Kluwer International Tax Blog

White, Grey and Black Hat Tax Administrations – A Proposal for a U.S. Carrot & Stick Approach Part I (followed by a Critical FATCA Update)

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This month I am going to present the first part (the justification) of a Congressional proposal that I am working upon for an academic article (I will appreciate any feedback). Thereafter, Haydon Perryman and I include a critical FATCA update for compliance officers.

I owe the next part of my Starbucks TNMM article. My Aggie economics Master students Nima and Carlos, and I are still crunching numbers, examining ratios, regression analysis and looking at comparables, and holding interviews. Keep sending me your thoughts – I read them all! Before IFA, I will post a substantial update here on Kluwer International Tax Blog.

White, Grey and Black Hat Tax Administrations: Part I

My esteemed colleague Haydon Perryman has critiqued the U.S. position on CRS: "The USA has made no commitment to participate with the AEoI. This is an awkward situation for many reasons. "

My response is that the world is full of black and grey hat tax administrations. The U.S. has the opportunity to leverage its power as the world's safe (tax) haven for bi-lateral information exchange as a carrot – stick policy tool to clean them up, and move them to become white hat, best practices tax administrations.

Carrot & Stick

The carrot is that the U.S. will reciprocally provide the tax information about their tax residents' assets in the U.S., as the U.S. requires be provided Treasury either directly by foreign financial institution or via the foreign government. The stick, my proposal that I will cover in a second post (Part II), requires that the U.S. Congress adopt the current U.S. protocols and penalties concerning annual designation for "Illicit Narcotics Producing and Transit Countries" to certify white hat tax administration and designate black hat and grey hat tax administrations.

The U.S. Financial Markets Did Not Collapse

If foreign financial institutions (or their governments when an IGA applies) do not provide the U.S. required FATCA information, the financial institution will be cut off from the U.S. financial markets with a 30 percent FATCA (IRC Chapter 4) withholding on the gross proceeds from the sale of shares, bonds, and other property, as well as interest payments. So a tit-for-tat response by another country of only exchanging information with the U.S. if the U.S. reciprocates is unrealistic, and for many countries may go unnoticed by the U.S. Treasury.

There has been a lot of noise about the potential giant sucking sound of foreign direct investment (FDI) exiting the U.S. financial markets, like a swirl through a drain. But the FDI numbers published by the Bureau of Economic Statistics simply do not bear that exit from the U.S. markets out. Expenditures by foreign direct investors to acquire, establish, or expand U.S. businesses totalled $420.7 billion in 2015, an increase of 68 percent from 2014, when expenditures were $250.6 billion. The accumulated total value of foreign direct investment totalled $3.1 trillion (on a historical-cost basis) at year-end 2015.

Expenditures by industry, country, and state

Expenditures for new investment in manufacturing were $281.4 billion in 2015. As in 2014, manufacturing accounted for more than half of total new investment expenditures. Within manufacturing, expenditures were largest in chemicals, mostly in pharmaceuticals and medicines. There were also large expenditures in finance and insurance, in real estate and rental and leasing, and in professional, scientific, and technical services.

By country of ultimate beneficial owner (UBO), the largest source country was Ireland, at $176.5 billion. There were also substantial expenditures from Canada and Germany. Of the eight largest countries in terms of foreign direct investment position in the United States—United Kingdom, Japan, Luxembourg, Netherlands, Canada, Switzerland, Germany, and France—six are also among the top eight countries for new foreign direct investment.

Arguably, the U.S. may have received more FDI and its financial markets may have grown faster without FATCA. But FDI drag is a price Congress decided it was willing to pay to clamp down on the lack of access to the financial information of U.S. taxpayers regardless of location. The FATCA train has left the station.

