NEWS ANALYSIS

Will U.S. Hypocrisy on Information Sharing Continue?

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This is an expanded version of a speech given to the Florida Bar Association annual international tax conference on January 10.

Our question today is whether the United States will get away with continuing its hypocritical policy toward information sharing in light of the Foreign Account Tax Compliance Act and other developments.

FATCA is not going to collect every scrap of information on every miscreant, but thus far it has been surprisingly successful in its narrower aim of gaining the cooperation of some governments and banks. FATCA is unpredictably succeeding through what David S. Miller of Cadwalader, Wickersham & Taft LLP recently called the ''inadvertent leadership'' of the United States.

The Latin American rich hide their money in the United States, where some banks gladly accept it without asking too many questions. Gobs of flight capital, only a small proportion of which represents drug money, comes to U.S. banks. Florida's economy is utterly dependent on outsiders, both domestic and foreign, bringing money in.

It is easy to incorporate anonymously in the United States.

The United States is an easy place to start a business. Unless you're selling liquor or some other means of enjoyment, there is no license requirement (the Puritans were kicked out of England and Holland and came here). It takes six days to start a business in the United States — less than half the time it takes in Germany and one-quarter of the time required in Japan. In some bureaucratized countries, it can take months.

The ease of starting a company in the United States is a good thing. The ability to do so anonymously is not. Anonymous companies are used domestically for crimes such as Medicaid fraud.

Daniel Nielson of Brigham Young University and Jason Sharman of Griffith University asked hundreds of law firms and incorporation companies to set up corporations for them, giving a variety of scenarios about who they were, including terrorists. (Prior coverage: *Tax Notes*, Oct. 29, 2012, p. 474.)

Their missives were too literate, and they didn't fool the law firms. But they found many willing U.S. firms to set up companies for them without documentation of their identities. The Florida secretary of state does not ask for identification. One U.S. law firm responded that it did not need identification, but it did accept credit cards.

''This is not a problem of capacity. It is a problem of interest. It is a problem of hypocrisy,'' said Nielson at the recent *OffshoreAlert* conference in London. There was no correlation between his and Sharman's results and the Financial Action Task Force (FATF) grades given to the statutory schemes of the host countries.

FATF recommendation 24 says: ''Countries should ensure that there is adequate, accurate and timely information on the beneficial ownership and control of legal persons that can be obtained or accessed in a timely fashion by competent authorities.''

Sen. Carl Levin, D-Mich., chair of the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, introduced a bill (S. 1483) that would require states to collect beneficial ownership information for corporations and perform background checks.

Last February Treasury's Financial Crimes Enforcement Network issued a notice of proposed rulemaking (RIN 1506-AB15) calling for customer due diligence rules to be strengthened by requiring financial intermediaries to identify beneficial ownership of entity accounts and verify the identity of owners. Banks would also have to ask the purpose of the account and monitor it.

Here it is useful to note that required anti-money-laundering disclosures, while pertinent to tax enforcement, are not sufficient for what governments want now.

The revenue rule is breaking down.

The United States maintains the ancient British common law revenue rule, which says that one country will not assist another country in the enforcement of its tax laws in the first country's

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Miami, the financial capital of Latin America. Will the United States get away with not sharing information?

territory. The revenue rule originally allowed the British to function as pirates and Britain as a tax haven.

Cooperation in enforcement of tax laws is the province of treaties and mutual agreements. The usual U.S. response to efforts by foreign governments to use U.S. courts to enforce their tax laws is to point to the treaty.

It is easy to incorporate anonymously in the United States.

The revenue rule is breaking down, especially with Canada, the largest U.S. trading partner. The U.S. treaty with Canada contains an ''assistance in collection'' article, which does not appear in the U.S. model treaty, in addition to the standard information exchange article. Implementing U.S. regulations require that bank deposit interest payment information be collected and reported (reg. section 1.6049-8).

