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ASK FOR HELP, UNCLE SAM: THE FUTURE OF GLOBAL TAX REPORTING

SUSAN C. MORSE*

I. INTRODUCTION

THE problem of tax evasion on principal placed in, and income earned from, offshore financial accounts is neither complicated nor subtle as a matter of law. Many jurisdictions' income tax laws require residents to pay income tax on income earned from such accounts even though the accounts happen to be housed outside the taxing jurisdiction.[1] But tax administrators lack the information necessary to enforce the law with respect to offshore accounts. These accounts largely remain hidden from tax administrators unless taxpayers self-report them. One estimate puts the resulting worldwide annual revenue loss at $255 billion, based on an assumption of $11.5 trillion total asset value in such accounts.[2] Residence governments have strong incentives to address this information problem, but banking jurisdictions, often historically committed to strong bank secrecy laws, do not.[3]

Third-party reporting by the banks and other large intermediaries that administer financial accounts solves the related information problem for domestic accounts held by U.S. taxpayers. Banks send reports of investment returns, such as interest and dividend income and gross proceeds from the sale of securities, to the U.S. government and to U.S. taxpayers.[4] The compliance rate on such reported income exceeds ninety-five percent.[5]

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* Associate Professor, UC Hastings College of the Law. Many thanks to Itai Grinberg and Dick Harvey for helpful conversations and to the participants and commentators at the Villanova Law Review Norman J. Shachoy Symposium held in September 2011.

1. *See* REUVEN S. AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME 23 (2007) ("The residence rule [for imposing income tax on individuals' investment income] is so widely followed and is incorporated into so many treaties that it can be considered part of customary international law . . . .").

2. *See* RONEN PALAN, RICHARD MURPHY & CHRISTIAN Chavagneux, TAX HAVENS: HOW GLOBALIZATION REALLY WORKS 61–64 (2010) (calculating $255 billion from estimated total assets of $11.5 trillion, average annual return of 7.5%, or roughly $860 billion, and average tax rate of 30%).

3. *See* Itai Grinberg, *The Battle Over Taxing Offshore Accounts*, 60 UCLA L. REV. (manuscript at 54–85) (forthcoming 2012) (describing opposing automatic information reporting and anonymous withholding models).

4. *See, e.g.*, I.R.C. § 6042 (2006) (requiring dividend reporting); *id.* § 6045 (requiring gross proceeds reporting); *id.* § 6049 (requiring interest reporting).

5. *See* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES 179 (4th ed. 2008) (reporting ninety-six percent compliance rate for dividend and interest income in United States, where reporting but not withholding requirements apply).

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An ongoing United States attempt to address the offshore account problem exports the concept of third-party reporting by large intermediaries to the international context.[6] The Foreign Account Tax Compliance Act, or FATCA, requires "foreign financial institutions," or FFIs, to obtain and report information about U.S. account holders and submit to certain audit requirements. Otherwise, the law provides for a thirty percent withholding tax on U.S.-source portfolio income streams and gross proceeds from the sale of certain securities that produce U.S.-source portfolio income, regardless of whether those payments are made to U.S. or non-U.S. accounts at the FFI.[7] FATCA follows a bank-to-residence government, or B2G, approach to global information reporting.

The European Savings Directive, or EUSD, also addresses the problem of offshore accounts held by domestic resident taxpayers. The EUSD uses a bank-to-bank jurisdiction-to-residence jurisdiction, or B2G2G, approach to global information reporting. Under the EUSD, a bank or other "paying agent" within the jurisdiction of a participating state must transfer information about interest payments made by the paying agent to the government of the participating state, which then reports the interest payment information to the government of residence of the beneficial owner of the interest payment.[8] A few countries, such as Luxembourg, offer withholding at a rate of thirty-five percent rather than reporting. Withholding instead of reporting maintains bank secrecy.[9]

The B2G approach of FATCA, which would cut non-U.S. governments out of the information reporting chain, has the advantages of greater simplicity and more latitude to develop broad and innovative reporting strategies. But FATCA almost certainly cannot solve the problem of U.S. taxpayers' offshore accounts without the cooperation of non-U.S. governments. The United States will be reluctant to actually impose the statutory withholding tax for capital markets and international relations reasons. In addition, jurisdictional constraints and local legal constraints, including bank secrecy laws, prevent the United States from building an adequate method of ensuring the compliance of non-U.S. FFIs. Except to the extent that FFIs, their auditors, or both adopt FATCA compliance as a positive reputational signal,[10] gaining the cooperation of non-U.S. governments is an essential piece of a FATCA implementation strategy.

6. *See generally* J. Richard Harvey, Jr., *Offshore Accounts: Insider's Summary of FATCA and Its Potential Future*, 57 VILL. L. REV. 471 (2012).

7. *See* I.R.C. § 1471.

8. *See* Council Directive 2003/48, 2003 O.J. (L157) 38 (EC).

9. *See* European Comm'n, *Rules Applicable*, TAX'N & CUSTOMS UNION, http://ec.europa.eu/taxation_customs/taxation/personal_tax/savings_tax/rules_applicable/index_en.htm (last visited Dec. 16, 2011) [hereinafter *EU Taxation of Savings: Rules Applicable*] (describing scope of ESD and withholding option).

10. *See* Susan C. Morse, *Tax Compliance and Norm Formation Under High-Penalty Regimes*, 44 CONN. L. REV. 675 (2012).

A successful future for global information reporting based on the FATCA model thus almost certainly requires the United States to enlist non-U.S. governments.[11] A 2012 framework devised by the United States and five European countries that anticipates B2G2G reporting provides one approach,[12] which is formalized in U.S. model agreements featuring reciprocal and non-reciprocal reporting.[13] The United States and the UK finalized the first bilateral agreement, including reciprocal B2G2G reporting, in September 2012.[14] Other incremental steps toward multilateral cooperation also deserve consideration.

Part II of this Article describes the United States and European approaches to the problem of offshore accounts and cross-border information reporting. Part III explores three recommendations that would further the important goal of gaining non-U.S. government cooperation in the administration of the FATCA. In particular, Part III considers the tactics of simplicity, reciprocity, and side payments.

II. UNITED STATES AND EUROPEAN SOLUTIONS

A. *The U.S. Approach: Bank-to-Residence Government*

FATCA is a new solution to the old problem of U.S. domestic taxpayers evading tax on their income from offshore accounts.[15] The recent

11. *See generally* ORG. FOR ECON. COOPERATION & DEV., REPORT OF THE INFORMAL CONSULTATIVE GROUP ON THE TAXATION OF COLLECTIVE INVESTMENT VEHICLES AND PROCEDURES FOR TAX RELIEF FOR CROSS-BORDER INVESTORS ON POSSIBLE IMPROVEMENTS TO PROCEDURES FOR TAX RELIEF FOR CROSS-BORDER INVESTORS 16–21 (2009) [hereinafter OECD 2009 TRACE REPORT] (describing three approaches to problem of cross-border reporting involving governments of residence jurisdiction, bank jurisdiction and source jurisdiction in different degrees).

12. *See* U.S. TREASURY DEP'T, JOINT STATEMENT FROM THE UNITED STATES, FRANCE, GERMANY, ITALY, SPAIN AND THE UNITED KINGDOM REGARDING AN INTERGOVERNMENTAL APPROACH TO IMPROVING INTERNATIONAL TAX COMPLIANCE AND IMPLEMENTING FATCA (2012) [hereinafter FATCA 2012 FRAMEWORK JOINT STATEMENT].

