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## The FATCA Provisions of the Hire Act: Boldly Going Where No Withholding Has Gone Before

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## COMMENT

### **THE FATCA PROVISIONS OF THE HIRE ACT: BOLDLY GOING WHERE NO WITHHOLDING HAS GONE BEFORE**

*Melissa A. Dizdarevic\**

*In an effort to crack down on offshore tax evasion, the United States is implementing a new set of information reporting and withholding requirements on foreign banks and other foreign entities. These provisions, known as the Foreign Account Tax Compliance Act (FATCA) provisions of the Hiring Incentives to Restore Employment (HIRE) Act, require thirty percent withholding of the entity's U.S.-source income, unless they disclose specific information regarding their customers' identities and account balances. While this may be an effective way to force foreign institutions into compliance, it also raises questions about how it will function within existing tax reporting systems, where the function of withholding serves a materially different purpose.*

*The FATCA reporting and withholding provisions depart from the norm of using withholding as a tax enforcement mechanism, and instead use it as a coercive compliance measure. This Comment looks to current domestic and international withholding systems as a point of comparison for this new regime. By examining the objectives and operation of these existing systems as compared to those of FATCA, it becomes clear that withholding income serves a drastically different purpose. Existing systems utilize withholding as a means of ensuring that taxes will be paid, while FATCA implements it as a way to force foreign banks to comply with a set of reporting requirements. Considering this is the first time withholding appears to be used in this way, it is prudent to ask whether this is a desirable use of withholding in our current international taxation system. This Comment posits that, without significant revision to account for conflicts arising with pre-existing obligations, converting the accepted concept of withholding into a drastically different punitive measure is both undesirable and unacceptable.*

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## INTRODUCTION

“Tentative Resolution Set in UBS Tax Evasion Case,”<sup>1</sup> “Deutsche Bank Settles Tax Shelter Case for \$553.6 mln,”<sup>2</sup> “HSBC Clients Scrutinized in U.S. Tax Evasion Probe,”<sup>3</sup> “Swiss Banker Pleads Guilty in U.S. Tax Case.”<sup>4</sup> These are just a few of the recent headlines from some of the most high-profile U.S. offshore tax evasion cases.<sup>5</sup> As part of the recent “crackdown” on tax evasion under the Obama Administration,<sup>6</sup> charges

1. Lynnley Browning, *Tentative Resolution Set in UBS Tax Evasion Case*, N.Y. TIMES, Aug. 1, 2009, at B2.

2. *Deutsche Bank Settles Tax Shelter Case for \$553.6 mln*, INT'L BUS. TIMES, Dec. 29, 2010, <http://www.ibtimes.com/articles/96076/20101229/deutsche-bank-settles-tax-shelter-case-for-553-6-mln.htm#>.

3. Clare Baldwin & Joe Rauch, *HSBC Clients Scrutinized in U.S. Tax Evasion Probe*, REUTERS, July 6, 2010, available at <http://www.reuters.com/article/idUSTRE66608720100707>.

4. Brent Kendall, *Swiss Banker Pleads Guilty in U.S. Tax Case*, WALL ST. J., Dec. 23, 2010, at C3.

5. These articles focus on offshore tax evasion cases. See *infra* Part I.E. For the most high-profile domestic income tax evaders, see *Top 10 Tax Dodgers*, TIME, [http://www.time.com/time/specials/packages/article/0,28804,1891335\\_1891333,00.html](http://www.time.com/time/specials/packages/article/0,28804,1891335_1891333,00.html) (last visited Apr. 20, 2011).

6. STAFF OF J. COMM. ON TAXATION, 111TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2011 BUDGET PROPOSAL 206–336

were brought against a number of foreign banks—UBS, LGT Bank of Liechtenstein,<sup>7</sup> and Deutsche Bank, among others—for helping Americans dodge their taxes by using fraudulent tax shelters.<sup>8</sup> After these cases were brought, however, it became clear that the problem might better be solved by prevention rather than by prosecution. This is how the Foreign Account Tax Compliance Act (FATCA) was born.<sup>9</sup> FATCA seeks to improve detection and further discourage tax evasion by implementing a new reporting and withholding system.<sup>10</sup> While these goals are laudable, these new requirements are not without their consequences.<sup>11</sup>

Since their enactment in March 2010, the FATCA provisions of the Hiring Incentives to Restore Employment (HIRE) Act have raised a number of questions as to how the requirements will function within existing information reporting and tax withholding systems. Practitioners have questioned how the provisions will apply to their clients, noting the difficulties and burdens associated with pre-existing obligations under Qualified Intermediary (QI) agreements, and benefits agreed to under income tax treaties.<sup>12</sup> The IRS has also sought suggestions from the legal and tax communities to better offer guidance as to how the provisions will operate with existing systems when they go into effect.<sup>13</sup> Because the provisions are not yet in effect, many questions remain as to how they will operate.

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(Comm. Print 2010), available at <http://www.jct.gov/publications.html?func=startdown&id=3704> (noting the various strategies by which international taxation can be better enforced); U.S. DEP'T OF THE TREASURY, UPDATE ON REDUCING THE FEDERAL TAX GAP AND IMPROVING VOLUNTARY COMPLIANCE 9–12 (2009), available at [http://www.irs.gov/pub/newsroom/tax\\_gap\\_report\\_final\\_version.pdf](http://www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf) (explaining that underreporting of offshore income is a top priority of the Obama Administration and that the comprehensive approach includes legislative proposals, improved tax information exchange agreements, and increased enforcement); Lynnley Browning, *I.R.S. Shift to Combat International Tax Evasion*, N.Y. TIMES, Aug. 5, 2010, at B3 (describing recent IRS changes geared toward stronger focus on international tax evasion and third-party reporting).

7. 156 CONG. REC. S1745 (daily ed. Mar. 18, 2010) (statement of Sen. Carl Levin) (explaining recent tax evasion problems with such foreign banks, and emphasizing the need for legislation such as the Foreign Account Tax Compliance Act (FATCA)).

8. See, e.g., *Deutsche Bank Settles Tax Shelter Case for \$553.6 mln*, *supra* note 2.

9. The term “FATCA” is used colloquially to refer to the new legislation enacted as a part of the Hiring Incentives to Restore Employment (HIRE) Act, and which now comprises Chapter 4 of the Internal Revenue Code (IRC). See *infra* note 145.

10. See *infra* Part II.

11. See *infra* Part III.

12. See, e.g., Alison Bennett, *Tax Legislation: Dozens of Stakeholders From Around Globe Raise Concerns on FATCA Regime*, 29 Tax Mgmt. Wkly. Rep. (BNA) 1535 (Nov. 22, 2010); Micah Bloomfield & Dmitriy Shamrakov, *The Thirty Percent Solution?: FATCA Provisions of the HIRE Act*, STROOCK SPECIAL BULLETIN, Apr. 21, 2010, at 1; Dean Marsan, *FATCA: The Global Financial System Must Now Implement a New U.S. Reporting and Withholding System for Foreign Account Tax Compliance, Which Will Create Significant New Exposures—Managing This Risk (Part I)*, TAXES, July 2010, at 27; Morrison & Foerster, *IRS Issues Initial Guidance on FATCA Withholding and Reporting*, TAX TALK, Oct. 2010, at 2.

13. See I.R.S. Notice 2010-60, 2010-37 I.R.B. 329 (providing some guidance as to grandfathered obligations and filing, and requesting comments on what provisions need further guidance).

This Comment examines the potentially problematic effects of the FATCA information reporting and withholding requirements on foreign institutions. With the taxation goals of equity and efficiency in mind, this Comment focuses on FATCA's information reporting requirements and penalty withholding tax in comparison to some of the reporting and withholding systems already in place in domestic and international taxation. More specifically, this Comment looks to the goals, methods, and policies of these systems, as compared to those of FATCA, to examine how the burdens and policies in force will change. One example of such anticipated change arises in the context of withholding. Under FATCA, unlike other withholding regimes, the tax withheld is not for the purpose of securing payment of the taxpayer's liability, but rather as a penalty for failure to report. This and other examples of uncommon usage of information reporting and withholding will show how FATCA uniquely crosses the policies of information reporting and withholding, and undercuts the policies upon which income tax treaties are made.

Part I focuses on the background against which the FATCA provisions were enacted. This includes an explanation of the problem of offshore tax evasion, and how withholding and information reporting systems have attempted to combat it. In addition, Part I provides a brief explanation of the goals and functions of income tax treaties that have modified the standard international taxation rules. Part II looks to the FATCA provisions themselves—the goals and the way the provisions are intended to apply. Part III then examines some of the problems involved in applying FATCA considering current U.S. withholding and information reporting systems. The first section of Part III considers withholding as a measure to coerce foreign financial institutions (FFIs) into agreements with the IRS. The second section of Part III analyzes whether the FATCA reporting requirements are an efficient use of information reporting. The third section examines the potentially dangerous reduction in treaty benefits to which many FFIs may be entitled. This Comment suggests that, without further revision or guidance to account for these difficulties, the use of withholding as a punitive instrument is unwarranted.

### I. THE TAX ENFORCEMENT ENTERPRISE

In the United States, collection of federal income tax is based on a system of “voluntary compliance.”<sup>14</sup> This means that initially it is up to the taxpayer, rather than the government, to determine and pay the appropriate amount of tax.<sup>15</sup> However, the naturally competing goals of taxpayers

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14. *Flora v. United States*, 362 U.S. 145, 176 (1960) (holding that “[o]ur system of taxation is based upon voluntary assessment and payment, not upon distraint”).

15. *See* Rev. Rul. 2007-20, 2007-14 I.R.B. 863. “Voluntary compliance” thus does not mean that paying income tax is voluntary or optional. *Id.* Rather, the requirements of filing tax returns are well established in the Internal Revenue Code. I.R.C. §§ 6011(a), 6012(a), 6072(a) (2006); *see also* Treas. Reg. § 1.6011-1(a) (1960). Failure to meet these requirements will have consequences. *See, e.g.*, *United States v. Tedder*, 787 F.2d 540, 542 (10th Cir. 1986) (stating that “although Treasury regulations establish voluntary compliance

seeking to minimize their tax liability, and the government looking to maximize revenue, complicate tax enforcement.<sup>16</sup> The Internal Revenue Service (IRS) has thus long been concerned with the enforcement of taxation so as to minimize noncompliance.