Countries Want Reciprocity – But…

Countries reciprocally want to receive financial information about their taxpayers from the U.S. Arguably, for the vast majority of countries, more of their taxpayers assets are held or through the U.S. than visa versa. But the 200+ countries and jurisdictions of the world are led by governments, some of whom – when it's comes to tax administration – are black hat. By black hat, I mean that the governments use tax administration, and the information derived therefrom, against the citizens or against foreign competitors. Tax administrators may selectively use tax information against political rivals. Some governments are ridden with criminal gangs or perhaps the government is the criminal gang. Some governments are accused of using nefarious means such as theft and espionage to obtain business information about foreign competitors on behalf of national champions.

Some governments are grey hat and do not protect tax information. Grey hats lack the capacity to do so because of lack of resources or lack of will. By example of the issue, some countries do not consider tax information confidential and quite opposite publish tax information publicly. By example, grey hats may allow tax information to be stolen by cyber criminals. Grey hat tax administrators pass the information to other government departments, against the rule for an exchange of information. Grey hats may leak taxpayer information to the press (Japan is accused of using this tactic against U.S. taxpayers, with IRS complicity).

The Protocol amending the Multilateral Convention on Mutual Administrative Assistance in Tax Matters will potentially lead to substantially more transnational identity theft, crime, industrial espionage, financial fraud, and suppression of political opponents and religious or ethnic minorities by authoritarian and corrupt governments, including Russia, China, Colombia, and Nigeria.[1]

This Protocol isn't limited to decent places like Canada and the U.S. — though even if it were, giving so much power to the tax agencies of the world is a bad idea.[2] The Protocol includes wildly corrupt places like Albania and Azerbaijan, dictatorships with aggressive intelligence services and a history of cyber thefts like China and Russia, and lots of places like Kazakhstan and Tunisia, which can't hope to protect the information we send them, even if they don't intentionally misuse it.

A further concern is the risk of misuse of information by corrupt administrations, or rogue government employees, such as the sale of personal financial data to would-be kidnappers. Global automatic exchange is "a developed-world solution for a global economy unsuited to it", argues Geoff Cook of Jersey Finance. Some developing countries lack the administration to deal with it, says Gurbachan Singh, a tax lawyer in Singapore. In places like Indonesia "you may have a tax officer but not a proper tax office."[3]

The Financial Transparency Coalition argues not to require small countries to collect and share information because these do not have staff capacity, financial resources or systems in place. However, these countries want to receive tax information from the developed economies under the guise that additional tax collections will allow the capacity building necessary to offer developed economy protections and create required data collection systems. The Financial Transparency Coalition states in an article:[4]

> While this requirement may sound sensible, the reciprocity clause is problematic for some developing countries that don't have the technological capacity or the staff to compile the information. Often, an entire country may have just one or two employees devoted to international tax issues. Sub-Saharan Africa, for example, would need to add roughly 650,000 tax administrators to reach average global staffing levels.

What has Treasury Promised?

The U.S. Treasury has promised in its implementation of the exchange of bank interest information regulations with foreign governments to assess each country with which the U.S. has an FATCA Intergovernmental Agreement (IGA), Tax Information Exchange Agreement (TIEA), and Double Tax Agreement (DTA) as to whether that country has proper protections and policy in place, and that such is actually exercised, for the tax information sent by the U.S. to it each year.

Rev. Proc. 2012-24 Implementation of Nonresident Alien Deposit Interest Regulations states in its preamble:

> … The purpose of this revenue procedure is to list … the countries with which the United States has in effect an income tax or other convention or bilateral agreement relating to the exchange of information… As discussed in the preamble to the regulations, even when such an agreement exists, the Internal Revenue Service (IRS) is not compelled to exchange information, including information collected pursuant to the regulations, if there is concern regarding the use of the information or other factors exist that would make exchange inappropriate.