13. *See* U.S. TREASURY, MODEL INTERGOVERNMENTAL AGREEMENT TO IMPROVE TAX COMPLIANCE AND TO IMPLEMENT FATCA (2012) [hereinafter "Reciprocal Model Agreement"], *available at* http://www.treasury.gov/press-center/press-releases/Documents/reciprocal.pdf; U.S. TREASURY, MODEL INTERGOVERNMENTAL AGREEMENT TO IMPROVE TAX COMPLIANCE AND TO IMPLEMENT FATCA (2012) [hereinafter "Nonreciprocal Model Agreement"], *available at* http://www.treasury.gov/press-center/press-releases/Documents/nonreciprocal.pdf. *See also* Kristen A. Parillo & Shamik Trivedi, *IRS Releases First FATCA Model Agreement*, 67 TAX NOTES INT'L 497, 497 (Aug. 6, 2012) (distinguishing between reciprocal and nonreciprocal reporting model agreements).

14. *See* Marie Sapirie and Kristin Parillo, *First FATCA Intergovernmental Agreement Signed With UK*, 67 TAX NOTES INT'L 1171 (Sept. 24, 2012); *see also* Agreement Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland to Improve International Tax Compliance and to Implement FATCA, Sept. 14, 2012 *available at* http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Agreement-UK-9-12-2012.pdf [hereinafter U.S.-UK FATCA Agreement].

15. For example, the 1970 legislative history of the Bank Secrecy Act shows a concern for tax evasion through offshore accounts. *See* H.R. REP. NO. 91-975

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path to FATCA's enactment began around 2008, when the offshore account issue came into the public spotlight.[16] The issue gained attention after the U.S. "qualified intermediary" ("QI") program for non-U.S. banks revealed an enforcement problem for holders of offshore accounts.[17]

From 2000 on, many non-U.S. banks and other financial intermediaries[18] have operated under QI agreements with the U.S. government. The QI program primarily aims to ensure that the correct amount of tax is collected when U.S.-source investment returns[19] are paid to non-U.S. investors. A non-U.S. bank that agrees to act as a QI may forward to U.S. intermediaries summary information about the treaty-based and other withholding positions of its client base, keep secret the identity of its non-U.S. account holders, and achieve the desired result of reduced withholding on U.S.-source investment returns paid to its accounts held by non-U.S. investors.[20]

The QI program was not set up to provide information on U.S. investors to the U.S. government, despite the nominal requirement that QIs disclose U.S. account holders.[21] The model QI agreement did not provide significant withholding penalties for payments to undocumented accounts, most notably refraining from imposing withholding on gross sale proceeds.[22] It did not apply to accounts held by U.S. taxpayers if those accounts did not produce U.S. source income.[23] It permitted diligence based on so-called "know your customer" rules developed to address

(1970), *reprinted in* 1970 U.S.C.C.A.N. 4394, 4398 ("[I]t is grossly unfair to leave the secret foreign bank account open as a convenient avenue of tax evasion."). The academic literature has considered this problem for some time. *See, e.g.*, Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1669 (2000) (noting problems posed by bank secrecy law and recommending an OECD-adopted uniform refundable withholding tax of "at least 40%").

16. *See* Harvey, *supra* note 6, at 475–78 (describing 2008 Liechtenstein and UBS scandals and contemporaneous Senate Permanent Subcommittee on Investigations hearing and report). R

17. *See generally* Treas. Regs. § 1.1441-1 (1997).

18. Over 5,000 foreign banks, such as UBS, Credit Suisse, and Deutsche Bank, have signed QI agreements with the United States. *See* Letter from N.Y. State Bar Ass'n to Sen. Max Baucus et al. (Sept. 10, 2009), *available at* 2009 TNT 175-67.

19. These include interest and dividends paid on debt or equity issued by U.S. corporations or the U.S. government. *See* I.R.C. § 1441(b) (2006).

20. *See* Susan C. Morse & Stephen E. Shay, *Qualified Intermediary Status: A New U.S. Withholding Role for Foreign Financial Institutions Under Final U.S. Withholding Regulations*, 27 TAX MGM'T INT'L J. 331, 333–34 (1998) (explaining attempt to enlist QIs in project of ensuring correct withholding on payments of U.S. source investment income to non-U.S. investors, in part by permitting QIs to maintain customer confidentiality).

21. *See* Rev. Proc. 2000-12, 2000 C.B. 387 § 6.01 (requiring disclosure of U.S. account holders).

22. *See* Treas. Reg. § 1.6049-5(d)(3)(ii) (2010).

23. *See* Harvey, *supra* note 6, at 476 (identifying ability to designate accounts outside system as weakness of QI regime). R

money laundering and related criminal law concerns.[24] And, finally, the QI rules defined "beneficial owner" to include a corporation, a rule which permitted U.S. account holders to hide their U.S. identity.[25]

Because the "beneficial owner" of an account was defined to include a corporation under the QI rules, a U.S. taxpayer could form a non-U.S. shell corporation, name the corporation as the account owner, and treat the account as owned by a bona fide non-U.S. person. The Swiss bank UBS, as well as, presumably, other non-U.S. banks, apparently openly advised its clients to avail themselves of this exit route.[26] The U.S. government learned about these practices in part thanks to ex-UBS banker Bradley Birkenfeld, who offered information about his former employer's practices including the formation of client shell corporations and the cross-border smuggling of cash and precious gems.[27]

The United States criminally prosecuted UBS and reached a deferred prosecution agreement.[28] It then pursued civil litigation against UBS which resulted in an agreement to disclose the identities of about four thousand U.S. UBS clients to the United States.[29] The path to this disclo-

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24. *See* Susan C. Morse & Stephen E. Shay, *Qualified Intermediary Status, Act II: Notice 99-8 and the Role of a Qualified Intermediary*, 28 TAX MGM'T INT'L J. 259, 262 (1999) (describing typical practice of country's bank association guiding KYC rules to IRS approval for use in QI agreement). These rules might not look automatically through entities, for example, but restrict investigation to situations where criminal activity seems likely.

25. *See* Treas. Reg. § 1.1441-1(c)(3) (1997) (defining foreign corporation as foreign beneficial owner). This rule is consistent with the principle of U.S. corporate income tax law that generally insists on the treatment of the corporation, not its shareholders, as the taxpayer. *See generally* Comm'r v. Bollinger, 485 U.S. 340 (1988); Moline Props., Inc. v. Comm'r, 319 U.S. 436 (1943). Domestic third-party reporting generally does not apply to corporate recipients. *See, e.g.*, Treas. Reg. § 1.6049-4(c)(1)(ii)(A) (1983) (listing corporation as exempt recipient for purposes of Section 6049 interest reporting).

26. *See* UBS EXEC. BD. WEALTH MGMT. & BUS. BANKING, QI SOLUTIONS FOR SIMPLE AND GRANTOR TRUSTS "SWISS SOLUTION"—ALTERNATIVE TO BE APPLIED/ THRESHOLDS 1 (2004) (recommending that "UBS . . . establish an underlying company in the Bahamas" where U.S. client account housed in "Swiss solution" trust exceeded certain threshold) (on file with author); UBS, QUALIFIED INTERMEDIARY SYSTEM: U.S. WITHHOLDING TAX ON DIVIDENDS AND INTEREST INCOME FROM U.S. SECURITIES 2 (2004) (noting that non-U.S. legal entities could claim reduced withholding rates under QI system and that certification with respect to any applicable limitation on benefits treaty article was required for reduced rates of dividend withholding, but not for portfolio interest exemption) (on file with author).

27. *See* Mark Hosenball & Evan Thomas, *Cracking the Vault*, NEWSWEEK, Mar. 23, 2009, at 32 (reporting Birkenfeld's cross-border transport of diamonds in toothpaste tube).

28. *See* Spencer Daly, Note, *Secrecy in Limbo: What the Most Recent Settlement with the IRS Means for UBS and the Rest of the Swiss Banking Industry*, 10 J. INT'L BUS. & L. 133, 143–48 (2011) (tracing criminal prosecution and deferred prosecution agreement story and connecting it to treaty relationship between U.S. and Switzerland).