Pasquantino v. United States, 544 U.S. 349 (2004), is seen as the beginning of the breakdown of the revenue rule in the United States. In that case, the United States helped Canada enforce its liquor taxes, even though the defendants had broken no U.S. law. The wire fraud route around the revenue rule was resuscitated in the recent Wegelin bank indictment.

In the long run, the revenue rule may be gone, so the United States may have to help Mexico and Brazil enforce their tax laws.

Tax evasion was not taken seriously before Birkenfeld.

How did it get so bad? Until recently, tax evasion was not taken seriously in the United States or the United Kingdom. In the United States, former UBS banker Bradley Birkenfeld forced tax evasion into the open. The IRS, with the apparent blessing of the Senate, had been ignoring rich people's tax misdeeds for years.

''The entire offshore world was a black hole,'' said former Justice Department attorney Mark E. Matthews of Caplin & Drysdale at the *OffshoreAlert* conference. Then Birkenfeld proved that the stories were true.

Treaties and TIEAs were not intended for automatic, preemptive information exchange.

Treaties and tax information exchange agreements do little or nothing to address tax evasion and may even have enabled it. That is because treaties are primarily intended for the aid and comfort of multinational corporations.

Multinationals are an obstacle to the tax evasion discussion, not merely because they minimize their own taxes — which separate company accounting gives them license to do — but also because they lend legitimacy to tax havens and enablers.

Multinationals keep tax havens in the bank clearing system and keep enablers like Ireland and the Netherlands in the U.S. treaty system. For good measure, they resist information sharing because it would interfere with their ability to tell different stories to different governments.

The bilateral treaty mechanism is not good for information exchange, especially because a lot of evasion involves third-country entities. The EU savings directive, 2003/48/EC, a multilateral instrument, works.

The United States blacklists countries by not having a tax treaty with them, which doesn't stop U.S. resident investors from using them or even arguing for treaty-based results (a position often taken by hedge funds).

The havens have to be differentiated from the tax avoidance enablers, some of which are also havens. Switzerland, the Netherlands, Ireland, and Luxembourg are among the enablers. Multinational patronage keeps the enablers in business and ensures that they will have U.S. treaties.

Latin American countries mostly don't sign treaties with the United States, and for good reason. They don't like giving up tax jurisdiction over the affiliates of American multinationals that would do business in their countries even without tax treaties.

A Latin American country signing a treaty with the United States unilaterally forgoes or reduces withholding tax on dividends, royalties, and business income earned by developed-country investors. Moreover, the usual interpretation of article 9 is that the host country has signed on to the OECD transfer pricing guidelines, which give multinationals carte blanche to take money out of the country in the absence of exchange controls.

Tax treaties are not necessary for investment. The only document necessary for investment is a bilateral investment treaty, which protects investments from confiscation but does not address taxation. Brazil has a U.S. bilateral investment treaty.

TIEAs were designed not to work. TIEAs do not force any country to do anything it does not want to do. TIEAs do not force any country to collect information or turn it over in a timely fashion even if it does bother to go get it. The OECD model TIEA was designed in cooperation with tax havens. If it were at all effective, tax havens wouldn't sign it.

The OECD model information sharing provisions are useful only in well-developed criminal cases, and then only when the government on the other side is in the mood to cooperate. Treaties are contracts. Contracts work better when there is mutuality.

The OECD model language requires the requesting party to have identified the taxpayer and to have a dossier. The requested party must have domestic implementing legislation that allows its tax authority to cooperate in an audit and obtain requested information that would otherwise be protected by bank secrecy. Even then, a reasonable request can be irreparably delayed by the requested party.

Until recently, the terms of the TIEA model permitted tax havens to hide behind bank secrecy laws to refuse to provide information. That is what the continuing dispute between Switzerland and the United States was about — and is still about since the protocol reversing it has not been ratified.

