FATCA and Foreign Bank Accounts: Has the U.S. Overreached?

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For the last three years, the U.S. government has mounted aggressive enforcement efforts against American taxpayers who have undeclared funds in foreign accounts, as well as the banks, bankers, financial and legal advisers, and even family members who may have assisted the taxpayers or facilitated their concealment of assets from the tax collector. We have seen secret informants and whistleblowers from in and outside the United States, stolen foreign bank data, criminal indictments and civil tax audits, enhancements in bilateral and multilateral information exchange, and two special IRS settlement initiatives to encourage Americans to make voluntary disclosures of unreported foreign accounts. For the first time in history, the IRS and the Tax Division of the U.S. Justice Department overcame sacrosanct Swiss bank secrecy, dealing a heavy blow to the notion that Switzerland, or any other country with strict financial privacy rules, could offer a haven from U.S. tax laws. These efforts are continuing, and the United States has been joined in ferreting out undeclared assets by many other countries, most notably Germany, Britain, Italy, Canada, and South Korea.

In 2010 Congress stepped into this frenzied enforcement climate, passing, with no hearings and little fanfare, the Foreign Account Tax Compliance Act. The provisions of FATCA were incorporated into the HIRE Act, aimed generally at improving the U.S. economy and signed by President Obama in March 2010. Since then, the global tax and financial community has awakened to what appears to be the most extensive extraterritorial reach of U.S. tax enforcement in history. As foreign banks and other financial institutions prepare to spend hundreds of millions of dollars to comply with FATCA, it is becoming more and more apparent that in the well-intentioned effort to find tax cheats hiding money overseas, the U.S. government has not only overplayed its hand, but has enacted an extensive and expensive new regulatory scheme that defies common sense.

What Is FATCA?

FATCA was born out of congressional investigations in 2008 and 2009 into undeclared offshore accounts. Such inquiries, including multiple hearings conducted by the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations chaired by Sen. Carl Levin, D-Mich., exposed both bankers and individuals who had taken steps to hide offshore money from the IRS. Capitol Hill lawmakers undoubtedly decided that a generic statutory solution would be more efficient than continuing anecdotal enforcement efforts, so FATCA quickly became law.

Typically for a series of amendments to the Internal Revenue Code, FATCA is highly technical, but its primary concept is simple. Under its provisions, foreign financial institutions, defined as broadly as one might imagine, must disclose the identity of any American account holder or face a severe financial sanction. In brief, effective January 1, 2013, *any* foreign financial institution worldwide that intends to invest in a U.S. asset, whether for itself or any client (American or not), must sign a contract with the IRS in which it promises:

- to review its existing account base and identify any American citizen or resident who is the beneficial owner of any of its accounts, whether title is held individually or by a company, trust, or other entity;

- to implement procedures to screen and monitor all new accounts for the same purpose;
- to agree to provide the IRS, annually, extensive information about these accounts, including the identity of the account's beneficial owner, the balance in the account, and the income generated in the account, as well as other information upon request; and
- to obtain waivers of any home country privacy or secrecy laws and if the account owner refuses, to take action against the owner, including possibly closing the account.

If the institution does not sign such an agreement, or if it is found to violate any such agreement in place, *100 percent of all income, including gross proceeds of investment transactions, sourced to a U.S. asset is subject to withholding at a 30 percent rate*. Furthermore, participating institutions are required to withhold on ''passthru payments,'' meaning payments made by such institutions that are attributable to withholdable payments.

In a nutshell, if any affected entity wants to invest in the United States, it has no choice but to comply with FATCA, irrespective of whether it has a U.S. branch, office, or other presence. Otherwise, its U.S. portfolio starts out down 30 percent before it invests a nickel in U.S. assets. The rules apply broadly — financial institutions, investment pools, insurance companies, and other companies and trusts may be subject to FATCA. To paint the extreme case, beginning in two years, when a farmer in Sichuan province walks into the bank office near his home to open an account for the proceeds from sale of his crop, the bank will have to take steps to ensure that he is not an American citizen or resident. On the amazing coincidence that he is, the bank will have to provide regular information to the IRS about his account activity. On a careful and considered view, this seems a bit extreme.