29. *See* Lynnley Browning, *I.R.S. to Drop Suit Against UBS Over Tax Havens*, N.Y. TIMES, Aug. 27, 2010, at B6 (reporting that 2000 names had been disclosed and that United States expected disclosure of balance).

sure, which presented no small tension with Swiss bank secrecy law,[30] involved the announcement of an agreement following a visit to Switzerland by Secretary of State Hillary Clinton,[31] acquiescence by the Swiss Parliament,[32] and the approval of Switzerland's highest court.[33] Meanwhile, the United States engaged in a high-profile and fairly successful campaign[34] to persuade taxpayers to self-report their offshore accounts, which included the use of Reports of Foreign Bank and Financial Accounts, or FBARs.[35]

The Obama administration then generated the idea of FATCA,[36] which was initially proposed in May 2009[37] and passed, in modified form, in March 2010.[38] The statutory and regulatory components of FATCA meticulously avoid various deficiencies of the QI program. FATCA's provisions allow for significant withholding penalties on a broad range of payment streams, require that all accounts must be disclosed regardless of whether they produce U.S.-source income, impose relatively stringent dili-

30. *See* Bradley J. Bondi, *Don't Tread on Me: Has the United States Government's Quest for Customer Records from UBS Sounded the Death Knell for Swiss Bank Secrecy Laws?*, 30 NW. J. INT'L L. & BUS. 1, 3–7 (2010) (describing historic Swiss commitment to legal regime of bank secrecy).

31. *See* Sue Pleming & Deborah Charles, *Clinton Says Agreement "in Principle" with UBS*, REUTERS (July 31, 2009), http://www.reuters.com/article/idUSN314232 8120090731 (reporting Hillary Clinton's announcement of litigation settlement agreement and her related meeting with Swiss foreign minister).

32. *See* Lynnley Browning & David Jolly, *Swiss Approve Deal for UBS to Reveal U.S. Clients Suspected of Tax Evasion*, N.Y. TIMES, June 18, 2010, at B3 (reporting that Swiss legislature approved deal in lieu of pursuing national referendum).

33. Originally, the Swiss Federal Administrative Court held that the failure to file a W-9 with UBS for transmission to the U.S. tax authorities did not constitute "tax fraud and the like" and therefore did not meet a requirement under the 1996 treaty for an exception to bank secrecy protection. *See* Daniel Pruzin, *Switzerland for Now to Hand Over Data on Only 250 Secret Accounts with UBS*, BNA TAX MANAGEMENT WEEKLY REPORT 144–45 (Feb. 1, 2010). In July 2011, the lower court's decision was reversed, preventing UBS account holders from claiming damages for breach of bank secrecy from UBS. *See* Emma Thomasson, *Swiss Court Says Was Right to Give U.S. Bank Data*, REUTERS (July 15, 2011), http://www.reuters.com/article/2011/07/15/ubs-idUSLDE76E12W20110715 (noting court's view that U.S. indictment that could have resulted absent Swiss regulator's order for handover of information "'would have led to the bankruptcy of the bank which in turn would have caused serious and virtually uncontrollable economic repercussions for Switzerland . . . .'" (quoting Federal Supreme Court of Switzerland)).

34. *See* Morse, *supra* note 10, at 710–18 (arguing that creative publicity and expectation-setting for appropriate penalties helped make offshore voluntary disclosure initiatives successful). R

35. *See* Reports of Foreign Financial Accounts, 31 C.F.R. § 103.24 (2010); TREASURY DEP'T, INTERNAL REVENUE SERV., FORM 90-22.1.

36. *See* Harvey, *supra* note 6, at 479–81 (relating initial concept of FATCA as expansion of QI system). R

37. *See* DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 43, 45 (2009).

38. *See* Hiring Incentives to Restore Employment Act, Pub. L. No. 111–147, § 501, 124 Stat. 71 (2010).

gence requirements, and use an expanded beneficial owner concept.[39] These provisions are remarkable innovations, and push existing law and practice in several ways.

First, FATCA broadens the scope of covered payments subject to its 30% withholding tax to include virtually all returns from financial investment accounts, and notably includes the sledgehammer of withholding on gross proceeds from the sale of securities.[40] This is not consistent with the idea that the application of an income tax to sale proceeds should be limited to gain on sale, or the difference between the gross proceeds realized from the sale and the basis of the securities sold.[41] One commentator has characterized FATCA as a penalty statute rather than an enforcement statute because it is not designed to reach taxable income.[42]

Second, FATCA's requirement for disclosure of accounts regardless of whether they generate U.S. source income or are held at an affiliate of a participating FFI broadens the existing idea that source withholding may be used to enforce taxes due to a source government by reason of its source jurisdiction. The source withholding idea is a cornerstone of the existing international tax system[43] and lies at the heart of the QI regime.[44] Under FATCA, the idea morphs, and the threat of source withholding on one set of accounts (those that hold securities that generate U.S.-source investment income) is used to prompt and enforce disclosure of another set of accounts (those owned by U.S. taxpayers). The first and second group of accounts may overlap only partially, or even not at all.

Third, FATCA refuses to allow FFIs to rely on documentation provided to them that asserts clients' residence or tax status, but instead spe-

39. In addition to the provisions discussed in the text, FATCA also features an innovative requirement to withhold on broadly defined "payments" received from other institutions and "attributable to withholdable payments." *See* I.R.C. § 1471(b)(1)(D)(i), (d)(7) (2006); Harvey, *supra* note 6 (describing pass-thru payment rule and recommending that government delay its implementation). FATCA addresses the possibility that participating FFIs will assign U.S. accounts to related banks outside the scope of the FFI agreement by requiring all affiliates to be party to the FFI agreement. *See* I.R.C. § 1471(e) (applying requirements of FATCA to all members of FFI's "expanded affiliated group"). FATCA guidance also indicates continued creative attention to problems like default rules for accounts as to which no information is provided. *See, e.g.*, I.R.S. Notice 2011–34, 2011-19 I.R.B. 765, 769 (noting that Treasury may terminate FFI Agreements due to number of recalcitrant account holders after certain amount of time). R

40. *See* I.R.C. § 1471(a) (imposing 30% tax); § 1473(1) (defining withholdable payment and including gross proceeds).

41. *See* I.R.C. § 1001 (providing for taxation of gain on sale of assets).

42. *See* Melissa A. Dizdarevic, Comment, *The FATCA Provisions of the HIRE Act: Boldly Going Where No Withholding Has Gone Before*, 79 FORDHAM L. REV. 2967, 2985 (2011) (noting FATCA's apparent penalty purpose).

43. *See, e.g.*, Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1036–38 (1997) (explaining importance of source jurisdiction protection in development of international tax system).

44. *See* Morse & Shay, *supra* note 20, at 333–34.

cifically requires extra diligence if certain indicia of de facto U.S. ownership exist in the materials provided in connection with the account.[45] This departs from, or at least changes the interpretation of, the usual principle that withholding agents[46] and tax preparers[47] may rely on representations provided to them by the taxpayer absent an obvious reason to believe that such representations are incorrect.

Fourth, FATCA refuses to presume that a corporation is a taxpayer and beneficial owner. It requires reporting, for example, of accounts held by a foreign entity if more than ten percent of the equity in that entity is held by a U.S. person.[48] This is consistent with the approach of the FBAR reporting rules, which require reporting for accounts over which a U.S. person has signatory authority, but it departs from the longstanding principle of U.S. federal income tax law that respects corporations as taxpayers.[49]

FATCA's status as a unilateral piece of legislation facilitated its innovations. U.S. policymakers immersed in the UBS case and responding to the revealed deficiencies of the QI regime crafted an audacious statute that goes right to the doors of FFIs to demand needed information.[50] The United States' decision to move the legislation without seeking consensus

45. For example, under proposed regulations, a U.S. address or telephone number or U.S. place of birth constitutes "reason to know" that non-U.S. documentation is inaccurate. *See* Prop. Treas. Reg. § 1.1471-3(e)(4), 77 Fed. Reg. 9022, 9027 (Feb. 15, 2012) (providing reason to know guidelines for U.S. withholding agents); *id.* § 1.1471-4(c)(4) (providing due diligence requirements for FFIs and adding other U.S. indicia). Diligence requirements are more stringent for larger accounts, *see, e.g.*, *id.* and for later-opened accounts. *See, e.g.*, *id.* § 1.1471-3(c)(8) (requiring additional diligence for accounts over $1 million); *id.* § 1.1471-4(c)(4)(ii) and (iii) (providing relief for certain pre-existing accounts at FFIs). The intergovernmental framework adopted by France, Germany, Italy, Spain, the United States, and the UK anticipates negotiation over due diligence requirements. *See* FATCA 2012 FRAMEWORK JOINT STATEMENT, *supra* note 12, at 3 (anticipating the "development of reporting and due diligence standards").

