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Changing Face of US's Foreign Account Tax Compliance Regime

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The purpose of this article is to provide a high level overview of the **changing landscape of foreign account tax compliance**, in light of United States taking a lead with the enactment of Foreign Account Tax Compliance Act ("**FATCA**") on March 1, 2010[1] and the subsequent issue of FATCA Regulations on February 8, 2012[2]. A discussion on this unique and innovative regime would be rendered futile, unless one discusses the provisions of FATCA, in light of the peculiarity of the US's citizenship based non-territorial tax regime.

Though at first blush it appears that this regime is far more over reaching and aggressive in its approach than its predecessor regime, an analysis of the events which lead to the passing of the FATCA Act allows us to appreciate the purpose behind the wide reach of the various provisions of this Act. The passing of this Act was indeed a **bold step taken by United States** in a rather undeveloped space of foreign account tax compliance and deserves all the kudos for leading the charge in this

> ***FATCA stands as an innovative regime in light of the peculiarity of the US's citizenship based non-territorial tax regime***

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[1] Reg-121647-10

[2] Pub. L. No. 111-147

space. Having said that, the ultimate test of this regime would lie in the implementation of similar provisions by major tax players in their respective jurisdiction.

1. Peculiarity of US's citizenship based system of taxation

At the outset, one must understand the US citizenship based tax regime, which may be regarded as one of the primary factors which lead to the introduction of a rather overreaching and extraterritorial FATCA mechanism to ensure foreign account tax compliance. Generally speaking,[3] **United States imposes taxes on the basis of citizenship**. Therefore, a US citizen is mandated to pay taxes on its worldwide income, irrespective of its length of stay in the United States. Even if the US citizen is not living in the United States for the entire calendar year, he is mandated to file returns and pay tax in the United States on his worldwide income by virtue of his citizenship.

This regime can be compared to other prevalent regimes existing in other parts of the world, wherein the tax residency of an individual is generally determined by the length of stay[4] or some other form of direct territorial nexus with a particular jurisdiction[5]. Thus, if an individual does not stay within a particular jurisdiction or does not have any form of territorial nexus/connection, he would not be considered a tax resident of that particular country.

In the light of the above discussion, it is apparent that there are **fundamental differences existing in US's citizen based system of taxation and the regimes prevalent in other parts of the world**. Thus, an effort has been made in this paper to discuss the various provisions of FATCA in the light of the peculiarity of US's citizenship based tax system.

2. Origin of FATCA

In order to get a correct perspective of the actual intent behind the introduction of the FATCA regime, one must fully appreciate and analyze the sequence of events which lead to the passing

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[3] US citizens and resident aliens are subject to tax on their worldwide income, regardless of source. Generally, foreign nationals may be considered as resident aliens if they hold green cards or if their physical presence in the United States is long enough to satisfy the substantial presence test. For purpose of this discussion, the imposition of US tax on resident aliens has been ignored, as this feature is similar to the ones existing in other jurisdiction around the world.

[4] Generally speaking United Kingdom taxes individual on basis of their residency or domicile. The residency in United States of an individual is determined by the number of days stay in a particular jurisdiction. Another example of a similar regime of taxation is India, wherein the residency of an individual is primarily determined on the basis of period of stay in India.

[5] France taxes individuals if their home, principal place of abode, professional activity or center of economic interest is located in France.

of this Act. These circumstances have been very lucidly explained in the paper written by J. Richard Harvey Jr. titled "*Offshore Accounts: Insider's Summary of FATCA and Its Potential Future*"[6]; and Carol Tello and Joan C. Arnold's article on "*Proposed FATCA Regulations Provide Much Relief though Administrative and Financial Burdens Still Remain*"[7]. The **factors leading to the ultimate passing of FATCA** were highlighted in these papers and the relevant ones have been summarized below:

- ***QI system being ineffective***

It was back in 2001 wherein a largely extra territorial compliance regime was conceptualized and implemented in the United States through the Qualified Intermediary ("QI") system. Before the conceptualization of this regime, the foreign account tax compliance was a largely unregulated sphere. As brought out by Richard Harvey in his paper[8], **before 2001 foreign financial institutions were neither required to collect any US tax documentation** about their clients (foreign and/ or US**) nor file information returns** with the Internal Revenue Services of the United States ("IRS"). It was, this vacuum of regulations which lead many US tax citizen/ residents investing in US source assets through foreign financial institutions.[9]

