accounts within the QI. One of the major FATCA design features was to require that a QI (now referred to as a P-FFI) have procedures in place to (i) identify all U.S. customers within the P-FFI,<sup>68</sup> and (ii) potentially identify U.S. customers in affiliated FFIs.<sup>69</sup> When FATCA was being designed, it was understood this would cause certain issues, especially in the short-run.

For example, assume a hypothetical foreign bank has one million customers throughout the world, but only (i) 1% of such customers are U.S. persons, and (ii) 4% of the foreign bank's customers invest in the United States. In this fact pattern, FATCA theoretically requires the foreign bank to perform detailed customer due diligence procedures on its entire one million customer base in order to properly identify the 5% that could be directly impacted by FATCA. Needless to say, one would expect the foreign bank to be unhappy about this requirement. This problem was known when FATCA was being conceptualized.

As a result, in order to make FATCA operational in the short-run, this IRS official was expecting that affiliated entities of the P-FFI would have an ability to demonstrate there were few if any material U.S. customers that would require reporting to the IRS. I was hoping this requirement could be met by some combination of written procedures and representations by affiliates of the P-FFI that there were no known U.S. customers.<sup>70</sup> It should be noted the final FATCA statutory language provided for "deemed compliant" FFIs.<sup>71</sup>

As will be discussed in Part IV(B) of this Article, this IRS official believed the long-term answer to the customer due diligence issue for affiliated FFIs was additional multilateral agreement among various tax authorities.

#### B. *Passthru Payments*<sup>72</sup>

As discussed in Part II(F), the passthru payment concept originated during legislative consideration of FATCA and was aimed (i) in general at further discouraging the existence of NP-FFIs, and (ii) partially addressing

67. See *infra* Part III(C).

68. I.R.C. § 1471(b)(1)(A) (West 2010).

69. I.R.C. § 1471(e) (West 2010). However, the Treasury was granted authority to provide exceptions for affiliated FFIs.

70. Or potentially no known U.S. customers above a certain level of assets.

71. I.R.C. § 1471(b)(2) (West 2010).

72. For a further discussion of passthru payments, see *supra* note 58.

the blocker issue. Although the ultimate goal was clearly worthwhile, it has become clear since the enactment of FATCA that implementation of the passthru payment regime poses many significant challenges, including:

- How does one determine whether a payment to a NP-FFI (or recalcitrant accountholder) is “attributable to a withholdable payment?”
- Potential restrictions under local law to the collection of withholding tax on payments that appear in form to be unrelated to the United States.

As of the drafting date of this Article,<sup>73</sup> the IRS/Treasury has tentatively decided to apply a pro-rata approach<sup>74</sup> in order to determine passthru payments. Thus, if 10% of a P-FFI’s worldwide assets are U.S. assets, then 10% of its non-U.S. source payments to an NP-FFI or recalcitrant account holder could be subject to a 30% U.S. withholding tax.

Needless to say, there are lots of issues and administrative complexity with this approach. Possibly in recognition of these issues and complications, the IRS announced in July 2011 that the passthru payment rules will not be effective until payments after January 1, 2015.<sup>75</sup> The IRS likely believes it has bought itself some more time to address the passthru payment issue.

However, informal discussions with several FFIs and their advisors suggest:

- Many FFIs view the passthru payment rules as the proverbial straw that could break the camel’s back in their decision whether to become a P-FFI.
- Other FFIs (i.e., those that clearly need to be a P-FFI because of their client base) are apparently considering only doing business with other P-FFIs so as to reduce their FATCA system design issues.
- Most FFIs do not want to start building a system to do withholding tax until they know whether the passthru payment rules will be applicable, and if so, how they will be applied.

As will be discussed in Part IV(A)(2) of this Article, this observer suspects the IRS will need to make some decisions soon with respect to the passthru payment rules. The decisions will not be easy and will depend upon several factors.

