

FATCA: SWATTING FLIES WITH ATOM BOMBS

Possible inflation of the offshore tax evasion problem and the staggering costs of the Foreign Account Tax Compliance Act are causing even the most ardent advocates of information sharing and ending bank secrecy to question the U.S. approach.

"For the U.S. to ask countries around the world to spend billions in implementation costs to deliver less than \$ 1 billion per year is, economically, complete nonsense," said Martin Naville, CEO of the Swiss-American Chamber of Commerce. He referred to FATCA as the least considered program in history and "mind boggling" in its unilateralism. "The net value of FATCA for the U.S. is probably negative," said Naville, who added that tax compliance is a must but that there are better ways to achieve it.

With FATCA, "the U.S. forced the world to the table in classic, American, our-way-or-the-highway style -- it was perceived as a stunningly arrogant play," said Mark E. Matthews of Caplin & Drysdale Chtd. "But it could have taken years to accomplish the same level of tax information sharing via traditional international consensus-building approaches," said Matthews, a former IRS deputy commissioner for services and enforcement.

While most of the cost of FATCA is being borne abroad, "the tax-deductible costs of the program to U.S. banks alone may exceed the revenue return," Matthews added.

But revenue collections aren't the only way to evaluate FATCA -- it's also the end to bank secrecy, said Bryan C. Skarlatos of Kostelanetz & Fink LLP. Bank secrecy eventually would have ended without FATCA but at a greater cost to the United States, he added. "Without FATCA a lot of money would have just moved from Switzerland over to places like Panama," and the government would have had to pursue banks individually, he said.

There can be social benefits to increased transparency and an evolution toward a smaller world, especially in this age of digital currency, terrorism, and cybercrime, Skarlatos said. "The government shouldn't always be constrained by how much money they're going to make in the next three years," he said.

Estimating the 'Pot of Gold'

An oft-cited 2008 investigative report (Doc 2008-15596) by the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations estimated the cost to the United States from offshore tax abuse to be \$ 100 billion annually. While that figure has seen its share of detractors over the years, the Justice Department Tax Division still cites it in support of its offshore compliance initiative.

"I've never seen anything concrete about how [the Senate] came up with that number," Naville said. "A lot of things were put into that basket, including unpaid taxes by corporations." If FATCA was expected to bring \$ 100 billion to the U.S. treasury, at least the economics would make sense, but FATCA was scored to raise much less than that, Naville said. The Joint Committee on Taxation estimated (JCX-5-10 (Doc 2010-3977)) that the legislation would bring in \$ 8.7 billion between 2010 and 2020.

But based on the numbers from the IRS's offshore voluntary disclosure program thus far, Matthews said, both of those projections may be too high. "FATCA will definitely increase foreign reporting of foreign assets, but I think people are seriously overestimating the pot of gold," Matthews said. "I spent most of my time on the government side, and I still feel that way."

The OVDP and its predecessors have yielded more than 45,000 voluntary disclosures and about \$ 6.5 billion in collections, according to a June 2014 IRS fact sheet (Doc 2014-15159). But much of that revenue comprises penalties and interest, and OVDP participants were filing as many as six to eight years of back tax returns, Matthews said. "It would be a generous estimate to say Swiss-based tax evasion is generating about a half a billion dollars a year in revenue as measured roughly by the results of the offshore program to date," he said. And that's after five or six years of the U.S. government "pounding the Swiss banks as hard as humanly possible," he added.

Filings of foreign bank account reports have increased from almost 350,000 in 2008, the year the DOJ began its offshore program, to just over 1 million in 2014, according to Treasury's Financial Crimes Enforcement Network. While those numbers include FBARs for prior years, "my sense is that the vast

majority are filed in a timely manner to fulfill current obligations," FinCEN spokesman Stephen Hudak told Tax Analysts.

Still, "compliance hasn't skyrocketed the way you would expect it to if the offshore tax problem was as large as it's been portrayed," Matthews said. Of the FBARs filed in recent years, "probably 90-plus percent were filed by domestic filers," he said. That leaves a significant gap between FBAR numbers and the State Department's 2013 estimate that 6.8 million U.S. citizens live abroad.

"U.S. citizens living abroad have a home country bank account in 99 percent of cases," Skarlatos said. So there's a lot of technical noncompliance with the reporting requirements going on, "but that doesn't necessarily equate to a lot of unreported income or unpaid tax," he said.

The offshore voluntary disclosure initiative and the OVDP have flushed out most of the people who were intentionally not reporting their offshore assets, Skarlatos said. There are still millions who aren't reporting their offshore assets, but many of them aren't willfully failing to do so, he said.

Matthews, who called the OVDP the most successful tax evasion enforcement program in history, agreed that "a lot of these people are not the Al Capones that the IRS is making them out to be." If FATCA does generate a windfall of money, "I'm not sure that's because it's catching mostly criminals," he said.