46. *See, e.g.*, Int'l Lotto Fund v. Va. State Lottery Dep't, 800 F. Supp. 337, 342 (E.D. Va. 1992) ("The role of a withholding agent is ministerial in nature. The agent is not granted the discretion by the I.R.S. to conduct an audit-like inquiry upon submission of a properly completed Form 1001." (citation omitted)), *rev'd*, 20 F.3d 589 (4th Cir. 1994).

47. *See* I.R.C. § 6694(a)(3) (2000) (providing that no tax preparer penalty is due if "there is reasonable cause for the understatement and the [preparer] acted in good faith"); Treas. Reg. § 1.6694-2(e)(4) (2008) (describing "good faith" standard to include consideration of actual knowledge of preparer and whether preparer's normal procedures promote accuracy and include "methods for obtaining necessary information from the taxpayer").

48. *See* I.R.C. § 1471(d)(1)(A) (defining "United States account" as "account which is held by one or more specified United States persons or United States owned foreign entities"); *id.* § 1471(d)(3) (defining "United States owned foreign entity" as entity with "substantial United States owners"); *id.* § 1473(2) (defining "substantial United States owner" as more than ten percent owner).

49. *See supra* note 25 and accompanying text (reviewing authorities regarding independent corporate taxpayer status).

50. *See* Harvey, *supra* note 6, at 479–82 (describing genesis of FATCA). R

from banking jurisdictions sped up the process of enacting FATCA. And if FATCA's streamlined information reporting channel does not involve non-U.S. governments, such governments should not be able to hold the system hostage, whether through intentional lack of cooperation or understandable logistical challenges.

But the United States almost certainly cannot enforce FATCA all by itself. First, imposing a withholding tax could produce unwanted capital market disruptions and require the commitment of international relations resources.[51] Second, local legal barriers including bank secrecy law limit banks' ability to disclose information about their account holders.[52] Third, the United States lacks the jurisdiction to confirm directly that FFIs are in fact complying with their obligations under their agreements.

The statute contemplates FFIs' agreement to regular audits, and the model FFI agreement will likely require FFIs to use a certified firm, such as one of the Big 4 firms or one of their affiliates, to conduct the audit.[53] These audit requirements push the responsibility for ensuring that FATCA's requirements are met onto the local divisions or affiliates of audit firms, over which the United States also generally does not exercise jurisdiction, making direct enforcement impractical. The potential of the audit firm gatekeeper enforcement strategy for FATCA is limited by the extent to which audit firms perceive that compliance will attract reputational benefits (or noncompliance will produce reputational detriments) and by such firms' capacity to execute their responsibility within the limits of local confidentiality requirements.

It is possible that FATCA may succeed under an expressive law and reputational signaling strategy. As I have written elsewhere, non-U.S. FFIs might embrace compliance with FATCA as a positive reputational signal to clients and governments.[54] This signal might grow in strength as more banks comply with FATCA and as compliant banks increasingly commit to FATCA compliance through their very acts of due diligence and reporting. There are certain choices that U.S. policymakers can make to maximize the chance that FATCA will succeed as a reputational strategy. For example, policymakers can consider strategies that reference reputation, have high salience, target management, and embrace incrementalism to foster

51. *See* Morse, *supra* note 10, at 725–26 (outlining capital markets and international relations obstacles to imposition of FATCA's withholding tax). U.S. government representatives have said that they want "transparency," not withholding, to result from FATCA. *See, e.g.*, Tom Braithwaite, *U.S. Delays Reporting Rules for Foreign Banks*, FIN. TIMES (July 15, 2011), http://www.ft.com/cms/s/0/fe2f7bae-ae49-11e0-844e-00144feabdc0.html#axzz1nQH7aEb7 (quoting IRS Commissioner Doug Shulman). R

52. *See Scratched by the FATCA*, ECONOMIST, Nov. 26, 2011, at 86 (noting conflict between FATCA and other nations' "data-protection laws").

53. The QI agreement also takes this approach. *See* Rev. Proc. 2000-12, 2000 C.B. 387 § 10.

54. *See* Morse, *supra* note 10, at 729 (proposing reputation-signaling FATCA administration strategy targeting FFIs). R

the development of a virtuous norm-development cycle.[55] But the success of this approach is far from certain. Except to the extent that a reputational strategy works, the United States will require the cooperation of other governments to enforce FATCA.

B. *The European Approach: Bank-to-Bank Government-to-Residence Government*

The European approach to the problem of offshore accounts has taken a more multilateral tone compared to FATCA. Its centerpiece, the EUSD, applies to more than forty countries when combined with closely related and parallel agreements. These countries include twenty-seven EU member states, plus ten territories associated with EU member states and five other European states, including Liechtenstein and Switzerland.[56] The core of the EUSD is its requirement that the competent authority, or national tax administration, of a jurisdiction must forward information about the interest income flows paid by banks located in that jurisdiction to the residence jurisdictions of the owners of the interest income.[57]

The "years of fierce debate" that preceded the adoption of the EUSD in June 2003 featured objections from EU members Austria, Belgium, and Luxembourg that they would not agree to the reporting requirement unless their banking industry competitor Switzerland—not an EU member—did the same.[58] The EU negotiators resolved the debate by permitting countries to opt to impose a withholding tax on interest income, now set at thirty-five percent, in lieu of reporting.[59] Relatively few countries permit withholding rather than reporting.[60] When a country withholds, it keeps twenty-five percent of the withholding proceeds and pays over seventy-five percent to the beneficial owner's residence jurisdiction.[61]

The weaknesses of the EUSD parallel some of the weaknesses of the roughly contemporaneous QI system, although the EUSD squarely aimed to address underreporting by domestic resident taxpayers while the QI system focused on taxpayers not resident in the United States. First, the

55. *See id.* at 728; *cf.* Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585, 593 (1998) (describing possibility of several compliance equilibria).

56. *See EU Taxation of Savings: Rules Applicable*, *supra* note 9 (describing scope of ESD). R

57. *See* Council Directive 2003/48, *supra* note 8, at art. 9 (providing for exchange of information between competent authorities).

58. *See* John C. Brouwer & Godfried J.W. Kinnegim, *What the EU Savings Directive Means*, 14 INT'L TAX REV. 10, 10 (2003) (recounting history of debate).

59. *See id.* (describing compromise).

60. These include EU member states Austria and Luxembourg and five banking jurisdictions with parallel withholding agreements: Andorra, Liechtenstein, San Marino, Monaco, and Switzerland. Belgium now reports rather than withholding. *See EU Taxation of Savings: Rules Applicable*, *supra* note 9 (listing countries that withhold). R

61. *See* Council Directive 2003/48, *supra* note 8, at art. 12 (providing for revenue sharing).