The May 14, 2012 "Guidance on Reporting Interest Paid to Nonresident Aliens" for the Rev. Proc. 2012-24 states in pertinent part:

> Second, consistent with established international standards, all of the information exchange agreements to which the United States is a party require that the information exchanged under the agreement be treated and protected as secret by the foreign government. In addition, information exchange agreements generally prohibit foreign governments from using any information exchanged under such an agreement for any purpose other than the purpose of administering, collecting, and enforcing the taxes covered by the agreement. Accordingly, under these agreements, neither country is permitted to release the information shared under the agreement or use it for any other law enforcement purposes.
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> Third, consistent with the international standard for information exchange and United States law, the United States will not enter into an information exchange agreement unless the Treasury Department and the IRS are satisfied that the foreign government has strict confidentiality protections. Specifically, prior to entering into an information exchange agreement with another jurisdiction, the Treasury Department and the IRS closely review the foreign jurisdiction's legal framework for maintaining the confidentiality of taxpayer information. In order to conclude an information exchange agreement with another country, the Treasury Department and the IRS must be satisfied that the foreign jurisdiction has the necessary legal safeguards in place to protect exchanged information and that adequate penalties apply to any breach of that confidentiality.
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> Finally, even if an information exchange agreement is in effect, the IRS will not exchange information on deposit interest or otherwise with a country if the IRS determines that the country is not complying with its obligations under the agreement to protect the confidentiality of information and to use the information solely for collecting and enforcing taxes covered by the agreement. The IRS also will not exchange any return information with a country that does not impose tax on the income being reported because the information could not be used for the enforcement of tax laws within that country.

On December 29, 2014, the Treasury updated Rev. Proc. 2012-24, Implementation of Nonresident Alien Deposit Interest Regulations, with Rev. Proc. 2014-64. This revenue procedure lists the countries with which the United States has in effect an income tax or other convention or bilateral agreement relating to the exchange of information pursuant to which the United States agrees to provide, as well as receive, information. This revenue procedure also lists, in Section 4, the countries with which the Treasury Department has determined that it is appropriate to have an automatic exchange relationship with respect to the reporting of certain deposit interest paid to nonresident alien individuals on or after January 1, 2013. The 18 countries include Australia, Canada, Denmark, Finland, France, Germany, Guernsey, Ireland, Isle of Man, Italy, Jersey, Malta, Mauritius, Mexico, Netherlands, Norway, Spain, and the United Kingdom.

Thus, Treasury and the IRS have promised that the U.S. will only engage in reciprocal exchange with foreign jurisdictions that, among other requirements, meet the IRS's stringent safeguard, privacy, and technical standards. ***Before exchanging with a particular jurisdiction, the U.S. will conduct detailed reviews of that jurisdiction's laws and infrastructure concerning the use and protection of taxpayer data, cyber-security capabilities, as well as security practices and procedures – right?***

Yet, the IRS announced on October 2, 2015 that it has achieved the exchange of financial account information with certain foreign tax administrators. To achieve this in light of the previous promise of safeguard, the IRS must have successfully and timely developed the information system infrastructure, procedures, data use and confidentiality safeguards, and means to access other countries developments thereof, to protect taxpayer data while facilitating reciprocal automatic exchange of tax information with these 18 foreign jurisdiction tax administrators that include Mexico. The American Bankers Association Comment Letter to the U.S. Mexico FATCA IGA states:

> By including an automatic exchange provision in the U.S.-Mexico IGA, it is difficult to see how the Treasury can honor its commitment and promise to only provide information to Mexico after it has made a determination (based on unknown factors) that Mexico is complying with its obligations to protect the confidentiality of such information.

Part II, to be published here on Kluwer International Tax Blog, will present my policy solution to extend the current annual U.S. certification and designation program for narcotics and money laundering to cover protection of taxpayer information received from U.S. exchange. The U.S, may borrow from the OECD's Global Forum peer review process, but not solely rely upon it unless the peer reviews are re-validated at least every three years. I look forward to any comments. Meanwhile, free download of my 115 page Guide to FATCA Compliance

***** Critical FATCA Updates for Compliance Officers *****

On July 29, 2016 the IRS published Announcement 2016-27 providing guidance to jurisdictions that are treated as if they have an IGA in effect and FFIs located in those jurisdictions.

