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The Need to Close the FATCA Loophole to Preserve The Integrity of U.S. Tax Enforcement Efforts

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The author also thanks Peter A. Cotorceanu and Eric D. Swenson for their valuable insights.

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In this article, the author explains how a "loophole" in the Foreign Account Tax Compliance Act enables unscrupulous tax and financial advisors to help their nonresident alien clients hide income earned in U.S. financial institutions out of the reach of foreign governments. This prevents governments from achieving the full tax compliance benefits of the goals stated in FATCA intergovernmental agreements.

In 2010 the U.S. government adopted a global transparency law: the Foreign Account Tax Compliance Act, meant to address international tax evasion by U.S. individuals who hide assets and income offshore, beyond the reach of U.S. tax authorities.

FATCA imposes reporting requirements on foreign financial institutions worldwide for U.S. taxpayers' income and specific financial information. It is a combination of a statutory withholding tax regime[1] and bilateral intergovernmental agreements entered into with more than 100 countries. The IGAs are the linchpin that automatically requires FFIs and foreign governments to provide income and financial information to the IRS.[2]

To help U.S. taxpayers hide their offshore income, unscrupulous bankers, lawyers, and accountants opened and maintained accounts for those taxpayers held in the name of non-U.S. corporations, foundations, trusts, or other legal entities. That allowed taxpayers to conceal their actual beneficial ownership of the accounts[3] and led to the rise of FATCA.

FATCA helps identify U.S. individual tax evasion by requiring FFIs to report comprehensive income information of U.S. persons from foreign accounts.[4] Reporting is required whether the U.S. taxpayers own the assets directly or through legal entities or opaque trust structures. In contrast, reporting is generally not required when non-U.S. taxpayers own their U.S.-based assets indirectly through legal entities or opaque trust structures. (See Figure 1.)

FATCA bases the definition of reportable accounts on whether U.S. taxpayers have them in

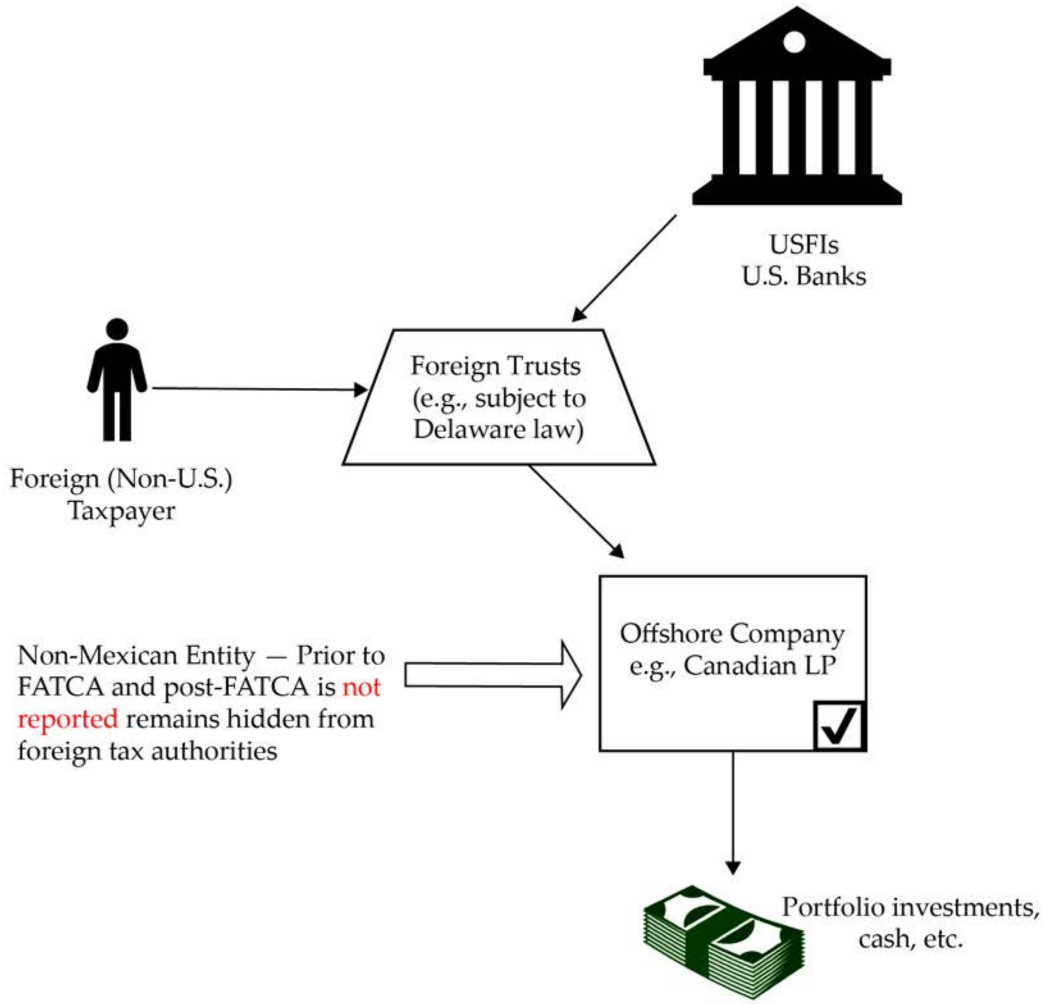
[1] The withholding tax is avoidable as long as the FFI provides detailed financial information about the offshore accounts of U.S. taxpayers and legal entities they control or over which the U.S. person has direct or indirect ownership.