Noncompliance with tax obligations can occur in three ways—non-filing, underpayment, and underreporting of taxes due.<sup>17</sup> These three components form the basis for the estimated tax gap, or the amount of tax that should have been paid but was not.<sup>18</sup> As of 2006, the tax gap was estimated at around \$345 billion.<sup>19</sup> In an effort to close this gap, the IRS has used various methods and mechanisms tailored to the nature of the problem. For example, punishment for nonfiling comes in the form of civil and criminal penalties.<sup>20</sup> However, the problems of underpayment and underreporting are not so easily solved.<sup>21</sup> Because underpayment is typically seen as a result of failure to set aside sufficient funds, the IRS has implemented a system of withholding at the source.<sup>22</sup> In so doing, the time between the taxpayer receiving the payment and having to pay the tax is eliminated, so there is less opportunity to fail to pay.<sup>23</sup> The problem of underreporting<sup>24</sup>

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as the general method of income tax collection, Congress gave the Secretary of the Treasury the power to enforce the income tax laws through involuntary collection”).

16. JANE G. GRAVELLE, CONG. RESEARCH SERV., R40623, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 1 (2010). Taxpayers minimizing their liability is considered “avoidance” and is encouraged. *Id.* Avoidance usually refers to legal reductions in taxes, whereas evasion refers to illegal reductions. *Id.* However, it is often the case that tax reductions are considered “avoidance” when they are actually “evasion.” *Id.* For more on this distinction, and how it tends to blur, see *id.*

17. *Tax Gap Facts and Figures*, INTERNAL REVENUE SERV., at 1, [www.irs.gov/pub/irs-utl/tax\\_gap\\_facts-figures.pdf](http://www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf) (last visited Apr. 20, 2011); see also Eric Toder, *What Is The Tax Gap?*, 117 TAX NOTES 367 (2007).

18. Toder, *supra* note 17, at 367. The tax gap has been defined as “[t]he difference between the tax that taxpayers should pay and what they actually pay on a timely basis.” *Tax Gap Facts and Figures*, *supra* note 17, at 1 (emphasis omitted). In other words, it is the amount by which taxpayers have failed to file and pay taxes on time. See Lily Kahng, *Investment Income Withholding in the United States and Germany*, 10 FLA. TAX REV. 315, 322–23 (2010).

19. This figure represents the gross tax gap, while \$290 billion is the estimated net gap for 2001. Toder, *supra* note 17, at 367.

20. I.R.C. § 6651 (detailing penalty computations for an individual’s failure to file a tax return or pay tax); *id.* § 7203 (making it a misdemeanor to fail to file a tax return, supply certain information, or pay taxes due, punishable by fine and no more than one year imprisonment).

21. This is not to say that underpayment and underreporting are not subject to such penalties once they have been discovered. See *id.* § 6654 (penalties for an individual’s failure to pay income tax); *id.* § 6652 (penalties for failure to file certain information returns).

22. Historically, withholding was trumpeted as a way to help taxpayers pay their taxes, but it was noted in House hearings that withholding was really a way to get payment from those with little experience in setting aside finances to meet their obligations. See Charlotte Twright, *Evolution of Federal Income Tax Withholding: The Machinery of Institutional Change*, 14 CATO J. 359, 370–71 (1995).

23. *Id.*

24. One third of the tax gap, or approximately \$109 billion, is the result of individuals who underreport their income taxes. Toder, *supra* note 17, at 367.

has mainly been framed as an issue of unequal information.<sup>25</sup> That is, while the taxpayer is in the position to know the transactions he was involved in, the government seeks to obtain this information to ensure appropriate tax payment after the fact.<sup>26</sup> The resolution to this problem has primarily been through information reporting.<sup>27</sup>

It is evident from the information about the tax gap that voluntary compliance is insufficient to secure tax compliance. Congress has thus sought to reinforce the system with the assistance of third parties.<sup>28</sup> Third parties are integral in the operation of withholding at the source and information reporting.<sup>29</sup>

In sum, there are two main areas in which the IRS has sought to enforce tax compliance: first, in the voluntary nature of the payment of taxes, by withholding at the source of certain payments to eliminate the possibility of nonpayment; and second, by ensuring that the government has another source of information to compare against the taxpayer's filings.

#### A. *Taxpayer Evasive Action and Offshore Accounts*

Noncompliance has been an especially pronounced problem in international taxation. A number of circumstances unique to international taxation make it an attractive way to avoid—and evade—taxes. This is evidenced by the estimation that the amount of evaded international income tax is between \$40 billion and \$70 billion each year.<sup>30</sup>

There are several reasons offshore financial centers are conducive to tax evasion.<sup>31</sup> First, the tax laws and philosophies of different countries can differ considerably.<sup>32</sup> Some countries do not impose an income tax because it is contrary to their policy; others levy a low rate of income tax, encouraging foreigners to receive and keep income there.<sup>33</sup> Second, foreign laws regarding banking secrecy differ as well.<sup>34</sup> Countries most conducive

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25. Leandra Lederman, *Reducing Information Gaps To Reduce the Tax Gap: When Is Information Reporting Warranted?*, 78 FORDHAM L. REV. 1733, 1735 (2010).

26. *Id.* (citing Danshera Cords, *Tax Protestors and Penalties: Ensuring Perceived Fairness and Mitigating Systemic Costs*, 2005 BYU L. REV. 1515, 1543–44).

27. *Id.*

28. Lederman, *supra* note 25, at 1737–38.

29. *See id.*

30. GRAVELLE, *supra* note 16, at 1 (citing Joseph Guttentag & Reuven Avi-Yonah, *Closing the International Tax Gap*, in ECON. POLICY INST., BRIDGING THE TAX GAP: ADDRESSING THE CRISIS IN FEDERAL TAX ADMINISTRATION 99, 101 (Max B. Sawicky ed., 2005)).

31. Richard K. Gordon, *On the Use and Abuse of Standards for Law: Global Governance and Offshore Financial Centers*, 88 N.C. L. REV. 501, 516 (2010).

32. *Id.*

33. *Id.*

34. *Id.* (citing RICHARD A. GORDON, TAX HAVENS AND THEIR USE BY UNITED STATES TAXPAYERS—AN OVERVIEW 15, 17 (1981)). Banking secrecy laws are beneficial to taxpayers seeking to avoid their resident country's tax liability because banks would not be required to give their account holder's information to a foreign government requesting it. Even in circumstances where banks are required to hand over such information—as per an information exchange agreement between the two nations—the information would be limited to that specifically requested. Authorities in the United States would have no way of

to tax evasion will typically have banking secrecy laws that safeguard the identity of the account holder.<sup>35</sup> Thus, a difficulty arises when one country seeks information that would require a foreign institution to violate its own country's laws. Some countries are known as "tax havens" precisely because of such low tax rates and banking secrecy laws.<sup>36</sup>

There are several common ways to avoid taxation by using such low tax, secretive jurisdictions. Some are as simple as a taxpayer opening an account in a foreign bank.<sup>37</sup> When a third party diverts payments to this account, the interest income goes untaxed and the taxpayer does not report it to the domestic jurisdiction.<sup>38</sup> Similarly, the income could simply be unreported in the taxpayer's country of residence, and the low tax jurisdiction would not have to report it.<sup>39</sup>

### *B. Harnessing Compliance Through Withholding at the Source*

#### 1. What Does It Mean To Withhold?

The question of tax compliance has, in many cases, been put to rest by the implementation of the "devastatingly effective" mechanism of withholding at the source.<sup>40</sup> Withholding is a relatively simple concept. It requires the payor to retain a part of the payment and hand it over to the tax authorities, and is applied against the payee's tax liability.<sup>41</sup> In the common system of wage withholding,<sup>42</sup> for example, this involves the employer holding back a part of the employee's wages, and the amount withheld is then considered tax already paid by the employee.<sup>43</sup>

Modern wage withholding began during World War II, when revenue needs were high and volatile.<sup>44</sup> Withholding acted as an attractive way to ensure collection from "new taxpayers, who had no experience filing a tax return or putting funds aside for the payment of taxes."<sup>45</sup> One year after its introduction, praising taxpayer convenience and patriotic sacrifice,

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knowing of the existence of such taxable income, let alone what information to request, or as to which taxpayers. *Id.* at 516–18.

35. *Id.* at 516 (citing GORDON, *supra* note 34, at 15, 17).

36. GORDON, *supra* note 34, at 3–5.

37. Gordon, *supra* note 31, at 516.

38. *Id.*

39. *Id.* at 516–18.

40. Kahng, *supra* note 18, at 322 (citing I.R.C. § 3402 (2006)); *see also* Twight, *supra* note 22, at 359 (noting that "withholding is the paramount administrative mechanism enabling the federal government to collect, without significant protest, sufficient private resources to fund a vastly expanded welfare state").

41. Kahng, *supra* note 18, at 322.

42. *See* I.R.C. §§ 3401–3406 (regarding provisions of collection of income tax at the source of wages); *see also id.* § 3403 (making the employer liable for payment of the tax deducted and withheld).

43. Charlotte Twight describes withholding as the "extraction of income taxes from taxpayers' pay envelopes before salaries were paid." Twight, *supra* note 22, at 369.

44. Kahng, *supra* note 18, at 322–23 (citing Richard L. Doernberg, *The Case Against Withholding*, 61 TEX. L. REV. 595, 599–603 (1982)).