The Cost of Ending Bank Secrecy

A 2010 article in Swiss newspaper *Neue Zürcher Zeitung* estimated the average introduction costs of FATCA to be \$ 5 million to \$ 10 million per foreign financial institution. If all FFIs implement FATCA, global costs could be between \$ 1 trillion and \$ 2 trillion. Naville, one of the article's coauthors, told Tax Analysts that while there have been some improvements in the program, \$ 1 trillion in implementation costs is still as good an estimate as any.

The number of FFIs that will be subject to FATCA has been estimated at between 200,000 and 700,000, and the implementation costs from \$ 1 million for small banks to several hundred million for larger ones, Naville said. There are too many variables for anyone to develop more than a ballpark figure, he said, adding, "The big question is whether everybody is really going to implement this."

The European Banking Federation and the Institute of International Bankers estimated in a joint comment letter (Doc 2010-25273) on Notice 2010-60, 2010-37 IRB 329 (Doc 2010-19071), that the incremental cost for an institution with 25 million accounts to bring those accounts into compliance with the notice's customer identification and documentation requirements would be at least \$ 250 million. The industry's overall cost of compliance for existing accounts will be in the billions of dollars, according to the letter.

In 2013 HM Revenue & Customs estimated (Doc 2013-13351) total costs of FATCA to U.K. businesses to be £1.1 billion to £2 billion over five years. Those numbers included both one-time costs associated with new internal systems and average annual costs estimated to be £50 million to £90 million per year. HMRC itself was expected to incur one-time costs of approximately £5 million with ongoing annual costs of £1.4 million beginning in 2016.

Australia estimated in a memorandum (Doc 2014-14353) explaining legislation to implement its intergovernmental agreement with the United States that a Model 1 IGA would cost the Australian financial sector AUD 482.68 million (\$ 367.75 million) over 10 years. That was the preferred alternative to a Model 2 IGA, which would have cost AUD 565 million (\$ 430 million), and the status quo alternative, estimated at more than AUD 1 billion (\$ 761 million) over 10 years.

FATCA has added materially to the complexity of the Internal Revenue Code, and the compliance cost for taxpayers is huge, Skarlatos said. "FATCA is the best thing that ever happened to the Big Four" accounting firms, he added.

While Alan W. Granwell of Sharp Partners PA agreed that FATCA has been good for the advisory industry, he added that the volume and incongruity of overlapping rules "is overwhelming, and there are probably lots of mistakes being made unintentionally."

Between U.S. FATCA regulations, IRS notices, revenue procedures, frequently asked questions, IGAs, and the internal guidance of other countries, "even if you know what you're doing, it's easy to make a misstep," Granwell said. Further, "you have U.S. FATCA, you have U.K. FATCA, and then you have the

OECD's common reporting standard, and again, these regimes are not entirely compatible," he said. All that complexity adds up to an enormous cost to taxpayers, he added.

Life is complicated for banks with many account holders, Granwell said. Banks in Switzerland are realizing that reporting is more complicated than they had envisioned, and some are discovering that their systems don't fully comport with FATCA, he said.

While there's no official estimate of FATCA's cost to the two largest Swiss banks, Credit Suisse AG and UBS AG have had several hundred people working on FATCA full time for years, Naville said. The effort involves departments from accounting to compliance -- "it's not just external costs for IT, coding, or tax specialists," Naville said.

There are also costly implications for U.S. citizens abroad, Naville said. U.S. citizens in European countries have a tough time getting services from banks and "pay a much higher premium for simple accounts because it's much more work for a bank to have a U.S. account holder," he said. Constraints may be less problematic for high-net-worth individuals because of the many SEC-licensed institutions offering wealth-management services to U.S. clients, "but a mid-level professor with \$ 500,000 in the bank is not going to get great banking service in Switzerland, Germany, or other places," Naville said. "It's going to get worse and worse," he added.

Treasury and the IRS have designed implementing regulations in a way that minimizes administrative burdens and related costs, according to a Treasury spokesperson, who cited the exemption from review for all preexisting accounts with \$ 50,000 or less held by individuals.

But that de minimis threshold isn't high enough, Naville said. "Account holders with \$ 100,000 to \$ 200,000 aren't going to make a difference in tax revenue to the U.S.," he said.

FATCA has "turned on its head how popular it is to be an American," Matthews said. "When clients who have lived abroad for years come in, concerned about whether they have an obligation under FATCA, they sometimes react to the suggestion that their kids might be American the way one might react to a horrible medical diagnosis," he said.

The number of individuals who have either renounced their citizenship or terminated their long-term U.S. residency generally has grown every year since 2009, when the number was 742, according to Federal Register data compiled by Andrew Mitchel, an international tax attorney in Centerbrook, Connecticut. An exception was 2012, when there were 932 published expatriations, compared with 1,781 in 2011. Expatriations jumped in 2013 and 2014 to 2,999 and 3,415, respectively. (Prior coverage (Doc 2013-20233).)