[2] *See* Model Intergovernmental Agreement to Improve Tax Compliance and to Implement FATCA.

[3] *See* U.S. Justice Department February 4, 2016, announcement (16-031) of criminal charges against Swiss bank Julius Baer & Co. Ltd.

[4] Model 1 IGAs require FFIs to report through their own governments, while Model 2 IGAs allow FFIs to report to the IRS directly. FFIs in countries without IGAs must also report directly to the IRS.

Figure 1. Structures to Conceal Beneficial Ownership by Non-U.S. Taxpayers to Hide Their Taxable Income in USFIs From Their Tax Authorities



FFIs or non-U.S. taxpayers[5] hold them in U.S. financial institutions (USFIs).

U.S. reportable accounts are held in FFIs by U.S. taxpayers. They can be U.S. individual accounts, as well as accounts held by offshore corporations,[6] offshore trusts, and other opaque structures with U.S. beneficial owners. (See Figure 3.) FATCA looks through the legal structures to identify the U.S. beneficial owners. That is not the case for [Country X] reportable accounts in the United States with beneficial ownership by individuals of [Country X]. Only individually titled accounts and certain corporate accounts (corporations resident in [Country X]) are defined as reportable accounts when held in FFIs.[7]

Thus, there is no reciprocal automatic exchange of information.

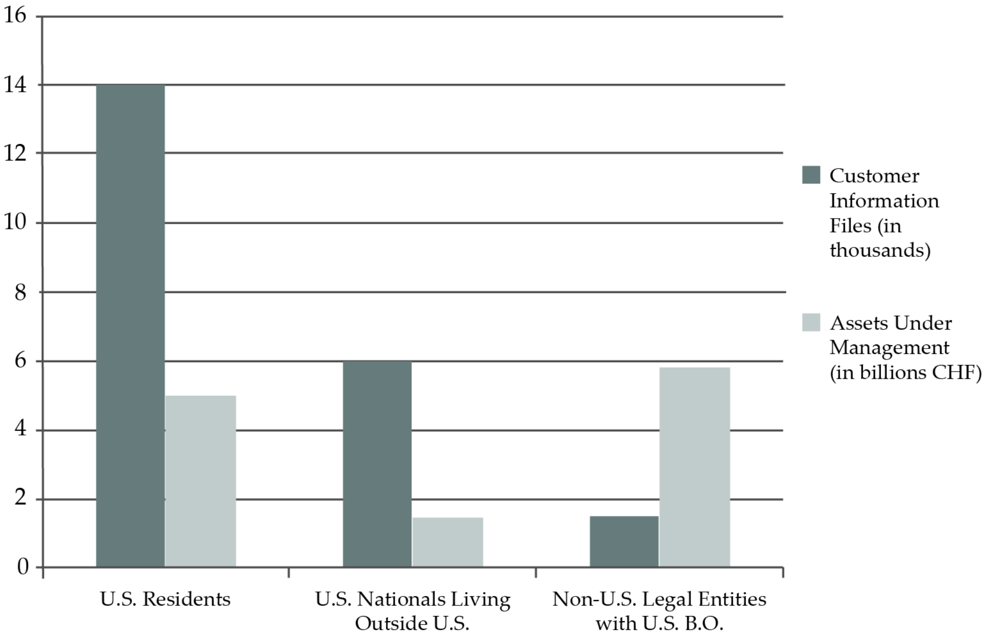
That incongruity, or FATCA loophole, creates an opportunity for nonresidents to evade taxes in

[5]The term "nonresident alien" is an individual who by definition is not a "resident alien." See section 7701(b)(1)(A), which defines a resident alien for U.S. federal income tax purposes. Title 26 defines a foreign trust as a trust that is not a "United States person." *See* section 7701(a)(31)(B) and (30)(E). *See* Patrick W. Martin and Jon Schimmer, "The Great Myth in Pre-Immigration Tax Planning — Why Section 679(A)(4) Does Not Apply to Subtitle B," *Calif. Tax L.* (2005). A foreign corporation is defined in section 7701(a)(5) as not a "domestic corporation." The terms "non-U.S. taxpayers" or "foreign taxpayers" as used in this article reference the terms "nonresident aliens," "foreign trusts," "foreign corporations," "foreign partnerships," and "foreign estates" as defined in section 7701.