EUSD requires withholding only on "interest payments," rather than reaching all types of income from financial investments.[62] In addition, the EUSD permits reliance on the same kinds of documentation presented for purposes of know-your-customer anti-money-laundering laws.[63] Finally, the EUSD, like the QI system, permits payers to recognize "legal persons" such as corporations as beneficial account holders.[64] Thus the shell corporation workaround also avoids EUSD reporting and withholding obligations.[65]

While Bradley Birkenfeld's disclosures about UBS revealed the QI system's deficiencies and prompted litigation against UBS in the United States, contemporaneous European events similarly disclosed the inadequacy of the EUSD. The EUSD simply did not ensure the taxation of European residents by their home countries, even when those residents held their interest-producing assets in banks subject to the disclosure or withholding requirements of the EUSD. In the most prominent example, Germany in 2008 launched a major investigation regarding up to four billion euros in funds held by German citizens in Liechtenstein banks. The investigation targeted a large number of prominent German taxpayers, many of whom held assets through shell entities.[66]

European residence jurisdictions responded to the shortcomings of the EUSD in several ways. First, they stepped up audit activity, in one instance purchasing confidential bank data to assist the effort.[67] Second, several residence jurisdictions struck bilateral deals with bank secrecy jurisdictions inspired by the withholding option offered by the EUSD.[68]

62. *See id.* at art. 6 (defining interest payment). It is possible that nearly all offshore accounts pay some kind of bank deposit interest, so that the ESD could operate as a comprehensive requirement to disclose offshore accounts if the withholding option did not apply. But the narrowness of the definition raises a close substitutes problem. In other words, banks might substitute another form of investment income or fee relief for bank deposit interest if only bank deposit income is subject to reporting. *Cf.* Morse, *supra* note 10, at 691–92 (describing close substitutes problem in general terms). R

63. *See* Council Directive 2003/48, *supra* note 8, at art. 3(2)(b) (permitting reliance on passport or personal identification card).

64. *See id.* at art. 4(2) (providing that paying agents need not look through "legal persons").

65. *See, e.g.*, Vanessa Houlder, *When There Are Fewer Places to Hide Funny Money*, FIN. TIMES (Aug. 3, 2006), http://www.ft.com/intl/cms/s/1/99eb9e7c-2247-11db-bc00-0000779e2340.html#axzz25iu2Y6NG (reporting relatively small withholding tax collections under ESD and "[l]oopholes[ ] such as the exemption of trusts and companies").

66. *See Not So Fine in Liechtenstein*, ECONOMIST (Feb. 22, 2008), http://www.economist.com/node/10750259 (describing German investigation and tension between Liechtenstein bank secrecy and "convoluted" German tax laws).

67. *See id.* (noting increased audit activity and recounting purchase of confidential bank data); *see also Not-So-Safe Havens*, ECONOMIST (Feb. 19, 2009), http://www.economist.com/node/13148143 (noting "intense pressure from Germany, France, Britain and a few others" on tax havens).

68. Germany and the UK have both struck agreements with Switzerland that provide for withholding and preserve secrecy. *See* Grinberg, *supra* note 3 (manu-

Under these agreements, banking jurisdictions would "in effect pay a fat fee" to residence jurisdictions, said to be equal to the withholding tax due on noncompliant accounts, "to avoid revealing clients' names."[69] When clients' names are kept secret, the residence government cannot further investigate their tax compliance, for example with respect to taxes due on account principal or on non-interest investment income.[70]

In 2008, the EU developed a proposal, still pending, to tighten the EUSD's provisions.[71] The EU's proposal falls short of the U.S. FATCA provisions in several respects. It expands the scope of the EUSD to returns on certain financial instruments that economically substitute for interest payments, but it does not attempt to reach other investment returns, including gross proceeds.[72] It does not impose expanded, tax-evasion-tailored diligence requirements based on indicia of connections with taxing jurisdictions. It provides that the owners of corporations may be treated as the beneficial owners of accounts nominally held by corporations, but these rules are limited by existing anti-money-laundering rules and diligence procedures.[73] Finally, November 2012 marks the fourth anniversary of the proposal's publication, and it has not become law.

In February 2011, a EU Directive regarding cooperation on direct taxation matters included the requirement that one member state automatically transfer to another member state information available to the tax

script at 8) (describing and criticizing agreements); Haig Simonian, *Confidentiality: Switzerland Moves to Avert Threat to Privacy Privileges*, FIN. TIMES (Nov. 20, 2011), http://www.ft.com/intl/cms/s/0/8b2a76b0-0f68-11e1-88cc-00144feabdc0.html#axzz25iu2Y6NG (reporting German-Swiss and UK-Swiss agreements and interest in similar agreements in France, Greece, and Italy). These agreements follow the preferred Swiss withhold-but-don't-disclose "Rubik" model. *Compare* TAX JUSTICE NETWORK, THE UK-SWISS TAX AGREEMENT: DOOMED TO FAIL 3 (2011), *available at* http://www.taxjustice.net/cms/upload/pdf/TJN_1110_UK-Swiss_master.pdf (reporting Swiss-German and Swiss-UK deals and negotiations to extend model to other countries and criticizing Rubik approach), *with* Niels Jense, Note, *How to Kill the Scapegoat: Addressing Offshore Tax Evasion with a Special View to Switzerland*, 63 VAND. L. REV. 1823, 1852–58 (2010) (describing Swiss-proposed solution as "a good starting point").

69. *Tax Havens: Trouble Island*, ECONOMIST (Oct. 15, 2011), http://www.economist.com/node/21532264; *see also* Vanessa Houlder, *Britons to Be Taxed on Secret Billions*, FIN. TIMES (May 2, 2011), http://www.ft.com/intl/cms/s/0/6b4f2fb2-74da-11e0-a4b7-00144feabdc0.html#axzz25iu2Y6NG (detailing agreements).

70. *See, e.g.*, Grinberg, *supra* note 3 (manuscript at 54); Simonian, *supra* note 68 (reporting that participants at G20 meetings "hint[ed] [that] Switzerland should do more"). **R**

71. *See Proposal for a Council Directive Amending Directive 2003/48/EC on Taxation of Savings Income in the Form of Interest Payments*, COM (2008) 727 final (Nov. 13, 2008).

72. *See id.* at 19 (recommending amendments to Article 6).

73. *See id.* at 14–15 (proposing amendment to Article 2). The explanation states that the intent of the proposal is to apply anti-money laundering look-through principles to the beneficial owner definition and the proposal lists types of entities that paying agents must look through. *See id.* at 3–4, 28–40 (discussing proposed amendments).

authorities of the first state.[74] The Directive includes member state reporting requirements, for example applicable to information-sharing statistics, and anticipates a 2017 proposal "regarding the categories of income and capital and/or the conditions [of reporting], including the condition that information concerning residents in other Member States has to be available."[75] Like FATCA, this 2011 EU Directive is moving in the direction of automatic global information reporting,[76] but it has made less progress than FATCA in setting forth the mechanics of how to achieve that goal and erecting an enforcement structure around it.

A system that permits withholding instead of reporting is generally less satisfactory to a taxing authority. There are at least two reasons for this. First, reporting, like withholding, should produce very high rates of compliance.[77] Second, a tax authority may use reported information about the individual taxpayer to determine whether that taxpayer has fully complied with the law. Suppose, for example, there was a strong statistical correlation between taxpayers who had large offshore bank accounts and taxpayers who failed to pay tax on amounts they deposited in such accounts. Or, suppose that many offshore account holders reported some, but not all, of their offshore income. A system that provides the residence government with the identity of the offshore account holders allows that information to improve audit selection and increase the chance of successful audit.[78]

Though the EU approach lacks the boldness of FATCA, it has greater potential for good enforcement. This is so simply because the EU approach involves the banking jurisdiction governments, which have the power to enforce its provisions, so far as these provisions go. From the perspective of a tax administrator, the disadvantages of Switzerland's decision to strike withholding tax deals on behalf of its banks include greater support for the goal of bank secrecy and the logistically difficult involvement of another party in the tedious project of crafting a working system. But a significant advantage is that the Swiss tax authority joins the project

74. *See* Council Directive 2011/16/EU, Administrative Cooperation in the Field of Taxation and Repealing Directive 77/799/EEC, 2011 O.J. (L 64) 1 (EU).