The **QI system** was the tax compliance regime which had existed before the introduction of the FATCA regime in 2010. It was the shortcomings of these regulations which ultimately lead to the passing of much more stringent and far reaching provisions of FATCA. Under the QI regime, US sought details from QIs (primarily being foreign financial institutions) of their customers. QIs were mandated to disclose all US source income of their US customers. However, as regards their foreign customers, there was a restraint in US's approach, being largely untested waters in the foreign account tax compliance space. The QI were permitted to keep the identity of their foreign (non-US) customers secret as long as the correct amount of US withholding tax was imposed.

Therein laid the shortcomings, which ultimately lead to the passing of the FACTA. Under the QI system, the thrust of the regulations were largely towards understanding the US source income of US customers and not finding out the beneficial owner of the income. This lead to a position where it was possible for US citizens to either **invest in foreign source income or set up foreign shell entities**, thereby orchestrating the existence of a foreign customer, and avoiding the purpose for which QI system was set up.[10]

[6] Villanova Law Review, Volume 57, Issue #3 (December 2011)
[7] Bulletin for International Taxation (April/ May 2012)
[8] Supra 6
[9] Ibid
[10] Supra 6

- ***LGT and UBS Scandals***

The success of the US Government in the UBS and LGT scandals in 2008 were also regarded as another major factor which led to the passing of FATCA. These scandals appeared to not only increase the political willingness of the US Government, but also **provided a substantial boost to the IRS to aggressively pursue and implement an effective administration of foreign tax accounts of US citizens.**

In the LGT scandal, German tax authorities had purchased customer account information from an employee at LGT, a bank in Liechtenstein.[11]It is believed that the IRS had received information on several US tax customers, and aggressively pursued action against them. Later in 2008, there was even a bigger scandal, linked with the Swiss Bank called UBS. The IRS issued a John Doe summons where the UBS was requested to disclose to the IRS all its US customers that had potentially been avoiding US tax. UBS refused to comply with the summons citing Swiss Bank secrecy law. With the mounting pressure of the US tax administration and the global community in general, UBS negotiated a settlement with the IRS.[12] By virtue of this, there was information of an **undisclosed number of UBS account holders was revealed to the US tax administration**.[13]

- ***US Senate Permanent Subcommittee on Investigation***

In 2009, US Senate Permanent Subcommittee on Investigation held **public hearing**, which received a lot of publicity and had a great media presence. At these hearings, many instances of US taxpayers avoiding tax by not reporting accounts held in foreign financial institutions were discussed in media gaze.[14] These public hearings created a lot of awareness of the various means used by US tax resident towards **evasion of tax** and generated a lot of public opinion

[11] See generally United States Senate Permanent subcommittee on Investigations, Tax Haven Banks and US Tax Compliance (2008), available at http://www.levin.senate.gov/imo/media/doc/supporting/2008/071708PSIReport.pdf.
[12] Deferred Prosecution Agreement at 3, 6 United States v. UBS AG. No. 09-60033-CR (S.D. Fla. 18 Feb. 2009)
[13] Ibid
[14] See generally United States Senate Permanent subcommittee on Investigations, Tax Haven Banks and US Tax Compliance (2008), available at http://www.levin.senate.gov/imo/media/doc/supporting/2008/071708PSIReport.pdf.

towards putting in place aggressive regulations to prevent the abuse of tax systems, to evade payment of US taxes.