The uptick in expatriations over the last few years is attributable both to FATCA and to increased enforcement of other reporting obligations by the IRS, Mitchel said. FATCA added momentum to the direction people were already going, following the introduction of penalties for unintentionally failing to file an FBAR, the UBS scandal, and the OVDPs, he said.

Most expatriates are middle-income, dual citizens living permanently abroad, perhaps born in the United States to non-U.S. parents who likely didn't stay in the U.S. long, Mitchel said. "One of the major issues they have is the cost of filing their U.S. tax returns every year," he said. "It can cost thousands, or in some cases tens of thousands of dollars, due to the complexity of the rules."

Of course, compliance costs aren't the end of the story. "There is no tax authority on Earth, including the IRS, that has the resources to process the information that's coming to it under FATCA or equivalent programs," said Richard Murphy, director of Tax Research LLP. "It's not clear that the IRS has enough people to turn this information into a sufficiently potent weapon that taxpayers with offshore accounts will start declaring them."

"How is FATCA going to work in a non-English-speaking, developing country where a bank clerk makes \$ 30 per month trying to digest 500 pages in English to determine whether entities are 10 percent or more owned by U.S. people?" Matthews asked. "I personally think it's ludicrous."

More Than One Way

"FATCA is the most extraordinarily over-engineered program on Earth," Murphy said. "The minimum

information needed to make sure a tax evader can be caught and penalized is much less than FATCA demands." The goal of information exchange "should not be to have perfect files so that the case can be closed on the data supplied" but rather "to make sure the inquiry we need for the successful identification and prosecution of tax evaders can be made so that the case need never be opened," he said.

All that's needed to provide "smoking gun" data is accurate and reliable information on who has an interest in what offshore account, with potentially some indication of scale, Murphy said. "I would trade off scale for disclosure of all accounts irrespective of scale because it is this data, rather than the more complex aspects of FATCA, that will create compliance," he said.

Murphy added that a public understanding that authorities will know about those accounts is key to enforcement. "Taxpayers will have already voluntarily complied because they know the chance of discovery is high," he said.

"We are not seeing the degree of sophistication and management of tax systems needed to make a program like FATCA, which requires a better understanding of the tax gap than the U.S. has demonstrated, efficient," Murphy said.

But Skarlatos said that reducing the information burden on FFIs would shift costs back to the U.S. government to follow up when something questionable arises. "Reducing the information required to be reported under FATCA is a political judgment as to who should bear the costs of transparency rather than a pure efficiency improvement," he said.

If FATCA guidance and IGAs could be made more compatible, "life would be a little easier," Granwell said. For example, definitions, qualification rules for some deemed-compliant categories, and some operating rules in the U.S. FATCA regulations sometimes differ from the corresponding rules under IGAs, Granwell said. It can be particularly difficult to ascertain whether an entity is a passive non-financial foreign entity or an FFI when the rules don't conform, he said.

As another example, currency conversion under the Swiss-U.S. IGA is determined by the rate at the prior year end, but the U.S. FATCA regulations look to the spot rate at the current year end, Granwell said. If a bank is unable to accommodate the prior year currency conversion rule and has to use the current year rule, it could use the rule in the regulations, he said. However, that could raise issues with the consistency rules of the IGA's annex 1.C if the bank wanted to use the annex rules for other purposes, he said.

The OECD's standard for automatic exchange of information is much more cost effective than FATCA and has the added benefit of being helpful for countries other than the United States, Naville said. "Automatic exchange of information has been discussed intensely now for five-plus years; FATCA has not," he said. "There is hope that automatic exchange and FATCA will somehow coalesce over time."

Misallocation of Effort

According to the IRS's tax gap map (Doc 2012-357) for 2006, underreporting of individual business income was much larger in scale than was the underreporting, underpayment, or nonfiling of any other category for which data was included in the study, at \$ 122 billion. That suggests that FATCA's focus on offshore accounts is a "misallocation of effort," Matthews said.

"If you look at tax compliance as a dike and there are little holes in it and you're trying to patch those holes, the gusher is small business taxpayers," Matthews said. But there's never been a hearing on small business tax evasion, he said, adding that for political reasons, small business owners are unlikely to become a target.

It may be easier to catch tax evaders by focusing on offshore accounts, Skarlatos said. The government has the leverage and information to pursue unreported foreign assets, and "it's relatively easy to prove that a) someone has a foreign bank account, and b) they didn't report it," he said, adding, "It's often black and white."

Domestic tax evasion, in contrast, is much more difficult to prove -- particularly if it involves cash or a complex corporate transaction -- and domestic enforcement comes with its own costs, Skarlatos said.