75. *See id. at art 8.*

76. *See* Grinberg, *supra* note 3 (manuscript at 34–35) (noting that this directive could lead to proposal including reporting of capital gains, dividends and royalties that would be generally consistent with FATCA). **R**

77. Reporting is generally sufficient to assure very high compliance. *See* SLEMROD & BAKIJA, *supra* note 5, at 179 (reporting very high rates of compliance when income is reported but not withheld upon). **R**

78. Itai Grinberg has raised the question of whether developing countries, as well as developed countries, would prefer an automatic information reporting system to an anonymous withholding system. An automatic information reporting system permits a residence jurisdiction more control over its public finance system. *See* Grinberg, *supra* note 3 (manuscript at 65–70). An anonymous withholding system produces tax revenue without reliance on domestic audit and collection functions. Different residence jurisdictions may weigh these opposing benefits differently. **R**

of achieving the tax collection goal. Also, the Swiss agreement to participate might provide a stronger starting point for reconciling a reporting law with Swiss confidentiality requirements.

FATCA features innovative provisions that adopt broad definitions of reportable payments, beneficial ownership, and diligence requirements.[79] It may well represent best practices for many elements of a global information reporting system. But the lack of any involvement by non-U.S. governments in FATCA's B2G reporting infrastructure makes FATCA enforcement unrealistic. U.S. tax administrators can improve the chances of FATCA's success by seeking the cooperation and involvement of non-U.S. governments. Part III outlines three possible tactics: simplicity, reciprocity, and side payments.

III. RECOMMENDATIONS FOR U.S. POLICYMAKERS

A. *Possible Forms of Non-U.S. Government Cooperation*

The cooperation of non-U.S. governments with the endeavor of FATCA could come in several different forms. Cooperation could follow the mainstream EUSD B2G2G reporting model and transfer the obligation to report beneficial owner income streams from FFIs to the tax authorities of the jurisdictions where such FFIs operate. The Model Agreements developed by the U.S. in accordance with a multilateral framework follow this approach.[80] Cooperation could also involve non-U.S. governments less formally in developing an approach to reconciling FATCA with other countries' bank secrecy laws.[81] For example, it could feature an agreement by a non-U.S. government to include a FATCA compliance checklist for examinations or reports required under domestic law, such as for securities, banking law, or third-party auditor licensing purposes.[82] A non-U.S. government might permit U.S. government representatives access to FFIs for direct audit purposes. Or cooperation could

79. For a further discussion of FATCA, see *supra* notes 36–49 and accompanying text (describing FATCA's provisions).

80. *See* FATCA 2012 FRAMEWORK JOINT STATEMENT, *supra* note 12 (noting parties United States, France, Germany, Italy and UK). R

81. One appropriate goal would be state-of-the-art data encryption and other system design features in order to prevent the leakage of customer information outside government computer systems, rather than an agreement to withhold and maintain bank secrecy based on the Swiss Rubik model.

82. Options that would involve non-U.S. governments' involvement in the enforcement of U.S. law assume that historic revenue rule constraints could be overcome. *See* William S. Dodge, *Breaking the Public Law Taboo*, 43 HARV. INT'L L.J. 161, 170–77, 202–06 (2002) (giving history of "revenue rule" refusal to enforce other countries' tax laws and absence of mutual collection assistance provisions from tax treaties). The ESD, treaty-based information exchange, and other developments, including U.S. case law developments, suggest that the revenue rule would not preclude this type of intergovernmental cooperation. *See, e.g.*, Pasquantino v. United States, 544 U.S. 349, 356, 364 (2005) (holding in five to four decision that scheme to evade Canadian excise taxes qualified as fraud under U.S. law and hence could support wire fraud conviction).

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consist of the non-U.S. governments' adoption of diligence provisions,[83] reporting provisions,[84] or both that are similar to or borrowed from FATCA—thus aligning non-U.S. governments' interests with U.S. interests without any explicit involvement of non-U.S. governments in U.S. enforcement of the FATCA rules.

In anticipating the development of a cooperative, intergovernmental system of automatic tax information reporting, policymakers must make regular choices between, on the one hand, accepting incremental agreements and anticipating further development of cooperation based on these incremental changes, and, on the other hand, striving to get things right the first time. Recent history in this area suggests the value of incremental change. The existence of QI laid the groundwork for FATCA within the U.S. political environment. The OECD's tepid Tax Information Exchange Agreement program provides a building block upon which automatic information exchange may partly rest.[85] The EU's 2011 Directive shows evidence of halting progress from on-demand, to spontaneous, to automatic information sharing.

As Itai Grinberg has written, one model for incremental change is a "bifurcated" system. This approach would establish a compliance model for cooperative nations and a noncompliance model for uncooperative nations. A noncompliant nation's banks would be subject to harsher rules, such as more onerous diligence and a real threat of punitive withholding.[86]

A bifurcated approach presents the risk that significant numbers of countries and non-U.S. banks will refuse to move into the compliance group on the terms offered. The nations negotiating intergovernmental FATCA agreements are generally developed nations with strong interests in collecting information about their residents' offshore income.[87] Other nations have different interests. For example, their interest in maintaining bank secrecy laws could be greater relative to their interest in collecting information on their residents' offshore income.

In a one-jurisdiction context, the idea of forcing a choice between two menu options draws support from the fact that taxpayers must deal with

83. *See* Harvey, *supra* note 6, at 495 ("If several major countries agreed on customer due diligence procedures, . . . it could significantly strengthen the IRS's hand when attempting to force a FFI to perform detailed due diligence procedures on its entire customer base . . . ."). **R**

84. *See id.* (outlining multilateral FATCA system where each FFI would report to more than one residence country).

85. *See* Morse, *supra* note 10, at 702–07 (framing OECD harmful tax competition project as incremental expressive law effort). **R**

86. *See* Grinberg, *supra* note 3 (manuscript at 86).

87. *See, e.g.*, FATCA 2012 FRAMEWORK JOINT STATEMENT, *supra* note 12 (naming United States, France, Germany, Italy, and UK as parties). **R**

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the tax administration of the jurisdiction on some terms.[88] In a multijurisdictional context, it may not work to force a choice between two menu options presented by a subset of the relevant jurisdictions because taxpayers might opt out of the menu altogether. U.S. taxpayers in the offshore account could opt out by seeking out banks that did not invest in U.S. securities. In addition, U.S. taxpayers might reasonably decide to try to call Uncle Sam's bluff, gambling that the United States is really not prepared to impose punitive withholding on U.S. source income streams going to, say, Hong Kong or Singapore.

The balance of this Part III presents the cooperation strategies of simplicity, reciprocity, and side payments. In part, the discussion frames the course of ongoing negotiations over intergovernmental FATCA agreements based on the multilateral FATCA framework and the models presented by the United States. In addition, it provides a toolbox that could establish different cooperative objectives to further the goal of persuading as many nations as possible to join the project of automatic information reporting.

The strategies described here could accommodate an incremental pattern of reform in which initial compromises help to build commitment to the program of global reporting, which could later support modifications that expand reporting requirements, tighten diligence obligations or otherwise strengthen the program.[89] The strategies could also accommodate a pattern of global information reporting development that varied from jurisdiction to jurisdiction.

B. *Simplicity*

The promise of FATCA lies in the possibility that it will become a model for an automatic global income tax information reporting system that effectively delivers bona fide beneficial owner information. The quality of FATCA reporting is important. Increasing the range of payments and accounts subject to reporting, expanding due diligence requirements, tailoring due diligence to the requirements of tax law rather than piggybacking on money laundering law's risk assessment approach, looking through shell corporations, and other FATCA innovations increase the chance of producing high-quality beneficial owner reporting.

Yet greater simplicity would also benefit FATCA's implementation. Effective non-U.S. government involvement in the implementation of FATCA—whether directly as part of the reporting stream, indirectly as enforcers of FFI compliance or FFI auditor compliance, or in parallel as users of the same rules for their own domestic tax enforcement pur-

88. *See* Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 COLUM. L. REV. 689, 710–14 (2009) (describing information-forcing mechanisms in context of tax compliance and enforcement).