45. *Id.*

Congress enacted comprehensive wage withholding.<sup>46</sup> In enacting wage withholding, Treasury officials insisted that the withholding requirement would not impose an additional tax burden, but instead would merely relate to the time and method of payment.<sup>47</sup> However, in recognition of a time-value problem where the government was getting the benefit of using the dollars before the tax was actually due, Treasury officials recommended that the Bureau of Internal Revenue be required to pay interest on amounts refunded under the new law.<sup>48</sup>

This is precisely how the current withholding system works. In the event that more tax has been withheld than required,<sup>49</sup> the government credits or refunds the balance, with interest.<sup>50</sup> Though the government is granted a forty-five day “grace period,” any refunds made after that period must include interest.<sup>51</sup> This provision was presumably intended to account for the time-value problem of the taxpayer being unable to reap the benefits of having the money in his pocket, money that was instead in the hands of the government.

## 2. Current Withholding Systems

Withholding has proven to be the single most effective enforcement mechanism for collecting taxes on income from labor.<sup>52</sup> The tax gap for amounts subject to withholding has consistently been measured at less than one percent.<sup>53</sup> By contrast, the percentage of income not reported for amounts not subject to withholding, such as interest and dividends, is much higher.<sup>54</sup>

Despite the early resistance to withholding measures, after fifty years of its implementation, people are accustomed to wage withholding and most

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46. *Id.* at 323.

47. Twight, *supra* note 22, at 374.

48. *Id.*

49. See I.R.C. § 6401 (2006) (defining overpayment of tax).

50. *Id.* § 6402 (reserving authority for the Secretary to make credits against a taxpayer's liability or refunds of the balance, taking into account interest due); see also *id.* § 6414 (setting extent of credits and refunds to withholding agents or employers for overpayment); Treas. Reg. § 301.6402 (2009) (detailing regulations for the administration of credits and refunds).

51. I.R.C. § 6611 (setting guidelines for when interest is due on credits and refunds); see also *id.* § 6621 (setting rate of interest to be paid).

52. Kahng, *supra* note 18, at 322.

53. *Id.* at 323 (citing INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, PUBL'N 1415 (REV. 4-96), FEDERAL TAX COMPLIANCE RESEARCH: INDIVIDUAL INCOME TAX GAP ESTIMATES FOR 1985, 1988, AND 1992, at 8 tbl.3, 15 tbl.7 (1996)). Professor Kahng also explains that this data was collected as part of a program that has been discontinued, and consequently this information is not available for recent years. *Id.* at 323 n.37. The program was revived and renamed, and the National Research Program published tax gap data for 2001, where the tax gap for income subject to withholding appears to be in a similar range. *Id.* at 322 (citing *Tax Gap Facts and Figures*, *supra* note 17, at 11).

54. Twight, *supra* note 22, at 386 (noting that as of 1980, where withholding was in place, there was only a two to three percent rate of underreporting, but that rate increased to nine to sixteen percent underreporting when payments were not subject to withholding).

no longer question it as a legitimate way to enforce tax compliance.<sup>55</sup> Furthermore, because withholding has proven so effective in reducing the gap between the liabilities taxpayers owe and the taxes they actually pay, its use within the U.S. taxation system has been growing. The withholding model for domestic income taxation previously mentioned provides the basic framework for the operation of withholding at the source in all of these systems.<sup>56</sup> That is, the taxable portion of the payment is held by the payor and counts towards the amount of tax owed by the taxpayer.<sup>57</sup> Essentially, it is an advance payment of tax before the taxpayer has a chance to use the money, or in this case, before the taxpayer has a chance to choose not to pay the tax owed.

The withholding system of tax on foreign corporations and nonresident aliens is known as Chapter 3 of the Internal Revenue Code.<sup>58</sup> It is directed at the withholding agents that pay income to foreign persons, and details the persons responsible for withholding, the types of income subject to withholding, and the information return and tax return filing obligations of withholding agents.<sup>59</sup> This chapter is the foreign tax equivalent of the income tax withholding for U.S. persons,<sup>60</sup> and serves a similar purpose in that it preemptively withholds a certain percentage of tax due on U.S.-source income in order to prevent tax avoidance by underreporting.<sup>61</sup>

Not all types of income are subject to such withholding, however. Section 871 of the Internal Revenue Code provides for the types of payments that are exempt from Chapter 3 taxation.<sup>62</sup> These include interest on deposits, percentages of any dividend paid by certain domestic corporations,<sup>63</sup> income from foreign banks, and certain dividends paid by foreign corporations.<sup>64</sup>

The IRS has also implemented a system of backup withholding that acts as a safeguard when a taxpayer has failed to report some information and has been notified of that failure.<sup>65</sup> Backup withholding requires the payor to withhold a certain percentage of withholdable payments if: the payee fails to give his Taxpayer Identification Number (TIN) to the payor; the Secretary of the Treasury notifies the payor that the TIN is incorrect; there has been notified underreporting; or if the payee fails to certify properly that certain payments are not subject to withholding.<sup>66</sup> Backup withholding

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55. *Id.* at 392.

56. *See supra* notes 40–43 and accompanying text.

57. *See supra* notes 41–43 and accompanying text.

58. I.R.C. §§ 1441–1443, 1445, 1446 (2006).

59. *Tax Withholding Types*, INTERNAL REVENUE SERV. <http://www.irs.gov/businesses/small/international/article/0,,id=104910,00.html> (last visited Apr. 20, 2011).

60. *See supra* notes 42–43 and accompanying text.

61. *See* I.R.C. §§ 3501–3510.

62. *Id.* §§ 871(i), 1441(c).

63. *See id.* § 871(i)(2) (referring to § 861(c) for requirements that must be met to be a qualifying domestic corporation).

64. *Id.* § 871(i); *see also id.* § 1441(c).

65. *Id.* § 3406.

66. *Id.* § 3406(a).

applies only to residents and resident aliens.<sup>67</sup> Thus, this system provides a sort of assurance that certain amounts will be withheld when the taxpayer has already been notified of filing flaws.

Currently, our tax system still does not impose withholding on most investment income.<sup>68</sup> Professor Lily Kahng notes that this is not all that surprising, considering the history of objections to the extension of withholding by banks and corporations.<sup>69</sup> Kahng explains that in 1982, Congress did try to enact dividend and interest withholding.<sup>70</sup> However, banks and corporations complained that this withholding would unfairly shift the cost of collecting the tax from the government to them.<sup>71</sup> After raising these complaints and organizing “protest mail” to Congress, in 1983, the dividend and interest withholding measure was repealed retroactively without ever having taken effect.<sup>72</sup>

In the areas where it has been implemented, therefore, withholding has been an effective way to bring taxpayers into compliance by taking control of the amounts owed before they are actually paid to the taxpayer. On the other hand, as it stands today, withholding on some investment income has been rejected primarily for policy reasons like unfairly shifting the costs of collecting tax from the government to banks.

### C. Using Information Reporting To Close the Information Gap

One of the core problems in enforcing tax laws comes from asymmetric information.<sup>73</sup> That is, the taxpayer has knowledge of the relevant taxable transactions he is engaged in, and the government seeks to discover that information after the fact.<sup>74</sup> In order to equalize this asymmetry, the government requires information from both the taxpayer and a third party<sup>75</sup>—usually an employer, financial institution, or other intermediary.<sup>76</sup> Unlike self-reporting alone,<sup>77</sup> this appears to be effective in increasing

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67. This is true except when the status of the payee as a foreign person or U.S. person cannot be determined, in which case the payee is assumed to be a U.S. person subject to backup withholding. *Tax Withholding Types*, *supra* note 59.

68. For an argument that the system should impose withholding on investment income, see Kahng, *supra* note 18.

69. *Id.* at 324–26.

70. *Id.* at 325–26.

71. *Id.*

72. *Id.* Professor Kahng contends that “adopting withholding on domestic investment income” might be an important part to “the solution of the international tax evasion problem” because it would signal commitment from the United States to other nations. *Id.* at 341.

73. Lederman, *supra* note 25, at 1735.

74. *Id.* (citing Cords, *supra* note 26, at 1543–44).

75. *Id.* at 1735–36.

76. Steven A. Dean, *The Incomplete Global Market for Tax Information*, 49 B.C. L. REV. 605, 620 (2008).

77. Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 698 & n.13 (2007) (quoting Charles P. Rettig, *Nonfilers Beware: Who’s That Knocking at Your Door?*, J. TAX PRAC. & PROC., Oct.–Nov. 2006, at 15, 15–16); see also Dean, *supra* note 76, at 620 (“When third-party information capable of

compliance.<sup>78</sup> This is so for two reasons: first, it gives the government a way of verifying the taxpayer's returns, making noncompliance easier to catch; second, because taxpayers are aware that the government receives this information, they have little reason to falsify returns and so they report more honestly.<sup>79</sup> Thus, in seeking to close the information gap, the U.S. has implemented a number of information reporting systems.<sup>80</sup>

This section highlights two of the information reporting systems created to equalize the asymmetry with respect to foreign accounts and transactions: the Report of Foreign Bank and Financial Accounts (FBAR)<sup>81</sup> and the Qualified Intermediary system.<sup>82</sup> It then introduces Professor Leandra Lederman's six-factor efficiency test for information reporting systems.<sup>83</sup> These current sources of foreign account information, along with the indicators of efficient information reporting systems, will shed light on the obligations and benefits of FATCA's new requirements.<sup>84</sup>

### 1. Raising the FBAR

Until FATCA was enacted, and until it becomes effective, the IRS has primarily been tracking offshore accounts through a system of voluntary disclosure on the part of the taxpayer.<sup>85</sup> Enacted under the Bank Secrecy Act (Title 31),<sup>86</sup> FBAR requires the taxpayer<sup>87</sup> to report annually any

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verifying that reported by taxpayers is not available . . . self-reporting becomes far less reliable.”).

78. See Lederman, *supra* note 77, at 697–98 (noting that the use of third parties has been successful in achieving tax compliance, with a net misreporting percentage of only 4.5% (citing Rettig, *supra* note 77, at 15–16)).

79. See Dean, *supra* note 76, at 620 & n.99; see also Lederman, *supra* note 77, at 697 (likening third party information reporting to “red light cameras, provid[ing] information to the government . . . that the taxpayer knows the government is receiving”).