3. Passing of FATCA

In the background of an ineffective QI regime and renewed political will, it was pretty evident that the new FATCA regime would adopt an aggressive and over-reaching mechanism which would **plug the various loopholes in the existing QI regime**. Further, with the world having their eyes on the US, in light of UBS and LGT scandal, the US sought to provide a guiding light for other tax policy makers and administrators around the world. Having said that, it must be borne in mind that the IRS authorities were fully aware that no system of foreign tax account compliance can be made fool proof without the coordination with other major players around the world. Thus, every effort would have to be made to ensure participation of these players in the implementation of FATCA, so as to make this is made a **multinational affair**, as compared to unilateral one.[15]

FATCA was the result of an ineffective QI regime and renewed political will

One must recognize that the US government understood that in order to fill in all the loopholes of the QI regime, one would be required to substantially **expand the extra territorial application of the compliance regime**. This end would be very difficult to achieve without an appropriately crafted, proverbial 'stick' in place to ensure the QI adequately comply with the regulations. In this background expansion of scope of the withholding regime was envisaged. Thus, if a foreign financial intermediary or non-financial foreign entity did not enter into an agreement with the IRS, it would be subject to a withholding tax at the tax of thirty percent on both US source income and gross proceeds from the sale of an asset that produces US source income. Thus, it was envisaged that this thirty percent withholding tax penalty was to **ensure appropriate disclosures and compliance by foreign institutions** as well. This approach was a very unique and crafty way of approaching the problem, as IRS capitalized on its territorial right of withholding to ensure that the FATCA regime had the relevant teeth to follow through on its extra territorial reach.

The minimalistic compliance when it came to foreign customers under the previous QI regime gave way to all-encompassing compliance procedures concerning these foreign institutions with

[15] The Joint statement issued by US Treasury Department along with France, Germany, Italy, Spain and the United Kingdom is an example of US Government's effort to make the implementation of FATCA a multinational process. The Joint Statement is available on http://www.treasury.gov/press-center/press-releases/Documents/020712%20Treasury%20IRS%20FATCA%20Joint%20Statement.pdf

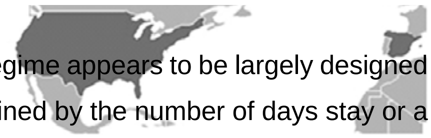
the passing of FATCA. There was a change in approach adopted by this regime, wherein there was clear mandate for intermediaries to find out the beneficial owner, thereby looking through foreign shell entities. Lastly, the intermediaries were mandated to review all customer accounts within the affiliated group to identify US taxpayers.[16]

4. Analysis of FATCA provisions

As highlighted above, the various provisions of FATCA appear to be particularly extra-territorial in their ambit, especially since heavy burden has been imposed on the non-US financial institution acting as intermediaries, over which US has no direct access or sovereignty. One wonders whether there would ever be a situation where all the foreign financial institutions were to take a position of non-compliance with the regime, and regard the excess thirty percent withholding tax as a cost of borrowing in the US. In other words, if other major tax players do not put in place a regime similar to the FATCA regime, US may be singled out as being the only country with such a regime. The foreign financial institutions would then be much more reluctant to comply with such a regime, and they may regard the thirty percent withholding tax as cost of borrowing itself. If this were to happen, **the increase in the cost of borrowing may augment a reduction of investment into the US**.

In the light of the aforementioned discussion, the US Government has correctly identified the need for other major tax players to put in place a similar tax compliance regime as well. However, it must be borne in mind that the motivation and political will of other countries may not be similar to those of the US. This may be largely because of the inherent difference in tax systems existing in the US as compared to other countries. As highlighted above, US has a citizen based tax system and the FATCA regime appears to be largely designed in this context. In a country in which tax residency is determined by the number of days stay or a form of territorial nexus, the direct access and sovereignty over the tax payer itself may reduce the potential need to put in place a compliance regime for foreign institution. Having said that, this does not mean that the other countries would not benefit from putting in place such a system, but **relative advantage to US is much more than that of other countries.**

Other major tax players need to put in place a similar tax compliance regime



One other aspect which must be borne in mind is that if other countries were to put in place a foreign tax compliance regime which is not based on US's FATCA. Such a situation may not go too well with the foreign financial institutions, as they would have **different compliance**

[16] Supra 6

obligations imposed by countries around the world, in addition to already existing compliance regime of the country of residence.

5. Conclusion

In-spite of the several limitations of the new face of foreign account tax compliance, one must commend the United States Government and IRS for taking such a bold position in this space. One must also appreciate the very active and crucial role played by them in trying to create global corporation in this space and thereby removing the compliance vacuums existing in the present mode of tax compliance. To conclude, **only time will stand judge to the effectiveness of this innovative but aggressive and overreaching new regime** of foreign account tax compliance.