The United States recently signed a mostly European multilateral TIEA, the 1988 OECD/CE Administrative Assistance Convention. Argentina, Colombia, and Brazil also signed it, obviating the need to sign other agreements. Brazil's U.S. TIEA has been stalled for a while. Colombia has had negotiations for a U.S. tax treaty. It signed a U.S. TIEA in 2001, which has not been ratified.

U.S. tax officials are excited about the phrase "foreseeably relevant for the administration or enforcement of their domestic laws" in article 4, added by the 2010 protocol to the multilateral TIEA.

The trouble is that the requested country gets to interpret what is relevant to the requesting country's investigation for itself. The Mexico-U.S. TIEA has even narrower language: "which is likely to be relevant to, and bear significantly on."

Another weakness in both treaties and TIEAs is that the English versions are drafted by lawyers trained in common law systems. Common law lawyers take an Alice in Wonderland approach to wording, in which words mean whatever they want them to mean. There are often civil law countries on the other side of the contract, and their lawyers are taught to read words narrowly and hypertechnically.

Mexico has a U.S. treaty and a separate TIEA, both at least 20 years old. In South America, only Venezuela has a U.S. tax treaty and only Peru has a separate TIEA.

Treasury told Rep. Debbie Wasserman Schultz, D-Fla., in writing that it would not give taxpayer information to Venezuela. The IRS "will not share tax information with another country absent a determination that the recipient country has sufficient safeguards in place to ensure the proper use of the information and to protect its confidentiality," Treasury Secretary Timothy Geithner wrote.

This was a highly unusual public admission of a policy that the U.S. government has practiced sotto voce forever. Predictably, it prompted a couple of Texas lawmakers to ask that Mexico not be given information because of drug violence.

> ***The bank interest reporting regulation is a token gesture to placate Europeans, but it has the side effect of catching some Latin American bank customers.***

U.S. treaties contain a public policy escape hatch in the information sharing article that enables the government to back out of its information sharing obligations if the other government is not trustworthy.

Paragraph 3(c) of article 26 of the U.S. model treaty relieves treaty parties of the obligation to provide information "the disclosure of which would be contrary to public policy.'' U.S. policy is not to provide information if a taxpayer would be physically harmed.

The Mexican treaty and TIEA do not have this clause, but both have the standard promise that the requesting country keep the information secret and use it only for tax enforcement. So that clause could be invoked for the United States not to give information to Mexico.

Until now, the government made sure that it was not in possession of bank deposit information it did not want to share. The qualified intermediary program was designed to hide information at the bank level so the United States would not have it to give to treaty partners. UBS was not kicked out of the program because there is no apparent requirement in the agreement that banks rat out U.S. customers hiding behind foreign entities.

The bank interest reporting regulation is a token gesture to placate Europeans, but it has the side effect of catching some Latin American bank customers.

The bank interest reporting regulation (T.D. 9584) just went into effect. Technically, the regulation requires disclosure of deposit interest not effectively connected with a U.S. trade or business paid directly to nonresident alien individuals, on an account maintained at a U.S. office (reg. sections 1.6049-4(b)(5) and 1.6049-8).

The regulation is symbolic. It is a show of U.S. good faith that the government will abide by information reporting obligations in treaties, TIEAs, and FATCA intergovernmental agreements (IGAs).

Europe only applied the savings directive 2003/48/EC to individual, directly held accounts when this regulation was proposed. The savings directive is in the process of being revised to pull in indirectly held accounts (COM(2008) 727, IP/08/1697, MEMO/08/704) and extend the directive to other countries.

In one sense, the fate of FATCA hinged on this show of good faith.

It only affects interest on directly held, nonbusiness bank deposits of individuals — in other words, the stupid rich. Because the sophisticated rich use corporations and Delaware LLCs, they would not be affected.

It would be fairly simple to plan around the regulation. The account has to be a deposit account, not the more sophisticated investment accounts that the very rich hold. It must be directly held by an individual — such as a convenience account for shopping trips.