80. See, e.g., I.R.C. §§ 6011, 6041–6042, 6049, 6111 (2006) (requiring various types of taxpayer and third-party information reporting). Professor Leandra Lederman details several other new and proposed third-party information reporting systems; these include reporting basis in securities transactions, reporting sales on online auction sites, and even the reporting of gifts by donees. See Lederman, *supra* note 25, at 1742–59.

81. See *infra* notes 85–93 and accompanying text.

82. See *infra* notes 94–107 and accompanying text.

83. See *infra* notes 113–22 and accompanying text.

84. See *infra* Part III.B.

85. In an ABA Section of International Law teleconference about the second Offshore Voluntary Disclosure Initiative, the question of whether FATCA is simply the new Report of Foreign Bank and Financial Accounts (FBAR) was answered in the negative; FATCA requires reporting of *all* foreign assets, and not just foreign *accounts* as required by FBAR. Furthermore, because FATCA is codified under a different title than FBAR, the enactment of FATCA will not displace taxpayers' obligations under FBAR. Audio recording: Teleconference on 2011 Offshore Voluntary Disclosure Initiative and Update on the Report of Foreign Bank and Financial Accounts (FBAR) Guidance, held by the ABA Section of International Law (Mar. 16, 2011) (on file with *Fordham Law Review*).

86. See 31 U.S.C. § 5314 (2006) (requiring individuals to report identities and relationships of parties involved in transactions with foreign financial entities); 31 C.F.R. §§ 103.24–27 (2010) (detailing persons and transactions subject to FBAR reporting); see also Mark Muntean, *Mark Muntean on the Perils of the Foreign Bank Account Reporting Rules*, 2009 EMERGING ISSUES 3726 (LEXIS), June 16, 2009.

foreign accounts exceeding \$10,000 (in the aggregate).<sup>88</sup> As previously mentioned, however, self-reporting standing on its own is ineffective.<sup>89</sup> Consequently, even with severe civil and criminal penalties for failure to comply,<sup>90</sup> these reporting requirements were ignored for years.<sup>91</sup>

Enforcement of the FBAR is on the rise, however, and has been heralded as “vital . . . not only in carrying out criminal and tax investigations, but also in conducting intelligence activities to protect against international terrorism.”<sup>92</sup> In its ongoing effort to enforce FBAR compliance, the Financial Crimes Enforcement Network (FinCEN) continues to issue regulations intending to prevent taxpayers from avoiding compliance.<sup>93</sup>

## 2. The QI Continuum

In 2000, the IRS initiated the QI program to further enhance the information reported about foreign bank accounts.<sup>94</sup> QIs are foreign intermediaries (usually financial institutions) that have entered into a withholding agreement with the IRS.<sup>95</sup> The program was created with the intent of balancing the government’s multiple concerns—including having a system to routinely report income and withholding of the proper amounts, administering treaty benefits, meeting the obligations of information exchange agreements, and promoting foreign investment in the U.S.<sup>96</sup> Because of their direct relationship with account holders, QIs were seen as being in the unique position to collect the appropriate information and help the government achieve these goals.<sup>97</sup>

The system operates on a voluntary agreement between the financial institution and the IRS.<sup>98</sup> The QIs withhold and report the appropriate

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87. This includes U.S. citizens and residents, as well as some foreign persons. See Muntean, *supra* note 86.

88. See 31 U.S.C. § 5314; 31 C.F.R. § 103.27(c); see also Muntean, *supra* note 86. The obligation to file the report is triggered when a taxpayer checks the “yes” box on the IRS Form 1040, which asks whether the taxpayer has an interest in a foreign financial account. Muntean, *supra* note 86.

89. See *supra* notes 77–78 and accompanying text.

90. 31 U.S.C. §§ 5321–5322; see also Muntean, *supra* note 86.

91. See Marsan, *supra* note 12, at 63–64.

92. Hale E. Sheppard, *Evolution of the FBAR: Where We Were, Where We Are, and Why It Matters*, 7 HOUS. BUS. & TAX L.J. 1, 2–3 (2006).

93. See Amendment to the Bank Secrecy Act Regulations—Reports of Foreign Financial Accounts, 76 Fed. Reg. 10234 (proposed Feb. 24, 2011) (to be codified at 31 C.F.R. pt. 1010).

94. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-08-99, TAX COMPLIANCE: QUALIFIED INTERMEDIARY PROGRAM PROVIDES SOME ASSURANCE THAT TAXES ON FOREIGN INVESTORS ARE WITHHELD AND REPORTED, BUT CAN BE IMPROVED 3 (2007); Gary S. Wolfe, *FATCA: Qualified Intermediary Reporting Requirements*, IRS TAX AUDIT NEWS (July 23, 2010), <http://gswlaw.com/irsblog/category/fatca/>.

95. Treas. Reg. § 1.1441-1(e)(5)(ii) (2010); see also Wolfe, *supra* note 94.

96. U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 94, at 9–10.

97. *Id.* at 12 (noting that the direct relationship between a Qualified Intermediary (QI) and account holders “may increase the likelihood that the QI will collect adequate account ownership information and be able to accurately judge whether its customers are who they claim to be”).

98. *Id.* at 10.

amount of tax on income from the United States heading to offshore persons.<sup>99</sup> This entails determining the kind and amount of income, applying treaty benefits, and then calculating, withholding, and reporting these amounts to the IRS.<sup>100</sup> Though it seems like a great burden on the financial institutions, these institutions do receive a significant benefit in exchange for their cooperation: they may keep their client list private.<sup>101</sup> By contrast, nonqualified intermediaries (NQIs) must disclose their clients' identities if they wish to be eligible for treaty benefits or other exemptions.<sup>102</sup> Thus, under this system, the QIs are incentivized by the ability to retain the privacy of their customers' identities, while the government benefits by receiving the correct amount of tax owed.

In their study of the strengths and weaknesses of the QI program, the Government Accountability Office (GAO) found that its features do provide "some assurance" that foreign intermediaries calculate and withhold the proper amount of U.S. tax.<sup>103</sup> The GAO report explains, however, that because the majority of the income leaving the United States goes through U.S. withholding agents, rather than QIs, identification issues arise from the fact that these entities are not subject to the same identity verification processes.<sup>104</sup> Additionally, both U.S. withholding agents and QIs were often reporting transactions in unknown jurisdictions and payments to unknown recipients.<sup>105</sup> In these situations, instead of withholding the default thirty percent, it was found that only two to three percent was withheld.<sup>106</sup> The GAO recommended that the IRS determine why these entities failed to withhold the appropriate amount for payments to unknown jurisdictions, and take appropriate steps to recover the amounts due.<sup>107</sup>

The QI program appeared to be on the right track, incentivizing banks to withhold and report accurate amounts by allowing them to retain the

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99. *Id.*

100. *Id.* The treaty benefits in question are those that reduce the percentage of tax owed. The determination of eligibility for treaty benefits is often a complicated process. Because treaty benefits are based on country of residence, QIs receive documentation from their clients declaring their residency. *Id.* These might be passports, national health cards, or other qualifying documents under the "know your customer" rules established in the applicable jurisdiction. *Id.* If sufficient documentation is not presented, the QI presumes that the client is ineligible and backup withholding would be imposed. *Id.* But this is regulated separately from typical nonresident alien income and withholding, *id.*, because the backup withholding provisions typically only apply to residents and resident aliens. *See supra* note 67 and accompanying text.

101. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 94, at 11.

102. *Id.*

103. *Id.* at 33.

104. *Id.* (noting that U.S. withholding agents might rely on self-certified identity information forwarded by QIs and NQIs for their customers, and NQIs may not have rigorous processes for identifying account holders, resulting in a problem of unaudited documentation for those claiming treaty benefits).

105. *Id.* Additional complaints about the QI program related to the IRS processing of the data received. *Id.*

106. *Id.*

107. *Id.* at 34.

privacy their clients so desired.<sup>108</sup> The weaknesses identified by the GAO, however, were not adequately repaired in the years to follow, and abuses of the privacy incentive and the persistence of the information gap paved the way for the current “crackdown” on offshore tax evasion.

### 3. Assessing Information Reporting Systems

Not all information reporting systems are the same. As we have seen, systems like the FBAR that rely solely on taxpayers’ self-reporting have a tendency to be unreliable.<sup>109</sup> Those like the QI program, while having a degree of “assurance” because of third party verification, still left loopholes that allowed transactions to go to “unknown jurisdictions.”<sup>110</sup> Professor Lederman analyzed information reporting systems to discover what makes these systems efficient.<sup>111</sup> Because information reporting imposes costs on the reporting party, she contends, it is not equally effective in all situations.<sup>112</sup> In her analysis, Lederman identified six factors that are indicative of whether third-party information reporting will be efficient and effective.<sup>113</sup>

The first factor concerns the nature of the parties’ relationship, and questions whether the reporting party and the taxpayer are arm’s length parties.<sup>114</sup> This is important because information reporting tends to be more successful where there is a small chance of collusion.<sup>115</sup> Lederman also notes that systems are even more successful where reporting parties receive a tax benefit that increases with the amount reported.<sup>116</sup> Second, Lederman explains, information reporting is more likely to be efficient where bookkeeping infrastructure already exists.<sup>117</sup> Third, Lederman looks to a centralization aspect; that is, an information reporting system will be more efficient where the number of parties reporting is exceeded by the number of parties on which they report.<sup>118</sup> Fourth, Lederman explains that “complete” reporting is required for an effective system since all necessary information must be provided in order to match the third party’s report with the corresponding amounts on the taxpayer’s return.<sup>119</sup> The fifth factor identified is the availability of few other alternatives to reporting in order to enforce the tax payment.<sup>120</sup> Lastly, Lederman looks to how much reporting

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108. *Id.* at 12–13 (describing the facets of the QI system that provided “assurance that tax is properly withheld and reported”).

109. *See supra* Part I.C.1.

110. *See supra* Part I.C.2.

111. *See* Lederman, *supra* note 25, at 1736.

112. *See id.* (“[I]t matters who the reporters are, what they are reporting about, and how much information they include.”).