### C. *Will FATCA Ultimately Accomplish Its Goals?*

Before answering this question, it is helpful to briefly discuss my perspective on the goals of FATCA. The overall goal was to reduce the number of U.S. taxpayers using offshore accounts to hide income from the IRS. Major specific goals included:

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73. November 15, 2011.

74. See I.R.S. Notice 2010-34, 2010-17 I.R.B. 612, at § II.

75. See I.R.S. Notice 2011-53, 2011-32 I.R.B. 124, at § II.C.2.

- *Encourage U.S. Taxpayers to Participate in the 2009 OVCI*—Given that FATCA was conceptualized at approximately the same time as the 2009 OVCI was being developed,<sup>76</sup> one goal of FATCA was to further encourage participation in the 2009 OVCI.<sup>77</sup> Clearly, to the extent U.S. taxpayers were fearful FATCA would substantially increase future reporting of information on offshore accounts to the IRS, U.S. tax cheats should have been more likely to participate in the 2009 OVCI.
- *Cure Deficiencies in the QI Reporting System for U.S. Taxpayers*—This was the main goal of FATCA with the end result that it should be substantially more difficult for a U.S. tax cheat to hide income offshore in a P-FFI.
- *Provide an Offshore Reporting Model for Other Countries to Emulate*—Although not all involved in developing FATCA necessarily shared this goal, it certainly was one of my goals. Furthermore, as discussed in Part IV(B), I believe the ultimate long-term success of FATCA may depend upon whether other countries adopt some version of FATCA, or at least adopt detailed customer due diligence procedures of the type embedded in FATCA.

Given the IRS has had two very successful offshore voluntary disclosure initiatives (i.e., the 2009 OVCI and the 2011 OVCI),<sup>78</sup> the first specific goal seems to have been met.<sup>79</sup> However, the second and third goals are more important. In order for them to be met, the United States needs to create a viable, long-term reporting system that is accepted by the vast majority of FFIs around the world. Unfortunately, the jury is still out.

The major weakness of FATCA is that the United States is attempting to unilaterally require FFIs to report information to the United States. When FATCA was being conceptualized, it was this author's hope that the United States would aggressively market the FATCA concept to other ma-

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76. The 2009 OVCI was announced in March 2009 and the President's Fiscal 2010 Budget Proposals were released in May 2009. The 2009 OVCI was originally scheduled to end in September 2009, but was ultimately extended to October 2009.

77. However, other goals were more important (e.g., curing deficiencies in the QI reporting system).

78. See *IRS Shows Continued Progress on International Tax Evasion*, INTERNAL REVENUE SERVICE (Sept. 15, 2011), <http://www.irs.gov/newsroom/article/0,,id=245768,00.html> (announcing that, as of September 15, 2011, approximately 30,000 taxpayers had voluntarily disclosed previously unreported offshore accounts resulting in almost \$3 billion of additional collections). In addition, one should expect that as disclosures are processed for the 2011 OVCI, the amount of collections should increase substantially.

79. One will never really know how many additional U.S. taxpayers decided to participate in the 2009 and 2011 OVCI's because of FATCA. Nevertheless, FATCA was one of the factors that many U.S. taxpayers likely considered when determining whether to participate.

2012]

OFFSHORE ACCOUNTS

489

for countries. It is not clear whether this has been occurring.<sup>80</sup> The issues caused by this unilateral action include:

- Resistance by FFIs to (i) perform extensive customer due diligence procedures on *all* of their customer bases to identify a relatively small number of U.S. taxpayers, and (ii) create a specific reporting and withholding system applicable to only the United States.
- Various sovereign country issues, including (i) bank secrecy laws, and (ii) laws prohibiting the closing of accounts.

Some might argue the United States should work through the Organization for Economic Co-operation and Development (OECD) to obtain a global consensus. Given such an effort could take many years (if not decades) to accomplish, the alternative is for the United States to approach other countries individually to pursue multilateral action.