The account must be maintained at a U.S. office of the bank, rather than a foreign office — some specialized banks have only a Miami office. The account must pay interest of $10 or more — the regulation is for reporting of interest, not the mere existence of accounts. The United States has a perpetual zero interest rate policy. And the account must not be connected to a U.S. trade or business.

A regulation alone does not empower the IRS to give information to other countries. There has to be some sort of international agreement. Depositors from non-treaty countries would not be affected. Bolivia, Cuba, and Haiti do not have U.S. treaties or TIEAs. (Neither do Argentina, Brazil, and Colombia, but they signed the multilateral TIEA.)

Thus an unsophisticated group of depositors (or the convenience accounts of the more sophisticated depositors) would be outed to placate foreign governments, while the big money could continue to come into the United States unreported.

Bills and a resolution attempt by the Florida delegation failed to upend the regulation. The legislative effort has gone all quiet while Treasury and the IRS are about to lose the officials who shepherded these rules and agreements through the process.

''Foreign accountholders should be treated the same as — not better than — U.S. citizens,'' said Levin when the regulation was proposed.

About $300 million left the state when the IRS rule was announced last April, but that's just a fraction of the estimated $50 billion or more in foreign deposits held in Florida banks. And there's little indication that much more has left since the clock ran down on 2012, says the Broward County *Sun-Sentinel* (http://www.sun-sentinel.com/business/os-irs-deposit-doom-20121228,0,3175704.story).

This is consistent with scholarly analysis of Bank of International Settlements (BIS) findings. Countries tell the BIS how much money they have on deposit, without admitting where it came from.

Investors flee when a tax haven signs a TIEA, despite the demonstrated inefficacy of these documents. They also tend to increase their offshoring when their home country signs TIEAs with havens. Once an individual's investment capital is offshore, it isn't coming back, even if it moves out of the first haven it lands in. Repatriation is not in the cards.

As usual, Florida is caught up in politics between the United States and Europe. But the U.S. Treasury appears to be convinced that it will be able to give taxpayer information to Europe without giving it to Latin American countries.

What will the effect of FATCA be on the U.S. relationship with Latin American governments?

The United States does not want to kill the goose that lays the golden egg while pursuing its own resident tax evaders. That's what diplomacy is about — saying one thing and doing another.

The U.S. government has as much as admitted that FATCA can only be implemented through IGAs. Foreign financial institution (FFI) agreements will only be for banks in non-IGA countries that have U.S. investments. It is important to note that the mere absence of U.S. customers does not let a bank off the hook.

When an IGA is in place, the signatory country's banks cannot sign individual FFI agreements with the IRS. They must report to their own government under the IGA and implementing law. Whether they suffer withholding depends on their government's performance under the IGA (which is cleverly drafted to encourage banks to lobby their governments).

Treasury is bragging that loads of countries have volunteered to discuss IGAs with it. To have an IGA, a country must have a tax treaty or TIEA in place with the United States so it has the legal ability to transfer information.

Japan and Switzerland have offered to sign unilateral IGAs under which their banks would report directly to the IRS, but the United States would not give any information to them. It's not like the Swiss are hiding money in the United States. Treasury billed this unilateral agreement (Model II) as something those countries asked for.

Could the United States offer only the nonreciprocal IGA to Latin American countries?

There is a nonreciprocal version of the Model I agreement, under which the signatory country promises to gather FATCA-compliant information and automatically transmit it to the United States. It is hard to imagine any country signing this document, but Treasury drafted the nonreciprocal version with the apparent intent of offering it to someone.

In Rev. Proc. 2012-24, IRB 2012-20, the IRS spelled out that the only country eligible for automatic sharing of bank deposit interest information is Canada, which is already receiving this information. Nothing in U.S. law requires the announcement of which countries will get bank deposit interest information, but Treasury promises to keep updating the revenue procedure.

The revenue procedure and the preamble to the regulation both explain that the IRS will not exchange information "if there is concern regarding the use of the information or other factors exist that would make exchange inappropriate."