113. *See id.*

114. *See id.* at 1739.

115. *See id.* (explaining that chances of collusion are high when the parties are related).

116. *See id.*

117. *See id.* at 1740.

118. *See id.*

119. *See id.*

120. *See id.* at 1740–41.

on the proposed third party would contribute to the tax gap.<sup>121</sup> This is because information reporting systems are most efficient where the amount at stake is great enough to justify the costs of administration of information returns.<sup>122</sup>

Though Lederman does not apply these factors to assess the efficiency of FATCA's information reporting requirements, she notes that the factors are just as applicable to systems "addressing cross-border transfers."<sup>123</sup> These factors will be applied to FATCA in Part III, and will highlight some of the ways in which FATCA differs from the systems Lederman describes.<sup>124</sup>

#### D. Agreements Open Frequencies for Tax Information

Apart from withholding and information reporting, the United States has taken part in a number of treaties designed to increase the sharing of taxpayer information so that tax laws may be enforced. This section outlines the typical traits of such agreements and their place in the analysis of FATCA as a new enforcement mechanism.

Though the United States purports to have authority to assert universal taxing jurisdiction (that is, over all individuals on all income worldwide), it has chosen to limit its taxation to U.S. persons' worldwide income and to U.S. source payments to foreigners.<sup>125</sup> Even with this limitation, the possibility of double taxation still exists between the U.S. and the foreign entity's resident country. In order to avoid the problems of double taxation resulting from two countries asserting jurisdiction over the same person or transaction, the United States has entered into tax treaties.<sup>126</sup>

In the absence of an income tax treaty, the United States imposes a thirty percent withholding tax on all payments to foreign entities or persons.<sup>127</sup> But this entails the problem of potential double taxation—the payment is taxed once when leaving the United States, and taxed again as income in the "destination" country.<sup>128</sup> Accordingly, nations reciprocally reduce tax rates so that the same income is not taxed twice.<sup>129</sup>

In addition, there are typically provisions for mutual exchange of information among nations regarding payments so that tax evasion is curbed. However, some countries' banking secrecy laws make them less willing to subvert their own laws to assist the United States in implementing its taxation regime.<sup>130</sup> Thus, information exchange

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121. See *id.* at 1741. For more on the tax gap statistics, see *supra* notes 17–19 and accompanying text.

122. See Lederman, *supra* note 25, at 1741.

123. See *id.* at 1736 n.15.

124. See *infra* Part III.B.

125. See PAUL R. MCDANIEL ET AL., INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 178 (5th ed. 2005).

126. See *id.*

127. *Id.*

128. *Id.*

129. *Id.*

130. This is especially so in cases where the other country's tax law has a different premise than the U.S. tax law does. *Id.*

provisions are lacking because they often require the United States to request information regarding specific persons, when the information that would allow them to know what to ask for is, by the terms of the agreement, unknown.<sup>131</sup> This is why the Organization for Economic Co-operation and Development (OECD) has issued model tax treaties and model Tax Information Exchange Agreements (TIEAs).<sup>132</sup>

There are certain characteristics common to U.S. tax treaties. First, there is typically a reduction in, or exemption from, tax on a reciprocal basis; the country of source will usually cede jurisdiction (in whole or in part) to the country of residence.<sup>133</sup> In addition, treaties seek to remove the possibility of double taxation in order to reduce barriers to investment in the United States by foreign country residents.<sup>134</sup> Finally, the treaties make procedures to improve the administration of tax laws, to settle tax issues, and to provide for the exchange of information.<sup>135</sup>

### E. The Federation in Trouble

The IRS has for many years been concerned about jurisdictions with favorable bank secrecy laws seen as “fostering tax avoidance and abuse.”<sup>136</sup> This issue was brought to the forefront with the case against the Union Bank of Switzerland (UBS) for conspiring to defraud the U.S. tax system by impeding IRS investigations.<sup>137</sup> UBS was accused of “us[ing] a variety of secrecy tricks to help U.S. clients open foreign bank accounts and hide millions of dollars in assets from U.S. tax authorities.”<sup>138</sup> The United States alleged that some UBS documents indicated that there were 52,000 Swiss accounts owned by U.S. persons that had not been disclosed to the IRS.<sup>139</sup> These accounts were estimated to contain about \$18 billion.<sup>140</sup>

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131. See generally Richard E. Andersen, Analysis of U.S. Income Tax Treaties (RIA) ¶ 24.01[1].

132. See *Tax Information Exchange Agreements (TIEAs)*, OECD CENTRE FOR TAX POL'Y & ADMIN., [http://www.oecd.org/document/7/0,3746,en\\_2649\\_33767\\_38312839\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/7/0,3746,en_2649_33767_38312839_1_1_1_1,00.html) (last visited Apr. 20, 2011). The Organization for Economic Co-operation and Development (OECD) has thirty-four member countries as part of its forum for measuring and analyzing data about economic, social, and environmental change. The OECD uses this information to predict future trends and to make policy recommendations to governments and other organizations around the world. See About the Organization for Economic Co-operation and Development, OECD, <http://www.oecd.org> (follow “About” hyperlink).

133. MCDANIEL ET AL., *supra* note 125, at 178.

134. *Id.*

135. *Id.*

136. *Payments Directed Outside the United States—Withholding and Reporting Provisions Under Chapters 3 and 4*, 915-3d Tax Mgmt. Portfolio (BNA) § XXIX(B) (2010) [hereinafter *Payments Directed Outside*], available at TMFEDPORT No. 915 s XXIX (Westlaw); see also GORDON, *supra* note 34, at 3, 15.

137. See *Payments Directed Outside*, *supra* note 136, at § XXIX(B); see also *United States v. UBS AG*, No. 09-20423-CIV, 2009 WL 2241122, at \*1 (S.D. Fla. July 7, 2009) (order denying motion to compel disclosure).

138. 156 CONG. REC. S1745 (daily ed. Mar. 18, 2010) (statement of Sen. Carl Levin).

139. *Id.*

140. *Id.*

The case ended in a settlement.<sup>141</sup> In the settlement agreement, “UBS admitted that it had participated in a scheme to defraud the United States of tax revenues, paid a \$750 million fine, and agreed to stop opening accounts that are not disclosed to the IRS.”<sup>142</sup>

Since then, the IRS has identified foreign withholding and reporting as a Tier I (i.e., high risk) issue.<sup>143</sup> In response to these problems, and in seeking to close the tax gap, the Obama Administration has undertaken a multifaceted approach to “crack down” on tax evasion.<sup>144</sup> Among the legislative proposals intended to combat the loopholes left open from the tax treaties and QI reporting requirements were the Chapter 4 withholding and reporting requirements, otherwise known as FATCA.

## II. FATCA’S MISSION AND TACTICS

The FATCA provisions<sup>145</sup> were enacted as a new approach to solving the unique enforcement problems presented by international taxation.<sup>146</sup>

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141. As part of the settlement, UBS was required to report income and other information about U.S. clients. See Settlement Agreement, United States v. UBS AG, No. 09-20423-CIV (S.D. Fla. Aug. 19, 2009), available at [http://www.irs.gov/pub/irs-drop/bank\\_agreement.pdf](http://www.irs.gov/pub/irs-drop/bank_agreement.pdf); see also I.R.S. News Release IR-2009-75 (Aug. 19, 2009), available at <http://www.irs.gov/newsroom/article/0,,id=212124,00.html>. In addition, the IRS announced a voluntary disclosure program for U.S. persons who had not filed FBAR reports or reported income from foreign accounts. Lynnley Browning, *14,700 Americans Tell I.R.S. of Foreign Accounts*, N.Y. TIMES, Nov. 18, 2009, at B1. By the end of this program, over 14,700 persons had disclosed their secret foreign bank accounts, and 7500 agreed to “repatriate the assets and pay back taxes and interest as well as reduced penalties.” *Id.*

142. 156 CONG. REC. S1745. Interestingly, Switzerland’s federal administrative tribunal determined that UBS did not have to give the IRS information regarding some of the accounts under the settlement agreement. See *Swiss Court Halts Release of Some UBS Account Holder Data*, J. ACCT. (Jan. 25, 2010), <http://www.journalofaccountancy.com/Web/20102540.htm>. While the question of the bank’s obligations under different nations’ conflicting laws is certainly an interesting and controversial one, it is outside the scope of this Comment.

143. See *Payments Directed Outside*, supra note 136, at § XXIX(B). The IRS ranks the riskiest transactions within the Large Business and International (LB&I) Division through a tiering system. See Issue Tiering - LB&I, INTERNAL REVENUE SERV., <http://www.irs.gov/businesses/corporations/article/0,,id=200567,00.html> (last visited Apr. 20, 2011). Those transactions identified as Tier I “require[] a continued level of coordination across the enterprise” and are usually identified as such because they “[p]ose the highest compliance risk across multiple LB&I Industries and generally include large numbers of taxpayers, significant dollar risk, substantial compliance risk, or are high visibility.” *Id.*

144. See supra note 6 and accompanying text.

145. These new foreign reporting and withholding provisions were originally introduced as FATCA in both houses of Congress in October 2009. See Foreign Account Tax Compliance Act of 2009, S.1934, 111th Cong.; see also *Payments Directed Outside*, supra note 136, at § XXIX(C). After some significant revisions, which included delaying the effective date to January 1, 2013, and including a “grandfather” exception for existing obligations, the House of Representatives passed the bill in December 2009. See *Payments Directed Outside*, supra note 136, at § XXIX(C). The “grandfather” exception refers to a clause that generally exempts certain transactions that exist before the new law takes effect. See BLACK’S LAW DICTIONARY 767 (9th ed. 2009). The provisions were finally signed into law on March 18, 2010, under Title V of the HIRE Act. Hiring Incentives to Restore Employment Act of 2010, Pub. L. 111-147, 124 Stat. 71. The HIRE Act gives tax benefits to employers who hire certain previously unemployed workers. See *id.* §§ 101–102.