[6]*See* Figure 4.

[7]*See* Figure 3.

Figure 2. Categories of U.S.-Linked Accounts in Switzerland — 2007



Source: U.S. Senate Permanent Subcommittee on Investigations, "Offshore Tax Evasion: The Effort to Collect Unpaid Taxes on Billions in Hidden Offshore Accounts" (Feb. 25, 2014).

their countries of residency using USFIs. It undermines U.S. international tax evasion efforts by allowing USFIs to become tax havens.[8]

Accordingly, this article recommends closing the FATCA loophole. The solution is simple and consistent with the stated goal of reciprocal automatic exchange.

I. FATCA's Purpose

The United States passed FATCA to achieve equivalent reciprocal automatic information exchange with its FATCA partners and improve international tax compliance through mutual assistance in tax matters.[9]

The FATCA regulations (T.D. 9809) explain that the automatic reporting of foreign financial account information is intended to address the use of foreign accounts to facilitate tax evasion and "strengthen the integrity of the voluntary compliance system by placing U.S. taxpayers with accounts held with FFIs in a comparable position to U.S. taxpayers with accounts held with [USFIs]."

FFIs have extensive U.S. reporting and registration obligations. They often must register with the IRS directly and receive a global intermediary identification number (GIIN).[10] The GIIN is a concept created by the U.S. government to help track and receive income and financial information of U.S. taxpayers' offshore accounts in FFIs and identify noncompliance.

The investigation efforts from the early part of this century focused on offshore tax evasion schemes centered in Switzerland, where Swiss financial institutions were able to keep taxpayers' names and accounts hidden from tax authorities under Swiss law.[11]

Accordingly, the IGA preambles include several specific objectives:

[8] *See* Kara Scannell and Vanessa Houlder, "US Tax Havens: The New Switzerland," *Financial Times*, May 18, 2016.

[9] *See, e.g.*, the preamble to the model IGA, *supra* note 2.

[10] *See* IRS, FATCA Foreign Financial Institution Registration System (last visited Apr. 2, 2019). As of January 2019, more than 325,000 FFIs had registered.

[11] *See* U.S. Senate Permanent Subcommittee on Investigations, "Offshore Tax Evasion: The Effort to Collect Unpaid Taxes on Billions in Hidden Offshore Accounts" (Feb. 25, 2014).

- improve international tax compliance, FATCA's underlying policy goal, through mutual assistance in tax matters;
- collect information regarding specific USFI accounts held by foreign residents; and
- establish reciprocal automatic information exchange.

The lack of automatic third-party reporting to foreign governments frustrates the objectives of FATCA.[12]

A. A Multi-Prong Approach to Address Evasion

The IRS and Justice Department took a multi-prong approach to identifying unreported income and undeclared assets, including:

- criminal prosecutions of individual taxpayers, bankers, accountants, and lawyers;[13]
- criminal investigations of numerous Swiss banks and other financial institutions;
- creation of an offshore voluntary disclosure program for U.S. persons with undisclosed assets in offshore financial institutions;
- creation of a special Swiss bank program to encourage Swiss banks to resolve potential criminal liabilities; and
- increased international tax audit and enforcement efforts.[14]

FATCA created the automatic exchange of information (AEOI) program, under which a foreign country agrees to exchange specific "tax- or financial account-related information on a regular and systematic basis, without the need for a specific request pursuant to a tax treaty or tax information exchange agreement."[15]

B. Structures to Conceal Beneficial Ownership

The IRS has dedicated significant resources to identify U.S. taxpayers with offshore legal structures and unreported income and undeclared assets. For instance, the IRS Large Business and International Division has developed numerous practice units to provide training materials.

LB&I explains in one especially applicable practice unit how U.S. taxpayers use offshore entities and opaque legal structures to conceal their beneficial ownership of assets and income.[16] A beneficial owner is typically liable for tax in its home country on income earned from its portfolio investments. That explanation is consistent with criminal tax indictments brought by the Justice Department when a taxpayer used those kinds of structures.