89. *See* Morse, *supra* note 10, at 731–35 (advocating incrementalism due to its norm-building potential but noting countervailing factors including possible close substitutes, uncertainty, and public choice). R

poses—will be easier if FATCA's requirements are simpler.[90] Also essential is the delivery of the required information in an electronic form compatible with different countries' and companies' database and software systems.[91]

One way to simplify the administration of FATCA is to provide exemptions to types of financial products and institutions that do not present a high risk of harboring tax-evading U.S. account holders. Some commentators describe this as "the primary area for negotiation" in the model intergovernmental FATCA agreements.[92] Annex II of the agreement between the U.S. and the UK exempts products like certain retirement funds, and institutions including the Bank of England and some financial institutions with a local client base and no non-UK fixed place of business, from FATCA requirements.[93]

As another example, FATCA implementation could take at least three approaches when describing required FATCA reporting. The first, minimal approach would restrict FATCA reporting to seven fields: (1) taxpayer name; (2) taxpayer address; (3) taxpayer identification number; (4) bank name; (5) bank identification number; (6) taxpayer account number; and (7) account value, for example the maximum during the reporting year. This is consistent with the statute, which conditions more detailed reporting requirements on the discretion of the Secretary of the Treasury.[94]

This first approach achieves the delivery of the most important piece of information: that a domestic taxpayer holds an offshore account of a certain size. The taxpayer's awareness of the government's knowledge of the offshore account serves a useful function even absent specific income flow information. Relevant empirical and experimental research demonstrates that perceived opportunity to evade drives decisions to not report income from certain sources. A taxpayer need not believe that the government knows the precise amount of income flows in order to believe that there is a significant chance of getting caught because the government knows that the account exists.[95]

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90. *Cf.* David Jolly, *For Americans Abroad, Taxes Just Got More Complicated*, N.Y. TIMES (Apr. 15, 2012), http://www.nytimes.com/2012/04/16/business/global/for-americans-abroad-taxes-just-got-more-complicated.html?pagewanted=1&_r=2, (quoting practitioners as describing unfortunately complicated "shadow FBAR" form required to be filed by taxpayers including American expatriates as "monstrosity" that would "take a full Saturday to [complete]").

91. *See, e.g.*, OECD 2009 TRACE REPORT, *supra* note 11, at 32 ("[E]lectronic submission of documents is not a sufficient answer to the question of how to create an efficient system for making and granting claims for treaty benefits.").

92. Sapirie & Parillo, *supra* note 14, at 1497. **R**

93. *See* U.S.-UK FATCA Agreement, *supra* note 14, at Annex II. **R**

94. *See* I.R.C. § 1471(c)(1)(D)(2010) (giving Secretary of Treasury discretion to decide whether to require reporting of receipts and withdrawals).

95. For example, studies have demonstrated that tax compliance is higher for income received in the form of a check than for cash income. *See* Maryann Richardson & Adrian J. Sawyer, *A Taxonomy of the Tax Compliance Literature: Further Findings, Problems and Prospects*, 16 AUSTL. TAX FORUM 137, 171 (2001) (citing studies);

Second, the U.S. government could require reporting of income streams as defined under local law. This is the approach taken in the proposed regulations, which also give FFIs some ability to report in local currency rather than U.S. dollars.[96] It may be that reporting of income streams as determined under local law does not add additional complexity to the reporting project, but that application of U.S. law, the currency conversion, or both would be particularly burdensome. If so, this compromise struck in the regulations is appropriate within the context of the goal of reaching cooperative solutions.

Finally, FATCA guidance could require reporting of income streams as defined under U.S. law, in U.S. currency. This would make automatic matching to tax return information easier.[97] But the compliance advantage, as the regulations appear to acknowledge, is likely not worth the trouble of implementing the approach within the non-U.S. banks on whom the success of FATCA rests.

The 2012 FATCA framework also anticipates negotiation over reporting and diligence requirements. Perhaps there is a chance that this process could produce a simple, salient electronic reporting methodology. That should be an important and stated goal.

C. *Reciprocity*

One challenge facing a U.S. attempt to persuade non-U.S. countries to cooperate with its FATCA project of offshore information reporting is that the United States does not readily share account holder information with other countries. Different obstacles to information sharing appear in the cases of payments of U.S. source income to non-U.S. beneficial owners depending on whether the beneficial owners hold accounts at non-U.S. institutions or U.S. institutions. Despite these challenges, the multilateral 2012 FATCA framework[98] and the finalized U.S.-UK agreement both feature reciprocity.[99]

In the case of accounts maintained at non-U.S. institutions, it may be that no institution under U.S. jurisdiction has the necessary customer in-

see also James Andreoni, Brian Erard & Jonathan Feinstein, *Tax Compliance*, 36 J. ECON. LIT. 818, 841–43 (1998) (explaining income source compliance factor).

96. *See* Prop. Treas. Regs. § 1.1471-4(d)(4)(iv), 77 Fed. Reg. 9046 (Feb. 15, 2012) (requiring reporting of dividends, interest, gross proceeds, and other income as determined under local law).

97. Precise income flows can facilitate the automatic matching of specific items of income to specific lines on a taxpayer's tax form. But different definitions of, for example, interest and dividends in different countries would make matching more difficult. *Cf.* Martin A. Sullivan, *Economic Analysis: Treasury Expects Billions from Credit Card Reporting Proposal*, 115 TAX NOTES 890, 891 (2007) (noting that automatic item matching requires separate listing on third party tax reports).

98. *See* FATCA 2012 FRAMEWORK JOINT STATEMENT, *supra* note 12. **R**

99. *See* U.S.-UK FATCA Agreement, *supra* note 14, at Article 2.2.b (describing U.S. undertaking to report interest income and U.S.-source dividend and certain other income paid to UK reportable accounts). **R**

formation. In particular, the QI program shields non-U.S. accountholder information from disclosure to any U.S. party, including both U.S. intermediaries and the U.S. government.[100] Consequently, at least with respect to payments routed through QIs, the United States is left without the information needed to assist a non-U.S. government with the non-U.S. government's project of combating tax evasion engaged in by its residents with respect to investment returns paid from U.S. sources into non-U.S. accounts.

In the case of accounts maintained at U.S. institutions, the example of Canada illustrates the possibility of automatic information sharing with another government. The United States-Canada tax treaty includes Article 26A, an addition to the usual U.S. model treaty form, which provides that "[t]he Contracting States undertake to lend assistance to each other in the collection of taxes."[101] A Treasury Regulation implements this treaty article by providing for automatic reporting of bank deposit interest "with respect to a deposit maintained [by a Canadian treaty resident] at an office within the United States."[102] Mexico has specifically requested similar reporting,[103] and a U.S. regulation finalized in 2012 would require this sort of bank deposit reporting to all other countries' residents.[104]

Opponents of reciprocal measures like the nonresident bank deposit reporting regulation warn of reduced inbound deposits from nonresidents, decreased lending capabilities, and regional economic contraction.[105] But the Treasury has stood its ground. For example, in a series of

100. *See* Rev. Proc. 2000-12, 2000 C.B. 387, at § 6.01 ("QI is not required to disclose . . . any information regarding the identity of an account holder that is a foreign person . . . .").

101. Income Tax Convention, U.S.–Can., art. 26A, Sept. 26, 1980, T.I.A.S. No. 1187. A 1995 Protocol added the collection assistance article. *See* Protocol Amending the Convention Between the United States and Canada with Respect to Taxes on Income and on Capital, S. Exec. Rep. No. 104-9, art. 15 (1995).

102. Treas. Reg. § 1.6049-8(a) (1996).

103. *See* Kevin Preslan, Note, *Turnabout is Fair Play: The U.S. Response to Mexico's Request for Bank Account Information*, 1 GLOBAL BUS. L. REV. 203, 224–26 (2011) (considering different ways to comply with Mexico's request for automatic information exchange).