Earlier measures had failed in adequately detecting and deterring offshore tax evasion<sup>147</sup> and left enough gaps to allow such grand schemes as seen in the UBS case.<sup>148</sup> FATCA is intended to fill these gaps by taking a more active approach to information reporting, and thus creating a better system of detection, with great penalties to act as deterrents.<sup>149</sup> Despite the obvious benefits of taking such a hard and fast approach to battling offshore tax evasion, efficacy is not the only concern; important foreign policy and economic policy choices are also implicated in this complex issue.<sup>150</sup> The objectives of the provisions, as well as their application, give some indication of how they will affect U.S. international tax enforcement. The following sections describe the purpose of the provisions.

#### A. FATCA's Prime Objective

The principal goal of the FATCA provisions, as with any tax enforcement system, is to raise revenue.<sup>151</sup> An estimated \$100 billion in revenue is lost annually to offshore tax evasion.<sup>152</sup> More specifically, however, FATCA seeks to “detect, deter and discourage”<sup>153</sup> evasion of U.S. taxes through the use of foreign accounts and investment vehicles.<sup>154</sup> Because detection of evasion was one of the main downfalls of pre-FATCA tax enforcement, increased reporting requirements are designed to achieve a more integrated system of information so evasion can be more readily ascertained.<sup>155</sup> This is because under the workings of existing treaties and

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This act intends to “help put Americans back to work” and “foster economic growth.” See 156 CONG. REC. S1745. The FATCA provisions were enacted as offsetting provisions to fund these exemptions. See Hiring Incentives to Restore Employment Act § 501 (falling under Title V which is entitled “Offset Provisions”). The withholding and information reporting provisions discussed in this Comment are only some of the provisions enacted under Title V to combat offshore tax evasion. Other provisions include, *inter alia*, requiring disclosure from U.S. taxpayers with foreign assets, the presumption that foreign trusts have a U.S. beneficiary in certain circumstances, and requiring the treatment of dividends from U.S. stock as income for non-U.S. persons. See *id.* §§ 511–522, 531–535, 541; see also 156 CONG. REC. S1745. However, a detailed discussion of these provisions is outside the scope of this Comment. The FATCA provisions that are the focus of this Comment comprise what is now Chapter 4 of the IRC. See Hiring Incentives to Restore Employment Act § 501 (to be codified at I.R.C. §§ 1471–1474).

146. See generally GORDON, *supra* note 34 (describing characteristics of other nations' tax systems that foster American tax evasion through offshore accounts).

147. International Tax Review, *Chapter 4 of the FATCA: Implementation Issues, Q&A*, BRIGHTTALK (Dec. 16, 2010), <http://www.brighttalk.com/webcast/23955&LS%3DEMS465283>.

148. See *supra* Part I.E.

149. See 156 CONG. REC. S1745; see also International Tax Review, *supra* note 147.

150. See *infra* Part III.

151. International Tax Review, *supra* note 147 (noting that FATCA intends to “recoup needed revenue”); see *supra* note 145 and accompanying text.

152. ORG. FOR ECON. CO-OPERATION AND DEV., PROMOTING TRANSPARENCY AND EXCHANGE OF INFORMATION FOR TAX PURPOSES: A BACKGROUND INFORMATION BRIEF 2 (2010), available at <http://www.oecd.org/dataoecd/26/28/44431965.pdf>.

153. International Tax Review, *supra* note 147.

154. Vlad Frants, *FATCA Provisions of the HIRE Act: Possible Effects on International Disclosure Norms*, A.B.A. SEC. OF TAX'N NEWSQUARTERLY, Summer 2010, at 12, 12–13.

155. See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 94, at 1.

information exchange agreements, it is often the case that information must be requested about specific persons or accounts.<sup>156</sup> Without proper knowledge, the U.S. tax authorities cannot know what information to specifically request.<sup>157</sup> Thus, one of FATCA's primary goals is to aid in early detection of offshore tax evasion.

In addition to aiding detection, FATCA seeks to deter future evasion of U.S. taxes.<sup>158</sup> This is accomplished not by giving FFIs an incentive to report, but instead by giving them a *disincentive* for *failure* to report on their U.S. account holders.<sup>159</sup> The "steep penalty" of thirty percent withholding for nondisclosure<sup>160</sup> discourages FFIs from engaging in the kind of evasion-aiding behavior seen in the UBS case.<sup>161</sup>

Increased efficiency in detection of evasion and discouraging banks from using secrecy to aid evasion of U.S. taxes are thus the primary objectives of FATCA.<sup>162</sup> The provisions are geared to effectuate these results, albeit in an interesting new way.<sup>163</sup> In so doing, however, they effectively ignore established policies underlying the pre-FATCA international taxation system and depart significantly from the "traditional" and typical usage of information reporting and withholding.<sup>164</sup>

### B. Resistance Is Futile: FATCA's Strategic Design

FATCA's operation is two-pronged, consisting of a reporting requirement component, and a penalty withholding component.<sup>165</sup> These prongs are uniquely linked in that the withholding penalty is contingent on the reporting requirements being met.<sup>166</sup> Essentially, FATCA requires a withholding agent to deduct and withhold a thirty percent tax on any withholdable payment made to an FFI<sup>167</sup> or non-financial foreign entity (NFFE),<sup>168</sup> unless certain reporting requirements are met.<sup>169</sup> By having the

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156. See *supra* notes 130–32 and accompanying text.

157. See *supra* notes 130–32 and accompanying text.

158. International Tax Review, *supra* note 147.

159. See *infra* Parts II.B, III.B.

160. 156 CONG. REC. S1745 (daily ed. Mar. 18, 2010) (statement of Senator Carl Levin).

161. See *id.*; see also *supra* Part I.E.

162. Marsan, *supra* note 12, at 38.

163. See *infra* Parts II.B, III.A.

164. See *infra* Part III.

165. Marsan, *supra* note 12, at 40–45.

166. *Id.* at 40–41.

167. "Foreign financial institution" (FFI) is defined as any financial institution that is a foreign entity, including those that accept deposits in the ordinary course of a banking or similar business, as a substantial portion of its business, holds financial assets for the account of others, or is engaged primarily in the business of investing, reinvesting or trading in securities. I.R.C. § 1471(d)(4)–(d)(5) (West 2010).

168. "Non-financial foreign entity" is defined as any foreign entity that is not a financial institution, but excepts corporations whose stock is regularly traded on an established securities market, any foreign governments, international organizations, foreign central banks of issue, and any class of payments identified as "posing a low risk of tax evasion," among others. *Id.* § 1472(c)–(d).

169. The institution is required to report the name, address, taxpayer identification number (TIN) of the account holder, the account number, the account balance, and often the

information come from the foreign institutions holding the accounts (or owners in the case of NFFEs), the IRS would be able to verify the information from the taxpayers by using the information provided by the institution holding the account.

There are several ways an FFI or NFFE can comply with the new regulations. The first is to enter into an agreement with the Secretary to provide all necessary information about their U.S. accounts or substantial U.S. owners.<sup>170</sup> By taking this route, the FFI can avoid the thirty percent withholding so long as it continues to comply.<sup>171</sup> Second, the FFI can be deemed “nonparticipating” by not entering into such an agreement, and instead be withheld upon.<sup>172</sup> However, this does not relieve the FFI of its reporting obligations.<sup>173</sup> Third, the FFI may choose to be withheld upon rather than withhold on payments to recalcitrant account holders<sup>174</sup> and nonparticipating FFIs.<sup>175</sup> This means that the withholding would not only apply to payments to those parties, but would require the FFI to waive any rights under a treaty with respect to amounts deducted and withheld under the election.<sup>176</sup> Finally, the FFI can elect to be subject to the same reporting requirements as a U.S. financial institution.<sup>177</sup> If it makes this election, the institution would be subject to Form 1099 reporting, but would not have to provide the account balance or value, or gross receipts and

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gross receipts and gross withdrawals or payments from the account. *Id.* § 1471(c)(1); see Hiring Incentives to Restore Employment (HIRE) Act: Law, Explanation & Analysis (CCH) ¶ 305 [hereinafter HIRE Act]. The Treasury and IRS intend to issue regulations detailing the reporting of annual gross receipts and withdrawals for FFIs that do not currently track such data. See I.R.S. Notice 2011-34, at 35–36 (Apr. 8, 2011), available at <http://www.irs.gov/pub/irs-drop/n-11-34.pdf>. The regulations will likely include gross dividends, gross interest, other income, and gross proceeds from sales of property, to be determined according to the rules of the jurisdiction in which the FFI is located. See *id.* at 35–38.

170. I.R.C. § 1471(b)(1).

171. *Id.* § 1471(a)–(b).

172. *Id.* § 1471(b)(3).

173. HIRE Act, *supra* note 169, at 5.

174. See I.R.C. § 1471(b)(3). “Recalcitrant account holder” is defined as any account holder that fails to comply with reasonable requests for the required information or that fails to provide a waiver of any foreign law that would prevent the reporting of the requested information. I.R.C. § 1471(d)(6). This provision was intended to provide relief for FFIs that are unable to collect the necessary information to comply with the reporting requirements. I.R.S. Notice 2011-34, at 19. However, it is not intended to provide a “permanent substitute for collecting and reporting information with respect to U.S. accounts.” *Id.* Thus, the IRS is still considering what repercussions should apply in the case of long term recalcitrant account holders, including potentially cutting off FFI Agreements if there are still too many recalcitrant account holders after a reasonable period of time. *Id.* The concern of choosing to be withheld upon instead of reporting the required information is reminiscent of the “loophole” seen in QI agreements, where QIs were simply reporting payments to unknown jurisdictions without withholding the proper amounts. See *supra* notes 105–07 and accompanying text.

175. I.R.C. § 1471(b)(3).

176. *Id.*

177. *Id.* § 1471(c)(2).

withdrawals from the account.<sup>178</sup> The primary factor encouraging the foreign entities to report, however, is still the avoidance of withholding.