The model for FATCA was a program implemented by the IRS over a decade ago, the qualified intermediary program, whereby foreign banks signed agreements with the IRS with far more limited provisions, aimed at enabling foreign investors to obtain U.S. tax benefits without disclosure of their identities to every foreign institution in the chain of payments between them and the United States. As an incident of this effort, the QI program sought to ensure that American account holders paid taxes on their U.S.-source investments. In recent years, the tax enforcement community widely, and correctly, perceived that many foreign banks had abused the QI program regarding their American customers and thus contributed to the apparent increase in the number of Americans hiding money overseas. So Congress seems to have determined that a more muscular version of the QI program was necessary (though the QI program remains in place for its core purpose).

FATCA contains additional provisions unrelated to the disclosure and withholding regime imposed on foreign accounts. It adds reporting obligations for foreign nonfinancial entities and for Americans with foreign financial assets on their tax returns. It also lengthens the amount of time for the IRS to audit tax returns and increases civil money penalties when there is a failure to report foreign assets. The legislation takes numerous steps to curtail perceived abuses by those who establish and benefit from certain types of foreign trusts. But it is FATCA's fundamental component — aimed at financial institutions all over the world — that is stirring up the most reaction.

Reaction to FATCA

Once the implications of FATCA settled in, there have been multiple responses. The IRS, whose resources are already strained by healthcare reform and other congressional mandates and potential corporate and individual tax reform, now confronts a series of daunting regulatory challenges. With the infinite variety of investment funds, financial and insurance products, corporate and trust structures, and the like, the task of implementing FATCA's broad but technical provisions now falls to regulation writers in the IRS National Office. The IRS has solicited comments from interested parties, received voluminous responses, and issued two highly technical notices, prescribing guidance on FATCA implementation and attempting to reduce the regulatory burden where there is little risk of undeclared offshore accounts. More extensive regulations are needed and will surely be forthcoming.

It is ironic that much of the regulatory focus is on the complicated withholding provisions meant to serve as the enforcement vehicle for FATCA — since FATCA is not about withholding. FATCA is about the disclosure of American account holders. Withholding from an institution's investments in the United States is just the hammer written into the law to compel institutions to identify their American account holders and provide information about them to the IRS. It seems clear that the IRS could collect far more in tax through other less burdensome and technically demanding enforcement measures, such as auditing more businesses. However, obtaining the disclosure of offshore accounts undoubtedly serves purposes that transcend revenue collection.

It is questionable whether, as a technical matter, FATCA will be effective. The sanction in the statute — 30 percent withholding — will only work if it cannot be circumvented, and that means that withholdable amounts paid from the United States must be traced through compliant financial institutions to account holders that are not so compliant (''recalcitrant'' in FATCA terms). The statute deals with this problem by requiring withholding on passthru payments, defined as payments attributable to withholdable payments (that is, payments by a compliant foreign financial institution to a recalcitrant account holder). This should work as long as the institution is foreign — the only financial institutions that FATCA deals with. However, the statute does not address U.S. financial institutions, and there are no provisions of U.S. law that would require comparable withholding by them on all passthru payments, which may have a foreign source. This may sound a bit obscure, but it represents a hole in the statutory fabric, and that could function like the drain in a bathtub.

Both foreign and domestic banks and other financial institutions (again, the term is defined as broadly as one could imagine) now face a need to spend substantial sums to comply with the statute. At companies such as Goldman Sachs, Standard Chartered, small private banks in Luxembourg, and even the government-owned postal bank in New Zealand, compliance and tax officers are puzzling over exactly what steps they must take to adhere to FATCA. Most appear to be, unhappily, plodding ahead, with task forces and compliance teams reporting to senior officers who then approach CFOs to ask for yet more funds to pay for consultants, new systems, and new personnel. These entities are also pondering who should bear the cost of this compliance — all their clients, those who invest in the United States, or just their American customers? Tax lawyers, accounting firms, forensic consultants, and money laundering specialists are engaged in a bit of a feeding frenzy attempting to solicit business from affected parties who want the comfort of professional advice to inoculate them from attack down the road when the IRS, perhaps randomly, decides to audit their companies for FATCA compliance. (The guidance has not begun to address what transpires when an audit occurs.)