#### IV. RECOMMENDATIONS

This Part is divided into short-run and long-term recommendations surrounding the issues discussed in Part III of this article.<sup>81</sup> Hopefully these recommendations will encourage discussion and comment. The author's ultimate goal is to attempt to improve the chances of FATCA being a long-term success by greatly improving transparency surrounding offshore accounts held by U.S. taxpayers.

##### A. *Recommendations Important to the Short-run Success of FATCA*

###### 1. *Customer Due Diligence Procedures for Affiliated FFIs*

As discussed in Part II(B), the QI system had a major loophole in that a QI and its affiliates could select which customer accounts to include in the system. When developing FATCA, there was a clear need to require P-FFIs to address all accounts held by a P-FFI *and* its affiliates. However, as discussed in Part III(A), it was generally understood that requiring detailed customer due diligence of affiliated FFIs could be difficult until there is more multilateral agreement surrounding the appropriate customer due diligence procedures.

As a result, the IRS/Treasury should balance (i) the urge to write airtight rules surrounding customer accounts in affiliated FFIs versus (ii) the need to develop an operational rule prior to more multilateral agreement on the appropriate customer due diligence procedures. The approach should be balanced taking into consideration the following factors:

- The nature of the affiliate FFI's customer base,

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80. Informal discussions suggest most of the IRS's attention has been on implementing FATCA in the United States without much attention being paid towards educating other countries about joining with the United States to leverage the FATCA system. Hopefully, my information is incorrect.

81. There are many other FATCA issues, but this Article does not attempt to address them.

- Management representations surrounding the nature of accounts in the affiliated FFI and the procedures/controls in existence to avoid doing business with material U.S. customers, and
- The possibility that an external auditor would review a P-FFI's representations surrounding affiliated FFIs.

Existing IRS guidance has attempted to consider some of these factors, but the general operating presumption seems to be that affiliated FFIs will go through the same customer due diligence procedures as P-FFIs unless the affiliated FFIs can meet the very restrictive criteria for a "deemed compliant FFI."<sup>82</sup> Among the criteria is that the affiliated FFI does not have any business outside of its country of organization.

I agree the long-term goal of FATCA should be very detailed customer due diligence procedures for all customer accounts held by an affiliated FFI. However, as described in Part IV(B), the method for obtaining this long-term goal is to obtain better international agreement surrounding customer due diligence procedures. In the meantime, the IRS/Treasury should be more willing to rely on management's representations surrounding procedures/controls at affiliated FFIs.<sup>83</sup> In addition or as an alternative, IRS/Treasury should consider relaxing the deemed compliant FFI criteria to allow certain affiliated FFIs that operate cross-border to qualify.

## 2. *Passthru Payments*<sup>84</sup>

As summarized in Part III(B), the requirement to withhold on "other payments to the extent attributable to a withholdable payment" (i.e., referred to as passthru payments for this Article) has created major issues. Given these complications and given passthru payments were not part of the IRS's original conceptualization of FATCA, I am tempted to suggest the IRS/Treasury figure out a way to avoid adopting or enforcing the position.<sup>85</sup>

Unfortunately, the analysis is not so straightforward. In case you do not want to wade through Parts IV(A)(2)(a) and IV(A)(2)(b), I basically conclude the IRS/Treasury should err on the side of *not* implementing the passthru payment regime unless IRS/Treasury is *highly confident* it is administrable *and* will not have any material negative consequences. My suspicion is the IRS may struggle to meet these two criteria. One option that has been proposed is to adopt a fixed percentage for the portion of the passthru payment attributable to a withholdable payment.

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82. See I.R.S. Notice 2011-34, 2011-19 I.R.B. 765, at § III(B) (discussing "deemed compliant FFIs"); see also *id.* at § VI (discussing affiliated FFIs).

83. Reliance is warranted as long as the nature of the business supports such representation.

84. See *supra* note 58.

85. This could involve either obtaining a legislative change, or more likely a creative reading of the existing Internal Revenue Code provisions.