Various enablers helped U.S. clients use undisclosed and unreported Credit Suisse accounts to evade U.S. income taxes by holding accounts in the names of nominee tax haven entities they created.[17]

The use of legal structures with nominee entities is why FATCA includes a specific reporting category for entity-owned accounts (that is in addition to individually owned accounts). FFIs must report accounts owned by so-called passive nonfinancial foreign entities (in broad terms, non-U.S. entities that are not operating businesses) under a specific set of FATCA rules when there are substantial U.S. owners.[18]

Pre-FATCA, FFIs were not required to report to the IRS the U.S. owners of passive nonfinancial foreign entities under the qualified intermediary program. The IRS has substantially increased the obligations of FFIs under the revised QI program

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[12] *See* Government Accountability Office, "Foreign Asset Reporting — Actions Needed to Enhance Compliance Efforts, Eliminate Overlapping Requirements, and Mitigate Burdens on U.S. Persons Abroad," GAO-19-180 (Apr. 1, 2019). *See also* Peter A. Cotorceanu, "Hiding in Plain Sight: How Non-US Persons Can Legally Avoid Reporting Under Both FATCA and GATCA," 21 *Trusts & Trustees* 1050 (2015).

[13] More than 160 individuals have been indicted since 2009. *See* Jack Townsend, "Offshore Charges/Convictions Spreadsheet (7/22/16)," Federal Tax Crimes blog, Aug. 6, 2019.

[14] *See* IRS, "Large Business and International Launches Compliance Campaigns" (Jan. 31, 2017).

[15] *See* IRM 4.60.1.10, "Automatic Exchange of Information (AEOI) Program."

[16] *See* IRS, "Practice Unit: Basic Offshore Structures Used to Conceal U.S. Person's Beneficial Ownership of Foreign Financial Accounts and Other Assets" (Dec. 1, 2015) (last visited Apr. 8, 2019).

[17] *See* Justice Department announcement 11-957.

[18] In general, substantial U.S. owners of foreign corporations are any persons that directly or indirectly own more than 10 percent of the corporation's stock. For a trust, a substantial U.S. owner is any person treated as an owner of any portion of a trust treated as a grantor trust under U.S. tax law and any person that directly or indirectly holds more than 10 percent of the beneficial interests of the trust and are specified U.S. persons.

that integrates various FATCA concepts, such as that of beneficial ownership.[19]

In a 2014 report, the U.S. Senate Permanent Subcommittee on Investigations showed how much more in relative assets Credit Suisse held in accounts held by individuals versus those held by non-U.S. entities with undisclosed U.S. beneficial owners.[20]

The greater concentration of assets under management in non-U.S. entity accounts indicates that the use of offshore legal entities created a further pathway for tax noncompliance by helping U.S. taxpayers feel confident the IRS would not receive financial information for those accounts.

AEOI on offshore accounts, including those owned through legal structures, creates a strong incentive for U.S. taxpayers to comply with their U.S. tax and information reporting obligations. Similarly requiring automatic information exchange for accounts held in USFIs by nonresident individuals and their legal structures would encourage nonresidents to comply with the tax and information reporting obligations of their countries of tax residency — a stated goal of FATCA.

C. Compliance and Third-Party Reporting

The U.S. Treasury Inspector General for Tax Administration has repeatedly said taxpayers are more likely to report their income when there is third-party reporting. According to a 2019 TIGTA report, there is a 93 percent compliance rate with information reporting versus 37 percent without.[21]

The United States has many third-party reporting requirements, under which the third party must automatically report various information directly to the IRS. FATCA works on the premise that the IRS will automatically obtain U.S. taxpayers' information on any offshore accounts they hold, including those held by non-U.S. legal entities and structures in FFIs.

In contrast, because of the FATCA loophole, USFIs are not required to automatically send foreign taxpayer information of their U.S.-based accounts held by most legal entities and offshore legal structures.[22] It thus allows nonresident aliens to use USFIs to do the same thing U.S. taxpayers did in Switzerland: Keep their accounts hidden from tax authorities.[23]

D. Foreign Portfolio Holdings of U.S. Securities

USFIs hold substantial U.S.-inbound investments for foreign investors. In February Treasury reported that total foreign portfolio holdings as of June 30, 2019, were $20.9 trillion, with $8.9 trillion held in U.S. equities, $11 trillion held in U.S. long-term debt securities, and $924 billion held in U.S. short-term debt securities. (See Exhibit 1.)

Nonresident individual investors, foreign trusts, and foreign corporate investors are not subject to U.S. taxation on capital gains from the sale of U.S. personal property (including stock of U.S. corporations)[24] and U.S.-source interest income that is portfolio interest.[25] Most investment portfolios held by nonresidents and their offshore corporations in USFIs fall into those two categories of gains and income that are exempt from U.S. taxation, although USFIs also commonly hold non-U.S. securities and private equity investments on behalf of their nonresident investor clients.