Most glaringly, as we have traveled around Europe and Asia in recent months, we have picked up, in the response to FATCA, noticeable changes in how U.S. tax enforcement and even America in general are perceived, with potentially significant consequences for the U.S. economy and the United States generally in the years ahead.

Implications for the U.S. Abroad

The most significant reaction is the sense that FATCA is another example of strong-armed American law enforcement imposing its will on other countries without their consent. It is thought that the United States has gone too far in asking non-Americans to spend time and substantial sums to help the United States enforce its own domestic law. The notion that foreign financial institutions must engage in automatic disclosure as a price for investing in U.S. assets strikes some foreign government officials as an imposition on their national sovereignty. In an era of delicately negotiated tax treaties and information exchange agreements between the United States and other nations, FATCA is seen as overreaching. One senior corporate executive in Hong Kong described the legislation as America's most imperialist act since it invaded the Philippine Islands in 1899. The Hong Kong financial community is speculating that Beijing will simply tell Chinese banks not to worry about FATCA, daring the United States to invoke 30 percent withholding on the principal financiers of the U.S. deficit. And a few foreign tax officials and legislators with whom we have spoken have considered retaliation, enacting their own versions of FATCA to require U.S. financial institutions to help enforce foreign tax laws. One can only imagine the reaction in the U.S. financial community to a law requiring U.S. firms to spend considerable sums of money to police their customer base for the violation of Chinese law. Broadly put, there is a growing sense overseas that the American government has gone too far.

Some countries view one particular aspect of FATCA as especially intrusive. The statute, as noted, requires any bank that signs a FATCA agreement to obtain waivers from U.S. account holders of their rights under applicable local bank secrecy, financial privacy, or related laws. Absent the waiver, banks are required to treat the account holder as recalcitrant and either close the account or withhold 30 percent on all passthru payments. In some countries waivers obtained under these circumstances are invalid, and in others it would be unlawful to condition the provision of financial services on such a forced consent. Thus, FATCA-required waivers present the real likelihood of a serious conflict between FATCA and the domestic laws of other countries, and it is unsurprising that many officials abroad view this provision as an improper interference by the United States in their legal affairs.

Of course, an affected foreign financial institution might escape the regulatory burdens of FATCA by simply deciding not to invest in the United States. This would obviously avoid the need to worry about a withholding sanction. To be sure, the United States remains the most powerful economy in the world, and any financial institution seeking a reasonable return for itself or its clients would be hard pressed to ignore U.S. investments. However, some smaller financial institutions have apparently decided to take this very step. Others note that FATCA is not imposed on U.S. institutions, giving American entities a competitive advantage, and they are weighing the expensive, margin-eating FATCA compliance burdens against the benefits of investing in a still struggling U.S. economy. One banker in Asia told us that his bank may consider pulling out of U.S. investments because, from an economic standpoint, the United States ''is simply becoming less relevant these days.'' At a time when the U.S. deficit is at a staggering level, and when the last thing America should discourage is the inflow of capital, it does seem odd that it would implement legislation that imposes great costs on affected entities and causes the worldwide investment community to pause and ask whether investing in the United States is worth it.

Largely as a result of FATCA, there is a class of persons now bearing a special burden — the millions of Americans living and working overseas. It is in America's economic interest for our companies to have a presence outside the United States, and it's also good for America that we have citizens who live, work, and contribute to societies throughout the world. American brands are ever present wherever one travels. Each American living outside the United States is a personal ambassador for our country. But the enhanced focus on Americans hiding money overseas and the regulatory burdens of FATCA have created enormous difficulties for this important community. When they attempt to open a bank account in a foreign country, they are viewed with suspicion and questioned like criminals. Many foreign banks, considering how to avoid FATCA's requirements, will no longer open accounts for Americans, while others are telling their existing American clientele to look elsewhere for financial services. Some of our clients who have sought to expatriate, for themselves or their children, point not only to the perceived high tax burden of the U.S. system, including the newly reinstituted estate tax, but also to the sense that their banks now view them with suspicion. It is somewhat unfair for Americans living abroad to face raised eyebrows and additional questioning when they seek to obtain routine financial services. This will discourage the export of American talent and culture at a time when we should want our companies and our people to be more engaged with the world.