Assuming the IRS decides to retain the passthru payment concept, the IRS/Treasury should seriously consider a fixed percentage approach. It would be substantially more administrable and would likely result in more FFIs deciding to become P-FFIs. In the long-run, the solution is to obtain multilateral agreement from other major countries to require withholding on *all* payments from a P-FFI to a NP-FFI.<sup>86</sup>

a. Analytical Framework

First, the IRS needs to evaluate whether there is a potentially workable solution to the passthru payment issue. If not, its decision should be obvious.<sup>87</sup> If there is a potentially workable solution, but it is has the potential to create major administrative issues for FFIs, the IRS needs to balance the costs and benefits of implementing the solution with respect to FFIs.

- *Benefit*—The potential benefit is that the mere existence of the passthru payment rules could drive NP-FFIs to become P-FFIs. This would obviously be a good result. This could occur if FFIs on the fence decide they need to do business with P-FFIs, but do not want to suffer the passthru withholding. It could also occur if a material number of respected P-FFIs decide they will only do business with other P-FFIs and thus, NP-FFIs could become pariahs in the financial system.

My sense is that the first scenario will not be that common because FFIs will likely have NP-FFIs with which they can do business. As to the second scenario, I have heard some large respected FFIs are thinking of only doing business with other P-FFIs.<sup>88</sup> If this is the case, the passthru payment rules could actually drive certain FFIs to decide they want to be part of the club.

- *Cost*—The passthru payment rules have the potential to drive FFIs away from the FATCA system. This could occur if either (i) NP-FFIs decide they do not want to do business with P-FFIs because of the additional withholding, or more likely (ii) FFIs decide they do not want to suffer the administrative burden of determining passthru payments and all the other requirements of FATCA. Said differently, the passthru payment rules could be the proverbial straw that breaks the camel's back as a FFI is deciding whether to become a P-FFI. This observer believes there is a real risk the camel's back

86. NP-FFIs would be effectively excluded from the worldwide financial system unless they either (i) subject themselves to a 30% withholding tax, or (ii) decide to become a P-FFI. In order for this to occur, several major countries would need to agree in order to have the leverage to implement such a radical system.

87. Do not enforce the provision.

88. Personally, I am skeptical there will be many P-FFIs that ultimately refuse to do business with NP-FFIs. Tax and systems employees may be of such view, but once the business folks get involved, I suspect there will be less interest in cutting off revenue sources.

could be broken if the IRS/Treasury retains the pro-rata approach to passthru payments proposed in IRS Notice 2011-34.

In addition to evaluating the impact of the passthru payment rule on FFIs, the IRS/Treasury should attempt to evaluate the impact on U.S. tax cheats potentially investing in (i) P-FFIs, and (ii) NP-FFIs. In theory, the passthru payment rules should result in some additional withholding tax from these two categories of individuals. However, practically one wonders what the real world consequences might be.

- *U.S. Tax Cheats Investing in P-FFIs*—If a U.S. tax cheat is going to invest in a P-FFI, they will presumably (i) become recalcitrant and (ii) only invest in non-U.S. source assets so as to avoid 30% withholding on U.S. source income and gross proceeds. If this occurs, the passthru payment rules could re-characterize a portion of the foreign source payments to U.S. sources and result in additional U.S. withholding tax. However, the question is how will a U.S. tax cheat react to this possibility?

If the withholding tax is imposed on a relatively small portion of the payments, it is possible the U.S. tax cheat may decide to bear the withholding tax. However, given the withholding tax can potentially be imposed on gross proceeds, my suspicion is that U.S. tax cheats may decide to take their business to a NP-FFI. In addition, to the extent the IRS will likely be monitoring recalcitrant account holders, one suspects P-FFIs will not be anxious to have too many recalcitrants in their customer bases, especially if they have any U.S. indicia. Finally, if I were a U.S. tax cheat, I would worry about a P-FFI ultimately being more likely to turn-over my name to the IRS, than a NP-FFI.<sup>89</sup>

For all the above reasons, I don't believe the passthru payment rule will have much impact on U.S. tax cheats attempting to directly invest with P-FFIs. Rather, I believe U.S. tax cheats will want to avoid P-FFIs and only invest in NP-FFIs.