Again, because of the FATCA loophole, USFIs are generally not required to report any information on those accounts.

[19] *See* IRS, FATCA — FAQs General (last visited Apr. 8, 2019).

[20] *See* Senate Permanent Subcommittee on Investigations report, *supra* note 11.

[21] *See* TIGTA, "Expansion of the Gig Economy Warrants Focus on Improving Self-Employment Tax Compliance," 2019-30-016 (Feb. 14, 2019).

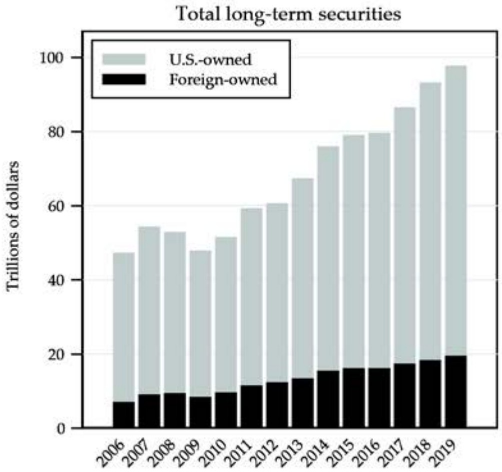
[22] The OECD common reporting standard for AEOI on foreign accounts is a multilateral agreement. Numerous countries are entering into bilateral AEOI agreements under that standard; the United States is not one of them. *See* OECD, "CRS by Jurisdiction."

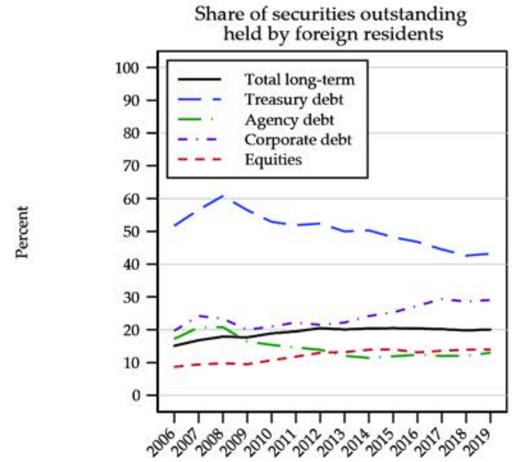
[23] U.S. taxpayers continue to hide money in FFIs. The U.S. Justice Department has entered deferred prosecution agreements with numerous banks over the last decade. *See, e.g.*, announcements 16-031 and 19-215.

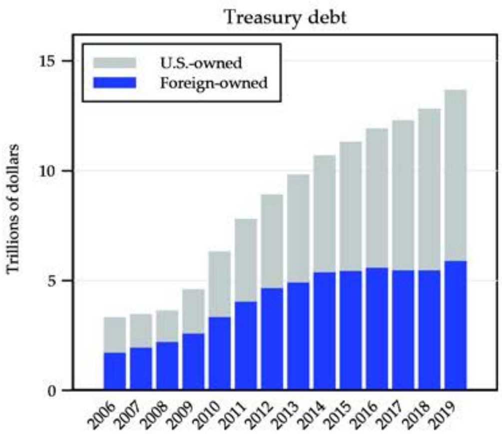
[24] *See* IRC sections 864(b) and 871(a)(2). Capital gains that come from real estate investments are generally subject to U.S. income taxation under the Foreign Investment in Real Property Tax Act. *See* IRC section 897.

[25] *See* IRC sections 871(h)(2) and 881(c). The bulk of publicly traded debt qualifies as portfolio interest debt instruments. *See* Martin and Roberto Perez Teuffer, "Overview of U.S. Interest Income, Exempt From U.S. Income Taxation for the Foreign Investor ('Portfolio Interest')," Procopio LLP (Sept. 2018).

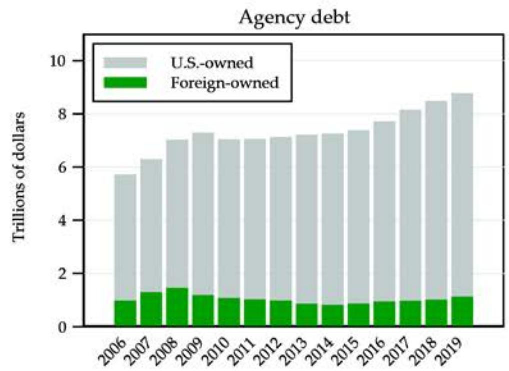
Exhibit 1. Foreign Holdings of U.S. Long-Term Securities Outstanding by Security Type As of End-June