Repeal and Alternatives

We believe it is time to seriously consider whether the disclosure and withholding regime imposed by FATCA should remain the law. Let us be clear — we do not condone tax evasion, and we believe that the United States has taken important, if not remarkable, steps toward reducing the number of Americans who hide money abroad. The increase in criminal and civil tax enforcement in this area has produced tangible results — the first IRS voluntary disclosure program brought nearly 17,000 taxpayers and hundreds of millions of dollars back into the tax system. And there is no doubt that many Americans continue to hide money overseas. But FATCA strikes us as going after a bee hive with a tactical nuclear weapon. We cannot imagine that this statute was the product of careful cost-benefit analysis.

There are surely alternatives. The disclosures compelled by FATCA are likely, in most cases, to involve Americans who already comply with the tax laws. The United States should focus on identifying those Americans who are not compliant — recent enforcement against banks in Switzerland and India, and their account holders, have achieved results and should continue. We suspect that the Justice Department and the IRS have other financial institutions in Asia and Europe under scrutiny for helping Americans hide money.

Every enforcement action has an outsized deterrent effect. Congress should encourage and fund IRS and Justice Department enforcement efforts to track down tax cheats and bring their money back into the tax base. The IRS should welcome, and treat with appropriate leniency, those who come forward to make voluntary disclosures of their undeclared foreign financial assets. The combination of dramatic and visible enforcement against Americans with undeclared accounts and the application of a sensible voluntary disclosure policy produced hundreds of millions of dollars in revenue in 2009. There is no reason why a similar ''iron fist and velvet glove'' approach could not work again. (Indeed, the second offshore voluntary disclosure program, announced in February 2011, is perceived, for now, as a failure; only a few hundred account holders are trickling in, with most scared off by the prospect of significant penalties imposed on their nonfinancial assets.)

There is also an approach favored by the OECD and European nations, the EU savings tax directive, which entails increased transparency and automatic withholding in some circumstances. Rather than compel disclosure and hold the sanction of withholding over the heads of financial institutions that fail to comply, various EU nations have agreed to a simpler regime whereby account holders may agree to disclosure by their financial institutions to their home countries, and if they fail to agree, the financial institution can withhold tax at the applicable treaty rate on interest and other income payments and pay the amounts to the home country, in some cases on an anonymous basis. This program would obviously cost financial institutions far less money than FATCA and accomplish the dual results of information disclosure and payment of tax. The program has flaws, including the limitation to individual beneficial owners, and it fails to contain a mechanism that would account for U.S. persons who are dual nationals. It is, however, worth considering whether this program, or some adaptation of it, might be appropriate for the U.S. system. History tells us that in economic matters the United States often accomplishes more working in cooperation with other nations and their institutions rather than seeking to impose its own law and its will.

There are undoubtedly other creative approaches to the problem of Americans hiding money abroad. Congress could enact a confiscatory combination of estate and gift taxes and penalties on previously unreported (and thus untaxed) foreign assets that emerge after a taxpayer's death. The IRS and Treasury's Financial Crimes Enforcement Network could implement a targeted and more sensible reporting regime for persons with financial interests over foreign accounts, substantially modifying the foreign bank account report requirements. A prophylactic withholding regime applied on an account-by-account basis and unified with both Chapter 3 and backup withholding would make a lot of sense. On such an approach, an account holder could decide how forthcoming to be, with a full 30 percent tax as the price of anonymity. Financial institutions, who know their own systems better than anyone, could put forth alternative disclosure and reporting structures. (It is worth making the point that institutions inveighing against FATCA might constructively be thinking about alternatives; it is not as though FATCA was enacted to address a non-problem.)

In any event, it is becoming increasingly apparent that the backlash from FATCA, the burden on IRS regulation writers, and the enormous cost of compliance are not worth the tax revenue that FATCA is likely to produce or to justify the other benefits of enhanced compliance. We urge Congress, working with Treasury and the IRS, to consider the repeal of FATCA's core provisions and the consideration of alternative approaches aimed at solving a perennial tax enforcement problem without engendering a profound anti-American reaction overseas. ◆