The preamble goes on to note that treaties and TIEAs require that tax information received in exchanges be kept confidential and used only for tax enforcement. It tellingly urges that the regulations should not affect the investment and savings decisions of aware nonresidents. It all adds up to a purposefully bland statement of the government's lack of trust in some Latin American governments.

It makes Latin American customers of small, specialized Miami banks nervous that their information is collected and furnished to the IRS at all, even though the mere act of collection does not ensure that the information would be handed over to their home governments. The point of the revenue procedure appears to have been to appease these customers, their bankers, and their advisers.

Mexico and the United States signed a reciprocal IGA last November. Mexico got a cheerleader promise.

Mexico is believed to have lost $872 billion in dubious outbound transfers over four decades, some of which is transfer pricing. Most of the money is believed to have ended up in the United States.

The Mexican government has long wanted bank interest information. Remember, the new bank interest reporting regulation is identical to a deal that has been in place with Canada for years. Mexico has been energetic about signing TIEAs with havens, including obscure ones like the Cook Islands.

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Information gathered under the IGA will be automatically exchanged under the U.S.-Mexico TIEA, which already provides for automatic exchange. The only information the United States will collect is the individual bank deposit interest data, so that would be automatically given to Mexico.

If the TIEA already called for automatic information exchange, what have the parties been doing? Article 4(2) of the TIEA allows the competent authorities to determine what information should be exchanged.

Paragraph 3(a) of article 1 of the TIEA states that the requested country need not supply the requested information if execution of the request would exceed its legal authority or would be prohibited by law, or if the information is not obtainable in the normal course of tax administration. Because the United States was not in the habit of collecting any Mexican bank account information, it could not have given any to Mexico.

Mexico and the United States exchange information on a case-by-case basis. They exchange bulk information on interest payments between corporations and on dividends and royalties.

Can the U.S. government now weasel out of automatic exchange once it has been agreed to and some information is being collected?

Apparently yes, especially because automatic sharing has been promised before. The IRS can still invoke the treaty discretion not to give information if it is likely to be misused. Article 4(7) of the Mexican TIEA requires the requesting country to keep the information confidential and use it only for tax enforcement.

Mexico is not on the list for receipt of information in Rev. Proc 2012-24. When the bank interest reporting regulation (REG-133254-02) was first proposed by the George W. Bush administration — and the Mexican TIEA was in effect — Mexico was not on the list of countries that would have gotten information.

Nonetheless, the IGA spells out concrete steps for gathering and sharing information. The IGA requires reporting of average monthly account balances — a unique provision. The agreement also allows the Servicio de Administración Tributaria (SAT) to contact U.S. banks directly, but the IRS must go through the SAT if it wants to contact Mexican banks.

Mexico also got a most favored nation clause. The IGA requires consultation if implementation is a problem. This same provision is in the British and Danish IGAs.

FATCA has a look-through rule, which is a first for the United States, which conveniently ignored ownership of entities while its banks gathered money from Latin America.

FATCA requires foreign corporations and partnerships to give withholding agents beneficial ownership information when U.S. resident ownership exceeds 10 percent by vote, value, profits interest, or capital interest. The same reporting rule applies to foreign trusts with any beneficial ownership by U.S. residents (sections 1471(d)(3) and 1473(2)(A)).

The definition of account holder under the Mexico IGA has a look-through rule, the same as in the Model II unilateral agreement, but it appears to cover only agents, not entities:

> A person, other than a Financial Institution, holding a Financial Account for the benefit or account of another person as agent, custodian, nominee, signatory, investment advisor, or intermediary, is not treated as holding the account for purposes of this Agreement, and such other person is treated as holding the account.