- *U.S. Tax Cheats Investing in NP-FFIs*—If a U.S. tax cheat is planning to invest in *non-U.S. assets* with a NP-FFI, the passthru payment rules would impose no direct withholding tax. However, if the NP-FFI wants to hedge its counter-party risk to the U.S. tax cheat, it needs to decide whether to do so by investing with another NP-FFI or investing with a P-FFI. If it chooses the P-FFI, it could suffer a withholding tax on a passthru payment. Thus, one would presume that

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89. For example, the United States may be able to make a treaty request to obtain the names of a P-FFI's customers that are recalcitrant *and* have U.S. indicia. Historically, treaty requests have required the requesting countries to have an individual's name and account information. However, the U.S. has recently been able to obtain information from Switzerland by just describing fact patterns in which it was interested (e.g., the UBS and Credit Suisse cases). If this approach spreads to other countries, U.S. tax cheats will likely want to avoid any financial institution with any sort of reporting responsibility to the United States.

a NP-FFI would want to hedge any risk with another NP-FFI, rather than a P-FFI.

If the U.S. tax cheat wants to invest in *U.S. assets* with a NP-FFI and the NP-FFI invests in U.S. assets, presumably when the dust settles the passthru payment rules will impose some withholding tax. This should occur in the blocker fact pattern discussed above and other similar fact patterns.

b. Passthru Payments Summary

In summary, there seem to be two major benefits of the proposed pro-rata passthru payment rule. First, because it is so administratively burdensome, it could cause certain P-FFIs to refuse to do business with NP-FFIs and recalcitrant customers. Second, it attempts to address the so-called blocker issue. The primary cost of the rule is that it is administratively complex and may result in many FFIs refusing to participate in FATCA because of the administrative difficulties.

Because IRS/Treasury has accumulated substantial information from their discussions with FFIs and others, they are in the best position to weigh the relative costs and benefits. However, I recommend IRS/Treasury err on the side of *not* implementing the passthru payment regime unless it is *highly confident* it is administrable *and* will not have any material negative consequences on the long-term success of FATCA. My suspicion is the IRS may struggle to meet these two criteria as the rule is currently proposed. Although it would be nice if the passthru regime could be made workable, it is likely not crucial to the long-term success of FATCA.<sup>90</sup> Rather, because of its complexity, it has the potential to do more harm than good in the short-run.<sup>91</sup>

One option that has been proposed is to adopt a fixed percentage for the portion of the passthru payment attributable to a withholdable payment. Assuming the IRS decides to retain the passthru payment concept, the IRS/Treasury should seriously consider a fixed percentage approach. It would be substantially more administrable and likely result in more FFIs deciding to become P-FFIs. Finally, if the IRS/Treasury can develop an alternative to addressing the blocker issue, it would be extremely helpful, even if it were only a short-run solution. One possibility might be to adopt an anti-abuse rule that specifically targets blocker entities. For example, if a P-FFI is determined to have been formed or availed of for the purpose of circumventing FATCA, the P-FFI would retroactively lose its P-FFI status and potentially be subject to other penalties.<sup>92</sup>

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90. For a discussion of what is needed to make FATCA a long-term success, see *supra* notes 93–101.

91. Depending upon how FFIs react, it is possible the passthru payment regime could cause FATCA to “crash and burn.” Given what is at stake, the IRS/Treasury should not risk this possibility.

92. In addition, if another P-FFI had knowledge of such activity, they could also be subject to various penalties or sanctions.



In the long-run, the solution is to obtain multilateral agreement from other major countries to require withholding on *all* payments from a P-FFI to a NP-FFI. In essence, NP-FFIs would be excluded from the worldwide financial system unless they either (i) subject themselves to a 30% withholding tax, or (ii) decide to become a P-FFI. For this to occur, several major countries would need to agree in order to have the leverage to implement such a radical system.