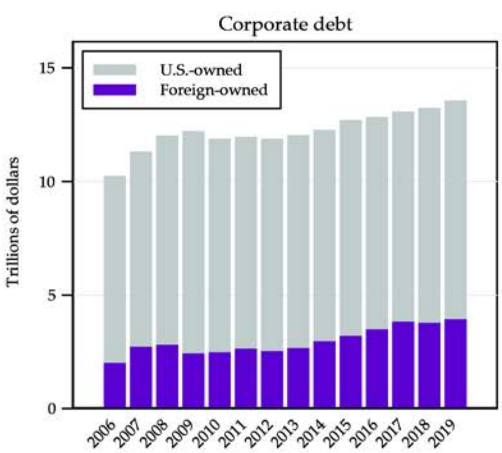




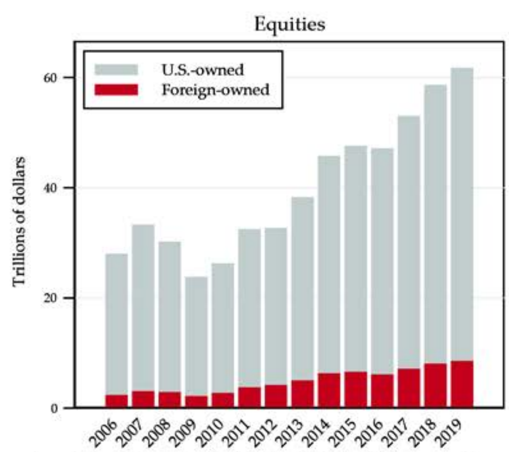
Source: Monthly Statement of the Public Debt of the United States, Table 1, Summary of Treasury Securities Outstanding, Total Marketable less Bills. Includes holdings of the Federal Reserve System.



Source: Federal Reserve Statistical Release Z.1, Financial Accounts of the United States, and consolidated balance sheets of Freddie Mac, Fannie Mae, and the combined Federal Home Loan Banks. The long-term outstanding amounts are the total long-term and short-term U.S. Government agency liabilities from Financial Account of the United States Z.1 Table L211, row 1, minus short-term debt securities outstanding issued by Freddie Mac, Fannie Mae, and the combined Federal Home Loan Banks. These short-term debt securities outstanding were approximately $486 billion as of June 2019. U.S. government agency securities include all securities issued by federally-sponsored agencies and corporations, as well as all securities guaranteed by the Government National Mortgage Association (GNMA). Amounts outstanding include those held by the Federal Reserve System.