### 1. FATCA's Withholding System

One of the biggest criticisms of FATCA—but also the most compelling reason for FFIs to enter into the desired information reporting agreement—is the type of payments that are withheld upon. Like Chapter 3 (also known as “substantive” withholding), the FATCA provisions also withhold upon payments such as interest, dividends, wages, and rents.<sup>179</sup> Unlike the substantive tax, however, FATCA imposes withholding on gross proceeds from the sale or disposition of interest-producing properties from sources in the United States.<sup>180</sup> This includes U.S. bonds, stocks, and other debt instruments.<sup>181</sup> Thus, these provisions impose a penalty tax on amounts that would not otherwise be subject to tax.

FATCA is not intended to impose an additional tax,<sup>182</sup> but it does impose considerable burdens that make it appear like an additional tax. This is primarily because of the types of payments subject to the withholding, but also due to its credit and refund provisions. Like the Chapter 3 credits and refund provisions,<sup>183</sup> if there has been an overpayment of tax in accordance with the substantive tax, the foreign entity may be entitled to a refund.<sup>184</sup> Indeed, these provisions are intended to function in the same manner as those under Chapter 3.<sup>185</sup> In addition, they are intended to be consistent with U.S. obligations under income tax treaties,<sup>186</sup> and therefore allow for credits and refunds for amounts overpaid if the taxpayer is eligible for treaty benefits. This works in two ways: there may be reduced withholding or exemption at time of the payment if proof of treaty entitlement is provided, or the entity may withhold and apply for refunds in order to get the treaty benefit.<sup>187</sup> One Commentator has also noted that “if a payment is of an amount not otherwise subject to U.S. tax . . . the beneficial owne[r] of the payment generally is eligible for a credit or refund of the full amount of the

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178. HIRE Act, *supra* note 169, at 7. Form 1099 reporting refers to the requirement that anyone engaged in business making payments to U.S. persons over \$600 report on these transactions. *Id.* at 2; *see also* I.R.C. § 6041.

179. The income sources listed in Chapter 3's provisions reference I.R.C. § 871 and include interest (other than original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits and income. This is income that is not connected with conducting a trade or business in the U.S. *See* I.R.C. § 871(a)(1)(A) (2006).

180. *Id.* § 1473(1)(A) (West 2010).

181. Frants, *supra* note 154, at 13.

182. Bloomfield & Shamrakov, *supra* note 12, at 1.

183. *See supra* notes 49–51 and accompanying text.

184. Bloomfield & Shamrakov, *supra* note 12, at 2.

185. Dean Marsan, *FATCA: The Global Financial System Must Now Implement a New U.S. Reporting and Withholding System for Foreign Account Tax Compliance, Which Will Create Significant New Exposures—Managing This Risk (Part II)*, TAXES, Aug. 2010, at 27, 88.

186. *Id.* at 90–94.

187. *Id.* at 98–100.

tax withheld.”<sup>188</sup> These provisions appear to be consistent with the existing systems.

By contrast, the interest due under Chapter 3 credits and refunds is not consistent. Instead of a forty-five day grace period, the FATCA provisions provide a 180-day grace period during which no interest must be paid.<sup>189</sup> This is in essence an additional penalty because it does not afford to the foreign entities the time-value benefit of the money that was improperly withheld for an extended period. Of course, the FFIs may avoid the withholding entirely by reporting on their account holders.

## 2. FATCA's Information Reporting Requirements

The scope of information required under FATCA is great. FATCA requires FFIs to report on foreign accounts owned by U.S. persons or U.S.-owned entities.<sup>190</sup> The FFIs would have to keep track and report not only when accounts are opened, but also throughout the “life” of the account.<sup>191</sup> This would include the gross receipts and withdrawals from the accounts, and is also likely to include transfers between accounts owned by the same person or relatives.<sup>192</sup> NFFEs, on the other hand, would have to report their substantial U.S. owners, or alternatively, that they do not have such owners; these provisions set forth reporting exceptions for nonfinancial entities such as publicly traded corporations, among others.<sup>193</sup>

These requirements present some concern about duplicative information because they supplement existing obligations under QI agreements.<sup>194</sup> Furthermore, though the IRS has provided some guidance as to how FFIs and NFFEs will need to identify beneficial owners of accounts and other entities,<sup>195</sup> the system remains “complex”<sup>196</sup> and rather “burdensome in a way that is disproportionate to the benefit to be expected from these

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188. *Id.* at 90.

189. *Id.* at 95.

190. Marsan, *supra* note 12, at 43.

191. *Id.* Initial guidance indicated that FFIs would have to report the highest month-end balances. See I.R.S. Notice 2010-60, 2010-37 I.R.B. 329, 341. Due to the high burdens associated with such periodic balance determinations, however, the Treasury and IRS intend to issue regulations limiting this reporting to year-end balances. See I.R.S. Notice 2011-34, at 34–35 (Apr. 8, 2011), available at <http://www.irs.gov/pub/irs-drop/n-11-34.pdf>.

192. Marsan, *supra* note 12, at 43.

193. *Id.*; see also I.R.C. § 1472 (West 2010).

194. See I.R.C. § 1471(c)(3); see also Marsan, *supra* note 12, at 41. The IRS indicated that they will “require[ ] all FFIs currently acting as QIs to consent to include in their QI agreements the requirement to become participating FFIs unless they qualify as deemed-compliant FFIs under section 1471.” I.R.S. Notice 2011-34, at 39–40. The Treasury and IRS intend to provide further guidance as to how this transition will work. *Id.*

195. The IRS has provided a five-step guide on how participating FFIs should identify existing individual accounts as U.S. accounts, recalcitrant accounts, or non-U.S. accounts. I.R.S. Notice 2011-34, at 3–19. This guidance also provides for the kinds of documentation upon which an FFI may rely. *Id.*

196. See Alison Bennett, *Financial Institutions: IRS Unveils Eagerly Awaited FATCA Guidance, Practitioners Say Many Challenges Remain*, 69 Daily Tax Rep. (BNA) GG-1 (Apr. 11, 2011).

rules.”<sup>197</sup> Foreign entities and practitioners alike await further guidance from the IRS with respect to the details of the information reporting requirements.

### III. FATCA AND THE UNCERTAIN FUTURE OF TAX ENFORCEMENT

FATCA presents a new direction in U.S. tax law. Though its goals of increasing revenue and bringing offshore tax evasion to a halt<sup>198</sup> are arguably similar to regimes past,<sup>199</sup> the method for implementing those goals departs significantly from existing systems in three ways: first, FATCA’s withholding system is used not to ensure tax collection, but as a means to coerce an information-sharing agreement; second, it seeks compliance by creating a disincentive for noncompliance where efficient information systems typically take an incentive-based approach; and third, its U.S.-focused approach to offshore tax evasion fails to consider the impact on existing tax treaties. This part examines these departures from the norm and considers the potential impact of doing so.

#### A. Coercing Compliance by Withholding

FATCA’s withholding differs significantly from other existing withholding systems in its usage. Though the end goal is still to reduce the tax gap and collect revenue more effectively,<sup>200</sup> FATCA’s implementation forces reporting at risk of additional taxation, rather than solely enforcing taxation.

Pre-FATCA withholding systems were designed to enforce tax payment by removing the time between receiving income and paying taxes.<sup>201</sup> This way, taxpayers would not have the opportunity to not file or pay appropriate amounts.<sup>202</sup> Though this takes away the taxpayer’s time-value benefit of using income as it is received, Congress signaled its desire to make withholding a “fair” enforcement mechanism by offering refunds with interest for amounts overpaid.<sup>203</sup> Thus, withholding is typically used to collect taxes up front rather than coerce taxpayer action in another field.

FATCA’s withholding most closely resembles backup withholding, as backup withholding also requires holding back a percentage of the taxpayer’s income if the taxpayer does not file certain information correctly (in this case, the TIN).<sup>204</sup> However, even backup withholding differs significantly from FATCA because of who is designated to provide what kind of information. In backup withholding, the payee withholds the amount from the taxpayer because the taxpayer has not properly provided

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197. *See id.* (quoting former Treasury international tax counsel Phil West).

198. *See supra* notes 151–54 and accompanying text.

199. *See supra* Part I.C.1–2.

200. *See supra* notes 151–54 and accompanying text.

201. *See supra* Part I.B.1.

202. *See supra* notes 22–23 and accompanying text; *see also* Part I.B.1.

203. *See supra* notes 48–51 and accompanying text.

204. *See supra* notes 66–67 and accompanying text.

his or her own TIN.<sup>205</sup> By contrast, FATCA requires an agent to withhold an amount from the tax-paying FFI if the FFI does not file proper information about *other* persons (in this case, their customers).<sup>206</sup> Though FFIs usually collect certain information about their customers, the kind of information FATCA demands is often difficult to verify. Not only does the information reporting impose the significant burden of determining the extent to which customer-provided information is accurate, it also imposes an up front thirty percent penalty for failure to do so. This is a far cry from withholding a certain amount of a payment at the outset in order to prevent failures on the part of the taxpayer to file or set aside funds to pay taxes.

Furthermore, FATCA's distinct failure to offer credit and refund provisions similar to those in other withholding systems<sup>207</sup> presents additional support for the proposition that this is not a withholding regime at all, but rather a penalty imposed at the outset. It is certainly not in keeping with the notion that amounts withheld are intended solely to meet current tax obligations. Rather, it imposes a sort of tax on FFIs that has little to do with taxes they actually owe (for those are already imposed and due), but has a lot to do with assisting the United States in enforcing its own laws.

Even though FATCA's withholding system provides an innovative way to force FFIs into reporting on their customers—and in that way enhances the tracking of offshore accounts, and eventually leads to the ability to close the tax gap by some measure—its implementation may present an undesirable departure from the typical withholding system. The undesirability arises from the indirectness of the link between purpose and effect. If withholding is to be used as a method of enforcing tax compliance, its purpose is better served by remaining close to that goal directly and conforming to the identifying marker of withholding systems—holding back from the taxpayer a percentage of taxes actually due.<sup>208</sup> If the intent of Congress was to circumvent potential regulatory issues that come with placing a penalty on foreign entities by calling it a “withholding of tax” over which the United States has jurisdiction, those issues are not avoided here.<sup>209</sup> Utilizing the accepted mechanism of withholding to effectuate results for which withholding was not intended presents a stark problem for tax policy. Because FATCA withholding does not conform to the standard layout of withholding systems generally, its implementation raises important new policy concerns that should be considered.