### B. *Recommendations Important to the Long-term Success of FATCA*

#### 1. *Unilateral vs. Multilateral Action*

In order to ultimately address offshore tax evasion by U.S. taxpayers, FATCA needs to be successful in the long-run. The effort to impose transparency on offshore accounts held by U.S. taxpayers (and other countries' taxpayers) is a marathon, not a sprint!

The key question is: What end result will indicate FATCA has been successful in the long-run? I believe the two key indicators will be:

- *The United States is Assured that Adequate Customer Due Diligence is Done by P-FFIs and Their Affiliates*—As discussed in Parts III(A) and IV(A)(1), there currently are issues with FATCA unilaterally attempting to force FFIs and their affiliates to perform detailed due diligence on their entire customer base.
- *The Investment Options Available to Offshore U.S. Tax Cheats are Very Limited*—Given a dedicated U.S. tax cheat can avoid FATCA by investing in non-U.S. assets with a NP-FFI, a key goal of the IRS/Treasury going forward should be to limit the investment opportunities for U.S. tax cheats.

There are two key variables surrounding investment options: (i) the number and quality of financial institutions, and (ii) the range of non-U.S. assets available to invest in. If ultimately U.S. tax cheats are relegated to investing in very small, disreputable financial institutions, *or* the assets available to invest in are severely limited, offshore tax evasion should be greatly reduced. If both occur,<sup>93</sup> offshore tax evasion should be effectively eliminated.<sup>94</sup>

There are two basic approaches the United States could use to accomplish both of these indicators:

- *Unilateral Action*—First, the United States could continue down the course of unilateral adoption of FATCA with the hope that the U.S. investment market is sufficiently large that substantially all FFIs will need to become P-FFIs. Although this is theoretically possible, it is

93. Tax cheats are relegated to investing in very small, disreputable financial institutions, *and* the assets available to invest in are severely limited.

94. Some diehard U.S. tax cheats may take to burying their money in the backyard, or pursuing other options (e.g. investing in diamonds), but as a practical matter the vast majority of U.S. tax cheats currently using offshore accounts will waive the white flag and agree to pay their U.S. taxes.

practically very unlikely.<sup>95</sup> For example, even if P-FFIs and their affiliates perform adequate due diligence, all a U.S. tax cheat needs to do is find one reasonably reputable NP-FFI and invest in non-U.S. assets with such NP-FFI. Given there are likely to be reasonably reputable FFIs that decide to be NP-FFIs, this is a real concern.

- *Multilateral Action*—Alternatively, the United States could pursue multilateral action to help accomplish both indicators. Multilateral action could take many forms. For example, the United States could work through the OECD to obtain a global consensus. However, such an effort could take many years<sup>96</sup> (if not decades) to accomplish. One alternative is for the United States to approach other major countries individually about jointly addressing offshore accounts. Again, there are various options.

The most limited option would be to pursue discussions with other major countries and attempt to reach agreement about the appropriate customer due diligence procedures to be performed.<sup>97</sup> If several major countries agreed on customer due diligence procedures, it could go a long way towards successfully addressing the customer due diligence issue in FATCA for affiliated FFIs.<sup>98</sup> Specifically, it could significantly strengthen the IRS's hand when attempting to force a FFI to perform detailed due diligence procedures on its entire customer base (i.e., FFIs and affiliated FFIs).

An additional major benefit from multilateral action would be to reduce the investment options for a U.S. tax cheat (i.e., reduce the number of (i) NP-FFIs and (ii) countries whose assets a U.S. tax cheat could invest). This could be accomplished by a multilateral FATCA system.<sup>99</sup>

95. Nevertheless, the IRS/Treasury needs to continue implementing FATCA so as to (i) effectively force U.S. tax cheats to invest in NP-FFIs, and (ii) create a model for other countries to hopefully follow. If the U.S. were to abandon FATCA, it would be a serious long-term setback to addressing offshore tax evasion both in the U.S. and the world.