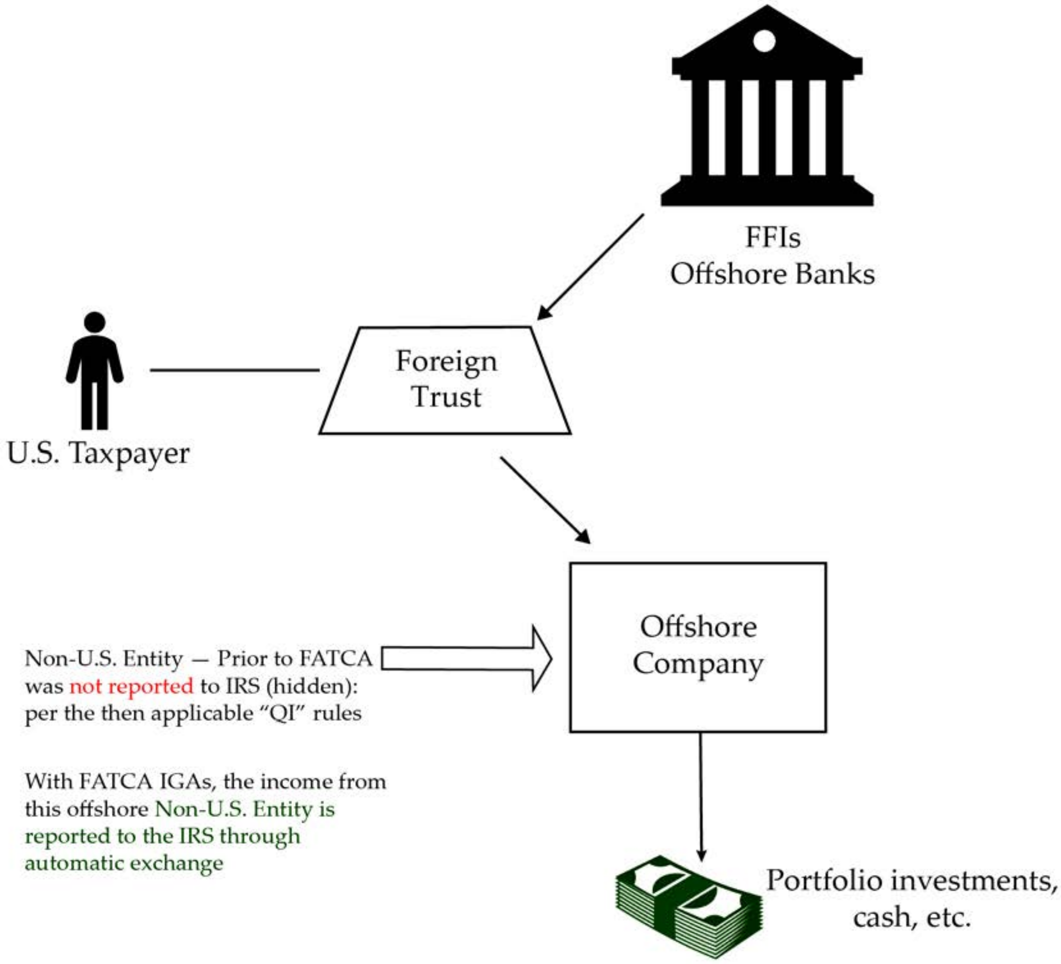


Source: Federal Reserve Statistical Release Z.1, Financial Accounts of the United States, Table L213 row 1, minus Table L133 row 29, plus Table L107 row 21.



Source: Federal Reserve Statistical Release Z.1, Financial Accounts of the United States, Table L223 row 1, minus Table L133 row 44, plus Table L234 row 21, plus Table L206 row 1.

Figure 3. Structures to Conceal Beneficial Ownership by U.S. Taxpayers to Hide Taxable Income in FFIs From the IRS



II. The FATCA Loophole

The U.S. government created the International Data Exchange Service so that financial institutions and tax authorities can transmit and exchange FATCA data with the United States.[26] However, many countries have privacy laws that generally prohibit them from automatically exchanging comprehensive financial information with third parties.[27] Therefore, the U.S. Treasury needed a bilateral framework for transmitting confidential financial information, which is accomplished with the IGAs.

A. Defining Reportable Accounts

Almost all IGAs define the term "U.S. reportable account" as:

> a Financial Account maintained by a Reporting [Country] Financial Institution and held by one or more Specified U.S. Persons or by a Non-U.S. Entity with one or more Controlling Persons that is a Specified U.S. Person.

FATCA defines the term "specified U.S. person" to exclude persons such as government agencies and tax-exempt organizations. It narrows the category of who is a U.S. person

[26] *See* IRS, "Foreign Account Tax Compliance Act (FATCA)" (last accessed Apr. 9, 2019).

[27] *See* Cynthia Rich, "A Look at New Trends: Data Privacy Laws in the Western Hemisphere (Latin America, Caribbean and Canada) Continue to Evolve," Bloomberg, July 17, 2017.

Figure 4. Switzerland Remained the Largest Offshore Center

	Switzerland	Hong Kong	Singapore	U.S.	Chanel Islands and Isle of Man	UAE	Luxembourg	U.K. Mainland	Monaco	Bahrain
Offshore wealth ($trillions)	2.3	1.1	0.9	0.7	0.5	0.5	0.3	0.3	0.2	0.2
CAGR 2012-2017	3%	11%	10%	5%	2%	4%	2%	2%	1%	5%
Top three sources	Germany France KSA	China Taiwan Japan	China Indonesia Malaysia	Mexico China Argentina	U.K. Russia KSA	KSA Iraq Iran	Germany France U.K.	China KSA Russia	France Italy U.K.	KSA Iran Iraq

Source: The Boston Consulting Group, "Global Wealth 2018: Seizing the Analytics Advantage" (June 2018).
Note: Offshore wealth in USD trillions. KSA = Kingdom of Saudi Arabia, UAE = United Arab Emirates.

subject to reporting, largely paralleling the IRC section 7701 definition, which includes U.S. citizens, resident aliens, and most lawful permanent residents.

Accordingly, the financial information of an offshore company must be reported to the IRS when the taxpayer is a specified U.S. person. In other words, by application of the broad definition of a U.S. reportable account, the FFI looks through the legal structure and reports automatically the income of the non-U.S. entity. That makes it harder for the taxpayer to hide the income in an FFI.