104. *See* Treas. Reg. § 1.6049-8; Guidance on Reporting Interest Paid to Nonresident Aliens, 77 Fed. Reg. 23391 (Apr. 19, 2012) (changing reporting requirements). However, opposition in Congress has produced a bill that would delay the regulations' effective date. *See* Lee A. Sheppard, *FATCA Intergovernmental Agreements*, 67 TAX NOTES INT'L 1083 (Sept. 17. 2012) (reporting on legislation that passed the House). The regulation lacks FATCA's careful investigation of accounts' ultimate beneficial ownership, as it simply requires the reporting of "interest paid to any nonresident alien individual." *See* Treas. Reg. 1.6049-8(a). Some had proposed amending the regulations to include more stringent beneficial owner rules. *See, e.g.*, Letter from Carl Levin, U.S. Senator, to Douglas H. Shulman, IRS Comm'r (Apr. 18, 2011), *available at* 2011 WTD 74-33 (LEXIS) (recommending identification of "beneficial owners behind shell entities").

105. *See, e.g.*, Lee A. Sheppard, *Bank Interest Reporting, Finally, Maybe* (Aug. 31, 2011), *available at* 2011 WTD 173-2 (LEXIS) (detailing objections to proposed regulation based on capital flight and other arguments and government's "stern and

similar letters written to legislators concerned about reductions in inbound bank deposits, officials explained that reciprocity is key to the success of the government's campaign against offshore tax evasion and that, after all, "the additional reporting requirements should affect only nonresidents who are not properly reporting interest income themselves in compliance with their home country's laws."[106]

Capital flight concerns arise if account holders have the opportunity to shift funds to banks in other countries with not only bank secrecy, but also strong property right protections and stable governments, so that nonresidents are willing to bank there. Investment in U.S. banks may be sticky enough that capital flight is simply not a significant concern.[107] But if policymakers were worried, they might consider coordination mechanisms to address this concern. For example, they might tie the effective date for U.S. bank deposit reporting to the effective date for FATCA adoption by a certain percentage of FFIs or a certain percentage of non-U.S. jurisdictions. Or they might make such reporting a part of ordinary course treaty negotiations. The negotiation of intergovernmental FATCA agreements provides another avenue to reciprocal information reporting.

D. *Side Payments*

Side payments are an important potential tool that might be used to induce non-U.S. governments to cooperate in the enforcement of FATCA.[108] The EUSD withholding option, which features 75/25 revenue sharing between the residence jurisdiction and the paying agent's jurisdiction,[109] provides one example of a side payment that is closely related to the architecture of the tax itself.

Different forms of side payments have different advantages and disadvantages. A side payment that fully compensates withholding or reporting

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detailed" responses); Letter from J. Thomas Cardwell, Fla. Office of Fin. Regulation, to Internal Revenue Service (Mar. 31, 2011), *available at* 2011 WTD 72-33 (LEXIS) (warning of dire consequences of imposition of bank reporting rule including reduced lending capacity and economic contraction in Florida); *see also* Letter from Rep. Bill Posey et al., U.S. Congressmen, to Barack Obama, U.S. President (Mar. 2, 2011) *available at* 2011 WTD 46-26 (LEXIS) (citing 2004 study finding that weaker version of similar regulation would cause $88 billion in capital flight).

106. Letter from Emily McMahon, Acting Treasury Assistant Sec'y for Tax Pol'y, to Charles W. Boustany, Jr., U.S. Congressman (Dec. 2, 2011), *available at* 2011 TNT 237-18 (LEXIS).

107. *See* Sheppard, *supra* note 105 (noting government position that "Treasury did not believe predictions of massive capital flight").

108. *See* Timothy V. Addison, Note, *Shooting Blanks: The War on Tax Havens*, 16 IND. J. GLOBAL LEGAL STUD. 703, 723–25 (2009) (recommending side payment to tax havens to align tax compliance incentives); Marshall J. Langer, *The Case for Limited Revenue-Sharing Tax Arrangements*, 55 TAX NOTES INT'L 641 (Nov. 14, 2005) (exploring revenue sharing options).

109. For a further discussion of the EUSD withholding option, see *supra* notes 59–61 and accompanying text.

agents for their costs may over-incentivize investment in withholding or reporting systems.[110] A nonrefundable side payment that is unrelated to the project of withholding fails to properly motivate the parties responsible for building the system.[111] Especially if there is no withholding tax, a side payment that shares revenue resulting from the cooperation of a particular government will face various accounting challenges including the identification of a baseline and the separation of increased revenue amounts resulting from the efforts of different governments.

Steven Dean has proposed one solution that strikes a promising balance between the advantages and disadvantages of different forms of side payments. Under Dean's proposal, a residence jurisdiction (like the United States) would loan a banking jurisdiction (like Switzerland) the funds necessary to construct a withholding and reporting system. Then, the paying jurisdiction would keep a certain percentage of amounts withheld, presumably repaying the loan out of these amounts.[112]

Dean's loan model might be amended to accommodate different features of a system. For example, in a system that required reporting rather than withholding, the residence jurisdiction might forgive the loan based on a percentage of the amounts reported. More liability for possible failure of the withholding or reporting system could be assigned to the non-U.S. banks or governments by loaning less than the full cost of building the system.[113] Loans from a consortium of residence jurisdictions could fund the initial construction of a system. Payment of maintenance and update costs could depend on audit access.

IV. CONCLUSION

The emerging U.S. FATCA system provides an innovative model for the future of offshore information reporting. But its bank-to-residence government, or B2G, model lacks a good enforcement mechanism, because the United States lacks jurisdiction over the non-U.S. banks and other foreign financial institutions targeted by the FATCA rules. In contrast, European nations' approach to the problem of offshore information reporting takes a bank-to-bank governing jurisdiction-to-residence govern-

110. In other words, the risk of loss from imprudently overinvesting in a system is fully insured so that the regulatee has little incentive to avoid such a loss. *Cf.* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 109-10 (7th ed. 2007) (explaining moral hazard using classic insurance example).

111. That is, it fails to assign liability to the parties, whether governments or banks, responsible for creating the withholding and reporting system. *Cf. id.* at 105–08 (explaining value of assigning liability to "cheapest insurer" among contracting parties).

112. *See* Steven A. Dean, *Philosopher Kings and International Tax: A New Approach to Tax Havens, Tax Flight, and International Tax Cooperation*, 58 HASTINGS L.J. 911, 957–60 (2007) (explaining "tax flight treaty" idea).

113. *Cf.* A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 61 (4th ed. 2011) (noting deductible and co-insurance approaches to improving risk allocation).

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ment, or B2G2G approach; this puts banking jurisdiction governments squarely in the middle of the reporting system.

The FATCA implementation project should seek non-U.S. government cooperation. Despite the possibility that FFIs or local auditors might adopt FATCA for reputational signaling reasons, the United States should open the possibility of successful enforcement by presenting FATCA as a model for automatic global information reporting and building other nations' commitment to the project. The greater involvement of non-U.S. governments could take several forms, including direct assumption of reporting responsibility, assistance in the project of reconciling FATCA's requirements with client confidentiality rules, inclusion of FATCA compliance in criteria for government inspection of non-U.S. banks or auditors, or adoption of parallel due diligence and/or reporting requirements. The 2012 FATCA framework agreed to by the United States, France, Germany, Italy, and the UK, together with the negotiation over intergovernmental agreements based on U.S.-drafted models, provides an example of the kind of cooperative action possible under FATCA.

U.S. administrators of FATCA can use tactics based on simplicity, reciprocity, and side payments to encourage non-U.S. governments to support the FATCA project. Existing model agreements make use of the reciprocity tactic and, to some extent, the simplicity tactic. FATCA administrators might also use the simplicity, reciprocity, and side payment tactics in incremental and varied fashion in seeking the cooperation of different jurisdictions in the effort to build a global automatic tax reporting system.