96. See, e.g., Org. for Econ. Co-Operation and Dev. (OECD), *About the TRACE Group*, CENTRE FOR TAX POLICY AND ADMINISTRATION, <http://www.oecd.org/ctp/taxtreaties/aboutthetracegroup.htm> (last visited Feb. 14, 2012).

97. The IRS/Treasury may be able to piggy-back to a certain extent on the desire of developed countries to address anti-terrorist financing activities. Thus, there are both tax and non-tax reasons for attempting to strengthen customer due diligence procedures around the world.

98. See *infra* Part III(A).

99. It could also be accomplished through a bilateral exchange of information among countries. However, this author believes it is better for the IRS to receive information directly from the financial institution, rather than relying on another country to forward the information. Aside from administrative issues with interposing an intermediary, it would seem to be much easier to force FFIs to participate in a multilateral FATCA system than it will be to get countries with bank secrecy to participate in information exchange arrangements.

## 2. *What Might a Multilateral FATCA System Look Like?*

The easiest way to illustrate a multilateral system would be to explain what would happen if another country joined with the United States in implementing FATCA. Assume Country A decided to join the United States in its FATCA system. In such case, the following would result:

- If a FFI wanted to invest in either the United States or Country A, it would need to execute a FFI agreement with both the United States and Country A.
- The FFI would agree to identify customers from both the United States and Country A and report information on such customers to the appropriate country (i.e., the United States or Country A).

The United States would obtain three principle benefits:

- First, because a FFI would need to perform detailed due diligence on its customer base to identify both U.S. and Country A customers, it would mitigate some of the criticism currently applicable to FATCA (i.e., it is a unilateral approach that requires FFIs to perform an unreasonable amount of due diligence to identify the proverbial needle in the haystack—a U.S. customer).
- Second, for a FFI contemplating not participating in FATCA, it would effectively have to make a decision to not do business with both the United States and Country A. This is obviously a tougher decision than just boycotting the United States.
- And third, a U.S. tax cheat should effectively be prevented from investing in both U.S. and Country A source assets.

Country A would also receive substantial benefits. Specifically, it could leverage the desire of FFIs to do business in the United States. Said differently, if Country A tried to implement FATCA on its own, it is highly likely that a substantial number of FFIs would boycott Country A's stand-alone FATCA system. However, if Country A joins-up with the United States, it will be substantially more difficult for a FFI to boycott both the United States and Country A.

Although it would be ideal if all countries in the world agreed to join the United States' FATCA system, in reality, the United States likely only needs a few other major countries to participate in a multilateral FATCA regime to mitigate many of the issues being raised with the United States' unilateral adoption. Plus, as each additional country joins in a multilateral FATCA system, the number of investment opportunities available to a U.S. tax cheat would decline. Although there will always be some tax cheats that are willing to go to great lengths to avoid paying tax, one suspects as the number of countries participating in a FATCA type system increases, viable investment options will become few and far between.

## 3. *Would Countries Need to Agree to All Aspects of FATCA?*

In short, the answer is "no." The major aspects of FATCA include: (i) the requirement to perform due diligence on a FFI's entire customer base

2012]

OFFSHORE ACCOUNTS

497

(including affiliated FFIs) to identify the true owner of an account, (ii) the imposition of a 30% withholding tax if a customer is either recalcitrant or a NP-FFI, and (iii) the reporting of information to the resident country for resident customers.

Certainly, it would be helpful if all countries participating in a multi-lateral FATCA arrangement could agree on all three major aspects of FATCA. However, in the real world the chances of different countries agreeing on all aspects of FATCA are not high. Fortunately, agreement on all three aspects is not necessary for the United States to accomplish its goals. Rather, all that is needed is for the United States and other countries to agree on (i) a standard set of customer due diligence requirements to be performed by P-FFIs, and (ii) some stick to get FFIs to participate.

The imposition of a 30% withholding tax on payments to NP-FFIs could be the stick, but each country would be free to choose its own penalty to be applied to a NP-FFI. However, the penalty would need to have some teeth to it.