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205. *See supra* notes 66–67 and accompanying text.

206. *See supra* note 169 and accompanying text.

207. *See supra* notes 48–51 and accompanying text.

208. *See supra* note 41 and accompanying text. By contrast, FATCA's withholding threatens to hold back on financial institutions' income that may not be subject to tax, or that may have already been reduced by treaty. *See supra* notes 62–64, 129, 180–81 and accompanying text.

209. *Cf. Marsan, supra* note 12, at 40–41 (noting the difficulty of creating a rule of law concerning foreign entities not subject to U.S. tax).

*B. FATCA's Disincentive Decision and Inefficiency*

The disincentive in FATCA comes from imposing the thirty percent withholding by default, unless certain information is reported or an agreement is made with the IRS.<sup>210</sup> FFIs are thus only forced to comply by being strongly discouraged, or even punished, for not complying. The necessity for this kind of approach is made quite clear because it deals with foreign entities. Because some of these would-be reporting entities may not themselves be subject to U.S. tax, the information reporting cannot be demanded in a rule of law, but must instead be incentivized.<sup>211</sup> However, it is not as clear why a disincentive, as opposed to an incentive, is used to achieve the goal of increased information reporting.<sup>212</sup> While it is true that there is little incentive benefit that can be offered to a foreign entity that has no U.S. tax obligation—i.e., a foreign bank that receives investment income statutorily exempt from the substantive tax would have little reason to be forthcoming with customer information as there is no benefit to be offered—it is also true that creating a disincentive that imposes withholding on payments that are statutorily exempt from U.S. tax circles back to the same problems of a rule of law demanding information. Thus, withholding is here once again used in a manner inconsistent with prior law: it is being used to withhold on payments that are statutorily exempt from tax.<sup>213</sup> This is not only problematic from a policy perspective, but also potentially an inefficient means of achieving its end goal.

In analyzing the efficiency of using withholding as a means to coerce information reporting, it is useful to recall Professor Lederman's six-part framework because it enables a comparison to the characteristics that typify efficient information reporting systems.<sup>214</sup> The first question in the analysis is whether there is a potential for collusion; this question looks to whether the parties are acting at arm's length.<sup>215</sup> Lederman's examples of parties not acting at arm's length typically include family members or parties with other relations.<sup>216</sup> Thus, in the case of the parties involved in FATCA, there would likely be little assumption of collusion between foreign banks and their clients. This is not necessarily the case, however, especially in light of the allegations against UBS. There, the bank representatives were accused of conspiring with their clients so as to avoid paying U.S. income tax.<sup>217</sup> Since, under Lederman's analysis, information reporting is more likely to be effective where parties are acting at arm's length, it is not entirely clear that this relationship is one that lends itself to efficient information reporting.

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210. *See supra* notes 167–70 and accompanying text.

211. Marsan, *supra* note 12, at 40–41.

212. *See supra* note 116 and accompanying text.

213. *See supra* notes 62–64 and accompanying text.

214. *See supra* Part I.C.3.

215. *See supra* notes 114–16 and accompanying text.

216. *See supra* notes 114–16 and accompanying text.

217. *See supra* Part I.E.

Second, Lederman looks to the existing bookkeeping infrastructure.<sup>218</sup> In her examples, small shops are noted as types of businesses tending to lack the infrastructure necessary to have the information the authorities would need anyway. Banks, on the other hand, have precisely this kind of infrastructure already in place. Because of the well-known Know-Your-Customer and European Anti-Money Laundering provisions, it is likely that most European banks would be abiding by some sort of client due diligence, even without the enactment of FATCA. The burden on other countries, however, may be very different. Here we might also wonder, then, whether the burdens of information collection and reporting would fall more heavily on certain countries than others. Generally speaking, however, the targeted foreign entities of FATCA would likely be in the position to collect the information necessary.

Lederman's third factor is the "centralization" aspect, focusing on the number of parties reporting in relation to the number of parties reported upon.<sup>219</sup> It is fair to assume here that there will be multiple accounts to each bank. For example, in the UBS facts discussed above, approximately 52,000 client accounts were undisclosed (and thus a relatively high ratio of taxpayers to reporters).<sup>220</sup>

Fourth is the requirement that an effective system has access to all the necessary information in order to match the report with the taxpayer's return.<sup>221</sup> In this instance it is also likely that the FATCA requirements of the account holder's name, and the account's gross receipts and withdrawals would provide the necessary information. Requiring the reporting of gross receipts and withdrawals eliminates the possibility that the taxpayer-account holder could average out the balance over the year to an amount approximating the amount on their tax return.

The fifth characteristic, which provides that there are few alternatives to reporting in order to enforce the payment, is the most crucial.<sup>222</sup> It presents a tricky scenario, since information reporting systems are already in place under the Banking Secrecy Act and with respect to QI agreements.<sup>223</sup> In addition, there are information exchange agreements with most of the nations with which there are also tax treaties. Were these information exchange agreements to be improved, it would not be necessary to impose a withholding penalty that claws back on treaty benefits in order to close the information gap.<sup>224</sup>

The sixth factor is the extent to which the imposition of this information reporting would contribute to closing the tax gap.<sup>225</sup> In the case of FATCA, the possibility of closing the tax gap is significant. Billions of

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218. *See supra* note 117 and accompanying text.

219. *See supra* note 118 and accompanying text.

220. *See supra* notes 139–40 and accompanying text.

221. *See supra* note 119 and accompanying text.

222. *See supra* note 120 and accompanying text.

223. *See supra* Part I.C.1–2.

224. *See supra* Part I.D.

225. *See supra* notes 121–22 and accompanying text.

dollars are lost to unreported offshore accounts each year,<sup>226</sup> and while the possibility of tapping into that stream of account information would be costly to administer, it would reap great revenue in the end. Since the tax authorities are placing the burden on the third parties to report, however, a default of thirty percent withholding makes this somewhat of a no-lose situation for the government. If the party reports, the authorities gain that information about the account holder; if they fail to report on their clients' accounts, the authorities have the time-value benefit of withholding thirty percent of that institution's U.S.-source income until applicable treaty benefits are claimed, or until a refund application is submitted and granted, without worrying about having to pay interest to the institution.

Furthermore, Lederman notes that the systems where the reporting party is given a tax-reducing incentive to report are more effective.<sup>227</sup> The FATCA provisions, as explained, provide for a withholding default to force agreements with the IRS. This kind of "incentive" may have a profoundly different result than if the IRS were to offer some sort of tax relief for providing the requisite information. With that type of approach, it would be in the best interest of FFIs to seek to minimize their own liability by receiving the benefit of a tax reduction. Though the default withholding provision also encourages minimizing tax liability by reporting, the FFI receives no benefit in the end, it simply avoids additional costs.

Thus, it would appear through Lederman's analysis that FATCA's withholding *disincentive* to *not* report may well be an effective way to collect information, but it may not be efficient.

### C. *Set on a Collision Course with Existing Obligations*

FATCA's withholding provisions, if not properly implemented, may have a severe impact on existing U.S. obligations toward foreign entities in jurisdictions with which the United States has tax treaties or TIEAs.<sup>228</sup> These provisions stand to draw back treaty benefits in two important ways: first, by imposing a higher rate of tax than that provided by treaty; and second, by not offering adequate credits and refunds to deal with overpayment of tax.

First, although FATCA is not intended to impose additional tax over the amounts to which FFIs are subject under treaties, it ultimately may have that effect. Currently, it is unclear how FFIs will be able to claim treaty benefits, and without proper administration the chances of over-withholding are great. This presents a serious problem for the United States' previous commitments to certain nations.<sup>229</sup> The policy choices made in creating these treaties are undercut in favor of U.S.-centric legislation seeking foreign assistance in U.S. tax enforcement. For example, the concerns for double taxation are blatantly overlooked when one considers that an FFI

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226. *See supra* note 30 and accompanying text.

227. *See supra* note 116 and accompanying text.

228. *See supra* Part I.D.

229. *See supra* Part I.D.

may be paying a thirty percent tax where they only owe a five percent tax. Such disregard for standing income tax treaties sets a dangerous precedent for future legislation.

Second, in the event such a case does occur—i.e., the FFI pays more tax than required by treaty—the credits and refunds provisions do not provide adequate remedy for over-withholding.<sup>230</sup> Once again, the withholding systems currently in place acknowledge the importance of fairness by including interest in refunds for amounts over-withheld. In the case of FATCA, where interest is often disallowed and the grace period for the IRS more than trebly extended, the penal nature of this withholding becomes more apparent. In attempting to foster free exchange of information among nations, such coercive tactics may not be in the best interest for the long term.

#### CONCLUSION

The new FATCA withholding and information reporting provisions take a hard stance against offshore tax evasion, and indicate very clearly the government's intolerance for the use of offshore structures to subvert payment of U.S. taxes. However, these provisions also impinge on a number of important policies that pre-date FATCA. These include honoring income tax treaties that were formed to prevent a number of issues seen as fundamentally unfair, such as double taxation. Further, fairness concerns are also implicated in the allocation of burdens. FATCA imposes a great burden on FFIs that do not necessarily assist the taxpayer in evading U.S. tax, and the creation of the presumption that all FFIs do so is a fundamentally unfair one indeed. Finally, the withholding tax penalty created for failing to meet the reporting requirements is a drastically different use of withholding from existing systems. While existing systems use withholding as a preemptive means of tax enforcement, FATCA employs it as a coercive tool to force foreign banks into compliance with reporting obligations. Without further guidance or revisions ameliorating the conflicts with pre-existing obligations, extending the concept of withholding from an accepted tax-enforcement mechanism to a punitive measure intended to harness otherwise out-of-jurisdiction foreign entities is both undesirable and unacceptable.

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230. See *supra* notes 183–89 and accompanying text.