On January 1, 2017, Treasury will begin updating the IGA List to provide that certain jurisdictions that have not brought their IGA into force will no longer be treated as if they have an IGA in effect. Each jurisdiction that is treated as if it has an IGA in effect and that wishes to continue to be treated as if it has an IGA in effect must provide the Treasury Department, by December 31, 2016, with a detailed explanation of why the jurisdiction has not yet brought the IGA into force. The jurisdiction must also provide a step-by-step plan that they intend to follow in order to sign the IGA (if it has not been signed) and bring the IGA into force. In evaluating whether a jurisdiction that has met these two steps will continue to be treated as if it has an IGA in effect from January 1, 2017, Treasury will consider the jurisdiction's prior course of conduct in connection with IGA discussions.

The IRS clearly stated that jurisdictions that are initially determined to have demonstrated firm resolve to bring an IGA into force will not retain that status indefinitely. For example, failure to adhere to the expected timeline set out in the jurisdiction's explanation could result in a determination that the jurisdiction is no longer demonstrating firm resolve to bring its IGA into force and therefore will no longer be treated as if it has an IGA in effect. In order to provide notice to FFIs, a jurisdiction will not cease to be treated as having an IGA in effect until at least 60 days after the jurisdiction's status on the IGA List is updated.

FFIs in a jurisdiction that ceases to be treated as if it has an IGA in effect will no longer be able to rely on the IGA to be treated as complying with, and exempt from withholding under, FATCA. Unless they qualify for an exemption under the FATCA regulations, such FFIs generally will have to enter into FFI Agreements in order to comply with their FATCA obligations, including reporting information to the IRS and withholding pursuant to the terms of the FFI Agreement.

A U.S. Withholding Agent (USWA) must begin to withhold 30 percent under Title IV upon withholdable payments to an FFI in a former IGA jurisdiction that has not yet entered into a FATCA reporting agreement directly with U.S. Treasury. Consequently, it is critical that FATCA Compliance Officers calibrate their system withholding protocols to address the potentially shifting sands of approved IGA jurisdictions and the changing list of approved GIINs. Reach out to Haydon Perryman if you want to discuss technical guidance and consultation in this respect.

FATCA and CRS Jurisdictions as at August 9, 2016:

IGAs Update

62 jurisdictions have an IGA "in force" for FATCA.

An additional 21 jurisdictions have Signed Agreements that are "Not in Force". The US Treasury will review the status of those IGAs in early 2017.

An additional 30 jurisdictions have IGAs "in substance". The US Treasury will review the status of those IGAs in early 2017.

62+21+30=113 jurisdictions commonly referred to as having an "IGA in effect" up to, at least, 31st December 2016.

CRS Updates

83 jurisdictions have signed the Amended Protocol to the MCAA, which pertains to the Automatic Exchange of Information (AEoI).

An additional 18 jurisdictions have committed to sign the Amended Protocolbringing the number of jurisdictions participating to 101.

Of the 101 jurisdictions participating with the AEoI, 55 are "Early Adopters", meaning that they will report on 2016 in 2017.

[1] David Burton, "Two Little Known Tax Treaties Will Lead to Substantially More Identity Theft, Crime, Industrial Espionage, and Suppression of Political Dissidents", Backgrounder No. 3087 (Heritage Foundation, December 21, 2015). Available at http://www.heritage.org/research/reports/2015/12/two-little-known-tax-treaties-will-lead-to-substantially-more-identity-theft-crime-industrial-espionage-and-suppression-of-political-dissidents (accessed Aug 1, 2016).

[2] Ted Bromund, Let's Send Your Tax Forms to China, Heritage Foundation (June 2, 2016). Available at http://www.heritage.org/research/commentary/2016/6/lets-send-your-tax-forms-to-china (accessed August 5, 2016).

[3] The way to make exchange of tax information work, Economist (Feb 16, 2013). Available at http://www.economist.com/news/special-report/21571561-way-make-exchange-tax-information-work-automatic-response (accessed August 3, 2016).

[4] Automatic Exchange Of Information, Financial Transparency Coalition. Available at https://financialtransparency.org/issues/automatic-tax-information-exchange (accessed Aug. 1, 2016).

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