When it comes to reporting, there also could be flexibility as to (i) the content of the information, and (ii) the flow of the information.<sup>100</sup> In addition, although it would introduce complications, it may be possible to have some countries adopt a withholding regime, and others adopt a reporting regime.<sup>101</sup> Both the withholding and reporting regimes would need to be subject to an audit.

#### V. OVERALL CONCLUSION

The United States and foreign countries have made significant headway in the past several years addressing the use of offshore accounts to evade tax. The United States has benefited from whistleblowers and two very successful offshore voluntary compliance initiatives. FATCA was enacted to help give the IRS the long-term tools necessary to better combat offshore tax evasion by U.S. taxpayers.

However, because FATCA is a unilateral action by the United States, there are several major implementation issues surrounding FATCA, including how to (i) require detailed customer due diligence procedures for a FFI and its affiliates, (ii) implement the potentially very complicated passthru payment rules, and (iii) minimize the offshore investment opportunities for U.S. tax cheats (i.e., NP-FFIs).

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100. For example, instead of the FFI reporting information to the residence country (e.g., the U.S.), information could flow first from the FFI to the country where the FFI is located (i.e., source country), and then from the source country to the residence country. As described in note 89, *supra*, this is not my preferred flow of information, but it could be made to work if the source country is cooperative.

101. See Daniel Pruzin, *Financial Institutions: As U.S. Prepares Hammer, U.K., Germany Ready to Leave Swiss Banking Secrecy Intact*, Analysis & Perspective, Foreign Income (BNA) 198 DER J-1 (October 13, 2011) (describing recent withholding agreements between Switzerland, UK, and Germany). Given these agreements, this is an issue that needs to be further evaluated.

Because it is important that FATCA be successful in the long-run, Treasury is urged to use significant judgment when first implementing FATCA with respect to the following:

- *Customer Due Diligence for Affiliated FFIs*—In general, the current proposed guidance surrounding affiliated FFIs and deemed compliant FFIs may be too restrictive.<sup>102</sup> The IRS/Treasury should consider allowing certain affiliates of a P-FFI to use policies and procedures to demonstrate adequate due diligence on their customer base. Alternatively, the deemed compliant FFIs provision could be expanded to allow FFIs that operate cross-border to potentially qualify.
- *Passthru Payment Rules*—The current proposed passthru payment rules<sup>103</sup> are very complex, and likely unadministrable. The IRS/Treasury should be seriously considering either (i) not enforcing the rules, or (ii) adopting an alternative (e.g., a fixed percentage for determining the portion of a payment that is “attributable to a withholdable payment,” an anti-abuse rule aimed at blocker entities, or both). Given many FFIs will not make a decision whether to become a P-FFI until they fully understand the passthru payment rules, the Treasury needs to make decisions quickly.

In the long-run, IRS and Treasury could greatly increase the probability of FATCA’s success by actively discussing FATCA with other major countries.<sup>104</sup> The goal of such discussions should at a minimum be to agree on common customer due diligence procedures. Preferably, other countries would join the United States in administering a multilateral FATCA type system. Foreign countries would benefit greatly from using the United States’ leverage to effectively force FFIs to join the system. The United States would benefit from reducing the number of investment options available to tax cheats, and making recalcitrant account holders significantly less likely.

Finally, financial institutions worldwide should seriously consider attempting to help forge an international consensus. Currently, some financial institutions appear as though they are planning to resist efforts for increased transparency. Although financial institutions will clearly incur substantial costs from FATCA, those costs may pale in comparison to the costs that could be incurred over the next five to twenty years as other countries implement their own specific systems. It would be substantially cheaper for financial institutions if there is one global standard, rather than ultimately building separate FATCA type systems for each country.

102. See I.R.S. Notice 2011-34, 2011 I.R.B. 765, at § III(B) (discussing “deemed compliant FFIs”); see also *id.* at § VI (discussing affiliated FFIs).

103. See *id.* at § II.

104. If not already taking place, these discussions should be taking place in the very near future because it will take many years to reach agreement with other major countries.