However, the reportable account definition contemplates some disclosure of Mexican resident entity accounts:

> The term ''Mexican Reportable Account'' means a Financial Account maintained by a Reporting U.S. Financial Institution if: (i) in the case of a Depository Account, the account is held by an individual resident in Mexico and more than ten ($10) dollars of interest is paid to such account in any given calendar year; or (ii) in the case of a Financial Account other than a Depository Account, the Account Holder is a resident of Mexico, including entities that certify that they are resident in Mexico for tax purposes, with respect to which U.S. source income that is subject to reporting under chapter 3 or chapter 61 of subtitle A of the U.S. Internal Revenue Code is paid or credited.

This is a ticket to putting the accounts in third-country corporate shells — again displaying the inefficacy of bilateral agreements. The Mexican IGA might effectively be a nonreciprocal agreement disguised as reciprocal.

Brazilian bankers want an IGA, and Brazil is talking about one.

U.S. multinationals are still laboring under the illusion that the United States will get a tax treaty with Brazil that would force it into using unwanted American transfer pricing rules and mutual agreement procedures.

Brazil has rebuttable presumptions of set profit margins for certain industries in its transfer pricing rules. Like Argentina, it recently instituted listed prices for imports and exports of commodities.

Brazil prohibits settlement at the audit level. Brazil essentially lacks competent authority. For fear of corruption, Brazilian tax authorities have no authority to negotiate tax liabilities once they are assessed, making any adjustments impossible. Brazil cannot make corresponding adjustments when the other country adjusts transfer prices.

Brazil also wants to keep its statutory withholding rates, which the United States regards as high. (U.S. 30 percent withholding exists to be negotiated away.)

Brazil wants tax sparing. The United States has tax sparing, for all practical purposes, in its permissive foreign tax credit rules. But it does not explicitly recognize tax sparing in treaties. Germany revoked its Brazilian treaty on the view that tax sparing was no longer appropriate.

The United States does not want Brazilian domestic law applied to American investors. The United States also wants a separate but related agreement, which would establish that disputes about U.S. investments in Brazil will be referred to international courts of arbitration — something Brazil has never agreed to do.

> ***Brazilian bankers want an IGA, and Brazil is talking about one.***

These factors are barriers to a full tax treaty. But Brazil has a TIEA with the United States signed and ready to go. It has not been ratified and is still stuck in the Brazilian Senate. Bank secrecy would not be overridden. Article 7 of this agreement allows the requested country to decline to supply information if doing so would contravene its public policy.

Brazil's stalled U.S. TIEA may be irrelevant in light of the signatures of both on the multilateral TIEA. The latter obliges the United States to furnish information that is foreseeably relevant to Brazilian tax enforcement.

Brazil has TIEAs with several countries where the government thinks its citizens hide money. It has TIEAS with the United Kingdom, Bermuda, and Uruguay, and it is working on one with Jersey. Uruguay is a tax haven. The United Kingdom is essentially a haven when entered through its satellite havens like Bermuda and the Channel Islands.

Brazil also collects bank account information, despite its bank secrecy laws. Brazil requires financial intermediaries to disclose extensive customer transaction information to the tax administrator, which must keep the information confidential. So while FATCA compliance cannot force Brazilian bank customers to waive bank secrecy, the banks already give the same information to the government.

An IGA requires the signatory country to make new domestic laws allowing bank information to be reported to the government and passed on to the IRS. It is unlikely that Americans are hiding money in Brazil, whose bankers have expressed a willingness to have an IGA.

It appears from the highly detailed letter that the Brazilian bankers' association FEBRABAN wrote Treasury that an IGA of some sort is in the works. But the bankers could live with a nonreciprocal IGA because it would take them off the hook.

Rich Brazilians invest in the United States through anonymous entities usually formed in Delaware, but these can also be had in other states. Brazil complains that Delaware does not provide beneficial ownership information for Brazilian investors in Delaware LLCs. Brazil recently put the state of Delaware on a blacklist and then removed it by a ruling.

U.S. multinationals still have the vain hope of a tax treaty with Brazil. Brazil wants information about the money its citizens are hiding in the United States. Thus the United States may not make the insulting offer of a unilateral, nonreciprocal IGA that it may offer other Latin American countries. ■