By contrast, the definition of the term "[Country X] reportable account" does not include entity accounts formed outside the other country that is party to a given IGA. For instance, the Mexico-U.S. IGA defines a Mexican reportable account as an account maintained by a reporting USFI if is held by an individual resident in Mexico or an entity that certifies that it is resident in Mexico for tax purposes.[28]

Figure 3 illustrates an arrangement that mirrors some of the key facts in a 2015 IRS private letter ruling obtained by the author. LTR 201544002 raised various tax questions for Mexican individual nonresidents who created a Delaware trust to hold assets for their dual-national children resident in Mexico. The Mexican settlors self-report their income from this structure to the Mexican tax authorities, but other taxpayers use that or similar structures to keep their assets and income hidden and not reported to the Mexican government.

That is the FATCA loophole. Individuals from outside the United States — say, Mexico — can form an offshore corporation to hold investment accounts with USFIs. The USFIs generally do not report any of the income or financial information of that non-Mexican entity, leaving it to the foreign taxpayer to self-report the income when filing a return with his or her tax administration. As mentioned, in the United States, self-reporting is largely ineffective in assuring tax compliance.[29]

Thus, there is a way for dishonest nonresident investors to earn U.S. capital gains and portfolio interest free from taxation in the United States (per U.S. law) and simply not report the income in their own country of tax residency. By not requiring USFI reciprocity, the United States perversely positions itself to attract the very

[28] *See* Allison Christians, "What You Give and What You Get: Reciprocity Under a Model 1 Intergovernmental Agreement on FATCA," *Cayman Fin. Rev.* (Apr. 12, 2013).

[29] TIGTA, *supra* note 21.

criminal behavior it has sought to eliminate in other jurisdictions. That is why critics and others have identified it as one of the world's top tax havens.[30] As one observer has noted:

> The United States has long functioned as a repository for foreign assets. With the repeal of U.S. tax on portfolio interest paid to non-U.S. persons in the 1980s, Latin American money began to flow into U.S. bank accounts and other U.S. portfolio investments. By 2011, about $240 billion of Latin American wealth had found its way to the United States, primarily Miami and New York.[31]

B. Cooperation Is Key to FATCA's Success

The U.S. government relies on foreign governments to identify U.S. taxpayers who hide their assets offshore in FFIs. It needs the cooperation of tax administrations and FFIs to improve international tax compliance and preserve FATCA's integrity and efficacy.

The FATCA loophole may mean that foreign tax authorities will be less inclined to help the IRS collect information on U.S. taxpayers holding accounts in FFIs. Why would they want to help the U.S. government identify income earned overseas by U.S. taxpayers if the same government will not obtain information on their taxpayers with undisclosed corporate accounts in USFIs?

III. Solution: Comply With the IGA Preamble

The model IGA already provides that U.S. and foreign governments will strive to reach several goals, including the reciprocal automatic information exchange of financial information. Having parity and consistency with the definition of reportable accounts for both USFIs and FFIs will help achieve reciprocal automatic exchange of financial information. The result will be that USFIs will automatically report income and financial information on U.S. accounts held by non-U.S. individual taxpayers the same way FFIs report that information on U.S. reportable accounts.

Accordingly, U.S. reportable accounts and [Country X] reportable accounts should be defined consistently:

> The term "U.S. Reportable Account" means a Financial Account maintained by a Reporting [Country X] Financial Institution and held by one or more Specified U.S. Persons or by a Non-U.S. Entity with one or more Controlling Persons that is a Specified U.S. Person.
>
> * * *
>
> The term "[Country X] Reportable Account" means a Financial Account maintained by a Reporting U.S. Financial Institution and held by one or more Specified [Country X] Persons or by a Non-[Country X] Entity with one or more Controlling Persons that is a Specified [Country X] Person.

That will foster reciprocal AEOI by giving USFIs the same reporting requirements as FFIs. Non-U.S. taxpayers will have the same expectation that their governments will automatically obtain information on their U.S.-based accounts, including those held through opaque legal, corporate, and trust structures. Finally, some cleaning up will be required to ensure that IGAs define new terms such as "non-[Country X] entity" and "specified [Country X] person."

How will the United States address international tax compliance and transparency questions that have arisen since it enacted FATCA? Will it close the FATCA loophole? ■

[30] *See* Christians, *supra* note 29. *See also* Ana Swanson, "How the U.S. Became One of the World's Biggest Tax Havens," *The Washington Post*, Apr. 5, 2016; Alex Cobham, "Empty OECD 'Tax Haven' Blacklist Undermines Progress," Tax Justice Network (June 28, 2017); and Craig Rose, "The Biggest Tax Haven of Them All? The U.S., FATCA and the CRS," Bloomberg International Tax Blog, Mar. 29, 2016.

[31] Samuel D. Brunso, "The U.S. as Tax Haven?" 5 *Colum. J. Tax L.* 170 (2014) [citations omitted].